CHAPTER 1

INTRODUCTION TO INDIAN ACCOUNTING STANDARDS



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Appreciate the concept of Accounting Standards
- Grasp the Indian scenario prior to Ind AS and the need of time leading to emergence of global accounting standards
- Acknowledge the benefits of global accounting standards
- Distinguish between convergence and adoption of global accounting standards
- Discuss about Ind AS transition in India and benefits thereof
- Recognise the process of development and finalisation of Ind AS (IASB to ICAI to MCA)
- Describe India's roadmap for applicability of Ind AS for listed and unlisted entities, NBFCs, banking and insurance sector
- Illustrate the salient features of Ind AS like numbering, flow and structure
- Tabulate the important statutory provisions under the Companies Act and SEBI regulations involving Ind AS
- Identify the format of balance sheet, statement of changes in equity, profit and loss and significant notes related to them as given in Division II to Schedule III to the Companies Act, 2013
- Analyse key takeaways from guidance note on Division II to Schedule III to the Companies Act, 2013

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UNIT OVERVIEW

Introduction to Indian Accounting Standards	Introduction	
	Indian Scenario prior to introduction of Ind AS in India	
	Limitations of AS	
	Emergence of Global Standards	
	Need for Global standard in India	
	Benefits of Global Accounting Standards	
	Convergence vs Adoption of IFRS	
	Process of development and finalisation of Ind AS	
	Transition from AS to Ind AS	About Indian Accounting Standards
		How Ind AS has been numbered
		How Ind AS has been structured
	Roadmap for applicability of Ind AS	For listed entities
		Ind AS Roadmap for Non -Banking Financial Companies (NBFC)
		Ind AS Roadmap for Banking and Insurance Companies
		Ind AS Roadmap for Mutual Funds
	Ind AS relevant Statutory Provisions	Relevant Sections referring Ind AS in the Companies Act, 2013 and Rules
		Relevant SEBI Rules and Regulations
	Format of Division II to Schedule III to the Companies Act - Structure	Part I - Format of Balance Sheet and Statement of Changes in Equity
		Part II – Statement of Profit and Loss
	Guidance Note on Division II to Schedule III to the Companies Act, 2013	

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1. INTRODUCTION

A set of financial statements are a key tool of communication about the financial position, performance and changes in financial position of an entity that is useful to a wide range of stakeholders in making economic decisions. Accounting Standards is an essential building block in the financial reporting world. These Accounting Standards provide principles and rules that must be followed to ensure accuracy, consistency and comparability of financial statements. These accounting guidelines also ensure that financial statements should be understandable, relevant, reliable and comparable.

Accounting Standards are a set of documents that lay down the principles covering various aspects, such as, recognition, measurement, presentation & disclosure of accounting transaction in the financial statements. Objective of accounting standards is to standardize the diverse accounting policies & practices with a view to eliminate the non-comparability of financial statements to the extent possible and also to enhance the reliability to the financial statements. Accounting standards play a very significant role in enabling the stakeholders to get the reliable and comparable accounting data and investors to make more informed economic decisions.

The Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (The ICAI), since its establishment way back in 1977, has been involved in the formulation of Accounting Standards and standard setting process of the country. ASB has been relentlessly working to ensure that the world's fastest growing emerging economy of India is equipped with high quality Accounting Standards (AS) comparable to the best in the world. The ICAI also issued Accounting Standards which are applicable to the entities other than companies and are aligned with Accounting Standards notified by the Ministry of Corporate Affairs (MCA) with certain differences.

ASB is an Accounting Standards-Setting arm of the ICAI, which formulates Accounting Standards through a process that is robust, comprehensive, and inclusive with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards to discharge its role of national standard-setter. Once the ASB finalises the draft of AS post incorporating the public comments on exposure draft, ASB recommends such approved draft of AS to National Financial Reporting Authority (NFRA)[1] and then Government of India, through MCA notifies AS or Ind-AS for corporate entities under Companies Act and ICAI issues AS for non-corporate entities.

[1] NFRA was constituted under the Companies Act, 2013 which replaced National Advisory Committee On Accounting Standards (NACAS) which was constituted under Companies Act, 1956.

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2. INDIAN SCENARIO PRIOR TO INTRODUCTION OF IND AS IN INDIA

Prior to introduction of Indian Accounting Standards (Ind AS) which are Accounting Standards duly converged with International Financial Reporting Standards (IFRS), ASB has issued various AS to deal with various reporting matters. As on February 2002, ICAI has issued 27 AS, the list thereof with their respective applicability is as under[2]. These AS are applicable to

(a) companies other than those following Ind AS,

(b) SMCs and also

(c) non-corporate entities.

AS No.	Name of AS	Applicable to all Companies Other than those following Ind AS	Applicable to Small and Medium Sized Companies (SMCs)[3]	Applicable to Non-Corporate Entities[4]			
				Level I	Level II	Level III	Level IV
1	Disclosure of Accounting Policies	Yes	Yes	Yes	Yes	Yes	Yes
2	Valuation of Inventories (Revised)	Yes	Yes	Yes	Yes	Yes	Yes
3	Cash Flow Statement	Yes	Yes	Yes	NA	NA	NA
4	Contingencies and Events occurring after the Balance Sheet Date	Yes	Yes	Yes	Yes	Yes	Yes

[2] This table should be read in conjunction of Appendix 1 to Compendium of Accounting Standards (as on 1st February, 2022)

[3] SMCs are defined under Notification dated 23rd June, 2021, issued by the Ministry of Corporate Affairs, Government of India

[4] Criteria for classification of Non-company Entities as decided by the Institute of Chartered Accountants of India should be referred back from Appendix 1 to Compendium of Accounting Standards (as on 1st February, 2022)

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	(Revised 2016)						
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Yes	Yes	Yes	Yes	Yes	Yes
7	Construction Contracts	Yes	Yes	Yes	Yes	Yes	Yes
9	Revenue Recognition	Yes	Yes	Yes	Yes	Yes	Yes
10	Property, Plant and Equipment (Revised)	Yes	Yes	Yes	Yes	Yes (with disclosure exemption)	Yes (with disclosure exemption)
11	The Effects of Changes in Foreign Exchange Rates	Yes	Yes	Yes	Yes	Yes (with disclosure exemption)	Yes (with disclosure exemption)
12	Accounting for Government Grants	Yes	Yes	Yes	Yes	Yes	Yes
13	Accounting for Investments (Revised)	Yes	Yes	Yes	Yes	Yes	) Yes (with disclosure exemption
14	Accounting for Amalgamation (Revised)	Yes	Yes	Yes	Yes	Yes	NA
15	Employee Benefits	No	Applicable with some exemptions	Yes	Yes (With certain exemptions)		
16	Borrowing Costs	Yes	Yes	Yes	Yes	Yes	Yes
17	Segment Reporting	No	No	Yes	No	No	No
18	Related Party Disclosure	Yes		Yes	Yes	No	No
19	Leases	No	Applicable	Yes	Yes (with disclosure exemption)		

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			with some exemptions				
20	Earnings per share	No	Applicable with some exemptions	Yes	No	No	No
21	Consolidated Financial Statements (Revised)	Yes	Yes	Yes	No	No	No
22	Accounting for Taxes on Income	Yes	Yes	Yes	Yes	Yes	Yes (only related to current tax provisions)
23	Accounting for Investments in Associates in Consolidated Financial Statements	Yes	Yes	Yes	No	No	No
24	Discontinuing Operations	Yes	Yes	Yes	Yes	No	No
25	Interim Financial Reporting	No	Applicable with some exemptions	Yes	No	No	No
26	Intangible Assets	Yes	Yes	Yes	Yes	Yes	Yes (with disclosure exemption)
27	Financial Reporting of Interests in Joint Ventures	Yes	Yes	Yes	No	No	No
28	Impairment of Assets	No	Applicable with some exemptions	Yes	Yes (with disclosure exemption)		NA
29	Provisions, Contingent Liabilities and Contingent Assets (Revised)	No	Applicable with some exemptions	Yes	Yes (with disclosure exemption)		

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3. LIMITATIONS OF ACCOUNTING STANDARDS

With the increasing flow of foreign funds, following were few of the rising complexities which were not explicitly and comprehensive dealt by AS and it was needed to have guidance around the same to witness consistent accounting treatments by entities.

a) Capital being raised in the form of complex financial instruments like optionally convertible / compulsorily convertible shares / debentures etc.

b) Various derivative instruments embedded in the foreign currency bonds / equity instruments, commodity derivatives etc.

c) Group restructuring, business acquisitions, mergers, demergers, slump sale etc.

d) Complex revenue arrangements and business models with innovating emerging digital economy

e) Diverse stock-based compensation with innovative remuneration models for C-suite

f) Complex tax provisions and impact thereof in determination of current and deferred tax

g) Different ways to provide shareholders' return and various modes of shareholder's investments in kind in the event of group reorganisation.

Further, a need was felt to have comprehensive disclosures in the financial statements so as to enable the investors to have a complete overview of business background, risks involved and other important aspects. The disclosure requirements in ASs are limited and the need was felt to improve those disclosures especially about aspects like revenue, related party transactions, segment reporting, business combinations etc. so as to improve the quality of financial reporting and enable investors to take an informed decision.

4. EMERGENCE OF GLOBAL ACCOUNTING STANDARDS

In 1973, International Accounting Standards Committee (IASC) was formed through an agreement made by professional accountancy bodies from Canada, Australia, France, Germany, Japan, Mexico, the Netherlands, the UK and Ireland, and the United States of America. The main goal of the committee was to harmonize different financial reporting practices. The standard setting board of the IASC was known as the IASC Board. The IASC Board promoted various standards, conceptual Framework, which was directly adopted by many countries and many national accounting standards setters were referring to the same to govern the standard setting process in their countries.

Nearly after 25 years of its operations, IASC felt a need to change its structure in order to effectively converge national accounting standards to lead to one set of Global Accounting

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Standards. As a result, International Accounting Standards Board (IASB) was formed on 1st July 2000. It was further decided that it would operate under a new International Accounting Standards Committee Foundation (IASCF, now known as IFRS Foundation). IASB members are responsible for the development and publication of International Financial Accounting Standards (IFRS). For IFRS to be truly global standards, consistent application and interpretation is required. The Interpretations Committee assists the IASB in improving financial reporting through timely assessment, discussion and resolution of financial reporting issues identified within the IFRS framework.

As early as 1989 the International Organisation of Securities Commissions (IOSCO), the world's primary forum for co–operation among securities regulators, prepared a paper noting that cross border security offerings would be facilitated by the development of internationally accepted standards. For preparers, greater comparability in financial reporting with their global peers had obvious attractions. In May 2000 IOSCO announced that it had completed its assessment of 30 accounting standards of the International Accounting Standards Committee (IASC 2000 standards). As a result, the IOSCO Presidents' Committee recommended that its members permit incoming multinational issuers to use the 30 IASC 2000 standards to prepare their financial statements for cross-border offerings and listings, as supplemented by reconciliation, disclosure and interpretation where necessary to address substantive outstanding issues at a national or regional level.

On 19th July 2002, a regulation was passed by the European Parliament and the European Council of Ministers requiring the adoption of IFRS. As a result of the Regulation, all EU listed companies were required to prepare their financial statements following IFRS from 2005. This has led to IFRS being considered as one of the major unified GAAP in the world.

So with this, two prominent and widely adopted accounting standards have emerged:

1) Accounting Standards set up by US Financial Accounting Standards Board (FASB) (widely known as "US GAAP") and

2) IFRS

The "Group of 20" (G20) is made up of the finance ministers and central bank governors of 19 countries and the European Union: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom and United States of America. The G20 meets regularly to discuss matters of common interest. As a result of the global financial crisis, the G20 began to explore ways to improve the global financial system, including regulations related to financial reporting and institutions. The G20 has for some time called for the global convergence of accounting standards and has supported the IASB-FASB convergence process.

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The joint convergence project was launched in 2002 by the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB). The objective of this project is to eliminate a variety of differences between International Financial Reporting Standards and US GAAP. The project, which is being done jointly by FASB and IASB, grew out of an agreement reached by the two boards in October 2002 (the 'Norwalk Agreement'). The scope of the overall IASB-FASB convergence project has evolved over time and is currently under progress.

So, IFRS is now, together with US GAAP, one of the two globally recognised financial reporting frameworks. Although the goal of a single set of high–quality global accounting standards has not been fulfilled, as per IASB research, presently, 167 jurisdictions require the use of IFRS Accounting Standards for all or most publicly listed companies, whilst a further 12 jurisdictions permit its use.

5. NEED FOR GLOBAL ACCOUNTING STANDARDS IN INDIA

Modern economies rely on cross-border transactions and the free flow of international capital. Investors seek diversification and investment opportunities across the world, while companies raise capital, undertake transactions or have international operations and subsidiaries in multiple countries.

In the past, such cross-border activities were complicated to be followed by Indian Companies due to increased compliance costs of maintaining multiple sets of financial books following varied national accounting standards. This reworking of accounting requirements often added cost, complexity and ultimately risk both to companies preparing financial statements and investors and others using those financial statements to make economic decisions.

Applying local accounting standards led to a totally different basis for amounts appearing in financial statements. Solving this complexity involved studying the details of national accounting standards, because even a small difference in requirements could have a major impact on a company's reported financial performance and financial position — for example, a company may recognise profits under one set of national accounting standards and losses under another. For e.g.: A company has made non-current investments in equity instruments and there is a temporary decline in the value of investments. As per AS, it may be required to report the investment at cost but may have to fair value the same as per IFRS. Hence this may lead to recognizing losses as per IFRS.

With this emerging need to move AS to comparable Global Standards and also considering the limitations of AS to deal with emerging business transactions and structure, need to revamp current AS was felt inevitably. International investors were apprehensive to rely on the financial

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information of Indian Companies due to their limited understanding of accounting framework in India and often sought companies to produce such financial information under IFRS.

Considering above, India made a commitment towards the convergence of Indian accounting standards with IFRS at the G20 summit in 2009.

6. BENEFITS OF GLOBAL ACCOUNTING STANDARDS

Global Accounting Standards address above challenges by providing a high-quality, internationally recognised set of accounting standards that bring transparency, accountability and efficiency to financial markets around the world. Global Standards bring transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.

Further, Global Standards strengthen accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. As a source of globally comparable information, Global Accounting Standards are also of vital importance to regulators around the world.

Global Accounting Standards also contribute to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language lowers the cost of capital and reduces international reporting costs. This also resulted into increased investment in jurisdictions adopting IFRS. Also for a Company which has operations in multiple countries, it became easy for them to consolidate their operations, track operational key performance indicators, and reduce the number of different reporting systems.

These advantages of global standards have been accepted by various jurisdictions, resulting into many countries following the path of adoption or convergency with IFRS with minimal carve outs.

7. CONVERGENCE VS ADOPTION OF IFRS

In common parlance, many users refer Convergence to IFRS and Adoption of IFRS interchangeably. However, there exists a significant difference between the two

Adoption of IFRS, in simple terms, means that the Country applying IFRS would be implementing IFRS in the same manner as issued by the IASB and would be 100% compliant with the guidelines issued by IASB.

The dictionary definition of Convergence states that *"to move towards each other or meet at the same point from different directions".* Hence convergence with IFRS means the national accounting standards setter would work with IASB to develop high quality Accounting Standards over the time. Hence the national accounting standard setter is said to have "Converged with

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IFRS" if it has adopted IFRS with some exceptions, and work with IASB towards those exceptions to reach at a point wherein there are no differences left.

An entity is required to apply IFRS 1 First–time Adoption of International Financial Reporting Standards – when it first asserts compliance with IFRS. The IASB has, therefore, established unambiguously the principle that full application of its standards and related interpretations is necessary for an entity to be able to assert that its financial statements comply with IFRS (as issued by the IASB). Consequently, it is necessary for countries that align their national standards with IFRS to require the application of IFRS 1 so that entities reporting under those standards can assert compliance with IFRS. In addition, an entity that applies IFRS as amended by a local authority cannot assert compliance with IFRS.

It is merely impossible for IASB to consider the individual factors of each country. Hence, such countries decide to converge to IFRS with limited exceptions. These exceptions are regularly looked upon and in order to meet at a point where no exceptions are left.

Countries like Canada, Bahrain, Cambodia etc have adopted IFRS while countries like India, China, Hongkong etc have converged with IFRS.

8. PROCESS OF DEVELOPMENT AND FINALISATION OF INDIAN ACCOUNTING STANDARDS

As discussed above, accounting standards in India are formulated by the ASB of ICAI. The central government prescribes the standards of accounting, or any addendum thereto, as recommended by the ICAI, in consultation with and after examination of the recommendations made by the NFRA. The Ministry of Corporate Affairs (MCA) notifies the standards under the Companies Act by publishing them in the Gazette of India. Notified standards are authoritative under Indian law.

It may be noted that IFRS are being issued / revised by the IASB from time to time. As a part of convergence with IFRS, the Ind AS may be issued/revised corresponding to the IFRS. Accordingly, whenever IASB issues any new IFRS or update the current one, ASB of ICAI considers the convergence thereof under Ind AS. While doing so ASB provides considerations to local regulatory landscape, business practices, tax and other relevant provisions to develop exposure draft with proposed carve in or carve out from IFRS.

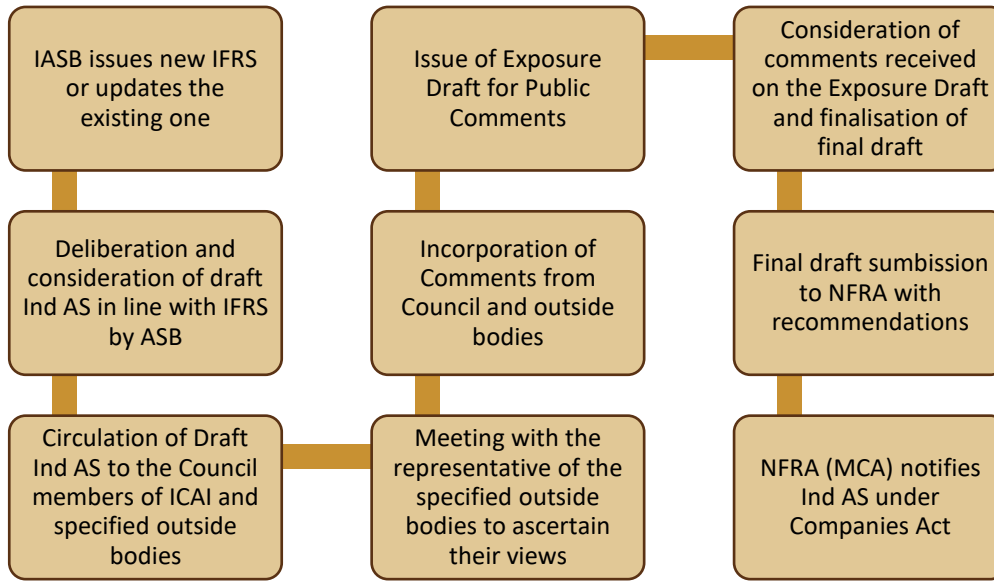
The Ind-AS setting process can be briefly outlined as follows:

- Consideration of preliminary draft prepared (with requisite carve in and carve out) by ASB and revision thereof, as need be.
- Circulation of Draft Ind AS to the Council members of ICAI and specified outside bodies such as MCA, Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT) etc.
- Meeting with the representative of the specified outside bodies to ascertain their views on the Draft Ind AS

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- Finalisation of Exposure Draft of Ind AS and its issuance for inviting public comments
- Consideration of comments received on the Exposure Draft and finalisation of Ind AS by ASB for submission to the Council of ICAI for its consideration and approval for issuance.
- Consideration of the final draft of proposed Ind AS by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB
- Final draft Ind AS to be submitted to NFRA with ICAI recommendations for notification
- NFRAs reviews and provides inputs, if any, to ICAI before finalising. Post that, MCA notifies the Ind AS under Companies Act for Companies to follow with announcement of applicability date.

To summarise,



9. TRANSITION FROM AS TO IND AS

India made a commitment towards the convergence of Indian accounting standards with IFRS at the G20 summit in 2009. In line with this, MCA issued a roadmap for implementation of Ind AS converged with IFRS beginning April 2011. However, this plan was suspended due to unresolved tax and other issues. In the presentation of the Union Budget 2014–15, the Honourable Minister for Finance, Corporate Affairs and Information and Broadcasting proposed the adoption of Ind AS. The Minister clarified that the respective regulators will separately notify the date of implementation for banks and insurance companies. Also, standards for tax computation would be notified separately. In accordance with the Budget statement, the MCA has notified the Companies (Indian Accounting Standards) Rules 2015 vide its G.S.R dated 16th February 2015.

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Accordingly, it has notified 39 Ind AS and has laid down Ind AS transition roadmap for companies and non-banking finance companies excluding banking companies and insurance companies.

The implementation of Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) by Indian Companies is a monumental step in the accounting history of India. It was possible due to the relentless and collective efforts of regulators and accounting professionals of this large growing economy aspiring to be economic superpower in the coming decades. ICAI believes that Ind AS implementation has provided better insights into the financial affairs of the companies and Ind AS based financial statements reflect the underlying economics of the transactions/events in a transparent and unbiased manner. It has also improved the comparability and benchmarking of the financials of Indian Companies with Global Peers, thereby improving the accessibility of Indian Companies to Global Capital Markets.

IFRS convergence is an ongoing initiative, and the process of issuing IFRS is dynamic. The IASB issues new/revised IFRS on a regular basis. To avoid significant changes in Ind AS for a period post its transition in India, it was decided to keep the applicability date of some of the IFRS earlier than its applicability date announced by IASB.

Example 1

IFRS 15 Revenue from Contracts with Customers is effective for annual periods beginning on or after 1st January 2017, while in India Ind AS 115 was applicable from 1st April 2018. Hence, it wasn't implemented in advance of IFRS 15. Another example is that of IFRS 16 Leases, which was issued in 2016 and made effective for annual reporting periods beginning on or after 1st January 2019, while in India Ind AS 116 was applicable from 1st April 2019.

9.1 About Indian Accounting Standards

Ind AS are the IFRS converged standards. Similar to IFRS they are principles-based standards, but substantially different from Indian GAAP. Ind AS is not the same as IFRS. It is a separate accounting framework based on IFRS as created by the MCA and has certain carve-outs to accommodate Indian business nuances.

As on date, 39 Ind AS are notified by Ministry of Corporate Affairs, which are as under:

IND AS	Description
Ind AS 101	First-time Adoption of Indian Accounting Standard
Ind AS 102	Share-based Payment
Ind AS 103	Business Combinations

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Ind AS 104	Insurance Contracts
Ind AS 105	Non-current Assets Held for Sale and Discontinued Operations
Ind AS 106	Exploration for and Evaluation of Mineral Resources
Ind AS 107	Financial Instruments: Disclosures
Ind AS 108	Operating Segments
Ind AS 109	Financial Instruments
Ind AS 110	Consolidated Financial Statements
Ind AS 111	Joint Arrangements
Ind AS 112	Disclosure of Interests in Other Entities
Ind AS 113	Fair Value Measurement
Ind AS 114	Regulatory Deferral Accounts
Ind AS 115	Revenue from Contracts with Customers
Ind AS 116	Leases
Ind AS 1	Presentation of Financial Statements
Ind AS 2	Inventories
Ind AS 7	Statement of Cash Flows
Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
Ind AS 10	Events after the Reporting Period
Ind AS 12	Income Taxes
Ind AS 16	Property, Plant and Equipment
Ind AS 19	Employee Benefits
Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
Ind AS 21	The Effects of Changes in Foreign Exchange Rates

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Ind AS 23	Borrowing Costs
Ind AS 24	Related Party Disclosures
Ind AS 27	Separate Financial Statements
Ind AS 28	Investments in Associates and Joint Ventures
Ind AS 29	Financial Reporting in Hyperinflationary Economies
Ind AS 32	Financial Instruments: Presentation
Ind AS 33	Earnings per Share
Ind AS 34	Interim Financial Reporting
Ind AS 36	Impairment of Assets
Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
Ind AS 38	Intangible Assets
Ind AS 40	Investment Property
Ind AS 41	Agriculture

9.2 How Ind AS have been numbered?

Ind AS are numbered in a similar manner as compared to IFRS. So in order to understand how Ind AS are numbered, it is important to understand how IFRS are numbered. Ind AS differ from the IFRS, as they contain certain carve outs and carve ins for making them contextually relevant to the Indian economic and legal environment.

International Accounting Standard Committee (IASC) was formed in 1973 and its main objective was to harmonize different financial reporting practices. It continued issuing standards under heading "International Accounting standards" (IAS) and they were numbered chronologically from 1. Eg: IAS 1, IAS 2 etc. Till 2000, it had notified 41 IAS (some of them are now repealed or omitted). Post incorporation of IASB on 1st July 2000., standards issued are known as IFRS and a new numerical series was started i.e. IFRS 1, IFRS 2 etc

In Indian context, numbers for IAS are retained. For e.g.: For IAS 1 – Presentation of Financial Statements, corresponding standard in Ind AS is Ind AS 1 – Presentation of Financial statements. For IFRS, a new series starting after 100 was used. For e.g.: For IFRS 1 – First time adoption of International Financial Reporting Standards, corresponding Ind AS is Ind AS 101 - First time adoption of Indian Accounting Standards.

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Further, IFRS Interpretations Committee (IFRIC) is the interpretative body of the IASB. Its main work is to address application issues and suggest official IFRS Interpretations, which are eventually approved by the IASB. These interpretations are titled 'IFRIC' and numbered as IFRIC 1,2 etc. Interpretations issued before 2003 were titled 'SIC' and some of them are still in force today. IFRIC and SICs are included in Ind AS as part of Appendix in relevant Ind AS.

- Total reporting standards issued under IFRS are 41. Total reporting standards issued under Ind AS are 39. IFRS 17 Insurance Contracts and IAS 26 Accounting and Reporting by Retirement Benefit Plans are yet not notified in India as Ind AS.
- Total interpretations under IFRS (IFRIC + SIC) are 18. Total interpretation included under Ind AS (Appendix to relevant standards) are 17. IFRIC 2 – Members' Shares in Co-operative Entities and Similar Instruments and SIC -7 Introduction of the Euro are neither included under Ind AS nor notified. However, Appendix C to Ind AS 103 – Business Combinations was developed and additionally included in India for which no corresponding IFRIC or SIC is available.

9.3 How Ind AS have been structured?

Ind AS have followed the structure of IFRS and IAS and have not changed the same. Ind AS retained the paragraph numbers of IFRS and IAS too to allow readers to refer back similar guidance under IFRS and IAS while also appreciating the carve out and carve in. For ex. If Ind AS do not contain corresponding paragraph of IFRS, the same number had been kept blank with a note mentioned referring to Appendix – Comparison with IFRS.

Ind AS have following components and they are generally structured as follows:

1) **Objective –** What is the main purpose for which the Ind AS is formed is mentioned in this heading. On a bird's eye view, it mentions the issues dealt by it and what objective it seeks to achieve from laying the principles in it.

Example 2

Following is Ind AS 2's objective:

"The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard deals with the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories."

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2) **Scope –** What the standard intends to cover in its ambit is mentioned in the scope heading. In many cases, it defines specifically what it intends not to cover. For e.g.: Para 2 of Ind AS 2 states that it applies to all inventories except financial instruments and biological assets related to agricultural activity and agricultural produce at the point of harvest.

3) **Definitions –** It includes definitions of various terms used in the standards. For standards which are converged from International Accounting standards, definition is a part of structure while for standards which are converged from International Financial Reporting standards (Ind AS 101 onwards), the definitions are included in appendices.

4) **Content of the Standard –** This includes the main principles of the standard. It generally contains principle of recognition, measurement, subsequent measurement along with any other standard specific contents grouped in appropriate headings.

5) **Disclosure –** This section covers what qualitative / quantitative information required to be disclosed in financial statements pertaining to the matter covered in the standard. Wherever applicable, it also contains how a particular asset / liability / income / expense should be presented in financial statements.

6) **Transitional provisions and effective date –**For any Ind AS notified, it mentions effective date and transitional provisions from which it would be applicable. Under Ind AS, transitional provisions are mentioned mainly at two places. Firstly, it is broadly mentioned in Ind AS 101 - First-time Adoption of Indian Accounting Standard and secondly in the individual Ind AS wherever applicable. The transitional provisions mentioned in Ind AS 101 are applicable to first time adopter of Ind AS. The transitional provisions mentioned in individual standards are applicable to entities that have already applied Ind AS. In many standards, transitional provisions and effective date are mentioned in Appendices

7) **Appendices –** As and where applicable, the Ind AS also has appendices which are integral part of the standard. They mainly consist of:

   a. Explanation on industry specific issues which require detailed guidance. For e.g.: Appendix to Ind AS 16 contains treatment of stripping costs in the production phase of a surface mine

   b. Application Guidance – These are mainly in standards which are converged from International Financial Reporting Standards (Ind AS 101 and onwards). It contains detailed guidance in applying the principles mentioned in the standard

   c. Defined terms – It mentions definition of terms mentioned in the standard

   d. References to matters contained in other Ind AS - It lists the appendix which is a part of another Indian Accounting Standard and makes reference to the particular standard.

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e. Comparison with IFRS – Differences with IFRS are explained in this section

f. IFRIC and SIC applicable and relevant for the respective Ind AS

In each Ind AS, certain texts are highlighted in bold while certain are in plain. The text in bold mentions the principle while the text in plain mentions its application guidance / other explanation. Paragraphs set in bold type and plain type, have equal authority. In Ind AS 101, principles are numbered in chronological order while detailed explanation or guidance applicable to these principles are included in the respective Appendices, as applicable.

10. ROADMAP FOR APPLICABILITY OF IND AS

MCA has notified the Companies (Indian Accounting Standards) Rules, 2015 vide its G.S.R dated 16 February 2015. Accordingly, it has notified 39 Ind AS and has laid down an Ind AS transition roadmap for companies and non- banking finance companies excluding banking companies and insurance companies. MCA has proposed phase-wise approach for mandatory transition to Ind AS.

10.1 For Listed Entities

Phase I

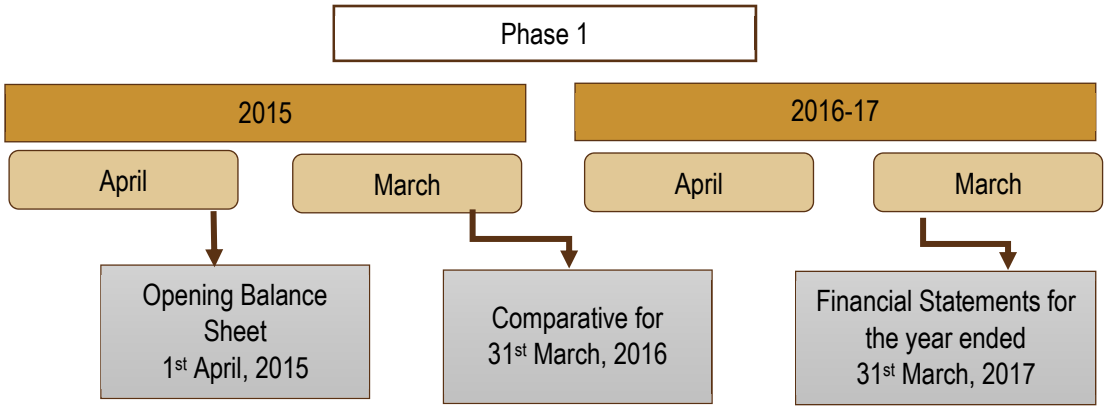
As per the Companies (Indian Accounting Standards) Rules, 2015, following companies were covered under Phase I for accounting periods beginning on or after 1st April 2016, with the comparatives for the periods ending on 31st March 2016:

a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of rupees five hundred crore or more;

b) companies other than those covered by sub-clause (a) above and having net worth of rupees five hundred crore or more;

c) holding, subsidiary, joint venture or associate companies of companies covered by sub-clause (a) and sub-clause (b) as mentioned above

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Phase II

Following companies were covered under Phase II for accounting periods beginning on or after 1st April 2017, with the comparatives for the periods ending on 31st March 2017:

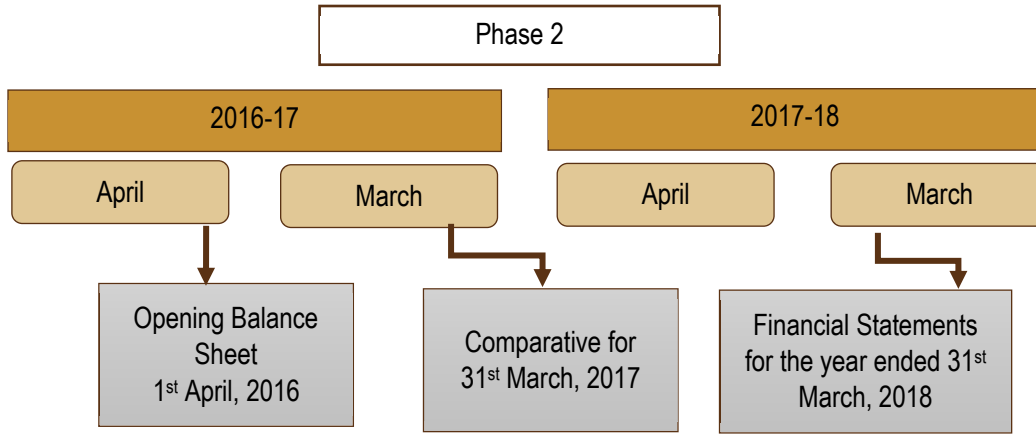
a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than rupees five hundred crore;

b) companies other than those covered in sub-clause (a) above i.e. unlisted companies having net worth of rupees two hundred and fifty crore or more but less than rupees five hundred crore.

c) holding, subsidiary, joint venture or associate companies of companies covered by sub-clause (a) and sub-clause (b) as mentioned above.

The Companies (Indian Accounting Standards) Rules, 2015 clarifies that, the roadmap shall not be applicable to companies whose securities are listed or are in the process of being listed on SME exchange as referred to in Chapter XB or on the Institutional Trading Platform without initial public offering in accordance with the provisions of Chapter XC of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009. For the purpose, it clarifies SME Exchange to have the same meaning as assigned to it in Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

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Ind AS would not be applicable to companies other than listed companies whose net worth is less than ₹ 250 Crores and they will continue to follow AS as per its applicability discussed above. However, they can voluntary adopt Ind AS.

It is notable that the Companies (Indian Accounting Standards) Rules, 2015 gave an option to the companies for early adoption of Ind AS for their financial statements for accounting periods beginning on or after 1st April 2015, with the comparatives for the periods ending on 31st March 2015 or any time thereafter.

10.1.1 Key Matters on Transition

1) Comparative Financial Information

All companies applying Ind AS are required to present comparative information as per Ind AS for one year. To comply with this requirement, Ind AS will be applicable from the beginning of the previous period.

Example 3

A company adopted Ind AS from 1st April, 20X4 for its accounting period 20X4-20X5. Hence it will be required to prepare its first Ind AS financial statements for financial year 20X4-20X5 with comparatives for financial year 20X3-20X4, and the date of transition to Ind AS will be considered as 1st April 20X3.

2) Ind AS applicability

As per clause 4 of the aforementioned MCA notification, companies to which Indian Accounting Standards (Ind AS) are applicable as specified in those rules shall prepare their first set of financial statements in accordance with the Ind AS effective at the end of its first Ind AS reporting period.

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Example 4

A company adopted Ind AS from 1st April, 20X4 for its accounting period 20X4-20X5. Hence it shall prepare Ind AS financial statements for financial year 20X4-20X5 by applying all Ind AS duly effective as on 31st March 20X5.

3) Consistent Application of Ind AS

As per clause 9 of the notification, once a company starts following the Indian Accounting Standards (Ind AS) either voluntarily or mandatorily on the basis of criteria specified, it shall be required to follow the Indian Accounting Standards (Ind AS) for all the subsequent financial statements even if any of the criteria specified in the Rules does not subsequently apply to it.

4) Ind AS Applicability for Indian Group Companies

As specified in the Companies (Indian Accounting Standards) Rules, 2015 issued by MCA, if Ind AS is applicable to a company, it would also be applicable to its holding company, subsidiary company, associate company and joint venture.

5) Ind AS Applicability for Overseas Group Companies

As per clause 5 of the Companies (Indian Accounting Standards) Rules, 2015 issued by MCA, overseas subsidiary, associate, joint venture and other similar entities of an Indian company may prepare its standalone financial statements in accordance with the requirements of the specific jurisdiction, provided that such Indian company shall prepare its consolidated financial statements in accordance with the Indian Accounting Standards (Ind AS) either voluntarily or mandatorily as per the criteria as specified in the Rules.

6) Ind AS Applicability for Standalone and Consolidated Financial Statements

As per clause 3 of the notification issued by MCA, Ind AS once required to be complied with in accordance with these rules, shall apply to both stand-alone financial statements and consolidated financial statements.

10.1.2 Calculation of Net Worth

For the purpose of determining the applicability of Ind AS as per the roadmap, net worth shall have meaning as per clause 57 of section 2 of the Companies Act, 2013.

Following is the definition of net worth as per the section:

"Net worth means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation;"

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Further, it is clarified that:

a) the net worth shall be calculated in accordance with the stand-alone financial statements of the company as on 31st March, 2014 or the first audited financial statements for accounting period which ends after that date;

b) for companies which are not in existence on 31st March, 2014 or an existing company falling under any of thresholds specified in the Ind AS applicability thresholds above for the first time after 31st March, 2014, the net worth shall be calculated on the basis of the first audited financial statements ending after that date in respect of which it meets the thresholds specified.

Example 5

The companies meeting net worth threshold for the first time as per financial statements of the year ending on 31st March, 2017 shall apply Ind AS for the financial year 2017-2018 with comparatives for financial year 2016-2017.

Hence to summarize, the roadmap considers net worth as on 31st March 2014 as cut-off date for Ind AS applicability. A company which meets the Ind AS applicability criteria on this cut-off date, needs to apply Ind AS as per the applicable phase. If any company does not meet the Ind AS applicability criteria as on the cut-off date, they will have to reassess the Ind AS applicability criteria at each balance sheet date.

Illustration 1

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

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

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

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Solution

Calculation of Net Worth:

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

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

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

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

Illustration 2

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

Solution

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

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

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

Illustration 3

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

Solution

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

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

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

Illustration 4

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

Solution

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

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

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

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Illustration 5

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

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

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

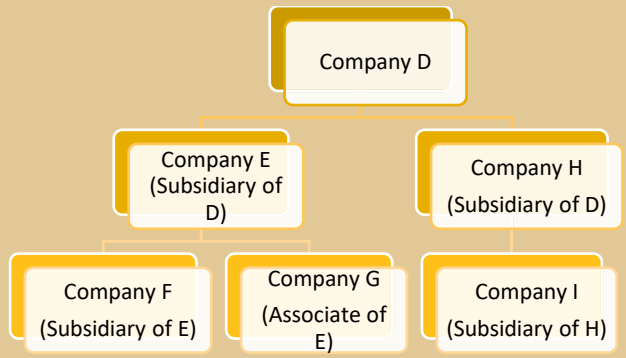
Solution

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

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

Illustration 6

Following is the structure of Company D



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

Solution

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

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

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

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

Illustration 7

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

Solution

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

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

10.2 Ind AS Roadmap for Non -Banking Financial Companies (NBFC)

For the purpose, NBFC is defined as a Non-Banking Financial Company as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934 and includes Housing Finance Companies, Merchant Banking companies, Micro Finance Companies, Mutual Benefit Companies, Venture Capital Fund Companies, Stock Broker or Sub-Broker Companies, Nidhi Companies, Chit Companies, Securitisation and Reconstruction Companies, Mortgage Guarantee Companies, Pension Fund Companies, Asset Management Companies and Core Investment Companies

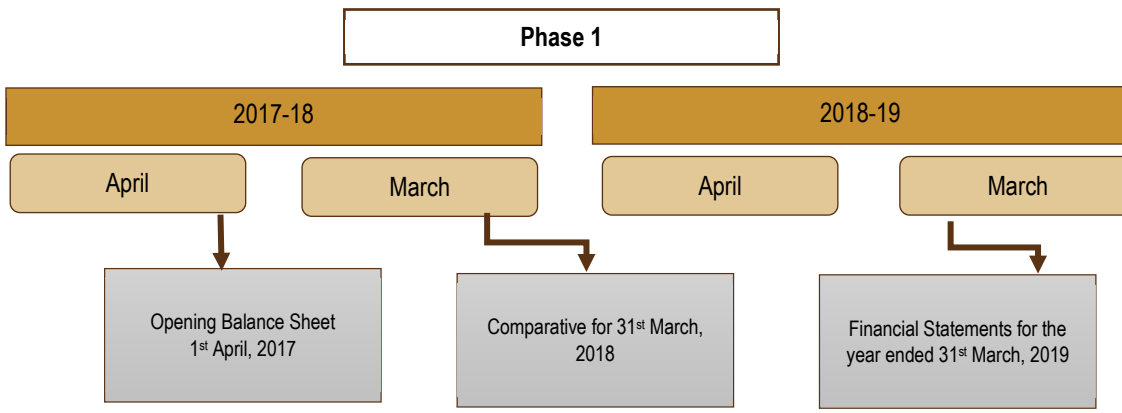
Ministry of Corporate Affairs, in its circular dated 30th March 2016, amended the Companies (Indian Accounting Standards) Rules, 2015 to include its applicability to Non-Banking Finance Companies. As per the circular, NBFCs to apply Ind AS in the following two phases:

Phase I

As per the Companies (Indian Accounting Standards) Rules, 2015, following NBFCs were covered under Phase I for accounting periods beginning on or after 1st April 2018, with the comparatives for the periods ending on 31st March 2018.

a. NBFCs having net worth of ₹ 500 Crores or more

b. Holding, subsidiary, associate or Joint Venture of NBFCs already covered under sub clause (a) above, other than companies already covered under Ind AS roadmap for Non-Financial companies



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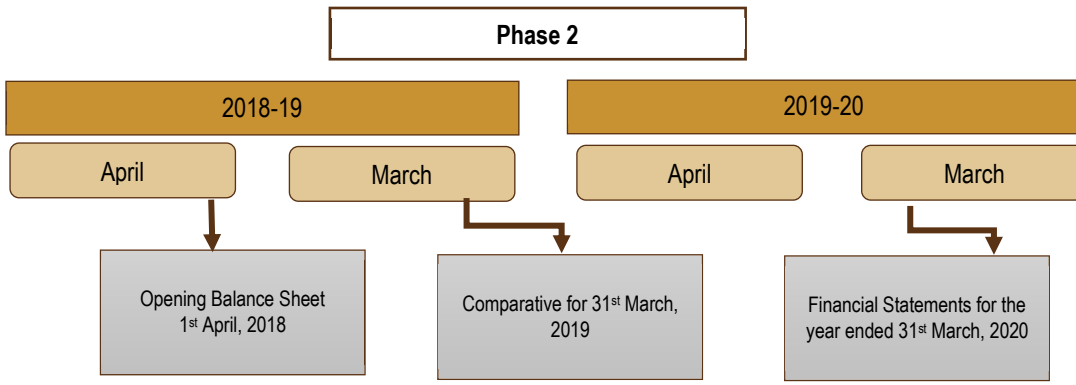
Phase II

Following NBFCs were covered under Phase II for accounting periods beginning on or after 1st April 2019, with the comparatives for the periods ending on 31st March 2019

a. NBFCs whose equity or debt securities are listed or in the process of listing on any stock exchange in India or outside India and having net worth less than rupees five hundred crore;

b. NBFCs, that are unlisted companies, having net worth of rupees two-hundred and fifty crore or more but less than rupees five hundred crore; and

c. Holding, subsidiary, associate or Joint Venture of Companies already covered under sub clause (a) and (b) above, other than companies already covered under Ind AS roadmap for Non-financial companies



NBFCs having net worth below rupees two fifty crores and not covered above shall continue to apply ASs. Further, where Ind AS is applicable to NBFCs, the same shall apply to both standalone and consolidated financial statements.

It is notable that NBFC can apply Ind AS only if they fall in any of the above criteria. Voluntary adoption of Ind AS by NBFCs are not allowed.

10.2.1 Clarification on calculation of Net Worth

For the purposes of calculation of net worth of NBFCs for determining the applicability of Ind AS, the following principles shall apply, namely:-

a) the net worth shall be calculated in accordance with the stand-alone financial statements of the NBFCs as on 31st March 2016 or the first audited financial statements for accounting period which ends after that date;

b) for NBFCs which are not in existence on 31st March 2016 or an existing NBFC falling first time, after 31st March 2016, the net worth shall be calculated on the basis of the first audited

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stand-alone financial statements ending after that date, in respect of which it meets the thresholds.

Explanation.- For the purposes of sub-clause (b), the NBFCs meeting the specified thresholds as given in the roadmap for the first time at the end of an accounting year shall apply Ind AS from the immediately next accounting year

For E.g. –

(i) The NBFCs meeting threshold for the first time as on 31st March, 2019 shall apply Ind AS for the financial year 2019-20 onwards.

(ii) The NBFCs meeting threshold for the first time as on 31st March, 2020 shall apply Ind AS for the financial year 2020-21 onwards and so on.

Application of Ind AS to non-finance companies whose parent / subsidiary or associate or joint venture is a NBFC

The date for application of Ind AS to non-finance companies is not aligned with that of NBFCs. Hence it has been clarified in the notification that the companies shall apply AS or Ind AS on the basis of respective standard applicable to them. However, for the purpose of preparation of Consolidated Financial Statements it is clarified that :

A) where an NBFC is a parent (at ultimate level or at intermediate level), and prepares consolidated financial statements as per AS, and its subsidiaries, associates and joint ventures are non-finance companies and are required to prepare financial statements as per Ind AS as per the roadmap given in The Companies (Indian Accounting Standards) Rules, 2015, such subsidiaries, associate and joint venture shall prepare its financials as per Ind AS. However, such subsidiaries, associate and joint venture has to provide the relevant financial statement data in accordance with the accounting policies followed by the parent company for consolidation purposes (until the NBFC is covered under Ind AS.

B) Where a parent is a non-finance company covered under Ind AS as per the roadmap given in The Companies (Indian Accounting Standards) Rules, 2015 and has a NBFC subsidiary, associate or a joint venture, the parent has to prepare Ind AS-compliant consolidated financial statements and the NBFC subsidiary, associate and a joint venture has to provide the relevant financial statement data in accordance with the accounting policies followed by the parent company for consolidation purposes (until the NBFC is covered under Ind AS).

It implies that the NBFC subsidiary, associate or a joint venture, in such case shall continue to prepare the financials under AS until Ind AS are applicable to it.

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Illustration 8

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

Solution

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

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

10.3 Ind AS Roadmap for Banking and Insurance Companies

As per the Companies (Indian Accounting Standards) (Amendment) Rules, 2016, The Banking Companies and Insurance Companies shall apply the Ind AS as notified by the Reserve Bank of India (RBI) and Insurance Regulatory Development Authority (IRDA) respectively. As the same are yet to be notified, Ind AS is not applicable to Banking and Insurance Companies presently.

It is notable that Banks and Insurance Companies shall not be allowed to voluntarily adopt Ind AS. However, this does not preclude them from providing Ind AS compliant financial statements for the purpose of preparation of consolidated financial statements by its parent/investor, as required by the parent/investor to comply with the existing requirements of law.

10.4 Ind AS Roadmap for Mutual Funds

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (the MF Regulations) lay down the regulatory framework for operations and functioning of Mutual Funds (MFs). The MF Regulations are amended by SEBI from time to time to enhance transparency and disclosures, to address emerging issues, to protect the interests of investors, and to strengthen the regulatory framework of MFs.

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On 25 January 2022, SEBI vide a notification issued the SEBI (Mutual Funds) (Amendment) Regulations, 2022. As per this notification, the financial statements and accounts of MF schemes will be prepared in accordance with Indian Accounting Standards (Ind AS). Additionally, SEBI vide a circular dated 4 February 2022 (the circular) provided certain guidelines on accounting with respect to Ind AS for MFs. The circular also provides specific formats of the financial statements to be prepared for the MF schemes under Ind AS. The requirements of the circular will become applicable from 1 April 2023.

11. IND AS RELEVANT STATUTORY PROVISIONS

11.1 Relevant Sections referring to Ind AS in the Companies Act, 2013 and Rules

Ind AS were initially notified under the Companies (Indian Accounting Standards) Rules, 2015. Post that it was amended from time to time to include the amendments / changes in the Ind AS.

Following are the some of the key relevant provisions of the Companies Act 2013, which gives reference to Ind AS:

- **Section 2(2)** states that accounting standards means the standards of accounting or any addendum thereto for companies or class of companies referred to in Section 133
- **Section 133** states the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949 (38 of 1949), in consultation with and after examination of the recommendations made by the National Financial Reporting Authority. Under the power given to the Central Government under section 133, it notified the Companies (Indian Accounting Standards) Rules, 2015.
- **Section 129** suggests the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III:
- **Section 134 (5) (a)**, a statement that the applicable accounting standards had been followed with proper explanation relating to material departures shall be given in the Director Responsibility statement to be issued under section 134 (3) (c) in the Director's report to be published in Annual General Meeting
- **Section 143**, auditor has to opine whether the financial statements comply with the accounting standards

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- **Section 230 –** Power to compromise or make arrangements with creditors and members and Section 232 – Merger and amalgamation of Companies, the scheme of compromise or arrangement is to be sanctioned by the tribunal only after obtaining a certificate from the company's auditor that the accounting treatment given proposed in the scheme of compromise or arrangement is in conformity with the accounting standards mentioned in Section 133.
- **Section 66** – Reduction of Share Capital, which states that no application for reduction of share capital shall be sanctioned by the Tribunal unless the accounting treatment, proposed by the company for such reduction is in conformity with the accounting standards specified in section 133 or any other provision of this Act and a certificate to that effect by the company's auditor has been filed with the Tribunal.

11.2 Relevant SEBI Rules and Regulations

Formats for publishing financial results (Circular dated 30th November 2015)

SEBI via circular dated 30th November, 2015 amended the format for publishing quarterly financial statements. Point 5 of the circular clarified that Companies adopting the Ind AS in terms of Companies (Indian Accounting Standards) Rules, 2015 notified by the Ministry of Corporate Affairs on 16th February, 2015 while publishing quarterly / annual financial results under Regulation 33 of the Listing Regulations, 2015, shall ensure that the comparatives filed along with such quarterly/annual financial results are also Ind AS compliant.

Clarification regarding applicability of Indian Accounting Standards to disclosures in offer documents under SEBI (ICDR) Regulations, 2018

The applicability of Ind AS for financial information (last 3 years financials) to be disclosed in the offer document as specified under SEBI (ICDR) Regulations, 2018 and provided the year wise applicability of Ind AS based on the period of filling offer document.

Example 6

For a company filling offer document between 1st April 2021 to 31st March 2022, the financial statements of latest financial year, second latest financial year and third latest financial year shall be as per Ind AS.

Revised Formats for financial results and implementation of Ind AS by Listed Entities

For the period ending on or after 31st March, 2017, the formats for Unaudited / Audited quarterly financial results i.e. Statement of Profit and Loss and the Unaudited / Audited Half-Yearly Balance Sheet to be submitted by the Listed Entities, with the stock exchanges, shall be as per the formats for Balance Sheet and Statement of Profit and Loss (excluding notes and detailed sub-classification) as prescribed in Schedule III to the Companies Act, 2013. However, Banking Companies and Insurance Companies shall follow the formats as prescribed under the respective Acts / Regulations as specified by their Regulators.

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12. FORMAT OF DIVISION II TO SCHEDULE III TO THE COMPANIES ACT - STRUCTURE

12.1 Introduction

Schedule III to the Companies Act, 2013 was notified along with the Companies Act, 2013 (Act) itself on 29th August, 2013 thereby providing the way every company registered under the Act shall prepare its Financial Statements. Financial Statements as defined under the Act include Balance Sheet, Statement of Changes in Equity for the period if applicable, the Statement of Profit and Loss for the period, Cash flow statement for the period and Notes.

'Division II' – 'Ind AS Schedule III' was inserted in the Companies Act,2013 to give a format of Financial Statements for companies that are required to comply with the Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time. This is newly inserted into Schedule III for companies that adopt Ind AS. Accordingly, such companies, while preparing its first and subsequent Ind AS Financial Statements, would apply Division II to Schedule III to the Act.

The requirements of Division II to Schedule III, however, do not apply any insurance or banking company or to any other class of company for which a form of Balance Sheet and Statement of Profit and Loss has been specified in or under any other Act governing such class of company. Moreover, the requirements of Division II to Schedule III do not apply to Non-Banking Finance Companies (NBFCs) that adopt Ind AS of Companies (Indian Accounting Standards) Rules, 2015 notified in Companies (Indian Accounting Standards) (Amendment) Rules, 2016 as amended from time to time. For NBFCs, Division III to Schedule III to the Companies Act, 2013 prescribes the formats of financial statements.

'Division II' – 'Ind AS Schedule III' is divided into following three parts:

- Part I – Format of Balance Sheet and Statement of Changes in Equity and notes related to them (Elements of Balance Sheet and its line items)
- Part II – Format of Statement of Profit and Loss and notes related to it (Elements of Statement of Profit and Loss and its line items)
- Part III – General Instructions for preparation of Consolidated Financial Statements

12.2 Applicability

As per the Government Notification no. S.O. 902 (E) dated 26 March, 2014, Schedule III is applicable for the Financial Statements prepared for the financial year commencing on or after 1st April, 2014. Further, as per the Government Notification no. G.S.R. 404(E) dated

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6th April, 2016, Schedule III is amended to include a format of Financial Statements for a company preparing Financial Statements in compliance with the Companies Ind AS Rules. Schedule III has been further amended vide the Government Notification dated 24th March, 2021 to include certain additional presentation and disclosures requirements and changes some existing requirements. These changes need to be applied in preparation of financial statements for the financial year commencing on or after 1st April, 2021. All companies that prepare, either voluntarily or mandatorily, Financial Statements in compliance with the Companies Ind AS Rules, should consider Ind AS Schedule III as well as ICAI's Guidance Note on Division II to Schedule III to the Companies Act, 2013. Additionally, preparers of financial statements should also consider requirements of the Act as well as other Statutes, Notifications, Circulars issued by various Regulators.

Division II to Schedule III to the Companies Act, 2013 has been annexed at the end of the study material for reference.

13. GUIDANCE NOTE ON DIVISION II TO SCHEDULE III TO THE COMPANIES ACT, 2013

Corporate Laws & Corporate Governance Committee (CLCGC) of ICAI issued the Guidance Note on Division-II to Schedule III to the Companies Act, 2013 in 2017 and kept on revising the same as per requirements. Latest Guidance Note on the subject is issued in January, 2022. This Guidance Note aims to provide guidance on the amended Division-II to Schedule III to the Companies Act, 2013. It also lays down broad guidelines to deal with practical issues that may arise in the implementation of Division-II to Schedule III to the Companies Act, 2013. Accordingly, wherever required conceptual guidance has been provided in the Guidance Note.

Following are the some of the key guidance stated in guidance note. The following should be read in conjunction with Guidance Note issued on the subject:

1) Property, Plant and Equipment: Under the Ind AS Schedule III, land and building are presented as two separate classes of property, plant and equipment. In contrast, paragraph 37 of Ind AS 16 gives an example of grouping land and building under same class for revaluation purposes. The para states that a class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. However, companies should continue to present land and building separately as given in Ind AS Schedule III and such presentation needs to be followed consistently.

   As per Ind AS Schedule III, capital advances/ advances for purchase of capital assets should be included under other non- current assets and hence, should not be included under capital work-in-progress

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2) Non-current Investment: Under each sub-classification of Investments, there is a requirement to disclose details of investments including names and the nature and extent of the investment in each body corporate which is a subsidiary, associate, joint venture and structured entity. The nature and extent would imply the number of such instruments held and the face value of such instrument.

Ind AS Schedule III requires disclosure of the aggregate amount of quoted investments and market value thereof and the aggregate amount of unquoted investments. The aggregate amount of such investments would include aggregate amount of carrying value of these investments as at the reporting date as included in the financial statements.

The market value of quoted investments would, generally, mean disclosure of the 'fair value' of quoted investments as at each reporting date. Ind AS 113 defines fair value and also states that the fair value of assets might be affected when there has been a significant decrease in the volume or level of activity for that asset in relation to normal market activity for that asset. A decrease in the volume or level of activity on its own may not indicate that a quoted price does not represent fair value. However, based on the company's evaluation, if it determines that a quoted price does not represent fair value, then the company shall disclose the market value of quoted investments based on the quoted price which would be different from the investment's fair value.

As per Ind AS Schedule III, aggregate amount for impairment in value of investments should be disclosed separately. As per Ind AS 109, the company is required to recognize a loss allowance (i.e. impairment) for expected credit losses on investments measured at amortized cost. Such loss allowance should be presented as an adjustment to the amortized cost of the investment.

As per Ind AS 109, in case of debt investments measured at fair value through other comprehensive income (FVTOCI), a company shall estimate a portion of fair value change, if any, attributable to a change in credit risk of such investment and disclose the same in the profit and loss section of the statement of profit and loss with a corresponding impact in other comprehensive income section.

No disclosure is required in case of equity investments measured at fair value since Ind AS 109 does not permit a separate calculation / evaluation of impairment amount for all such investments.

The aggregate provision for impairment as per Ind AS 36 in the value of investments may be either presented in totality, where relevant, for all the investments or separately for each class of investments (e.g., 'Investment at amortized cost', 'Investment in debt instruments at FVOCI') disclosed in the financial statements.

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A limited liability partnership is a body corporate and not a partnership firm as envisaged under the Partnership Act, 1932. Hence, disclosures pertaining to Investments in partnership firms will not extend to investments in limited liability partnerships. The investments in limited liability partnerships will be disclosed separately under 'other investment'.

Note: Any application money paid towards securities, where security has not been allotted on the date of the Balance Sheet, shall be disclosed as a separate line item under 'other non-current financial assets'. In case the investment is of current investment in nature, such share application money shall be accordingly, disclosed under other current financial assets.

3) Trade Receivables: A receivable shall be classified as 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business and the company has a right to an amount of consideration that is unconditional (i.e. if only the passage of time is required before payment of that consideration is due). Hence, amounts due under contractual rights, other than arising out of sale of goods or rendering of services, cannot be included within Trade Receivables. Such items may include dues in respect of insurance claims, sale of Property, Plant and Equipment, contractually reimbursable expenses, etc. Such receivables should be classified as "other financial assets" and each such item should be disclosed nature-wise

The ageing of the trade receivables needs to be determined from the due date of the invoice. Due date is generally considered to be the date on which the payment of an invoice falls due. The due date of an invoice is determined based on terms agreed upon between the buyer and supplier. In case if the due date is neither agreed in writing nor orally, then the ageing related disclosure needs to be prepared from the transaction date.

Schedule III requires split of trade receivables between 'disputed' and 'undisputed'. These terms have not been defined in the Schedule III. A dispute is a matter of facts and circumstances of the case; however, dispute means disagreement between two parties demonstrated by some positive evidence which supports or corroborates the fact of disagreement. In case there are any disputes such fact should also be considered while assessing the credit risk associated with respective party while computing the impairment loss. However, a dispute might not always be an indicator of counterparty's credit risk and vice-versa. Hence, both of these should be evaluated independently for the purpose of making these disclosures.

4) Other Non-Current Financial Assets – Ind AS Schedule III does not specify about the presentation of finance lease receivables. However, the guidance note clarifies that he non-current portion of a finance lease receivable shall be presented under 'Other non-current financial assets' while its current portion shall be presented under 'Other current financial assets'.

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5) Current Assets - As per Ind AS Schedule III, all items of assets and liabilities are to be bifurcated between current and non-current portions. In some cases, the items presented under the "non-current" head of the Balance Sheet may not have a corresponding "current" head under the format given in Ind AS Schedule III. Since Ind AS Schedule III permits the use of additional line items, in such cases the current portion should be classified under the "Current" category of the respective balance as a separate line item and other relevant disclosures should be made.

6) Cash and Cash Equivalents - Cash and cash equivalents is not defined in Ind AS Schedule III however, according to Ind AS 7 Statement of Cash Flows, Cash is defined to include cash on hand and demand deposits with banks. Cash Equivalents are defined as short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

   As per para 8 of Ind AS 7 "where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn." Although Ind AS 7 permits bank overdrafts to be included as cash and cash equivalent, however for the purpose of presentation in the balance sheet, it is not appropriate to include bank overdraft as a component of cash and cash equivalents unless the offset conditions as given in paragraph 42 of Ind AS 32 are complied with. Bank overdraft, in the balance sheet, should be included as 'borrowings' under Financial Liabilities.

7) Current Tax Assets - If amount of tax already paid in respect of current and prior periods exceeds the amount of tax due for those periods (assessment year-wise and not cumulative unless tax laws allow for e.g., say tax laws in the country of overseas subsidiary permits), then such excess tax shall be recognised as an asset. The excess tax paid (presented as current tax assets) may not be expected to be recovered / realised within one year from the balance sheet date and if so, the same shall be presented under non-current assets. An entity should evaluate whether current tax assets meet the definition of current assets or not and should accordingly present the same.

8) Equity Share Capital - The accounting definition of 'Equity' is principle based as compared to the legal definition of 'Equity' or 'Share', such that any contract that evidences residual interest in an entity's net asset is termed as 'Equity' irrespective of whether it is legally recognized as a 'Share' or not. Accordingly, all instruments (including convertible preference shares and convertible debentures) that meet the definition of 'Equity' as per Ind AS 32 in its entirety and when they do not have any component of liability, should be considered as having the nature of 'Equity' for the purpose of Ind AS Schedule III. Such instruments shall be termed as 'Instruments entirely equity in nature'.

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9) Borrowings- The phrase "term loan" has not been defined in the Schedule III. Term loans normally have a fixed or pre-determined maturity period or a repayment schedule.

Terms of repayment of term loans and other loans shall be disclosed. The term 'other loans' is used in general sense and should be interpreted to mean all categories listed under the heading 'Non – Current borrowings' as per Ind AS Schedule III. Disclosure of terms of repayment should be made preferably for each loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated.

Ind AS Schedule III requires presenting 'current maturities of long-term debt' under 'current borrowings'. Long-term debt is specified in Ind AS Schedule III as a borrowing having a period of more than twelve months at the time of origination. The portion of non-current borrowings, which is due for payments within twelve months of the reporting date is required to be classified under "current borrowings" while the balance amount should be classified under non-current borrowings.

10) Trade Payable - A payable shall be classified as 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business. Hence, amounts due under contractual obligations or which are statutory payables should not be included within Trade Payables. Such items may include dues payable in respect of statutory obligations like contribution to provident fund or contractual obligations like contractually reimbursable expenses, amounts due towards purchase of capital goods, etc.

Due date shall be the date by when a buyer should make payment to the supplier as per terms agreed upon between the buyer and supplier. In case if the due date is neither agreed in writing nor oral, then the disclosure needs to be prepared from the transaction date. Transaction date shall be the date on which the liability is recognised in the books of accounts as per the requirement of applicable standards. A dispute is a matter of facts and circumstances of the case. However, dispute means disagreement between two parties demonstrated by some positive evidence which supports or corroborates the fact of disagreement. Reference is given to the term "Dispute" as defined under the Insolvency and Bankruptcy Code, 2016.

11) Current Borrowings - Loans payable on demand should be treated as part of current borrowings. Current borrowings will include all loans payable within a period of 12 months from the date of the loan. In the case of current borrowings, the period and the amount of defaults existing as at the date of the Balance Sheet should be disclosed (item-wise).

To provide relevant information to the users of the financial statements regarding total amount of liability under the respective category of noncurrent borrowings, Companies shall provide the amount of non-current as well as current portion for each of the respective category of non-current borrowings either by way of a note or a schedule or a cross-reference, as appropriate. This shall be in addition to Ind AS Schedule III requirements for presenting 'current maturities of long-term borrowings' under current borrowings.

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12) Other Current Liabilities - Trade Deposits and Security Deposits, which do not meet the definition of financial liabilities, should be classified as 'Others' grouped under this head. Others may also include liabilities in the nature of statutory dues such as Withholding taxes, Service Tax, VAT, Excise Duty, Goods and Services Tax (GST), etc.

13) Contingent Liabilities and Commitments - A contingent liability in respect of guarantees arises when a company issue guarantees to another person on behalf of a third party e.g. when it undertakes to guarantee the loan given to a subsidiary or to another company or gives a guarantee that another company will perform its contractual obligations. However, where a company undertakes to perform its own obligations, and for this purpose issues, what is called a "guarantee", it does not represent a contingent liability and it is misleading to show such items as contingent liabilities in the Balance Sheet. For various reasons, it is customary for guarantees to be issued by Bankers e.g. for payment of insurance premium, deferred payments to foreign suppliers, letters of credit, etc. For this purpose, the company issues a "counter-guarantee" to its Bankers. Such "counter-guarantee" is not really a guarantee at all, but is an undertaking to perform what is in any event the obligation of the company, namely, to pay the insurance premium when demanded or to make deferred payments when due. Hence, such performance guarantees and counter guarantees should not be disclosed as contingent liabilities.

14) Revenue from Operations and other operating income- Indirect taxes such as Sales tax, Goods and Services tax, etc. are generally collected from the customer on behalf of the government in majority of the cases. However, this may not hold true in all cases and it is possible that a company may be acting as principal rather than as an agent in collecting these taxes. Whether revenue should be presented gross or net of taxes should depend on whether the company is acting as a principal and hence, is responsible for paying tax on its own account or, whether it is acting as an agent i.e. simply collecting and paying tax on behalf of government authorities. If the entity is the principal, then revenue should also be grossed up for the tax billed to the customer and the tax payable should be shown as an expense. However, in cases, where a company collects such taxes only as an agent, revenue should be presented net of taxes.

    The term "other operating revenue" is not defined. This would include Revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities.

15) Exceptional Items - The term 'Exceptional items' is neither defined in Ind AS Schedule III nor in Ind AS. However, Ind AS 1 has reference to such items. Ind AS 1 states that disclosing the components of financial performance assists users in understanding the financial performance achieved and in making projections of future financial performance. An entity

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considers factors including materiality and the nature and function of the items of income and expense. It indicates circumstances that would give rise to the separate disclosures of items of income and expenses and include:

(a) Write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;

(b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;

(c) disposals of items of property, plant and equipment;

(d) disposals of investments;

(e) discontinued operations;

(f) litigation settlements; and

(g) other reversals of provisions.

SUMMARY

- Accounting Standards is an essential building block in the economics financial reporting world. These Accounting Standards provide principles and rules that must be followed to ensure accuracy, consistency and comparability of financial statements
- Prior to introduction of Ind AS, ASB has issued various AS to deal with various reporting matters which were known as AS and were applicable to companies and also non-corporate entities.
- To enable free flow of capital across jurisdiction without increasing cost and complexity of compliances along with need to provide comprehensive guidance to deal with rising complexities of business and financial world, the need to have Global Accounting Standards have strongly emerged, leading to rise of IFRS.
- In response to commitment to G20, MCA has notified IFRS converged Standards i.e. Ind AS phase wise for India Corporates in 2015, which eventually got extended to NBFCs.
- MCA and ICAI had worked extensively together to align Statutory provisions not in cognisant with Ind AS to ease the implementation challenges for the companies.

Schedule III revision, extensive guidance note dealing with practical application thereof, amendment in listing regulations by SEBI, continuous guidance on key matters by ITFG are some of the many initiatives which helped companies to transition to Ind AS smoothly.

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NOTES

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CHAPTER 2

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING UNDER INDIAN ACCOUNTING STANDARDS (IND AS)



LEARNING OUTCOMES

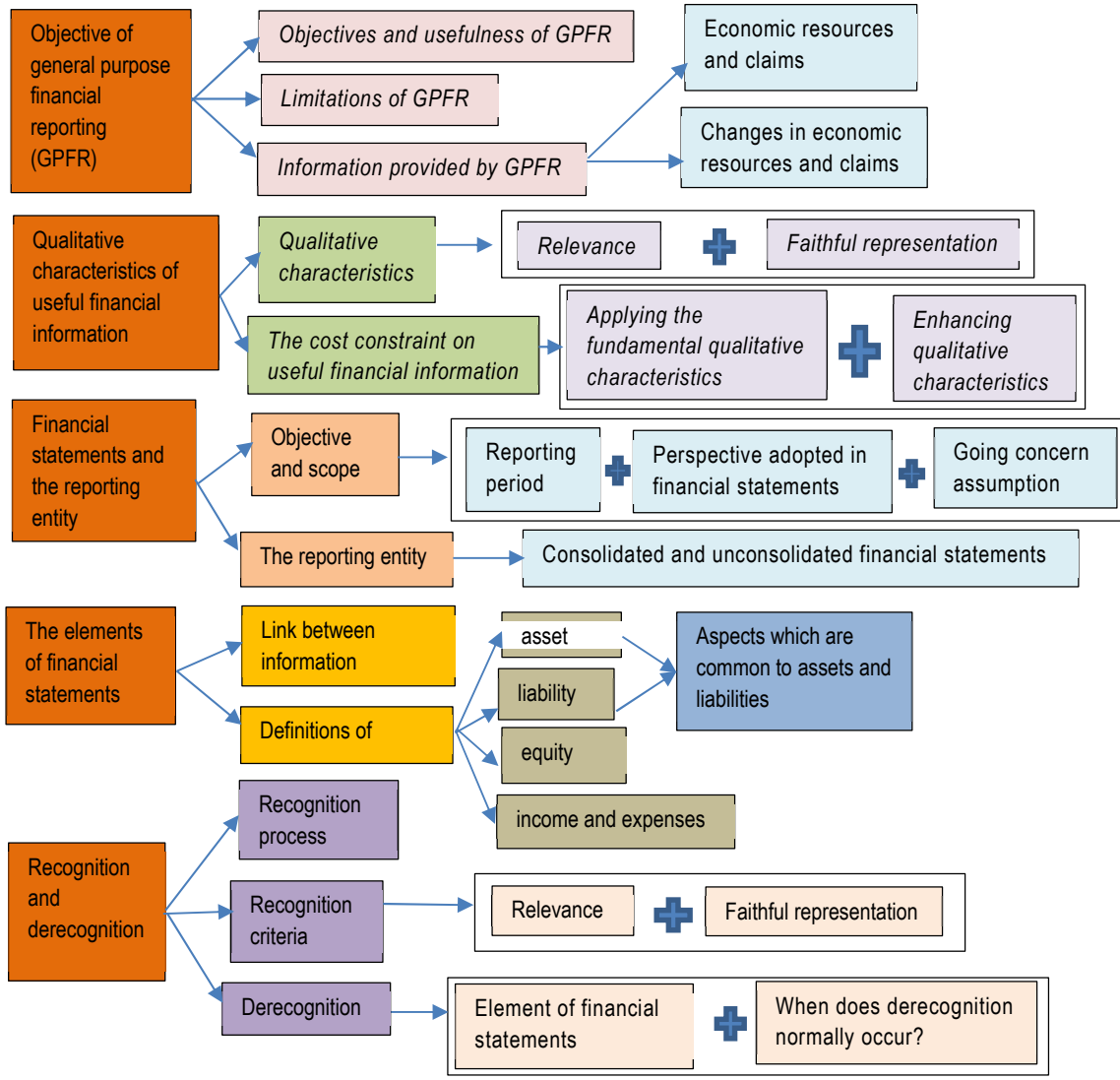
After studying this chapter, you would be able to:

- Identify the objectives of general purpose financial reporting.
- Apply qualitative characteristics of useful financial information
- Define the concept of financial statements and the reporting entity
- Describe the various elements of financial statements i.e. asset, liability, income and expenses
- Explain the criteria for including assets and liabilities in financial statements (recognition) and when to remove them (derecognition)
- Recognize measurement bases and when to use them
- Comprehend the concept of presentation and disclosure and its importance as communication tools
- Explain the concept of capital and capital maintenance and identify how it links to the concept of profit.

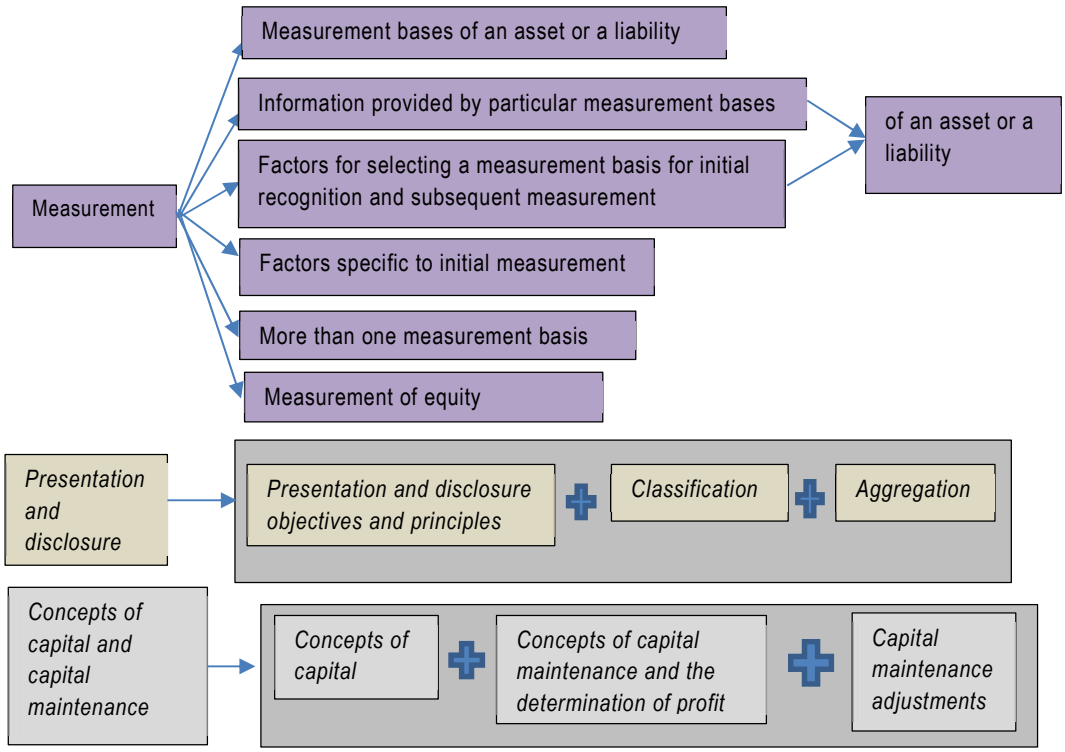
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UNIT OVERVIEW

Conceptual Framework for Financial Reporting



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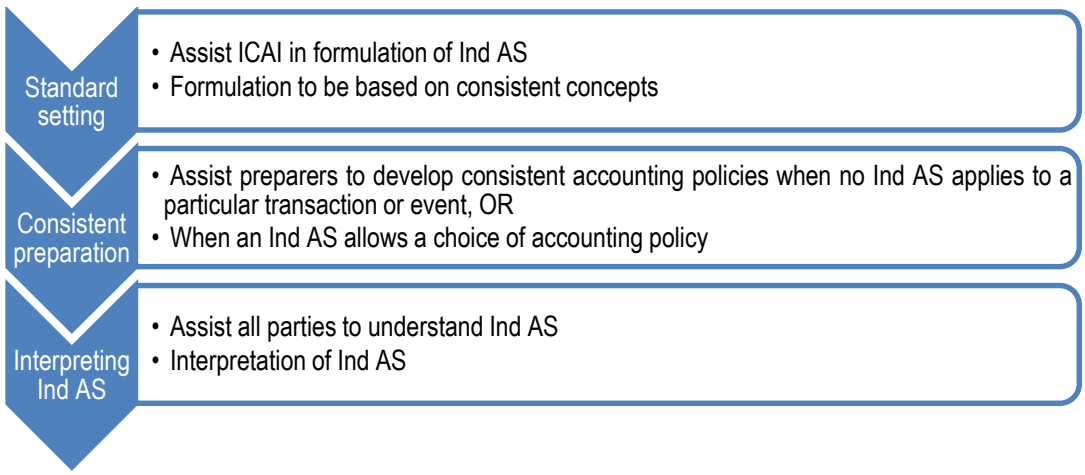
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UNIT 1: INTRODUCTION

The Conceptual Framework for Financial Reporting under Indian Accounting Standards (Ind AS) (hereinafter the '*Conceptual Framework under Ind AS*') is not a Standard and it does not override any standard or any requirement in any standard. Therefore, this does not form part of a set of standards pronounced by the standard-setters. While the *Conceptual Framework under Ind AS* is primarily meant for the standard-setter for formulating the standards, it has relevance to the preparers in certain situations such as to develop consistent accounting policies for areas that are not covered by a standard or where there is a choice of accounting policy, and to assist all parties to understand and interpret the Standards. As a result, certain individual standards e.g. Ind AS 1, Presentation of Financial Statements, Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors, Ind AS 103, Business Combinations, etc., require the preparers to follow the guidance in the *Conceptual Framework for Financial reporting under Indian Accounting Standards*.

The Institute of Chartered Accountants of India (ICAI), in the past, has issued a pronouncement with the title 'Framework for the Preparation and Presentation of Financial Statements under Indian Accounting Standards'. This framework was primarily based on the Framework issued by the International Accounting Standards Board's (IASB's) predecessor body IASC in 1989 (Framework 1989). In March 2018, the IASB issued a comprehensive revised framework titled 'Conceptual Framework for Financial Reporting'. In view of the issuance of new Conceptual Framework by the IASB and with an objective to remain converged with the global accounting framework, the ICAI has developed the *Conceptual Framework under Ind AS* corresponding to IASB's Conceptual Framework 2018.

The purpose of the *Conceptual Framework under Ind AS* can be summarised as below:



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Ind AS or any requirement in an Ind AS overrides the *Conceptual Framework under Ind AS*. To meet the objective of general-purpose financial reporting, the ICAI may sometimes specify requirements that depart from aspects of the Conceptual Framework. If the ICAI does so, it will explain the departure in the Appendix to the relevant Ind AS.

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UNIT 2
OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

2.1 OBJECTIVES AND USEFULNESS OF GENERAL PURPOSE FINANCIAL REPORTING

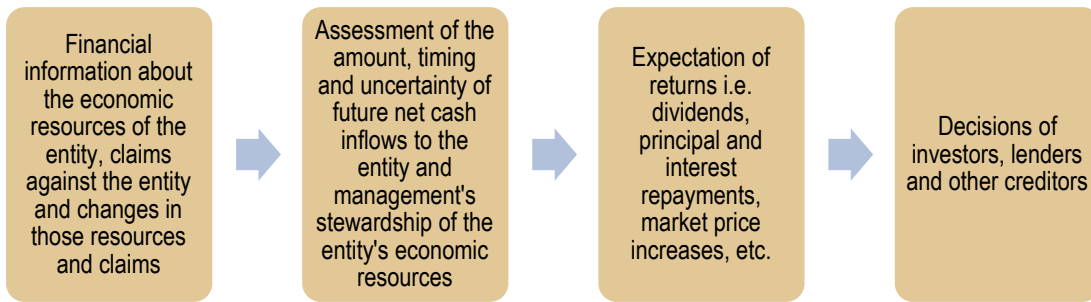
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about:

(a) buying, selling or holding equity and debt instruments;

(b) providing or settling loans and other forms of credit; or

(c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

The chart below is intended to demonstrate the strong correlation between general purpose financial reports and decision making process of relevant stakeholders:



2.2 LIMITATIONS OF GENERAL PURPOSE FINANCIAL REPORTING

General purpose financial reports:

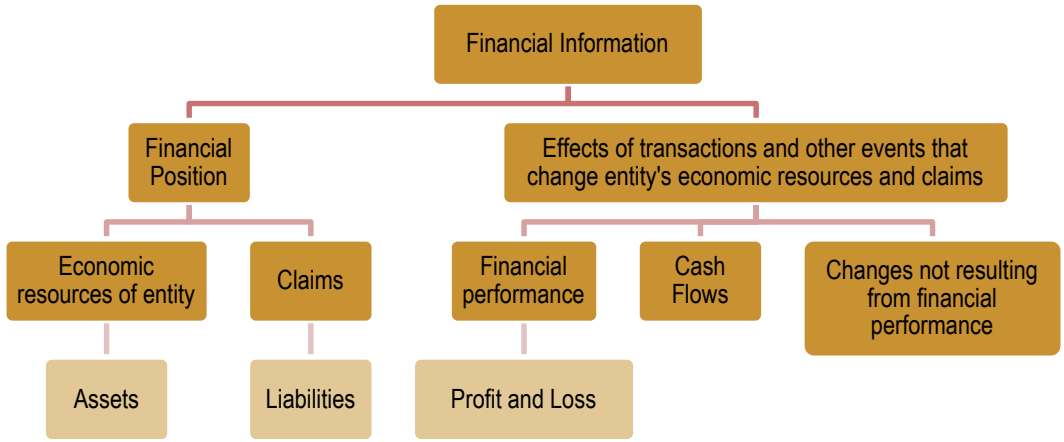
- do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks;

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- are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity; and
- are not primarily directed to other parties, such as regulators and members of the public other than investors, lenders and other creditors.

2.3 INFORMATION PROVIDED BY GENERAL PURPOSE FINANCIAL REPORTS

The chart below provides an overview of the information sought to be provided in the general purpose financial reports, which will, in turn, be used by the relevant stakeholders in making their economic decisions, as presented in the flowchart above.



2.3.1 Economic resources and claims

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to:

(a) assess the reporting entity's:

  (i) liquidity and solvency,

  (ii) its needs for additional financing and

  (iii) how successful it is likely to be in obtaining that financing

(b) assess management's stewardship of the entity's economic resources

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(c) predict how future cash flows will be distributed among those with a claim against the reporting entity

2.3.2 Changes in economic resources and claims

Changes in a reporting entity's economic resources and claims result from:

- that entity's financial performance and
- other events or transactions such as issuing debt or equity instruments

To properly assess both the prospects for future net cash inflows to the reporting entity and management's stewardship of the entity's economic resources, users need to be able to identify those two types of changes.

2.3.2.1 Financial performance reflected by accrual accounting

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Such information is useful in:

- assessing the entity's past and future ability to generate net cash inflows,
- indicating the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations,
- helping users to assess management's stewardship of the entity's economic resources, and
- indicating the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.

2.3.2.2 Financial performance reflected by past cash flows

Information about a reporting entity's cash flows during a period helps in assessment of:

- entity's ability to generate future net cash inflows, by helping users:
  - understand reporting of entity's operations,
  - evaluate its financing and investing activities,
  - assess its liquidity or solvency and
  - interpret other information about financial performance
- management's stewardship of the entity's economic resources.

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2.3.2.3 Changes in economic resources and claims not resulting from financial performance

A reporting entity's economic resources and claims may also change for reasons other than financial performance, such as issuing debt or equity instruments. Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance.

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UNIT 3
QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

If financial information is to be useful, it must be **relevant** and **faithfully represent** what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

Let's look at these two fundamental qualitative characteristics in more detail.

3.1 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

3.1.1 Relevance

The following chart will explain what is considered as "relevant financial information":

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

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

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

The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value.

Example 1

Revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

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The characteristic of 'relevance' also includes the concept of **materiality**. Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the ICAI cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

3.1.2 Faithful representation

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

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

- *Complete*: A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

  Example 2

  A complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, historical cost or fair value). For some items, a complete depiction may also entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction (e.g. facts such as encumbrance / hypothecation / mortgage of items of Property, Plant and Equipment against secured borrowings, disclosure of fair value of Investment Property etc.).

- *Neutral*: A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.

  Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated.

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Equally, the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses.

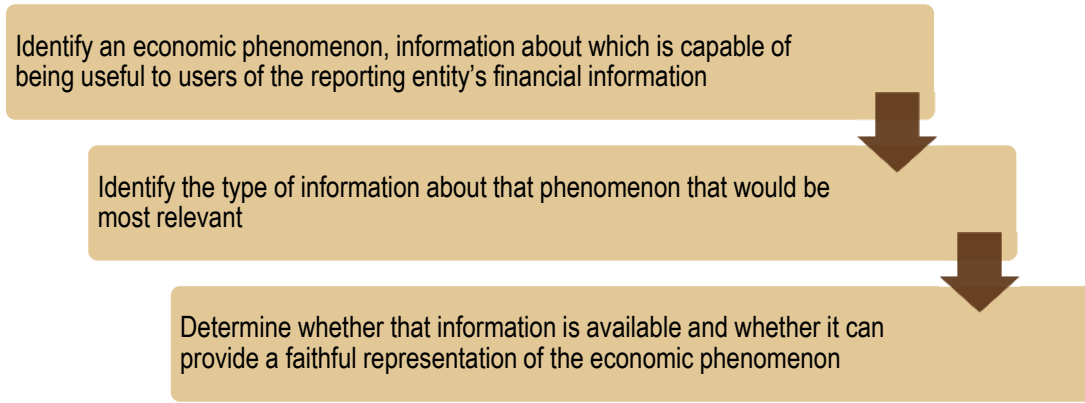
- *Free from error*: Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

Example 3

The use of reasonable estimates is an essential part of the preparation of financial statements. Examples of estimates could include useful life of an item of Property, Plant and Equipment, net realizable value of inventories, fair value of investment in an unlisted entity, expected credit losses etc. As long as the estimates are fair, the financial statements will be concluded to be free from error, even though the actual outcome may be different from the original estimate.

3.1.3 Applying the fundamental qualitative characteristics

The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows:



If faithful representation is achieved, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

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In some cases, a trade-off between the fundamental qualitative characteristics may need to be made in order to meet the objective of financial reporting, which is to provide useful information about economic phenomena. For example, the most relevant information about a phenomenon may be a highly uncertain estimate. In some cases, the level of measurement uncertainty involved in making that estimate may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that phenomenon. In some such cases, the most useful information may be the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it. In other such cases, if that information would not provide a sufficiently faithful representation of that phenomenon, the most useful information may include an estimate of another type that is slightly less relevant but is subject to lower measurement uncertainty. In limited circumstances, there may be no estimate that provides useful information. In those limited circumstances, it may be necessary to provide information that does not rely on an estimate.

3.1.4 Enhancing qualitative characteristics

As mentioned at the beginning of Unit 3, the usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. Having identified the fundamental qualitative characteristics of useful financial information, let's understand how to enhance the usefulness by applying four enhancing qualitative characteristics.

- *Comparability:* Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

  Comparability is neither same as consistency, nor as uniformity. Comparability is the goal; consistency helps to achieve that goal. Comparability refers to the use of the same methods for the same items, and uniformity implies that like things must look alike and different things must look different.

- *Verifiability:* Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

  Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation, for example, by counting cash. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. An example is verifying the carrying amount of

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inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, using the first-in, first-out method).

- *Timeliness:* Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.
- *Understandability:* Classifying, characterising and presenting information clearly and concisely makes it understandable. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore possibly misleading. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

3.1.5 Applying the enhancing qualitative characteristics

- Enhancing qualitative characteristics should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or does not provide a faithful representation of what it purports to represent.
- Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new Ind AS may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for non-comparability.

3.2 THE COST CONSTRAINT ON USEFUL FINANCIAL INFORMATION

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

Both the providers and users of financial information incur costs in reporting and analysing financial information. In applying the cost constraint, the ICAI assesses whether the benefits of

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

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

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UNIT 4
FINANCIAL STATEMENTS AND THE REPORTING ENTITY

In this unit, we will address two critical aspects:

- What are financial statements?
- What is reporting entity?

4.1 OBJECTIVE AND SCOPE OF FINANCIAL STATEMENTS

The objective of financial statements is to provide financial information about the reporting entity's:

- assets, liabilities and equity; and
- income and expenses

(i.e. the elements of the financial statements – we will discuss this in more detail in Unit 5)

that is useful to users of financial statements in assessing:

- the prospects for future net cash inflows to the reporting entity, and
- management's stewardship of the entity's economic resources.

Such financial information is provided:

(a) in the balance sheet, by recognising assets, liabilities and equity;

(b) in the statement of profit and loss, by recognising income and expenses; and

(c) in other statements and notes, by presenting and disclosing information about:

  (i) recognised assets, liabilities, equity, income and expenses, including information about their nature and about the risks arising from those recognised assets and liabilities;

  (ii) assets and liabilities that have not been recognised, including information about their nature and about the risks arising from them;

  (iii) cash flows;

  (iv) contributions from holders of equity claims and distributions to them; and

  (v) the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements.

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4.1.1 Reporting period

Financial statements are prepared for a specified period of time (reporting period) and to help users of financial statements to identify and assess changes and trends; financial statements also provide comparative information for at least one preceding reporting period.

Information about possible future transactions and other possible future events (forward-looking information) is included in financial statements if it:

(a) relates to the entity's assets or liabilities—including unrecognised assets or liabilities—or equity that existed at the end of the reporting period, or during the reporting period, or to income or expenses for the reporting period; and

(b) is useful to users of financial statements.

For example, if an asset or liability is measured by estimating future cash flows, information about those estimated future cash flows may help users of financial statements to understand the reported measures. Financial statements do not typically provide other types of forward-looking information, for example, explanatory material about management's expectations and strategies for the reporting entity.

Financial statements include information about transactions and other events that have occurred after the end of the reporting period if providing that information is necessary to meet the objective of financial statements.

4.1.2 Perspective adopted in financial statements

Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors.

4.1.3 Going concern assumption

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to enter liquidation or to cease trading. If such an intention or need exists, the financial statements may have to be prepared on a different basis. If so, the financial statements describe the basis used.

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4.2 THE REPORTING ENTITY

A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.

Sometimes one entity (parent) has control over another entity (subsidiary). If a reporting entity comprises both the parent and its subsidiaries, the reporting entity's financial statements are referred to as '**consolidated financial statements**'. If a reporting entity is the parent alone, the reporting entity's financial statements are referred to as '**standalone financial statements**' or 'separate financial statements' as the case may be.

If a reporting entity comprises two or more entities that are not all linked by a parent-subsidiary relationship, the reporting entity's financial statements are referred to as '**combined financial statements**'.

If the reporting entity is not a legal entity and does not comprise only legal entities linked by a parent-subsidiary relationship, how can the boundary of reporting entity be determined?

In such cases, determining the boundary of the reporting entity is driven by the information needs of the primary users of the reporting entity's financial statements. Those users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that:

(a) the boundary of the reporting entity does not contain an arbitrary or incomplete set of economic activities;

(b) including that set of economic activities within the boundary of the reporting entity results in neutral information; and

(c) a description is provided of how the boundary of the reporting entity was determined and of what constitutes the reporting entity.

4.2.1 Consolidated and unconsolidated financial statements

Consolidated financial statements provide information about the assets, liabilities, equity, income and expenses of both the parent and its subsidiaries as a single reporting entity. That information is useful for existing and potential investors, lenders and other creditors of the parent in their assessment of the prospects for future net cash inflows to the parent. This is because net cash inflows to the parent include distributions to the parent from its subsidiaries, and those distributions depend on net cash inflows to the subsidiaries.

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Consolidated financial statements are not designed to provide separate information about the assets, liabilities, equity, income and expenses of any particular subsidiary. A subsidiary's own financial statements are designed to provide that information.

Unconsolidated financial statements are designed to provide information about the parent's assets, liabilities, equity, income and expenses, and not about those of its subsidiaries. That information can be useful to existing and potential investors, lenders and other creditors of the parent because:

(a) a claim against the parent typically does not give the holder of that claim a claim against subsidiaries; and

(b) in some jurisdictions, the amounts that can be legally distributed to holders of equity claims against the parent depend on the distributable reserves of the parent.

Another way to provide information about some or all assets, liabilities, equity, income and expenses of the parent alone in consolidated financial statements, is in the notes.

Information provided in unconsolidated financial statements is typically not sufficient to meet the information needs of existing and potential investors, lenders and other creditors of the parent. Accordingly, when consolidated financial statements are required, unconsolidated financial statements cannot serve as a substitute for consolidated financial statements. Nevertheless, a parent may require, or choose, to prepare unconsolidated financial statements in addition to consolidated financial statements.

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UNIT 5
THE ELEMENTS OF FINANCIAL STATEMENTS

As explained in Unit 2, general purpose financial reports provide the information about:

- **Financial position** i.e. economic resources of the entity and claims against the entity; and
- **Effects of transactions and other events** that change entity's economic resources and claims

The elements of financial statements defined in the *Conceptual Framework under Ind AS* are:

(a) assets, liabilities and equity, which relate to a reporting entity's financial position; and

(b) income and expenses, which relate to a reporting entity's financial performance.

5.1 LINK BETWEEN INFORMATION IN GENERAL PURPOSE FINANCIAL REPORTS AS PER CONCEPTUAL FRAMEWORK AND ELEMENTS OF FINANCIAL STATEMENTS

In this Unit 5, we will discuss how the information in general purpose financial reports is represented by the elements of financial statements. The table below links the two:

Information provided by general purpose financial reports	Element of financial statements	Definition or description
Economic Resources	Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
Claim	Liability	A present obligation of the entity to transfer an economic resource as a result of past events.
	Equity	The residual interest in the assets of the entity after deducting all its liabilities.

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Changes in economic resources and claims, reflecting financial performance	Income	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
	Expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.
Other changes in economic resources and claims	-	Contributions from holders of equity claims, and distributions to them.
	-	Exchanges of assets or liabilities that do not result in increases or decreases in equity.

5.2 DEFINITION OF AN ASSET

The definition of 'asset', which, in turn, is dependent on definition of economic resource, has three key aspects – right, potential to produce economic benefits and control.

Let us look at these three aspects in more detail.

5.2.1 Right

The concept of what constitutes a 'right' is a very wide subject and can be better illustrated with reference to various lenses through which it can be seen, and a couple of such lenses are explained below. It must be understood that merely having a right does not mean the entity has an 'asset'.

5.2.1.1 Obligation of another party

Certain rights correspond to obligation of another party. For example:

- *Rights to receive cash* – say, when a loan or security deposit is given or debt instrument of another entity is subscribed for
- *Rights to receive goods or services* – say, when an advance for purchase of inventory or capital goods is given
- *Rights to exchange economic resources with another party on favourable terms* – say, a forward contract to buy an economic resource on terms that are currently favourable or an option to buy an economic resource

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- *Rights to benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs* – say, an insurance claim receivable upon happening of the insured event.

However, there are cases when a right exists even when no other party has any obligation towards the entity. For example,

- Rights over physical objects, such as property, plant and equipment or inventories. Examples of such rights are a right to use a physical object or a right to benefit from the residual value of a leased object
- Rights to use intellectual property.

5.2.1.2 Contract, legislation or similar means

Many rights are established by contract, legislation or similar means. For example, an entity might obtain rights from owning or leasing a physical object, from owning a debt instrument or an equity instrument, or from owning a registered patent.

However, an entity might also obtain rights in other ways, for example:

(a) by acquiring or creating know-how that is not in the public domain; or

(b) through an obligation of another party that arises because that other party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statements, often referred to as a 'constructive obligation'.

Some goods or services—for example, employee services—are received and immediately consumed. An entity's right to obtain the economic benefits produced by such goods or services exists momentarily until the entity consumes the goods or services.

Not all of an entity's rights are assets of that entity — to be assets of the entity, the rights must have the potential to produce for the entity economic benefits beyond those available to all other parties. The concept of 'asset' can also be understood if we understand what rights **do not** constitute asset. A couple of such situations are discussed below:

(a) Rights available to all parties without significant cost — for instance, rights of access to public goods, such as public rights of way over land, or know-how that is in the public domain — are typically not assets for the entities that hold them.

(b) Similarly, an entity cannot have a right to obtain economic benefits from itself. Hence:

  (i) debt instruments or equity instruments issued by the entity and repurchased and held by it—for example, treasury shares—are not economic resources of that entity; and

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(ii) if a reporting entity comprises more than one legal entity, debt instruments or equity instruments issued by one of those legal entities and held by another of those legal entities are not economic resources of the reporting entity.

In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights are often treated as a single unit of account that is a single asset. For example, legal ownership of a physical object may give rise to several rights, including:

(a) the right to use the object;

(b) the right to sell rights over the object;

(c) the right to pledge rights over the object; and

(d) other rights not listed in (a)–(c).

In many cases, the set of rights arising from legal ownership of a physical object is accounted for as a single asset. Conceptually, the economic resource is the set of rights, not the physical object. Nevertheless, describing the set of rights as the physical object will often provide a faithful representation of those rights in the most concise and understandable way.

Example 4

Ownership of land gives the entity the right to use the land, the right to sell the land, the right to give the land on lease, the right to pledge land to obtain a secured loan etc. However, these rights are normally bundled up as a single asset 'Land' as such classification provides a faithful representation of those rights in the most concise and understandable way.

Lastly, in some cases, it is uncertain whether a right exists.

Example 5

An entity and another party might dispute whether the entity has a right to receive an economic resource from that other party. Until that existence uncertainty is resolved — for example, by a court ruling — it is uncertain whether the entity has a right and, consequently, whether an asset exists.

5.2.2 Potential to produce economic benefits

Role of probability

For the potential to exist, it does not need to be certain, or even likely, that the right will produce economic benefits. It is only necessary that the right already exists and that, in at least one circumstance, it would produce for the entity economic benefits beyond those available to all other parties.

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A right can meet the definition of an economic resource, and hence can be an asset, even if the probability that it will produce economic benefits is low. Nevertheless, that low probability might affect decisions about what information to provide about the asset and how to provide that information, including decisions about whether the asset is recognised and how it is measured.

Example 6

Receivable from a bankrupt customer is a right, even if the measurement principle renders the net carrying amount of such an asset as 'nil'.

Role of timing

Although an economic resource derives its value from its present potential to produce future economic benefits, the economic resource is the present right that contains that potential, not the future economic benefits that the right may produce.

For example, a purchased option derives its value from its potential to produce economic benefits through exercise of the option at a future date. However, the economic resource is the present right—the right to exercise the option at a future date. The economic resource is not the future economic benefits that the holder will receive if the option is exercised.

Role of expenditure

There is a close association between incurring expenditure and acquiring assets, but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that the entity has sought future economic benefits but does not provide conclusive proof that the entity has obtained an asset. Similarly, the absence of related expenditure does not preclude an item from meeting the definition of an asset. Assets can include, for example, rights that a government has granted to the entity free of charge or that another party has donated to the entity.

5.2.3 Control

Control links an economic resource to an entity. Assessing whether control exists helps to identify the economic resource for which the entity accounts. For example, an entity may control a proportionate share in a property without controlling the rights arising from ownership of the entire property. In such cases, the entity's asset is the share in the property, which it controls, not the rights arising from ownership of the entire property, which it does not control.

An entity controls an economic resource if:

(a) it has the present ability to direct the use of the economic resource i.e. it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that other party's activities, and

(b) obtain the economic benefits that may flow from it. For an entity to control an economic resource, the future economic benefits from that resource must flow to the entity either directly or indirectly rather than to another party. This aspect of control does not imply that

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the entity can ensure that the resource will produce economic benefits in all circumstances. Instead, it means that if the resource produces economic benefits, the entity is the party that will obtain them either directly or indirectly. Having exposure to significant variations in the amount of the economic benefits produced by an economic resource may indicate that the entity controls the resource. However, it is only one factor to consider in the overall assessment of whether control exists.

An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. Control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it. It follows that, if one party controls an economic resource, no other party controls that resource.

Control of an economic resource usually arises from an ability to enforce legal rights. However, control can also arise if an entity has other means of ensuring that it, and no other party, has the present ability to direct the use of the economic resource and obtain the benefits that may flow from it. For example, an entity could control a right to use know-how that is not in the public domain if the entity has access to the know-how and the present ability to keep the know-how secret, even if that know-how is not protected by a registered patent.

It must be remembered that if one party controls an economic resource, no other party controls that resource.

Would control exist with the principal in a principal-agent relationship?

Sometimes one party (a principal) engages another party (an agent) to act on behalf of, and for the benefit of, the principal. For example, a principal may engage an agent to arrange sales of goods controlled by the principal. If an agent has custody of an economic resource controlled by the principal, that economic resource is not an asset of the agent.

Furthermore, if the agent has an obligation to transfer to a third party an economic resource controlled by the principal, that obligation is not a liability of the agent, because the economic resource that would be transferred is the principal's economic resource, not the agent's.

5.3 DEFINITION OF A LIABILITY

For a liability to exist, three criteria must all be satisfied:



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Let us look at these three criteria in more detail.

5.3.1 Obligation

An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party (or parties). The other party (or parties) could be a person or another entity, a group of people or other entities, or society at large. It is not necessary to know the identity of the party (or parties) to whom the obligation is owed. However, a requirement for one party to recognise a liability and measure it at a specified amount does not imply that the other party (or parties) must recognise an asset or measure it at the same amount. For example, particular Ind AS may contain different recognition criteria or measurement requirements for the liability of one party and the corresponding asset of the other party (or parties) if those different criteria or requirements are a consequence of decisions intended to select the most relevant information that faithfully represents what it purports to represent.

Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a '**constructive obligation**'.

Whether an entity's duty to transfer an economic resource, that is conditional on an action that an entity itself may choose to take, is an obligation or not?

In such situations, the entity has an obligation if it has no practical ability to avoid taking that action. A conclusion that it is appropriate to prepare an entity's financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade.

The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer.

5.3.2 Transfer of an economic resource

To satisfy this criterion, the obligation must have the potential to require the entity to transfer an economic resource to another party (or parties). For that potential to exist, it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource — the transfer may, for example, be required only if a specified uncertain future event occurs. It is only

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necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource.

An obligation can meet the definition of a liability even if the probability of a transfer of an economic resource is low. Nevertheless, that low probability might affect decisions about what information to provide about the liability and how to provide that information, including decisions about whether the liability is recognised and how it is measured.

Obligations to transfer an economic resource include, for example:

(a) obligations to pay cash.

(b) obligations to deliver goods or provide services.

(c) obligations to exchange economic resources with another party on unfavourable terms. Such obligations include, for example, a forward contract to sell an economic resource on terms that are currently unfavourable or an option that entitles another party to buy an economic resource from the entity.

(d) obligations to transfer an economic resource if a specified uncertain future event occurs.

(e) obligations to issue a financial instrument if that financial instrument will oblige the entity to transfer an economic resource.

Instead of fulfilling an obligation to transfer an economic resource to the party that has a right to receive that resource, entities sometimes decide to, for example:

(a) settle the obligation by negotiating a release from the obligation;

(b) transfer the obligation to a third party; or

(c) replace that obligation to transfer an economic resource with another obligation by entering into a new transaction.

It is however important to note that in the situations described above, the entity has the obligation to transfer an economic resource until it has settled, transferred or replaced that obligation.

5.3.3 Present obligation as a result of past events

A present obligation exists as a result of past events only if:

(a) the entity has already obtained economic benefits (for example, goods or services obtained from a supplier) or taken an action (for example, operating a particular business or operating in a particular market); and

(b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

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A present obligation can exist even if a transfer of economic resources cannot be enforced until some point in the future. For example, a contractual liability to pay cash may exist now even if the contract does not require a payment until a future date. Similarly, a contractual obligation for an entity to perform work at a future date may exist now even if the counterparty cannot require the entity to perform the work until that future date.

An entity does not yet have a present obligation to transfer an economic resource if it has not yet satisfied the criteria above, that is, if it has not yet obtained economic benefits, or taken an action, that would or could require the entity to transfer an economic resource that it would not otherwise have had to transfer.

Example 7

If an entity has entered into a contract to pay an employee a salary in exchange for receiving the employee's services, the entity does not have a present obligation to pay the salary until it has received the employee's services. Before then the contract is executory — the entity has a combined right and obligation to exchange future salary for future employee services. We will discuss more about 'executory contracts' in more detail later in this Chapter.

5.4 ASPECTS WHICH ARE COMMON TO ASSETS AND LIABILITIES

5.4.1 Unit of account

The unit of account is the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied.

A unit of account is selected for an asset or liability when considering how recognition criteria and measurement concepts will apply to that asset or liability and to the related income and expenses.

In some circumstances, it may be appropriate to select one unit of account for recognition and a different unit of account for measurement. For example, contracts may sometimes be recognised individually but measured as part of a portfolio of contracts. For presentation and disclosure, assets, liabilities, income and expenses may need to be aggregated or separated into components.

A unit of account is selected to provide useful information, which implies that:

(a) the information provided about the asset or liability and about any related income and expenses must be relevant; and

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(b) the information provided about the asset or liability and about any related income and expenses must faithfully represent the substance of the transaction or other event from which they have arisen.

Sometimes, both rights and obligations arise from the same source. For example, some contracts establish both rights and obligations for each of the parties. If those rights and obligations are interdependent and cannot be separated, they constitute a single inseparable asset or liability and hence form a single unit of account.

Conversely, if rights are separable from obligations, it may sometimes be appropriate to group the rights separately from the obligations, resulting in the identification of one or more separate assets and liabilities. In other cases, it may be more appropriate to group separable rights and obligations in a single unit of account treating them as a single asset or a single liability.

5.4.2 Executory contracts

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

An executory contract establishes a combined right and obligation to exchange economic resources. The right and obligation are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are currently favourable; it has a liability if the terms of the exchange are currently unfavourable.

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

5.4.3 Substance of contractual rights and contractual obligations

The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance. In some cases, the substance of the rights and obligations is clear from the legal form of the contract. In other cases, the terms of the contract or a group or series of contracts require analysis to identify the substance of the rights and obligations.

All terms in a contract — whether explicit or implicit — are considered unless they have no substance. Implicit terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts to sell goods to customers.

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Terms that have no substance are disregarded. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example:

(a) terms that bind neither party; or

(b) rights, including options, that the holder will not have the practical ability to exercise in any circumstances.

A group or series of contracts may achieve or be designed to achieve an overall commercial effect. To report the substance of such contracts, it may be necessary to treat rights and obligations arising from that group or series of contracts as a single unit of account. For example, if the rights or obligations in one contract merely nullify all the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that the two contracts create no rights or obligations. Conversely, if a single contract creates two or more sets of rights or obligations that could have been created through two or more separate contracts, an entity may need to account for each set as if it arose from separate contracts in order to faithfully represent the rights and obligations.

5.5 DEFINITION OF EQUITY

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

Sometimes, legal, regulatory or other requirements affect particular components of equity, such as share capital or retained earnings. For example, some such requirements permit an entity to make distributions to holders of equity claims only if the entity has sufficient reserves that those requirements specify as being distributable.

5.6 DEFINITION OF INCOME AND EXPENSES

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

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

It follows from these definitions of income and expenses that contributions from holders of equity claims are not income, and distributions to holders of equity claims are not expenses.

Income and expenses are the elements of financial statements that relate to an entity's financial performance. Users of financial statements need information about both an entity's financial

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position and its financial performance. Hence, although income and expenses are defined in terms of changes in assets and liabilities, information about income and expenses is just as important as information about assets and liabilities.

Different transactions and other events generate income and expenses with different characteristics. Providing information separately about income and expenses with different characteristics can help users of financial statements to understand the entity's financial performance.

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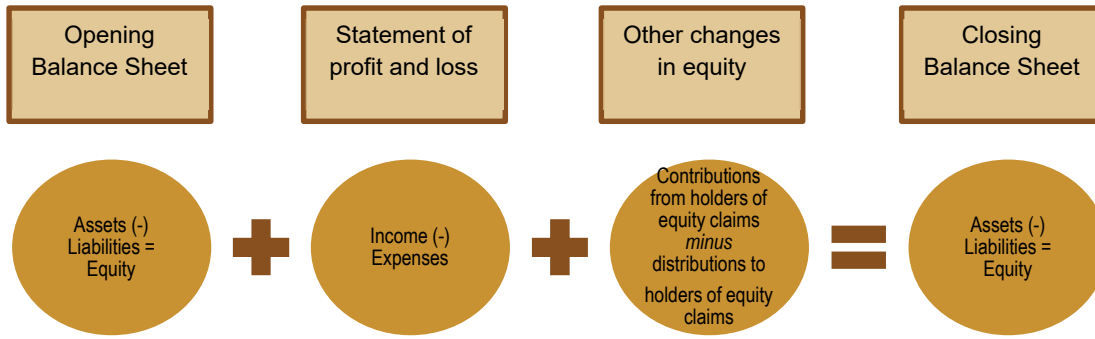
UNIT 6
RECOGNITION AND DERECOGNITION

6.1 THE RECOGNITION PROCESS

- Recognition is the process of capturing for inclusion
- in the balance sheet or the statement of profit and loss
- an item
- that meets the definition of one of the elements of financial statements—an asset, a liability, equity, income or expenses.

The amount at which an asset, a liability or equity is recognised in the balance sheet is referred to as its 'carrying amount'.

Recognition links the elements (as discussed in Unit 5), the balance sheet and the statement of profit and loss as follows:



The balance sheet and statement of profit and loss are linked because the recognition of one item (or a change in its carrying amount) requires the recognition or derecognition of one or more other items (or changes in the carrying amount of one or more other items). This principle can be explained in the form of a journal entry as below:

Particulars	Statement of profit or loss	Balance Sheet (alternatives)	
Recognition of income	Credit Income	Debit Asset	Debit Liability

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		(initial recognition or increase in carrying amount)	(derecognition or decrease in carrying amount)
Recognition of expense	Debit Expense	Credit Asset (derecognition or decrease in carrying amount)	Credit Liability (initial recognition or increase in carrying amount)

The initial recognition of assets or liabilities arising from transactions or other events may result in the simultaneous recognition of both income and related expenses.

Example 8

The sale of goods for cash results in the recognition of both income (from the recognition of one asset — the cash) and an expense (from the derecognition of another asset—the goods sold).

The simultaneous recognition of income and related expenses is sometimes referred to as the **matching of costs with income**. It may be noted that matching of costs with income is not an objective of the *Conceptual Framework under Ind AS*. The *Conceptual Framework under Ind AS* does not allow the recognition in the balance sheet of items that do not meet the definition of an asset, a liability or equity.

6.2 RECOGNITION CRITERIA

Only items that meet the definition of an asset, a liability or equity are recognised in the balance sheet. Similarly, only items that meet the definition of income or expenses are recognised in the statement of profit and loss. However, not all items that meet the definition of one of those elements are recognised.

Not recognising an item that meets the definition of one of the elements makes the balance sheet and the statement of profit and loss less complete and can exclude useful information from financial statements. On the other hand, in some circumstances, recognising some items that meet the definition of one of the elements would not provide useful information.

An asset or liability is recognised only if recognition provides users of financial statements with information that is useful, i.e. with:

(a) relevant information; and

(b) a faithful representation

of the asset or liability and of any resulting income, expenses or changes in equity.

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What is useful to users depends on the item and the facts and circumstances. Consequently, judgement is required when deciding whether to recognise an item, and thus recognition requirements may need to vary between and within Ind AS.

It is important when making decisions about recognition to consider the information that would be given if an asset or liability were not recognised. For example, if no asset is recognised when expenditure is incurred, an expense is recognised. Over time, recognising the expense may, in some cases, provide useful information, for example, information that enables users of financial statements to identify trends.

Even if an item meeting the definition of an asset or liability is not recognised, an entity may need to provide information about that item in the notes. It is important to consider how to make such information sufficiently visible to compensate for the item's absence from the structured summary provided by the balance sheet and, if applicable, the statement of profit and loss.

Let's look at the aspects of 'relevance' and 'faithful presentation' in a bit more detail.

6.2.1 Relevance

Information about assets, liabilities, equity, income and expenses is relevant to users of financial statements. However, recognition of a particular asset or liability and any resulting income, expenses or changes in equity may not always provide relevant information. That may be the case if, for example:

(a) it is uncertain whether an asset or liability exists (see 6.2.1.1 below); or

(b) an asset or liability exists, but the probability of an inflow or outflow of economic benefits is low (see 6.2.1.2 below)

The presence of one or both of the factors described above does not lead automatically to a conclusion that the information provided by recognition lacks relevance. Moreover, factors other than those described above may also affect the conclusion. It may be a combination of factors and not any single factor that determines whether recognition provides relevant information.

6.2.1.1 Existence uncertainty

- *Asset*

  In some cases, it is uncertain whether a right exists. For example, an entity and another party might dispute whether the entity has a right to receive an economic resource from that other party. Until that existence uncertainty is resolved — for example, by a court ruling — it is uncertain whether the entity has a right and, consequently, whether an asset exists.

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- *Liability*

  In some cases, it is uncertain whether an obligation exists. For example, if another party is seeking compensation for an entity's alleged act of wrongdoing, it might be uncertain whether the act occurred, whether the entity committed it or how the law applies. Until that existence uncertainty is resolved — for example, by a court ruling — it is uncertain whether the entity has an obligation to the party seeking compensation and, consequently, whether a liability exists.

In those cases, that uncertainty, possibly combined with a low probability of inflows or outflows of economic benefits and an exceptionally wide range of possible outcomes, may mean that the recognition of an asset or liability, necessarily measured at a single amount, would not provide relevant information. Whether or not the asset or liability is recognised, explanatory information about the uncertainties associated with it may need to be provided in the financial statements.

6.2.1.2 Low probability of an inflow or outflow of economic benefits

If the probability of an inflow or outflow of economic benefits is low, the most relevant information about the asset or liability may be information about the magnitude of the possible inflows or outflows, their possible timing and the factors affecting the probability of their occurrence. The typical location for such information is in the notes.

However, in some cases, recognition of the asset or liability may provide relevant information beyond the disclosure in the notes.

Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or liability may provide relevant information beyond the information described above. Whether that is the case may depend on a variety of factors. For example:

(a) if an asset is acquired or a liability is incurred in an exchange transaction on market terms, its cost generally reflects the probability of an inflow or outflow of economic benefits. Thus, that cost may be relevant information, and is generally readily available. Furthermore, not recognising the asset or liability would result in the recognition of expenses or income at the time of the exchange, which might not be a faithful representation of the transaction.

(b) if an asset or liability arises from an event that is not an exchange transaction, recognition of the asset or liability typically results in recognition of income or expenses. If there is only a low probability that the asset or liability will result in an inflow or outflow of economic benefits, users of financial statements might not regard the recognition of the asset and income, or the liability and expenses, as providing relevant information.

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6.2.2 Faithful representation

Recognition of a particular asset or liability is appropriate if it provides not only relevant information, but also a faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. Whether a faithful representation can be provided may be affected by the level of measurement uncertainty associated with the asset or liability or by other factors.

6.2.2.1 Measurement uncertainty

For an asset or liability to be recognised, it must be measured. In many cases, such measures must be estimated and are therefore subject to measurement uncertainty. The use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the information if the estimates are clearly and accurately described and explained. Even a high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information.

In some cases, the level of uncertainty involved in estimating a measure of an asset or liability may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. The level of measurement uncertainty may be so high if, for example, the only way of estimating that measure of the asset or liability is by using cash-flow-based measurement techniques and, in addition, one or more of the following circumstances exists:

(a) the **range of possible outcomes is exceptionally wide** and the probability of each outcome is exceptionally difficult to estimate.

(b) the measure is **exceptionally sensitive to small changes** in estimates of the probability of different outcomes — for example, if the probability of future cash inflows or outflows occurring is exceptionally low, but the magnitude of those cash inflows or outflows will be exceptionally high if they occur.

(c) measuring the asset or liability requires **exceptionally difficult or exceptionally subjective allocations of cash flows** that do not relate solely to the asset or liability being measured.

In some of the cases described above, the most useful information may be the measure that relies on the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it. This is especially likely to be the case if that measure is the most relevant measure of the asset or liability. In other cases, if that information would not provide a sufficiently faithful representation of the asset or liability and of any resulting income, expenses or changes in equity, the most useful information may be a different measure (accompanied by any necessary descriptions and explanations) that is slightly less relevant but is subject to lower measurement uncertainty.

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In limited circumstances, all relevant measures of an asset or liability that are available (or can be obtained) may be subject to such high measurement uncertainty that none would provide useful information about the asset or liability (and any resulting income, expenses or changes in equity), even if the measure were accompanied by a description of the estimates made in producing it and an explanation of the uncertainties that affect those estimates. In those limited circumstances, the asset or liability would not be recognised.

Whether or not an asset or liability is recognised, a faithful representation of the asset or liability may need to include explanatory information about the uncertainties associated with the asset or liability's existence or measurement, or with its outcome — the amount or timing of any inflow or outflow of economic benefits that will ultimately result from it.

It may be noted that the level of measurement uncertainty beyond which a measure does not provide a faithful representation depends on facts and circumstances and so, the standard-setters felt, that level can be determined only when developing Standards.

6.2.2.2 Other factors

Faithful representation of a recognised asset, liability, equity, income or expenses involves not only recognition of that item, but also its measurement as well as presentation and disclosure of information about it.

Hence, when assessing whether the recognition of an asset or liability can provide a faithful representation of the asset or liability, it is necessary to consider not merely its description and measurement in the balance sheet, but also:

- the depiction of resulting income, expenses and changes in equity. For example, if an entity acquires an asset for consideration, not recognising the asset would result in recognising expenses, and that result could provide a misleading representation that the entity's financial position has deteriorated.
- whether related assets and liabilities are recognised. If they are not recognised, recognition may create a recognition inconsistency (accounting mismatch). That may not provide an understandable or faithful representation of the overall effect of the transaction or other event giving rise to the asset or liability, even if explanatory information is provided in the notes.
- presentation and disclosure of information about the asset or liability, and resulting income, expenses or changes in equity. A complete depiction includes all information necessary for a user of financial statements to understand the economic phenomenon depicted, including all necessary descriptions and explanations. Hence, presentation and disclosure of related information can enable a recognised amount to form part of a faithful representation of an asset, a liability, equity, income or expenses.

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6.3 DERECOGNITION

Derecognition is the removal of all or part of a recognised asset or liability from an entity's balance sheet. Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability:

Element of financial statements	When does derecognition normally occur?
Asset	When the entity loses control of all or part of the recognised asset
Liability	When the entity no longer has a present obligation for all or part of the recognised liability

The accounting requirements for derecognition are as below:

(a) derecognise any assets or liabilities that have expired or have been consumed, collected, fulfilled or transferred (referred to as 'transferred component'), and recognise any resulting income and expenses.

(b) continue to recognise the assets or liabilities retained, referred to as the 'retained component', if any. That retained component becomes a unit of account separate from the transferred component. Accordingly, no income or expenses are recognised on the retained component as a result of the derecognition of the transferred component, unless the derecognition results in a change in the measurement requirements applicable to the retained component. For example, when a parent loses control over a subsidiary and retains a minority shareholding therein, the measurement principles in Ind AS require that minority shareholding to be recognised at its fair value, the resulting gain or loss is then recognised in statement of profit or loss.

(c) applying following presentation and disclosure requirements:

  (i) presenting any retained component separately in the balance sheet

  (ii) presenting separately in the statement of profit and loss any income and expenses recognised as a result of the derecognition of the transferred component

  (iii) providing explanatory information.

In some cases, an entity might appear to transfer an asset or liability, but derecognition of that asset or liability is not appropriate. For example,

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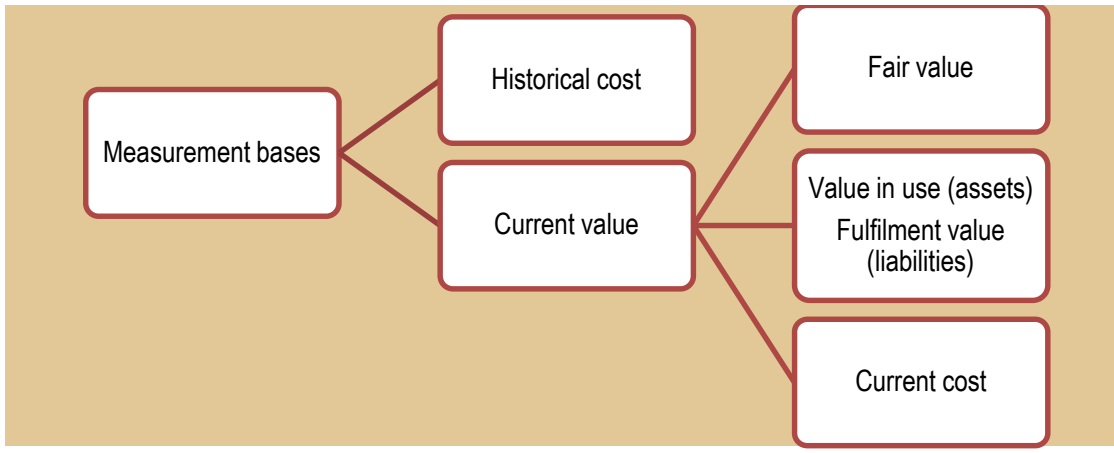
- if an entity has apparently transferred an asset but retains exposure to significant positive or negative variations in the amount of economic benefits that may be produced by the asset, this sometimes indicates that the entity might continue to control that asset
- if an entity has transferred an asset to another party that holds the asset as an agent for the entity, the transferor still controls the asset.

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UNIT 7
MEASUREMENT

Elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis. A measurement basis is an identified feature — for example, historical cost, fair value or fulfilment value — of an item being measured. Applying a measurement basis to an asset or liability creates a measure for that asset or liability and for related income and expenses.

7.1 MEASUREMENT BASES OF AN ASSET OR A LIABILITY



A very broad comparison between the historical cost and current value measurement bases is given below:

Factor	Historical cost	Current value
Monetary information about assets, liabilities and related income and expenses	Derived, at least in part, from the price of the transaction or other event that gave rise to them	Using information updated to reflect conditions at the measurement date
Changes in values	Not reflected except to the extent that those changes relate to impairment of an asset or a liability becoming onerous	Reflect changes, since the previous measurement date, in estimates of cash flows and other factors reflected in those current values

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7.1.1 Historical cost

The table below summarises the concept of 'historical cost' in case of assets and liabilities:

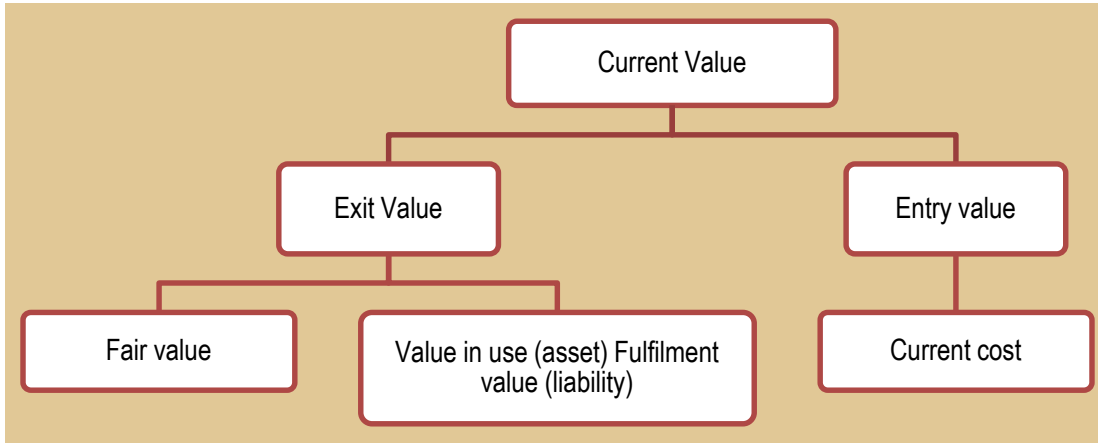
Particulars	Assets	Liabilities
Components	Consideration paid (+) transaction costs	Consideration received (-) transaction costs
Changes	• consumption of part or all of the economic resource that constitutes the asset (depreciation or amortisation)	
	• payments received that extinguish part or all of the asset (collection from trade receivables)	• fulfilment of the liability, for example, by making payments that extinguish part or all of the liability or by satisfying an obligation to deliver goods
	• effect of events that cause the historical cost of the asset to be no longer recoverable (impairment)	• effect of events that increase the value of the obligation to transfer the economic resources needed to fulfil the liability to such an extent that the liability becomes onerous. A liability is onerous if the historical cost is no longer sufficient to depict the obligation to fulfil the liability
	• accrual of interest to reflect any financing component	accrual of interest to reflect any financing component

When an asset is acquired or created (say, a loan is given by a parent to a subsidiary), or a liability is incurred or taken on, as a result of an event that is not a transaction on market terms (say, at a discounted interest rate), it may not be possible to identify a cost, or the cost may not provide relevant information about the asset or liability. In some such cases, a current value of the asset (say, fair value) or liability is used as a deemed cost on initial recognition and that deemed cost is then used as a starting point for subsequent measurement at historical cost (say, amortised cost in case of the loan - see next paragraph for discussion on this).

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One way to apply a historical cost measurement basis to financial assets and financial liabilities is to measure them at amortised cost. The amortised cost of a financial asset or financial liability reflects estimates of future cash flows, discounted at a rate determined at initial recognition. For variable rate instruments, the discount rate is updated to reflect changes in the variable rate. The amortised cost of a financial asset or financial liability is updated over time to depict subsequent changes, such as the accrual of interest, the impairment of a financial asset and receipts or payments.

7.1.2 Current value



7.1.2.1 Exit value – Fair value and Value in use / Fulfilment value

The following table summarises these concepts in a comparative form:

Particulars	Fair value	Value in use / Fulfilment value
Definition	Price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date	Value in use - present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value - present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability.
Value from whose perspective?	Reflects the perspective of market participants—participants in a market to which the entity has access. The asset or liability is	Reflect entity-specific assumptions rather than assumptions by market participants

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	measured using the same assumptions that market participants would use when pricing the asset or liability if those market participants act in their economic best interest.	
How determined?	Directly by observing prices in an active market or using measurement techniques, for example, cash-flow-based measurement techniques	Cannot be observed directly and are determined using cash-flow based measurement techniques
Transaction costs considered in measurement?	Neither those costs incurred on initial recognition, nor those costs to be incurred on disposal of asset or settlement of liability are considered.	Those costs incurred on initial recognition are not considered, but the present value of those costs to be incurred on disposal of asset or settlement of liability are considered.

7.1.2.2 Entry value – Current cost

Like historical cost, current cost is also an entry value. Hence, it would be appropriate to understand the concept of 'current cost' by comparing it with 'historical cost' as below:

Particulars	Historical cost	Current cost
Value determined on	Date of acquisition of asset or incurrence of liability	Each measurement date
Components	Assets: Consideration paid (+) transaction costs Liabilities: Consideration received (-) transaction costs	Assets: Consideration **that would be** paid (+) transaction costs **that would be** incurred Liabilities: Consideration **that would be** received (-) transaction costs **that would be** incurred

7.2 INFORMATION PROVIDED BY PARTICULAR MEASUREMENT BASES

When selecting a measurement basis, it is important to consider the nature of the information that the measurement basis will produce in both the balance sheet and the statement of profit and loss. The tables below summarise that information.

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7.2.1 Assets

7.2.1.1 Balance Sheet

	Historical cost	Current cost	Fair value (market participant assumptions)	Value in use (entity-specific assumptions)
Carrying amount – primary value	Historical cost to the extent unconsumed or uncollected, and recoverable (Includes interest accrued on any financing component)	Current cost to the extent unconsumed or uncollected, and recoverable	Price that would be received to sell the asset	Present value of future cash flows from the use of the asset and from its ultimate disposal
Transaction costs	Included	Included	Without deducting transaction costs on disposal	After deducting present value of transaction costs on disposal

7.2.1.2 Statement of profit and loss

Event	Historical cost	Current cost	Fair value (market participant assumptions)	Value in use (entity-specific assumptions)
Initial recognition – primary value	-	-	Difference between consideration paid and fair value of the asset acquired	Difference between consideration paid and value in use of the asset acquired
Transaction costs – purchase	-	-	Expense	Expense

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Event	Historical cost	Current cost	Fair value (market participant assumptions)	Value in use (entity-specific assumptions)
Sale or consumption of the asset	Expense: Historical cost of the asset sold or consumed (eg. Cost of sales of inventory or WDV of a fixed asset)	Expense: Current cost of the asset sold or consumed	Expense: Fair value of the asset sold or consumed	Expense: Value in use of the asset sold or consumed
	Income: Consideration received			
	Expenses and Income could be presented gross or net			
Transaction costs – sale	Included	Included	Included	Already considered in computation of value in use, hence not included
Interest income	At historical rates, updated if the asset bears variable interest	At current rates	Already included in fair value changes, could be identified separately	Already included in value in use changes, could be identified separately
Impairment	Expense	Expense	Already included in fair value changes, could be identified separately	Already included in value in use changes, could be identified separately
Value changes	None, except impairment Financial assets – effect of changes in estimated cash flows is an income or expense	Effect of change in prices is income or expense	Already included in fair value changes	Already included in value in use changes

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7.2.2 Liabilities

7.2.2.1 Balance Sheet

	Historical cost	Current cost	Fair value (market participant assumptions)	Fulfilment value (entity-specific assumptions)
Carrying amount – primary value	Consideration received for taking on the unfulfilled part of the liability, increased by excess of estimated cash outflows over consideration received.	Consideration that would be currently received for taking on the unfulfilled part of the liability, increased by excess of estimated cash outflows over that consideration.	Price that would be paid to transfer the unfulfilled part of the liability	Present value of future cash flows that will arise in fulfilling the unfulfilled part of the liability
Transaction costs	Netted off from above	Netted off from above	Not including transaction costs that would be incurred on transfer	Including present value of transaction costs to be incurred in fulfilment or transfer

7.2.2.2 Statement of profit and loss

Event	Historical cost	Current cost	Fair value (market participant assumptions)	Fulfilment value (entity-specific assumptions)
Initial recognition – primary value	-	-	Difference between consideration received and the fair value of the liability	Difference between consideration received and the fulfilment value of the liability

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Event	Historical cost	Current cost	Fair value (market participant assumptions)	Fulfilment value (entity-specific assumptions)
Transaction costs – purchase	-	-	Expense	Expense
Fulfilment or transfer of the liability	Income: historical consideration	Income: reflects current consideration	Income: fair value of the liability	Income: fulfilment value of the liability
	Expenses: costs incurred in fulfilling the liability or cost paid to transfer the liability			
	Could be presented net or gross			
Interest expense	At historical rates, updated if the liability bears variable interest	At current rates	Already included in fair value changes, could be identified separately	Already included in changes in fulfilment value, could be identified separately
Effect of events that cause a liability to become onerous	Expenses = estimated cash outflows *minus* historical cost of the liability	Expenses = estimated cash outflows *minus* current cost of the liability	Already included in fair value changes, could be identified separately	Already included in changes in fulfilment value, could be identified separately
Value changes	None, to the extent that the liability is onerous. Financial liabilities – effect of changes in estimated cash flows is an income or expense	Effect of change in prices is income or expense	Already included in fair value changes	Already included in changes in fulfilment value

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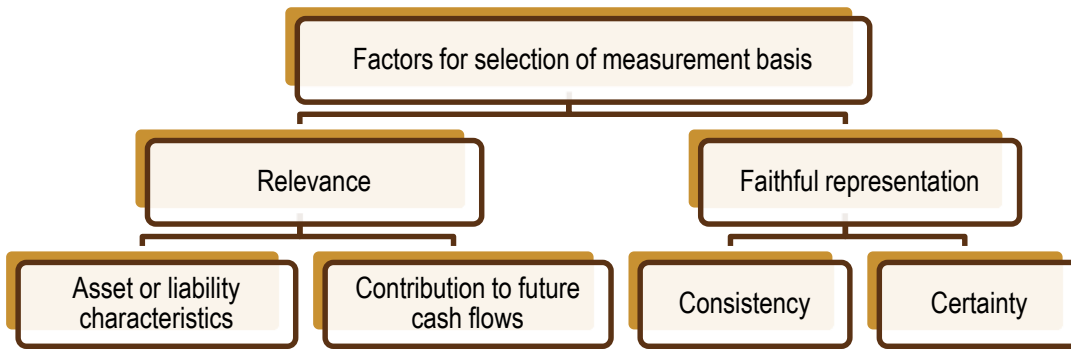
7.3 FACTORS TO CONSIDER WHEN SELECTING A MEASUREMENT BASIS FOR INITIAL RECOGNITION AND SUBSEQUENT MEASUREMENT OF AN ASSET OR A LIABILITY

In section 7.2, we have discussed the information that various measurement basis will produce in both the balance sheet and the statement of profit and loss. While selecting a measurement basis, it is necessary to consider such information.

Additionally, certain other factors must also be considered while selecting a measurement basis for initial recognition and subsequent measurement and this section 7.3 focuses on the same. Section 7.4 will focus on certain additional factors to be considered when selecting measurement basis for initial measurement only.

In most cases, no single factor will determine which measurement basis should be selected. The relative importance of each factor will depend on facts and circumstances. As discussed in Unit 3, the information provided by a measurement basis must be useful to users of financial statements. To achieve this, the information must be relevant and it must faithfully represent what it purports to represent. In addition, the information provided should be, as far as possible, comparable, verifiable, timely and understandable.

The following chart lays down the overall scheme of factors relevant for selection of measurement basis, besides the information provided by the same:



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7.3.1 Relevance

7.3.1.1 Characteristics of the asset or liability

The relevance of information provided by a measurement basis depends partly on the characteristics of the asset or liability, in particular, on:

- Variability of cash flows, and
- Sensitivity of the value of the asset or liability to market factors or other risks

Asset or liability carried at historical cost

If the value of an asset or liability is sensitive to market factors or other risks, its historical cost might differ significantly from its current value and hence may not provide relevant information if information about changes in value is important to users of financial statements.

As an example, amortised cost cannot provide relevant information about a financial asset or financial liability that is a derivative.

Furthermore, if historical cost is used, changes in value are reported not when that value changes, but when an event such as disposal, impairment or fulfilment occurs. This could be incorrectly interpreted as implying that all the income and expenses recognised at the time of that event arose then, rather than over the periods during which the asset or liability was held.

Moreover, because measurement at historical cost does not provide timely information about changes in value, income and expenses reported on that basis may lack predictive value and confirmatory value by not depicting the full effect of the entity's exposure to risk arising from holding the asset or liability during the reporting period.

Asset or liability carried at fair value

Changes in the fair value of an asset or liability reflect changes in expectations of market participants and changes in their risk preferences. Depending on the characteristics of the asset or liability being measured and on the nature of the entity's business activities, information reflecting those changes may not always provide predictive value or confirmatory value to users of financial statements. This may be the case when the entity's business activities do not involve selling the asset or transferring the liability.

As an example, if the entity holds assets solely for use or solely for collecting contractual cash flows or if the entity is to fulfil liabilities itself, information reflecting changes in the fair value of an asset or liability may not always provide predictive value or confirmatory value to users of financial statements.

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7.3.1.2 Contribution to future cash flows

How economic resources are used, and hence how assets and liabilities produce cash flows, depends in part on the nature of the business activities conducted by the entity.

When a business activity of an entity involves the use of several economic resources that produce cash flows indirectly, by being used in combination to produce and market goods or services to customers, historical cost or current cost is likely to provide relevant information about that activity.

For example, property, plant and equipment is typically used in combination with an entity's other economic resources. Similarly, inventory typically cannot be sold to a customer, except by making extensive use of the entity's other economic resources (for example, in production and marketing activities). Paragraphs 6.24–6.31 and 6.40–6.42 of the Conceptual Framework explain how measuring such assets at historical cost or current cost can provide relevant information that can be used to derive margins achieved during the period.

For assets and liabilities that produce cash flows directly, such as assets that can be sold independently and without a significant economic penalty (for example, without significant business disruption), the measurement basis that provides the most relevant information is likely to be a current value that incorporates current estimates of the amount, timing and uncertainty of the future cash flows.

As discussed in more detail in the chapter on financial instruments, when a business activity of an entity involves managing financial assets and financial liabilities with the objective of collecting contractual cash flows, amortised cost may provide relevant information that can be used to derive the margin between the interest earned on the assets and the interest incurred on the liabilities. However, in assessing whether amortised cost will provide useful information, it is also necessary to consider the characteristics of the financial asset or financial liability. Amortised cost is unlikely to provide relevant information about cash flows that depend on factors other than principal and interest.

7.3.2 Faithful representation

7.3.2.1 Consistency

When assets and liabilities are related in some way, using different measurement bases for those assets and liabilities can create a measurement inconsistency (accounting mismatch). If financial statements contain measurement inconsistencies, those financial statements may not faithfully represent some aspects of the entity's financial position and financial performance.

Therefore, when the cash flows from one asset or liability are directly linked to the cash flows from another asset or liability, using the same measurement basis for related assets and liabilities may provide users of financial statements with information that is more useful than the information that would result from using different measurement bases. This may be particularly likely when the

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cash flows from one asset or liability are directly linked to the cash flows from another asset or liability.

7.3.2.2 Certainty

When a measure cannot be determined directly by observing prices in an active market and must instead be estimated, measurement uncertainty arises. The level of measurement uncertainty associated with a particular measurement basis may affect whether information provided by that measurement basis provides a faithful representation of an entity's financial position and financial performance. A high level of measurement uncertainty does not necessarily prevent the use of a measurement basis that provides relevant information. However, in some cases the level of measurement uncertainty is so high that information provided by a measurement basis might not provide a sufficiently faithful representation. In such cases, it is appropriate to consider selecting a different measurement basis that would also result in relevant information.

Measurement uncertainty is different from both outcome uncertainty and existence uncertainty, but their presence may sometimes contribute to measurement uncertainty.

(a) outcome uncertainty arises when there is uncertainty about the amount or timing of any inflow or outflow of economic benefits that will result from an asset or liability.

(b) existence uncertainty arises when it is uncertain whether an asset or a liability exists.

The presence of outcome uncertainty or existence uncertainty may sometimes contribute to measurement uncertainty. However, outcome uncertainty or existence uncertainty does not necessarily result in measurement uncertainty. For example, if the fair value of an asset can be determined directly by observing prices in an active market, no measurement uncertainty is associated with the measurement of that fair value, even if it is uncertain how much cash the asset will ultimately produce and hence there is outcome uncertainty.

Illustration 1: Derecognition vs. Faithful Representation

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

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

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Solution:

Accounting Treatment:

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

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

(a) the contractual rights to the cash flows from the financial asset expire, or

(b) it transfers the financial asset or substantially all the risks and rewards of ownership of the financial asset to another party.

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

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

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

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

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According to the Conceptual Framework, an asset should be derecognized when control of all, or part of an asset is lost.

As discussed in Section 6.3 above, in some cases, an entity might appear to transfer an asset or liability, but derecognition of that asset or liability is not appropriate. For example, if an entity has apparently transferred an asset but retains exposure to significant positive or negative variations in the amount of economic benefits that may be produced by the asset, then this sometimes

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indicates that the entity might continue to control that asset, which appears to be the case in the current scenario.

The accounting requirements for derecognition aim to faithfully represent both:

(a) any assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event); and

(b) the change in the entity's assets and liabilities as a result of that transaction or other event.

Meeting both the above requirements becomes difficult if there is only a part disposal of an asset, or there is a retention of some exposure to that asset. It is difficult to faithfully represent the legal form (which is, in this scenario, a decrease in trade receivables under the factoring arrangement) with the substance of retaining the corresponding risks and rewards.

In view of the difficulties in practical scenarios in meeting the two aims, the Conceptual Framework does not advocate the use of a control approach or a risk-and-rewards approach to derecognition in every circumstance.

As such, the treatment as per Ind AS 109, as well as the principles laid down in the Conceptual Framework do not appear to be in conflict with each other in this case.

Illustration 2:

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

Solution:

The Conceptual Framework defines an asset as a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. Assets should be recognized if they meet the Conceptual Framework definition of an asset and such recognition provides users of financial statements with information that is useful (i.e. it is relevant as well as results in faithful representation). However, the criteria of a cost-benefit analysis always exists i.e. the benefits of the information must be sufficient to justify the costs of providing such information. The recognition criteria outlined in the Conceptual Framework allows for flexibility in the application in amending or developing the standards.

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

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

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Furthermore, Para 21 of Ind AS 38 states that an intangible asset shall be recognised if, and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.

This requirement is applicable both in case of an externally acquired intangible asset or an internally generated intangible asset. The probability of expected future economic benefits must be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset. Further, as per Para 33 of Ind AS 38, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations. If the recognition criteria are not satisfied, Ind AS 38 requires the expenditure to be expensed as and when it is incurred.

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

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

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Illustration 3:

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

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

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Solution:

Usage of Fair Value in Ind AS:

Treatment under Ind AS:

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

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

About Fair Value (Ind AS 113)

Ind AS 113 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This price is an exit price.

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

Examples of use of fair value in Ind AS:

(a) Ind AS 16 Property, Plant and Equipment permits revaluation through other comprehensive income, provided it is carried out regularly.

(b) Disclosure of fair value of Investment Property in Ind AS 40, while the companies account for the same under the cost model.

(c) Ind AS 38 Intangible Assets allows measurement of intangible assets at fair value with corresponding changes in equity, but only if the assets can be measured reliably by way of existence of an active market for them.

(d) Ind AS 109 Financial Instruments requires some financial assets and liabilities to be measured at amortized cost and others at fair value. The measurement basis is largely determined by the business model for that financial instrument. Where the financial instruments are carried at fair value, depending on the category and circumstances, the

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movement in the fair value (gain or loss) is either recognized in profit or loss or in other comprehensive income.

Financial value of an entity

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

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

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7.3.3 Implications of enhancing qualitative characteristics for the selection of measurement basis

As per Section 3.1.4, the usefulness of financial information is enhanced by applying four enhancing qualitative characteristics – comparability, verifiability, timeliness and understandability. Of these, timeliness has no specific implications for measurement. Let's briefly discuss the implications of the other three:

***Comparability**:* Consistently using the same measurement bases for the same items, either from period to period within a reporting entity or in a single period across entities, can help make financial statements more comparable. A change in measurement basis can make financial statements less understandable. However, a change may be justified if other factors outweigh the reduction in understandability, for example, if the change results in more relevant information. If a change is made, users of financial statements may need explanatory information to enable them to understand the effect of that change.

Understandability: Understandability depends partly on how many different measurement bases are used and on whether they change over time. In general, if more measurement bases are used in a set of financial statements, the resulting information becomes more complex and, hence, less understandable and the totals or subtotals in the balance sheet and the statement of profit and loss become less informative. However, it could be appropriate to use more measurement bases if that is necessary to provide useful information.

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Verifiability: Verifiability is enhanced by using measurement bases that result in measures that can be independently corroborated either directly, for example, by observing prices, or indirectly, for example, by checking inputs to a model. If a measure cannot be verified, users of financial statements may need explanatory information to enable them to understand how the measure was determined. In some such cases, it may be necessary to specify the use of a different measurement basis.

7.4 FACTORS SPECIFIC TO INITIAL MEASUREMENT OF AN ASSET OR A LIABILITY

As a general principle, the entities should use the same measurement basis for initial recognition and subsequent measurement. Let's look at the two possible scenarios of "at-market" transactions and "off-market" transactions.

7.4.1 Transactions on market terms

Transactions using currency (i.e. cash):

At initial recognition, the cost of an asset acquired, or of a liability incurred is normally similar to its fair value at that date, unless transaction costs are significant. Therefore, whether historical cost or current value is used as a measurement basis subsequently, the same basis is also normally appropriate at initial recognition.

Exchange of asset or liability

When an entity acquires an asset, or incurs a liability, in exchange for transferring another asset or liability, the initial measure of the asset acquired, or the liability incurred, determines whether any income or expenses arise from the transaction.

For example, if the asset transferred is carried for ₹ 100 in the books and the asset acquired is initially measured at fair value (because it is subsequently measured at fair value), of say ₹ 120, the difference of ₹ 20 is recognised in statement of profit and loss as an income. The reverse will apply for a liability.

Continuing with the example above, if the asset acquired is subsequently measured at cost, no income or expenses arise at initial recognition since the asset acquired is initially measured at cost which is the fair value of the asset transferred i.e. given up, unless income or expenses arise from the derecognition of the transferred asset or liability, or unless the asset is impaired or the liability is onerous.

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7.4.2 Transactions not on market terms (or off-market transactions)

Assets may be acquired, or liabilities may be incurred, as a result of an event that is not a transaction on market terms. For example:

(a) the transaction price may be affected by relationships between the parties;

(b) an asset may be granted to the entity free of charge by a government or

(c) an asset may be donated to the entity by another party;

(d) a liability may be imposed by legislation or regulation; or

(e) a liability to pay compensation or a penalty may arise from an act of wrongdoing.

In such cases, measuring the asset acquired, or the liability incurred, at its historical cost may not provide a faithful representation of the entity's assets and liabilities and of any income or expenses arising from the transaction or other event. Hence, it may be appropriate to measure the asset acquired, or the liability incurred, at deemed cost. In some such cases, a current value of the asset or liability is used as a deemed cost on initial recognition and that deemed cost is then used as a starting point for subsequent measurement at historical cost. Any difference between that deemed cost and any consideration given or received would be recognised as income or expenses at initial recognition.

Example 9

If a parent provides an interest free loan to its subsidiary, it is an off-market transaction. The loan, in parent's books, should be initially measured at its fair value and the difference between the loan given and its fair value should be appropriately accounted for (refer Ind AS 109).

When assets are acquired, or liabilities incurred, as a result of an event that is not a transaction on market terms, all relevant aspects of the transaction or other event need to be identified and considered. For example, it may be necessary to recognise other assets, other liabilities, contributions from holders of equity claims or distributions to holders of equity claims to faithfully represent the substance of the effect of the transaction or other event on the entity's financial position and any related effect on the entity's financial performance.

In the example given above, the difference shall be accounted for as an equity contribution (classified as "investments") in the books of the parent.

7.5 MORE THAN ONE MEASUREMENT BASIS

In some cases, consideration of the factors described in sections 7.3 and 7.4 above may lead to the conclusion that more than one measurement basis is needed for an asset or liability and for

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related income and expenses in order to provide relevant information that faithfully represents both the entity's financial position and its financial performance.

In most cases, the most understandable way to provide that information is:

(a) to use a single measurement basis both for the asset or liability in the balance sheet and for related income and expenses in the statement of profit and loss ; and

(b) to provide in the notes additional information applying a different measurement basis.

However, in some cases, that information is more relevant, or results in a more faithful representation of both the entity's financial position and its financial performance, through the use of:

(a) a current value measurement basis for the asset or liability in the balance sheet; and

(b) a different measurement basis for the related income and expenses in the profit or loss section of statement of profit and loss

Example 10

An entity may choose to measure an interest bearing financial asset at fair value through other comprehensive income. In this case, the total fair value change is separated and classified so that:

(a) the profit or loss section of statement of profit and loss includes the interest income applying the amortised cost as the measurement basis; and

(b) other comprehensive income includes all the remaining fair value changes.

For more details on the principles used in this example, refer to chapter on financial instruments.

Therefore, the principle for all such cases is stated as below:

The total income or total expenses arising in the period from the change in the current value of the asset or liability is separated and classified so that:

(a) the profit or loss section of statement of profit and loss includes the income or expenses measured applying the measurement basis selected for that statement; and

(b) other comprehensive income includes all the remaining income or expenses.

As a result, the accumulated other comprehensive income related to that asset or liability equals the difference between:

(i) the carrying amount of the asset or liability in the balance sheet; and

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(ii) the carrying amount that would have been determined applying the measurement basis selected for the profit or loss section of statement of profit and loss.

7.6 MEASUREMENT OF EQUITY

The total carrying amount of equity (total equity) is not measured directly. It equals the total of the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities.

What 'equity' in the financial statements does not represent?

The general purpose financial statements are not designed to show an entity's value. Hence, the total carrying amount of equity will not generally equal:

(a) the aggregate market value of equity claims on the entity;

(b) the amount that could be raised by selling the entity as a whole on a going concern basis; or

(c) the amount that could be raised by selling all of the entity's assets and settling all of its liabilities.

Although total equity is not measured directly, it may be appropriate to measure directly the carrying amount of some individual classes of equity and some components of equity. Nevertheless, because total equity is measured as a residual, at least one class of equity cannot be measured directly. Similarly, at least one component of equity cannot be measured directly.

The total carrying amount of an individual class of equity or component of equity is normally positive but can be negative in some circumstances. Similarly, total equity is generally positive, but it can be negative, depending on which assets and liabilities are recognised and on how they are measured.

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UNIT 8
PRESENTATION AND DISCLOSURE

A reporting entity communicates information about its assets, liabilities, equity, income and expenses by presenting and disclosing information in its financial statements.

8.1 PRESENTATION AND DISCLOSURE OBJECTIVES AND PRINCIPLES

To facilitate effective communication of information in financial statements, when developing presentation and disclosure requirements in Ind ASs a balance is needed between:

(a) giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses; and

(b) requiring information that is comparable, both from period to period for a reporting entity and in a single reporting period across entities.

Effective communication in financial statements is also supported by considering the following principles:

(a) entity-specific information is more useful than standardised descriptions; and

(b) duplication of information in different parts of the financial statements is usually unnecessary and can make financial statements less understandable.

8.2 CLASSIFICATION

Classification is the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes. Such characteristics include — but are not limited to — the nature of the item, its role (or function) within the business activities conducted by the entity, and how it is measured.

Classifying dissimilar assets, liabilities, equity, income or expenses together can obscure relevant information, reduce understandability and comparability and may not provide a faithful representation of what it purports to represent.

8.2.1 Classification of assets and liabilities

Classification is applied to the unit of account selected for an asset or liability. However, it may sometimes be appropriate to separate an asset or liability into components that have different

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characteristics and to classify those components separately. That would be appropriate when classifying those components separately would enhance the usefulness of the resulting financial information. For example, it could be appropriate to separate an asset or liability into current and non-current components and to classify those components separately.

8.2.2 Offsetting

Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the balance sheet. Offsetting classifies dissimilar items together and therefore is generally not appropriate.

Offsetting assets and liabilities differs from treating a set of rights and obligations as a single unit of account.

8.2.3 Classification of equity

To provide useful information, it may be necessary to classify equity claims separately if those equity claims have different characteristics.

Similarly, to provide useful information, it may be necessary to classify components of equity separately if some of those components are subject to particular legal, regulatory or other requirements. For example, in some jurisdictions, an entity is permitted to make distributions to holders of equity claims only if the entity has sufficient reserves specified as distributable. Separate presentation or disclosure of those reserves may provide useful information.

8.2.4 Classification of income and expenses

Classification is applied to:

(a) income and expenses resulting from the unit of account selected for an asset or liability; or

(b) components of such income and expenses if those components have different characteristics and are identified separately. For example, a change in the current value of an asset can include the effects of value changes and the accrual of interest (see tables in section 7.2). It would be appropriate to classify those components separately if doing so would enhance the usefulness of the resulting financial information.

8.2.5 Profit or loss and other comprehensive income

Income and expenses are classified and included either:

(a) in the profit or loss section of statement of profit and loss; or

(b) outside the profit or loss section of statement of profit and loss, in other comprehensive income.

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Because the profit or loss section of statement of profit and loss is the primary source of information about an entity's financial performance for the period, all income and expenses are, in principle, included in that statement. However, in formulating Ind AS, the ICAI may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the profit or loss section of statement of profit and loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period.

In principle, income and expenses included in other comprehensive income in one period are reclassified from other comprehensive income into the profit or loss section of statement of profit and loss in a future period when doing so results in the profit or loss section of statement of profit and loss providing more relevant information or providing a more faithful representation of the entity's financial performance for that future period. However, if, for example, there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should be reclassified, the ICAI may, in formulating Ind AS, decide that income and expenses included in other comprehensive income are not to be subsequently reclassified.

8.3 AGGREGATION

Aggregation is adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification.

Aggregation makes information more useful by summarising a large volume of detail. However, aggregation conceals some of that detail. Hence, a balance needs to be found so that relevant information is not obscured either by a large amount of insignificant detail or by excessive aggregation.

Different levels of aggregation may be needed in different parts of the financial statements. For example, typically, the balance sheet and the statement of profit and loss provide summarised information and more detailed information is provided in the notes.

Illustration 4:

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

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

Discuss whether the classification of Kanchenjunga Ltd. as held for sale and its presentation as a discontinued operation is appropriate, by referring to the principles of the relevant Ind AS and evaluating the treatment in the context of the Conceptual Framework for Financial Reporting.

Solution:

Kanchenjunga Ltd. is a disposal group in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations. Disposal group can be defined as a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

Para 6 of Ind AS 105 provides that a disposal group shall be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Ind AS 105 is particularly strict as far as the application of held for sale criteria is concerned, and often the decision to sell an asset or a disposal group is made well before the criteria are met.

Thus, as per Ind AS 105, for the asset (or disposal group) to be classified as held for sale, it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.

For the sale to be highly probable:

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

In the given case, the draft agreements and correspondence with investment bankers are not specific enough to fit in the points above to prove that the criteria for held for sale was met at that

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date. Additional information would be needed to confirm that the subsidiary was available for immediate sale, and that it was being actively marketed at an appropriate price so as to satisfy the criteria in the year to 31st March 20X2.

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

Conclusion:

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

Evaluation of treatment in context of the Conceptual Framework

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

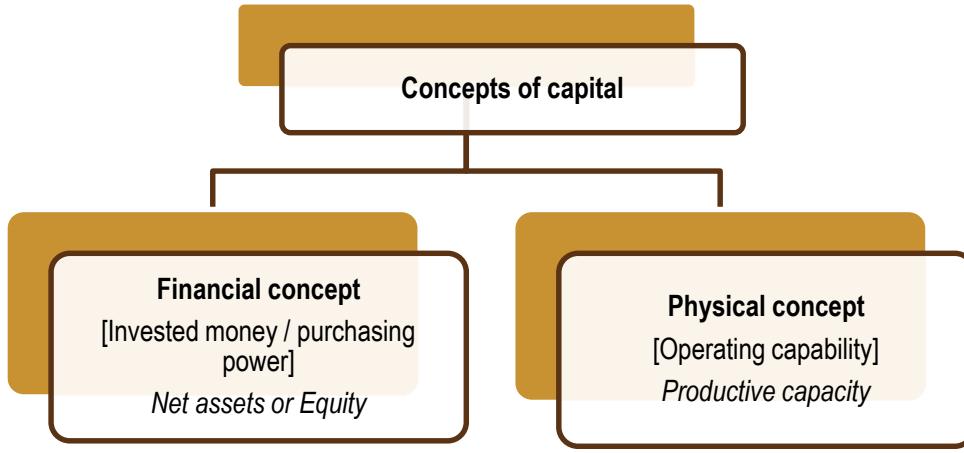
If a company has made a firm decision to sell the subsidiary, it could be argued that the subsidiary should be classified as discontinued operation, even if the criteria to classify it as 'held for sale' as per Ind AS 105 have not been met, because this information would be more useful to users. However,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

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UNIT 9
CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

9.1 CONCEPTS OF CAPITAL



The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the entity, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

9.2 CONCEPTS OF CAPITAL MAINTENANCE AND THE DETERMINATION OF PROFIT

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

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There are two concepts of capital maintenance:

- Financial capital maintenance: Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.
- Physical capital maintenance: Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity.

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

9.3 CAPITAL MAINTENANCE ADJUSTMENTS

The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves.

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Example 11

A trader commenced business on 1.1.20X1 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 20X1, he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Thus:

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

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

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

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

Example 12

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

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

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

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

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

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

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

Example 13 (Physical Capital Maintenance)

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

Current cost of opening stock = (₹ 12,000 / 100) x 125 = 6,000 x ₹ 2.50 = ₹ 15,000

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

Opening equity at closing current costs = ₹ 15,000

Closing equity at closing current costs = ₹ 9,000

Retained Profit = ₹ 9,000 – ₹ 15,000 = (-) ₹ 6,000

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

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

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

Financial Capital Maintenance at historical costs

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

Financial Capital Maintenance at current purchasing power:

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

Physical Capital Maintenance:

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

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TEST YOUR KNOWLEDGE

Question

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

   To: Directors of Jayant Ltd.

   Re: Measurement

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

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

Answer

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

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

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

The Conceptual Framework confirms the allowance of the usage of a mixed measurement approach in developing standards. The measurement methods included in the standards are

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

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

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

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NOTES

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CHAPTER 3

IND AS ON PRESENTATION OF GENERAL PURPOSE FINANCIAL STATEMENTS



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

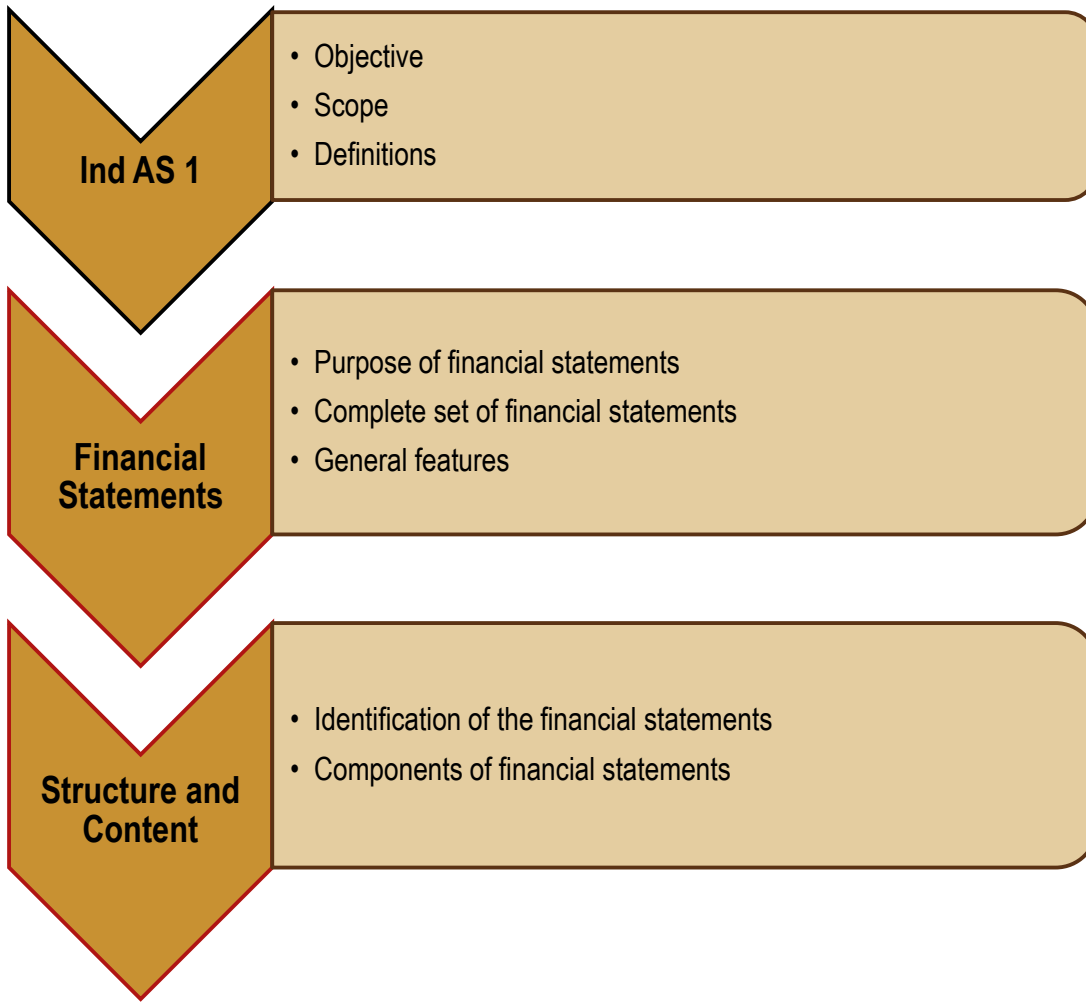
LEARNING OUTCOMES

After studying this unit, you will be able to:

- List the scope and objective of Ind AS 1
- Define the relevant terms used in Ind AS 1
- Explain the purpose of financial statements
- Illustrate the complete set of financial statements
- Describe the general features of the financial statements
- Follow the structure and content of the financial statements
- Identify the various components of financial statements
- Prepare the disclosures to be made in the financial statements
- Discuss the significant differences in Ind AS 1 vis-à-vis AS 1
- Reconcile the carve out in Ind AS 1 from IAS 1.

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UNIT OVERVIEW



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

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

1.2 OBJECTIVE

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

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

b) with the financial statements of other entities.

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

1.3 SCOPE

- This standard **applies** to all types of entities including those that present:
  - (a) consolidated financial statements in accordance with Ind AS 110 'Consolidated Financial Statements'; and
  - (b) separate financial statements in accordance with Ind AS 27 'Separate Financial Statements'.
- This standard **does not apply** to structure and content of condensed interim financial statements prepared in accordance with Ind AS 34 except for para 15 to 35 of Ind AS 1.
- This Standard uses terminology that is suitable for profit-oriented entities, including public sector business entities.

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- If entities with not for-profit activities in the private sector or the public sector apply this Standard, they may need to amend the descriptions used for line items in the financial statements and for the financial statements themselves.
- Similarly, entities that do not have equity as defined in Ind AS 32 Financial Instruments: Presentation (e.g. some mutual funds) and entities whose share capital is not equity (e.g. some co-operative entities) may need to adapt the financial statement presentation of members' or unit holders' interests.

1.4 DEFINITIONS

1. **Accounting policies** are defined in paragraph 5 of Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors, and the term is used in this Standard with the same meaning.
2. **General purpose financial statements** (referred to as 'financial statements') are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.
3. **Impracticable**: Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.
4. **Indian Accounting Standards (Ind AS)** are Standards prescribed under Section 133 of the Companies Act, 2013.
5. **Material**

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

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

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

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

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

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

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

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

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

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

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

6. **Notes** contain information in addition to that presented in the balance sheet, statement of profit and loss, other comprehensive income, statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements.

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

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

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

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

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

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

The components of Other Comprehensive Income include the following:

S.No.	Components	Reference
1.	Changes in revaluation surplus	Ind AS 16 'Property, Plant and Equipment' and Ind AS 38 'Intangible Assets'
2.	Re-measurements of defined benefit plans	Ind AS 19, Employee Benefits
3.	Gains and losses arising from translating the financial statements of a foreign operation	Ind AS 21 'The Effects of Changes in Foreign Exchange Rates'
4.	Gains and losses from investments in equity instruments designated at fair value through other comprehensive income	Paragraph 5.7.5 of Ind AS 109, Financial Instruments
5.	Gains and losses on financial assets measured at fair value through other comprehensive income	Paragraph 4.1.2A of Ind AS 109
6.	The effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income	Paragraph 5.7.5 of Ind AS 109
7.	For liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk	Paragraph 5.7.7 of Ind AS 109
8.	Changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and	Ind AS 109

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	designating as the hedging instrument only the changes in the intrinsic value	
9.	Changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument	Ind AS 109

1.5 PURPOSE OF FINANCIAL STATEMENTS

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

- assets;
- liabilities;
- equity;
- income and expenses, including gains and losses;
- contributions by and distributions to owners in their capacity as owners; and
- cash flows.

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

1.6 COMPLETE SET OF FINANCIAL STATEMENTS

A complete set of financial statements comprises:

- a balance sheet as at the end of the period;
- a statement of profit and loss for the period;
- statement of changes in equity for the period;

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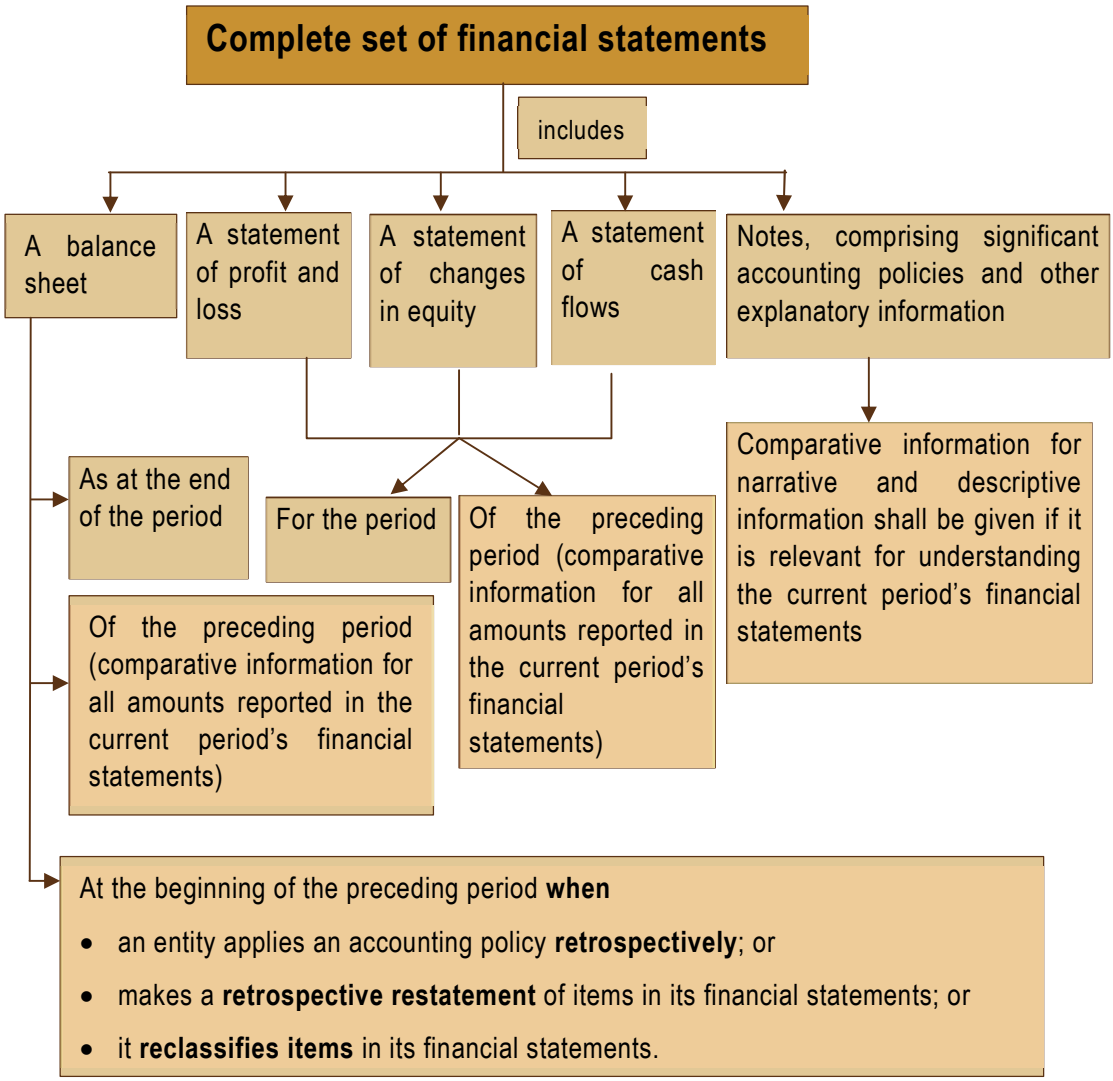
- a statement of cash flows for the period;
- notes, comprising material accounting policy information and other explanatory information;
- comparative information in respect of the preceding period;
- a balance sheet as at the beginning of the preceding period when an entity applies an accounting policy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

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

An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.

Many entities also present reports and statements (generally in annual reports) such as financial reviews by management, environmental reports, and value added statements that are outside the financial statements. Such reports and statements that are presented outside the financial statements are outside the scope of Ind AS.

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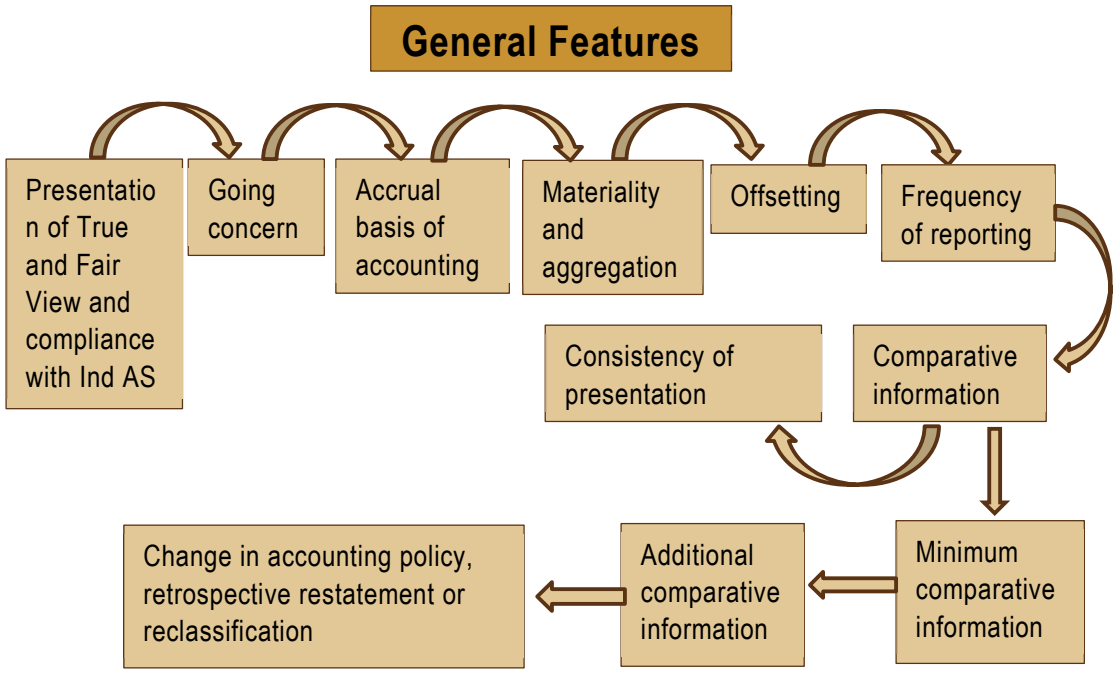


Note:

1. An entity shall present a single statement of profit and loss, with profit or loss and other comprehensive income (OCI) presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.
2. Reports and statements presented outside financial statements are outside the scope of Ind AS.
3. An entity is not required to present the related notes to the opening balance sheet as at the beginning of the preceding period.

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1.7 GENERAL FEATURES OF FINANCIAL STATEMENTS



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

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

1.7.1.1 An explicit and unreserved statement

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

An entity shall not describe financial statements as complying with Ind AS unless they comply with all the requirements of Ind AS. There may be disagreement between the Company and its auditor on the applicability of any Ind AS or any particular requirement of any Ind AS and accordingly auditor may qualify the audit report. Even in such a situation, the financial statements shall be assumed to be Ind AS compliant.

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In virtually all circumstances, presentation of a true and fair view is achieved by compliance with applicable Ind AS. Presentation of a true and fair view also requires an entity:

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

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

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

An extract from the annual report of Tata Consultancy Services Limited for the year ended 31st March, 2022:

Notes forming part of Standalone Financial Statements

2) Statement of compliance

These standalone financial statements have been prepared in accordance with the Indian Accounting Standards (referred to as "Ind AS") as prescribed under section 133 of the Companies Act, 2013 read with the Companies (Indian Accounting Standards) Rules as amended from time to time.

1.7.1.2 Inappropriate Accounting Policies

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

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

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

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

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

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

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

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

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

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

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

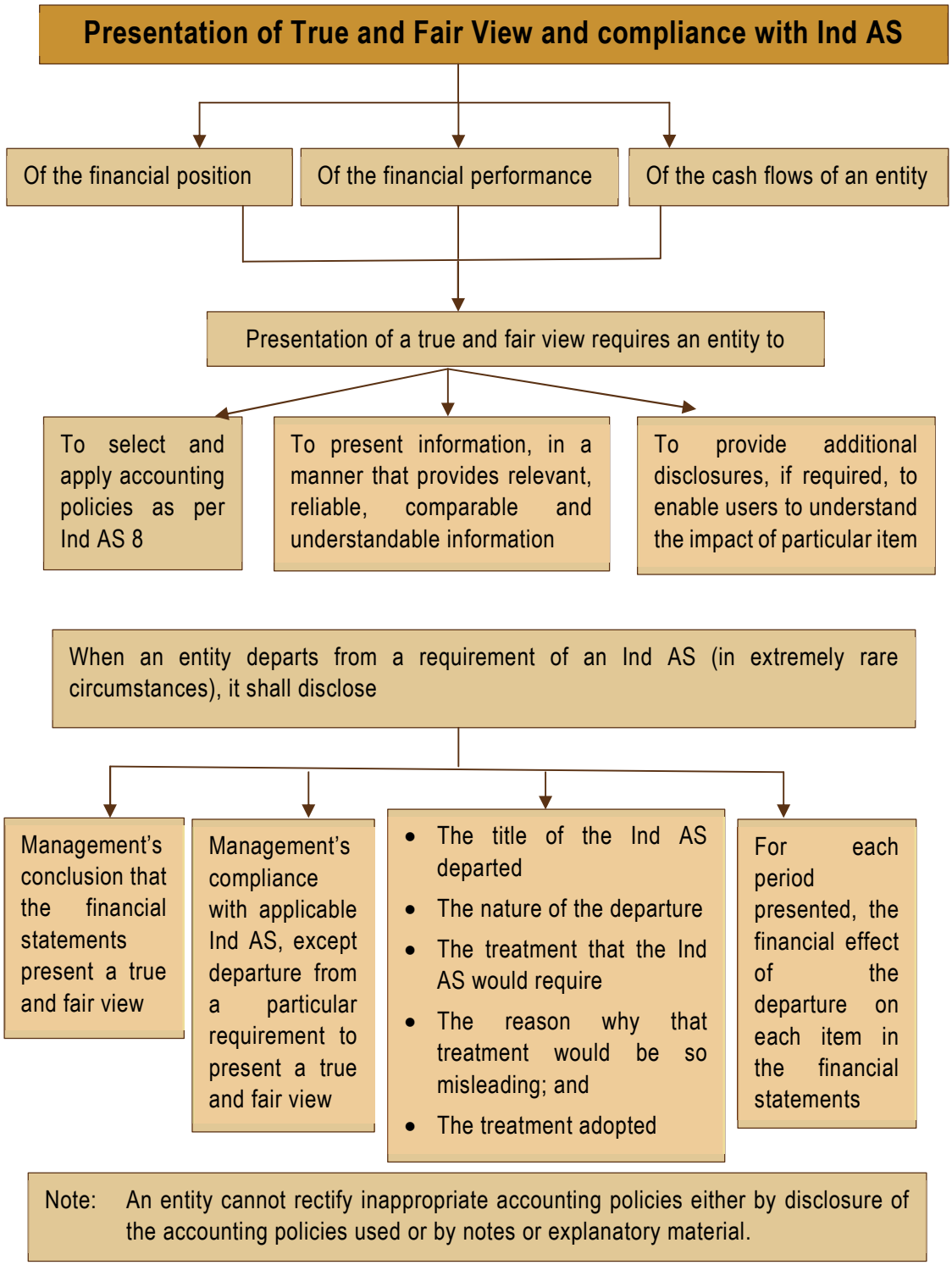
(b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to present a true and fair view.

An item of information would conflict with the objective of financial statements when it does not represent faithfully the transactions, other events and conditions that it either purports to represent or could reasonably be expected to represent and, consequently, it would be likely to influence economic decisions made by users of financial statements. When assessing whether complying with a specific requirement in an Ind AS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, management considers:

(a) why the objective of financial statements is not achieved in the particular circumstances; and

(b) how the entity's circumstances differ from those of other entities that comply with the requirement. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the Framework.

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Illustration 1

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

Solution

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

*****

1.7.2 Going concern

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

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

The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. This listing is neither all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists:

- Net liability or net current liability position;

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- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets;
- Indications of withdrawal of financial support by creditors;
- Negative operating cash flows indicated by historical or prospective financial statements;
- Adverse key financial ratios;
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows;
- Arrears or discontinuance of dividends;
- Inability to pay creditors on due dates;
- Inability to comply with the terms of loan agreements;
- Change from credit to cash-on-delivery transactions with suppliers;
- Inability to obtain financing for essential new product development or other essential investments;
- Loss of key management without replacement;
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s);
- Emergence of a highly successful competitor;
- Changes in law or regulation or government policy expected to adversely affect the entity.

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

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

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

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Illustration 2

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

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

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

Solution

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

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

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

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

Note 1: Basis of preparation

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

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

*****

1.7.3 Accrual basis of accounting

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

1.7.4 Materiality and aggregation

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

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that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.

- An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.
- An entity need not provide a specific disclosure required by an Ind AS if the information is not material except when required by law.

Examples 1 - 3

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

*****

1.7.5 Offsetting

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

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Examples 4 and 5

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

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

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

Illustration 3

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

Solution

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

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

*****

1.7.6 Frequency of reporting

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

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Example 6

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

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

Note 1

Basis of preparation and accounting policies

Reporting period

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

1.7.7 Comparative information

1.7.7.1 Minimum comparative information

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

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

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

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1.7.7.2 Additional comparative information

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

Example 7

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

Illustration 4

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

Solution

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

*****

1.7.7.3 Change in accounting policy, retrospective restatement or reclassification

- When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements and the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period, it shall present, as a minimum, three balance sheets, two of each of the other statements, and related notes. An entity presents balance sheets as at
  - ♦ the end of the current period,

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- ♦ the end of the preceding period, and
- ♦ the beginning of the preceding period.

- When an entity is required to present an additional balance sheet as at the beginning of the preceding period, it must disclose the information as required by Ind AS 8 and also the information as explained in subsequent points. However, it need not present the related notes to the opening balance sheet as at the beginning of the preceding period.
- When the entity changes the presentation or classification of items in its financial statements, the entity shall reclassify comparative amounts unless reclassification is impracticable.
- When the entity reclassifies comparative amounts, the entity shall disclose:
  - ♦ the nature of the reclassification;
  - ♦ the amount of each item or class of items that is reclassified; and
  - ♦ the reason for the reclassification.
- When it is impracticable to reclassify comparative amounts, an entity shall disclose:
  - ♦ the reason for not reclassifying the amounts, and
  - ♦ the nature of the adjustments that would have been made if the amounts had been reclassified.

1.7.8 Consistency of presentation

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

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

Example 8

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

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1.8 STRUCTURE AND CONTENT

Ind AS 1 requires particular disclosures in the balance sheet or in the statement of profit and loss, or in the statement of changes in equity and requires disclosure of other line items either in those statements or in the notes. Ind AS 7, Statement of Cash Flows, sets out requirements for the presentation of cash flow information.

1.8.1 Identification of Financial Statements

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

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

    As per Schedule III of the Companies Act 2013, depending upon the total income of the company, the figures appearing in the financial statements shall be rounded off as below:

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- Less than one hundred crore rupees - To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
- One hundred crore rupees or more- To the nearest, lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

1.8.2 Balance Sheet

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

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

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p	Liabilities included in disposal groups classified as held for sale in accordance with Ind AS 105
q	Non-controlling interests, presented within equity
r	Issued capital and reserves attributable to owners of the parent

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

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

Example 9

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

1.8.2.1 Distinction between Current / Non-current

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

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

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

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

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

b) more than twelve months after the reporting period.

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

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to be realised within the current operating cycle, and liabilities that are due for settlement within the same period.

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

Note:

1. Financial institutions may present assets and liabilities in increasing or decreasing order of liquidity if the presentation is reliable and more relevant than a current / non-current presentation. This is because such entity does not supply goods or services within a clearly identifiable operating cycle.
2. An entity is permitted to present some of its assets and liabilities using a current / non-current classification and others in order of liquidity. The need for a mixed basis of presentation might arise when an entity has diverse operations.

1.8.2.2 Current Assets

An entity shall classify an asset as current when:

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

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

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

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

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

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

An extract from the annual report of Reliance Industries Limited for the year ended 31st March, 2022:

Notes to the Standalone Financial Statements for the year ended 31st March, 2022

B.2 Summary of Significant Accounting Policies

(a) Current and Non-current Classification

The Company presents assets and liabilities in the Balance Sheet based on Current/ Non-Current classification.

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An asset is treated as current when it is –

- Expected to be realised or intended to be sold or consumed in normal operating cycle;

- Held primarily for the purpose of trading;

- Expected to be realised within twelve months after the reporting period, or

- Cash or cash equivalent unless restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

All other assets are classified as non-current.

Deferred tax assets and liabilities are classified as non-current assets and liabilities.

1.8.2.3 Operating Cycle

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

For example

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

Examples 10 -13

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

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

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

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

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

12. On 31st December 20X2, an entity replaced a machine in its production line. The replaced machine was sold to a competitor for ₹ 3,00,000. Payment is due 15 months after the end of the reporting period.

The receivable is a non-current asset because:

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

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

13. On 1st April, 20X2, XYZ Ltd invested ₹ 15,00,000 surplus funds in corporate bonds that bear interest at 8 percent per year. Interest is payable on the corporate bonds on 1st April, of each year. The principal is repayable in three annual instalments of ₹ 5,00,000 starting from 1st April, 20X3.

In its statement of financial position at 31st March, 20X3, the entity must present the ₹ 1,20,000 accrued interest and ₹ 5,00,000 current portion of the non-current loan (i.e. the portion repayable on 31st March, 20X3) as current assets because they are expected to be realised within twelve months of the end of the reporting period.

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

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Illustration 5

X Ltd. provides you the following information:

Raw material stock holding period	*: 3 months*
Work-in-progress holding period	*: 1 month*
Finished goods holding period	*: 5 months*
Debtors collection period	*: 5 months*

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

Solution

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

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

*****

Illustration 6

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

Solution

These should be classified as current.

*****

Illustration 7

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

(a) What is the length of operating cycle?

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

Solution

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

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

*****

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1.8.2.4 Current Liabilities

- An entity shall classify a liability as current when:

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

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

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

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

An extract from the annual report of Reliance Industries Limited for the year ended 31st March, 2022:

Notes to the Standalone Financial Statements for the year ended 31st March, 2022

B.2 Summary of Significant Accounting Policies

(a) Current and Non-Current Classification

The Company presents assets and liabilities in the Balance Sheet based on Current/ Non-Current classification.

A liability is current when:

- *It is expected to be settled in normal operating cycle;*
- *It is held primarily for the purpose of trading;*
- *It is due to be settled within twelve months after the reporting period, or*
- *There is no unconditional right to defer the settlement of the liability for at least twelve months after the reporting period.*

The Company classifies all other liabilities as non-current.

Deferred tax assets and liabilities are classified as non-current assets and liabilities.

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

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

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

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

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and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

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

Illustration 8

On 1st April, 20X3, Charming Ltd issued 1,00,000 ₹ 10 bonds for ₹ 10,00,000. On 1st April, each year interest at the fixed rate of 8 percent per year is payable on outstanding capital amount of the bonds (ie the first payment will be made on 1st April, 20X4). On 1st April each year (i.e from 1st April, 20X4), Charming Ltd has a contractual obligation to redeem 10,000 of the bonds at ₹ 10 per bond. In its statement of financial position at 31st March, 20X4. How should this be presented in the financial statements?

Solution

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

*****

Illustration 9

X Ltd provides you the following information:

Raw material stock holding period : 3 months

Work-in-progress holding period : 1 month

Finished goods holding period : 5 months

Debtors collection period : 5 months

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

Solution

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

*****

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Illustration 10

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

Solution

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

*****

Illustration 11

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

(a) Electricity Deposit

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

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

Solution

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

(b) **Tender Deposit/Earnest Money Deposit [EMD] -**Generally, tender deposit / EMD are paid for participation in various bids. They normally become recoverable if the entity does not win the bid. Bid dates are known at the time of tendering the deposit. But until the date of the actual bid, one is not in a position to know if the entity is winning the bid or otherwise.

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Accordingly, depending on the terms of the deposit if entity expects to realise the deposit within a period of twelve months, it should be classified as current otherwise non-current.

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

*****

Illustration 12

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

Solution

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

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

*****

Illustration 13

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

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

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

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

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

Solution

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

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

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

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

*****

Illustration 14

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

The bank cannot demand immediate repayment during the grace period. The annual reporting period of the entity ends on 31st March, 20X2.

(a) As on 31st March, 20X2, how should the entity classify the loan?

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(b) Assume that in anticipation that it may not be able to get the promoter's contribution by due date, in February 20X2, the entity approached the bank and got the compliance date extended up to 30th June, 20X2 for getting promoter's contribution. In this case will the loan classification as on 31st March, 20X2 be different from (a) above?

Solution

(a) Paragraph 75 of Ind AS 1, inter alia, provides, "An entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment." In the present case, following the default, grace period within which an entity can rectify the breach is less than twelve months after the reporting period. Hence as on 31st March 20X2, the loan will be classified as current.

(b) Ind AS 1 deals with classification of liability as current or non-current in case of breach of a loan covenant and does not deal with the classification in case of expectation of breach. In this case, whether actual breach has taken place or not is to be assessed on 30th June 20X2, i.e., after the reporting date. Consequently, in the absence of actual breach of the loan covenant as on 31st March 20X2, the loan will retain its classification as non-current.

*****

Illustration 15

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

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

Solution

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

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

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

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

*****

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

- An entity shall disclose, either in the balance sheet or in the notes, further sub-classifications of the line items presented, classified in a manner appropriate to the entity's operations.
- The detail provided in sub-classifications depends on the requirements of Ind AS and on the size, nature and function of the amounts involved. The disclosures vary for each item, for example:
  - (i) items of property, plant and equipment are disaggregated into classes in accordance with Ind AS 16;
  - (ii) receivables are disaggregated into amounts receivable from trade customers, receivables from related parties, prepayments and other amounts;
  - (iii) inventories are disaggregated, in accordance with Ind AS 2, Inventories, into classifications such as merchandise, production supplies, materials, work in progress and finished goods;
  - (iv) provisions are disaggregated into provisions for employee benefits and other items; and
  - (v) equity capital and reserves are disaggregated into various classes, such as paid-in capital, share premium and reserves.
- An entity shall disclose the following, either in the balance sheet or in the statement of changes in equity which is part of the balance sheet, or in the notes:
  - (i) for each class of share capital:
    - (a) the number of shares authorised;
    - (b) the number of shares issued and fully paid, and issued but not fully paid;
    - (c) par value per share, or that the shares have no par value;
    - (d) a reconciliation of the number of shares

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

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

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

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

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

Illustrated format of Balance Sheet

Balance Sheet (with hypothetical figures given for ease in understanding) ₹ '000

	As at 31st March 20X6	As at 31st March 20X5
Assets		
Non-current Assets		
Property, plant and equipment	1,37,048	97,023
Capital work in progress	17,450	3,100
Investment property	7,419	7,179
Goodwill	8,670	4,530
Other Intangible Assets	12,033	10,895
Intangible assets under development	2,365	1,965
Financial assets		
Investments	38,576	32,416
Loans	1,033	850
Trade Receivables	3,238	2,376
Deferred tax assets (net)	4,598	2,774
Other non-current assets	21,586	10,565
Total Non-Current Assets (A)	2,54,016	1,73,673

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Current Assets			
Inventories		67,878	61,062
Financial assets			
Loans		623	546
Trade receivables		30,712	30,078
Derivative instruments			
Cash and cash equivalents		25,031	7,035
Investments		10,695	9,170
Other financial assets		2,856	2,093
Prepayments		459	543
		1,38,254	1,10,527
Assets classified as held for sale		220	19,310
Total Current Assets	(B)	1,38,474	1,29,837
Total Assets	(A+B)	3,92,490	3,03,510

	As at 31st March 20X6	As at 31st March 20X5
Equity and liabilities		
Equity		
Equity share capital	22,400	12,600
Other equity		
Equity component of compound financial instruments	372	
Reserves and surplus	2,16,092	1,60,796
Other reserves	4,233	3,215
Equity attributable to equity holders of the parent	2,43,097	1,76,611
Non-Controlling interest	24,742	16,248
Total equity (C)	2,67,839	1,92,859

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Non-current liabilities			
Financial liabilities			
Borrowings		41,455	35,565
Other financial liabilities		1,670	199
Long term provision		241	91
Deferred Income - Government grants		2,352	2,550
Net employee defined benefit liabilities		7,296	5,076
Deferred tax liabilities (net)		12,085	9,864
Other non-current liabilities			
Total non-current liabilities	(D)	65,099	53,345
Current Liabilities			
Financial liabilities			
Borrowings		2,807	2,685
Trade payables (Other than micro enterprises and small enterprises)		38,011	28,977
Other current financial liabilities		8,909	8,837
Deferred income - Government grants		938	1,017
Employee benefit obligations		430	378
Deferred revenue		4,152	3,986
Liabilities for current tax (net)		2,803	1,905
Provisions		1,502	531
Liabilities directly associated with the assets classified as held for distribution			8,990
Total current liabilities	(E)	59,552	57,306
Total liabilities	(F=D+E)	1,24,651	1,10,651
Total equity and liabilities	(C+F)	3,92,490	3,03,510

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1.8.3 Statement of Profit and Loss

- The statement of profit and loss shall present, in addition to the profit or loss and other comprehensive income sections:

  (a) profit or loss;

  (b) total other comprehensive income;

  (c) comprehensive income for the period, being the total of profit or loss and other comprehensive income.

- An entity shall present (in case of consolidated statement of profit and loss) the following items as allocation of profit or loss and other comprehensive income for the period:

  (a) profit or loss for the period attributable to:

    (i) non-controlling interests, and

    (ii) owners of the parent.

  (b) comprehensive income for the period attributable to:

    (i) non-controlling interests, and

    (ii) owners of the parent.

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

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

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

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

(c) finance costs;

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

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

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

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between the previous amortised cost of the financial asset and its fair value at the reclassification date;

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

(h) tax expense;

(i) a single amount for the total discontinued operations

1.8.3.2 Information to be presented in the Other Comprehensive Income section

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

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

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

- An entity shall present additional line items, headings and subtotals in the statement of profit and loss, when such presentation is relevant to an understanding of the entity's financial performance.

- When an entity presents subtotals, those subtotals shall:

  (a) be comprised of line items made up of amounts recognised and measured in accordance with Ind AS;

  (b) be presented and labelled in a manner that makes the line items that constitute the sub total clear and understandable;

  (c) be consistent from period to period; and

  (d) not be displayed with more prominence than the subtotals and totals required in Ind AS for the statement of profit and loss.

- An entity shall present the line items in the statement of profit and loss that reconcile any sub totals presented with the subtotals or totals required in Ind AS for such statement.

- An entity shall not present any items of income or expense as extraordinary items, in the statement of profit and loss or in the notes.

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1.8.3.3 Profit or loss for the period

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

Illustrative format of Statement of Profit and Loss *(only profit or loss section of statement of profit and loss)*

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

	31st March 20X6	31st March 20X5
	₹ '000	₹ '000
Revenue from operations	6,33,124	4,86,316
Other Income	6,704	6,676
Total Income	**6,39,828**	**4,92,992**
Expenses		
Cost of raw material consumed	2,43,929	2,34,262
Purchase of stock-in-trade	56,300	51,700
(Increase)/decrease in inventories of finished goods, Stock-in-Trade and work-in-progress	2,895	(2,587)
Employee benefits expenses	80,998	69,962
Finance costs	3,085	2,963
Depreciation and amortisation expense	10,147	8,534
Impairment of non-current assets	480	790
Other expenses	15,308	9,065
Total Expense	**4,13,142**	**3,74,689**
Profit/(loss) before exceptional items and tax	2,26,686	1,18,303
Exceptional items	(2,856)	
Profit / (loss) before tax from operations	2,23,830	1,18,303

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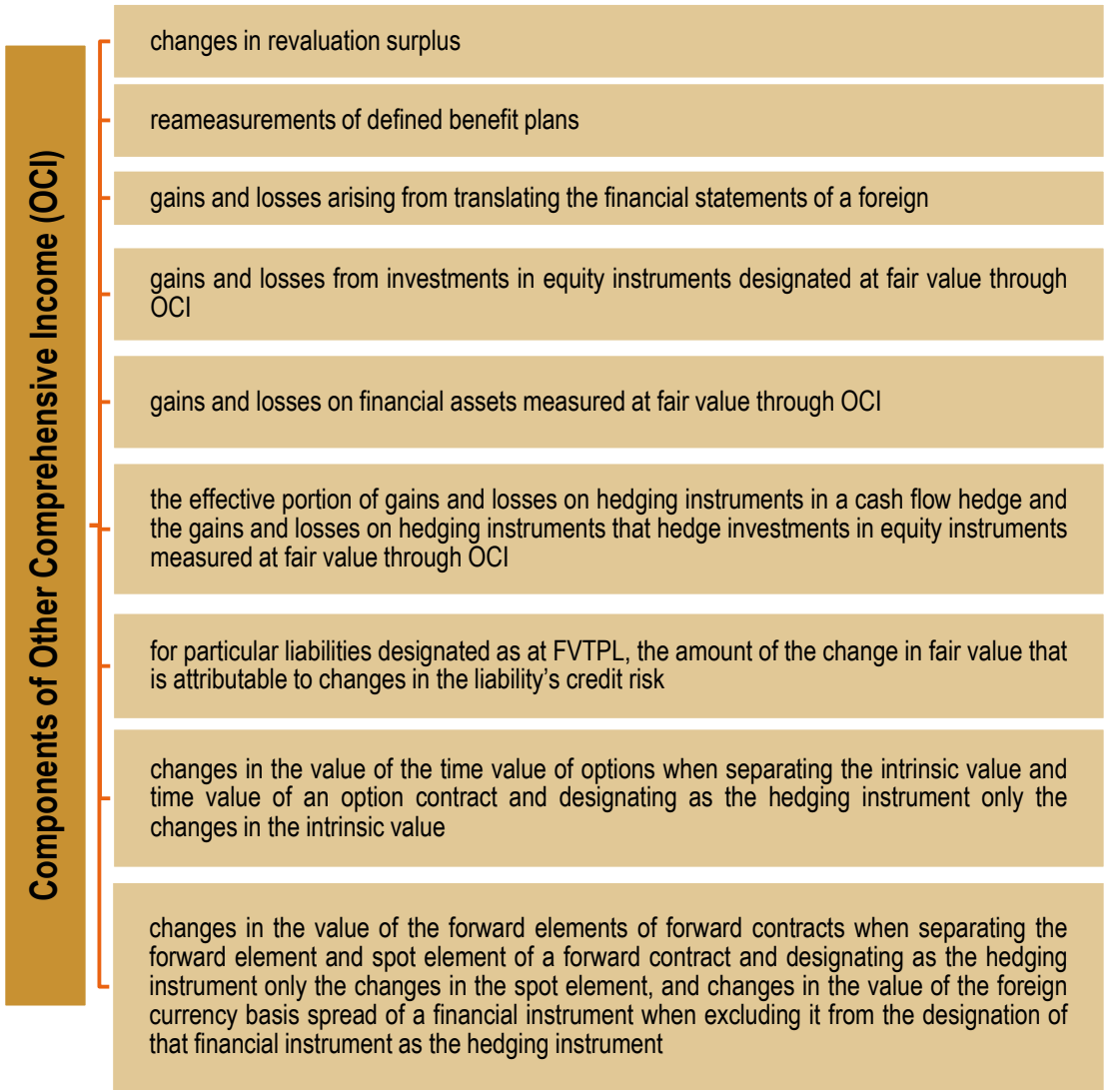
a) Current tax	5,388	4,474
b) Deferred tax	427	(746)
Income tax expense	5,815	3,728
Profit / (loss) for the year	2,18,015	1,14,575
Profit for the year attributable to*		
Equity holders of the parent	2,11,475	1,11,138
Non-controlling interest	6,540	3,437

* To be given in case of consolidated statement of profit and loss.

1.8.3.4 Other comprehensive income for the period

- With regard to other comprehensive income for the period, the Standard requires to disclose the amount of income tax relating to each item of other comprehensive income, including reclassification adjustments, either in the statement of profit and loss or in the notes.
- An entity may present items of other comprehensive income either:
  (a) net of related tax effects, or
  (b) before related tax effects with one amount shown for the aggregate amount of income tax relating to those items.
- The Standard further prescribes that an entity should disclose reclassification adjustments relating to components of other comprehensive income.
- Other Ind AS specify whether and when amounts previously recognised in other comprehensive income are reclassified to profit or loss. Such reclassifications are referred to in this Standard as reclassification adjustments.
- A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss.

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Example 14

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

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

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

- An entity may present reclassification adjustments in the statement of profit and loss or in the notes. An entity presenting reclassification adjustments in the notes presents the items of other comprehensive income after any related reclassification adjustments.

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- Reclassification adjustments arise, for example, on disposal of a foreign operation (see Ind AS 21), and when some hedged forecast cash flows affect profit or loss (see paragraph 6.5.11(d) of Ind AS 109 in relation to cash flow hedges).
- Reclassification adjustments do not arise on changes in revaluation surplus recognised in accordance with Ind AS 16 or Ind AS 38 or on re-measurements of defined benefit plans recognised in accordance with Ind AS 19. These components are recognised in other comprehensive income and are not reclassified to profit or loss in subsequent periods. Changes in revaluation surplus may be transferred to retained earnings in subsequent periods as the asset is used or when it is derecognised (see Ind AS 16 and Ind AS 38). In accordance with Ind AS 109, reclassification adjustments do not arise if a cash flow hedge or the accounting for the time value of an option (or the forward element of a forward contract or the foreign currency basis spread of a financial instrument) result in amounts that are removed from the cash flow hedge reserve or a separate component of equity, respectively, and included directly in the initial cost or other carrying amount of an asset or a liability. These amounts are directly transferred to assets or liabilities.

Illustrative format of other Comprehensive Income

	31.3.20X6	31.3.20X5
	₹ '000	₹ '000
Other comprehensive income to be reclassified to profit and loss in subsequent periods		
Net gain on hedge of a net investment	467	300
Income tax effect	(156)	(100)
	311	**200**
Exchange differences on translation of foreign operations	(590)	(281)
Income tax effect	0	0
	(590)	**(281)**
Net movement on cash flow hedges	(1757)	80
Income tax effect	528	(22)
	(1229)	**58**
Net gain / (loss) through FVTOCI debt securities	(115)	7

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Income tax effect	36	(2)
	(79)	**5**
Net other comprehensive income to be reclassified to profit or loss in subsequent periods	**(1587)**	**(18)**
Other comprehensive income not to be reclassified to profit or loss in subsequent periods		
Re-measurement gains /(losses) on defined benefit plans	886	(933)
Income tax effect	(269)	278
	617	**(655)**
Revaluation of land and building	2030	
Income tax effect	(610)	
	1420	**0**
Net loss / (gain) through FVTOCI equity securities	(24)	
Income tax effect	7	
	(17)	
Net other comprehensive income not to be classified to profit or loss in subsequent periods	2020	(655)
Other comprehensive income for the year, net of tax	**433**	**(673)**
Total comprehensive income for the year attributable to*		
Equity holders of the parent	2,11,908	1,10,465
Non-controlling interest	6,540	3,437

*To be given in case of consolidated statement of profit and loss.

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

- When items of income or expense are material, an entity shall disclose their nature and amount separately.

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- Circumstances that would give rise to the separate disclosure of items of income and expense include:

  (a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;

  (b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;

  (c) disposals of items of property, plant and equipment;

  (d) disposals of investments;

  (e) discontinued operations;

  (f) litigation settlements; and

  (g) other reversals of provisions.

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

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

1.8.4 Statement of Changes in Equity

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

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

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

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

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

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

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

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

*For the purpose of convenience, the movement has been given only for one year. However as per the requirement, the similar reconciliation is also required from 31st March, 20X4 to 31st March, 20X5 as comparatives in the Statement of changes in equity.

1.8.5 Statement of Cash Flows

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

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1.8.6 Notes

1.8.6.1 Structure

The notes shall:

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

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

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

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

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

Examples of systematic ordering or grouping of the notes include:

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

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

(c) Notes may be in the following order:

  (i) statement of compliance with Ind AS;

  (ii) material accounting policy information;

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

  (iv) other disclosures, including:

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

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

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

1.8.6.2 Disclosure of accounting policies

An entity shall disclose material accounting policy information. Accounting policy information is material if, when considered together with other information included in an entity's financial statements, it can reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements.

Accounting policy information that relates to immaterial transactions, other events or conditions is immaterial and need not be disclosed. Not all accounting policy information relating to material transactions, other events or conditions is itself material.

An entity is likely to consider accounting policy information material to its financial statements if that information relates to material transactions, other events or conditions and:

(a) the entity changed its accounting policy during the reporting period and this change resulted in a material change to the information in the financial statements;

(b) the entity chose the accounting policy from one or more options permitted by Ind AS

(c) the accounting policy was developed in accordance with Ind AS 8 in the absence of an Ind AS that specifically applies;

(d) the accounting policy relates to an area for which an entity is required to make significant judgements or assumptions in applying an accounting policy, and the entity discloses those judgements or assumptions; or

(e) the accounting required for them is complex and users of the entity's financial statements would otherwise not understand those material transactions, other events or conditions—such a situation could arise if an entity applies more than one Ind AS to a class of material transactions.

Accounting policy information that focuses on how an entity has applied the requirements of the Ind AS to its own circumstances provides entity-specific information that is more useful to users of financial statements than standardised information, or information that only duplicates or summarises the requirements of the Ind AS.

If an entity discloses immaterial accounting policy information, such information shall not obscure material accounting policy information.

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An entity's conclusion that accounting policy information is immaterial does not affect the related disclosure requirements set out in other Ind AS.

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

1.8.6.3 Sources of estimation uncertainty

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

1.8.6.4 Capital

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

Examples 15 -17

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

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

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₹

	31.3.20X6	31.3.20X5
Borrowings other than convertible preference shares	1,44,201	1,57,506
Trade payables	1,26,489	1,36,563
Other payables	13,506	12,693
Less : Cash and cash equivalents	(1,18,362)	(1,05,615)
Net debt	**1,65,834**	**2,01,147**
Convertible preference shares	20,001	19,038
Equity	4,29,600	3,37,000
Total Capital	**4,49,601**	**3,56,038**
Capital and net debt	**6,15,435**	**5,57,185**
Gearing ratio	27	36

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

16. **Capital Allocation Policy**: The Board reviewed and approved a revised Capital Allocation Policy of the Company after taking into consideration the strategic and operational cash requirements of the Company in the medium term.

The key aspects of the Capital Allocation Policy are:

1. The Company's current policy is to pay dividends of up to 50% of post-tax profits of the Financial Year. Effective from Financial Year 20X1, the Company expects to payout up to 70% of the free cash flow* of the corresponding Financial Year in such manner (including by way of dividend and/or share buyback) as may be decided by the Board from time to time, subject to applicable laws and requisite approvals, if any.

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2. In addition to the above, the Board has identified an amount of upto ₹ 13,000 crore ($2 billion)** to be paid out to shareholders during Financial Year 20X1, in such manner (including by way of dividend and/ or share buyback), to be decided by the Board, subject to applicable laws and requisite approvals, if any. Further announcements in this regard will be made, as appropriate, in due course

*Free cash flow is defined as net cash provided by operating activities less capital expenditure as per the consolidated statement of cash flows prepared under Ind AS.

**USD/Rupee exchange rate as on 31st March, 20X0 was 65.

17. The groups' objective when managing capital are to:

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

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

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

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

1.8.6.5 Puttable financial instruments classified as equity

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

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

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

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

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

1.8.6.6 Other disclosures

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

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

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

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

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

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

(a) An extract from the annual report of Tata Consultancy Services Limited for the year ended 31st March, 2022:

Notes forming part of Standalone Financial Statements

1) Corporate information

Tata Consultancy Services Limited (referred to as "TCS Limited" or "the Company") provides IT services, consulting and business solutions and has been partnering with many of the world's largest businesses in their transformation journeys. The Company offers a consulting-led, cognitive powered, integrated portfolio of IT, business and engineering services and solutions. This is delivered through its unique Location-Independent Agile delivery model, recognised as a benchmark of excellence in software development.

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The Company is a public limited company incorporated and domiciled in India. The address of its corporate office is TCS House, Raveline Street, Fort, Mumbai - 400001. As at 31st March, 2022, Tata Sons Private Limited, the holding company owned 72.27% of the Company's equity share capital.

The Board of Directors approved the standalone financial statements for the year ended 31st March, 2022 and authorised for issue on 11th April, 2022.

(b) An extract from the annual report of Tata Consultancy Services Limited for the year ended 31st March, 2022:

Overview and notes to the standalone financial statements

1. Overview

1.1 Company overview

Infosys Limited ("the Company" or Infosys) provides consulting, technology, outsourcing and next-generation digital services, to enable clients to execute strategies for their digital transformation. Infosys strategic objective is to build a sustainable organization that remains relevant to the agenda of clients, while creating growth opportunities for employees and generating profitable returns for investors. Infosys strategy is to be a navigator for our clients as they ideate, plan and execute on their journey to a digital future.

The Company is a public limited company incorporated and domiciled in India and has its registered office at Electronic city, Hosur Road, Bengaluru 560100, Karnataka, India. The Company has its primary listings on the BSE Ltd. and National Stock Exchange of India Limited. The Company's American Depositary Shares (ADS) representing equity shares are listed on the New York Stock Exchange (NYSE).

The Standalone financial statements are approved for issue by the Company's Board of Directors on 13th April 2022.

Illustration 16

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

Particulars	31st March, 20X1	31st March, 20X0
ASSETS		
Cash	250	170

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Cash equivalents	*70*	*30*
Non-controlling interest's share of profit for the year	*160*	*150*
Dividend declared and paid by A Limited	*90*	*70*
Accounts receivable	*2,300*	*1,800*
Inventory at cost	*1,500*	*1,650*
Inventory at fair value less cost to complete and sell	*180*	*130*
Investment property	*3,100*	*3,100*
Property, plant and equipment (PPE) at cost	*5,200*	*4,700*
Total	***12,850***	***11,800***
	₹	₹
CLAIMS AGAINST ASSETS		
Long term debt (₹ 500 crores due on 1st January each year)	*3,300*	*3,885*
Interest accrued on long term debt (due in less than 12 months)	*260*	*290*
Share Capital	*1,130*	*1,050*
Retained earnings at the beginning of the year	*1,875*	*1,740*
Profit for the year	*1,200*	*830*
Non-controlling interest	*830*	*540*
Accumulated depreciation on PPE	*1,610*	*1,240*
Provision for doubtful receivables	*200*	*65*
Trade payables	*880*	*790*
Accrued expenses	*15*	*30*
Warranty provision (for 12 months from the date of sale)	*600*	*445*
Environmental restoration provision (restoration expected in 20X6)	*765*	*640*
Provision for accrued leave (due within 12 months)	*35*	*25*
Dividend payable	*150*	*230*
Total	***12,850***	***11,800***

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

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Solution

A Limited

Consolidated Balance Sheet as at 31st March 20X1

(₹ in crores)

Particulars	Note	31.3.20X1	31.3.20X0
ASSETS			
Non-current assets			
(a) Property, plant and equipment	1	3,590	3,460
(b) Investment property		3,100	3,100
Total non-current assets		**6,690**	**6,560**
Current assets			
(a) Inventory	2	1,680	1,780
(b) Financial assets			
(i) Trade and other receivables	3	2,100	1,735
(ii) Cash and cash equivalents	4	320	200
Total current assets		**4,100**	**3,715**
Total assets		**10,790**	**10,275**
EQUITY & LIABILITIES			
Equity attributable to owners of the parent			
Share capital		1,130	1,050
Other Equity	5	2,825	2,350
Non-controlling interests		**830**	**540**
Total equity		**4,785**	**3,940**
LIABILITIES			
Non-current liabilities			
(a) Financial Liabilities			
Borrowings - Long-term debt	6	2,800	3,385

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(b) Provisions			
Long-term provisions (environmental restoration)		765	640
Total non-current liabilities		**3,565**	**4,025**
Current liabilities			
(a) Financial Liabilities			
(i) Trade and other payables (Other than micro enterprises and small enterprises)	7	895	820
(ii) Current portion of long-term debt	8	500	500
(iii) Interest accrued on long-term debt		260	290
(iv) Dividend payable		150	230
(b) Provisions			
(i) Warranty provision		600	445
(ii) Other short-term provisions		35	25
Total current liabilities		**2,440**	**2,310**
Total liabilities		**6,005**	**6,335**
Total equity and liabilities		**10,790**	**10,275**

Working Notes:

Notes	Particulars	Basis	Calculation ₹ crores	Amount ₹ crores
1	Property, plant and equipment	Property, plant and equipment (PPE) at cost *less* Accumulated (depreciation on PPE	5,200 – 1,610 (4,700 – 1,240)	3,590 (3,460)
2	Inventory	Inventory at cost *add* Inventory at fair value less cost to complete and sell	1,500 + 180 (1,650 + 130)	1,680 (1,780)

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3	Trade and other receivables	Accounts receivable *less* Provision for doubtful receivables	2,300 – 200 (1,800 – 65)	2,100 (1,735)
4	Cash and cash equivalents	Cash and Cash equivalents	250 + 70 (170 + 30)	320 (200)
5	Other Equity	Retained earnings at the beginning of the year *add* Profit for the year *less* Non-controlling interest's share of profit for the year *less* Dividend declared by A Limited	1,875 + 1,200– 160 – 90 (1,740 + 830 – 150 – 70)	2,825 (2,350)
6	Long-term debt	Long-term debt *less* Due on 1st January each year	3,300 – 500 (3,885 – 500)	2,800 (3,385)
7	Trade & other payables	Trade payables *add* Accrued expenses	880 + 15 (790 + 30)	895 (820)
8	Current portion of long- term debt	Due on 1st January each year	- -	500 (500)

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

*****

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

Ind AS 1 deal with presentation of financial statements, whereas AS 1 deal only with the disclosure of accounting policies. The scope of Ind AS 1 is thus much wider and some of its requirements are contained in other AS e.g. AS 5 and, therefore, line by line comparison of the differences between Ind AS 1 and AS 1 is not possible. Therefore, the differences between Ind AS 1 and Indian GAAP are divided into following parts and summarised below.

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S.No.	Particulars	Ind AS 1	AS 1
I.	**Part 1 Ind AS 1 requirement not covered in any AS**		
1.	Complete set of Financial Statements	Ind AS 1 prescribes what comprises a complete set of financial statements such as balance sheet, statement of profit and loss, statement of changes in equity, statement of cash flows, notes, comprising significant accounting policies, and comparative information in respect of preceding period.	Not covered in any AS
2.	Purpose and General Features of Financial Statements	Ind AS 1 lays down purpose of financial statements and general feature of financial statements such as True and Fair view and compliance with Ind AS. An enterprise shall make an explicit statement in the financial statements of compliance with all the Indian Accounting Standards. Further, Ind AS 1 allows deviation from a requirement of an accounting standard in case the management concludes that compliance with Ind AS will be misleading and if the regulatory framework requires or does not prohibit such a departure.	Not covered in any AS
3.	Off-setting	Ind AS 1 state that an entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.	Not covered in any AS
4.	Frequency of reporting	Ind AS 1 requires an entity to present a complete set of financial statements (including comparative information) at least annually.	Not covered in any AS
5.	Structure and Contents	Ind AS 1 requires an entity	Not covered in any AS

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S.No.	Particulars	Ind AS 1	AS 1
		▪ to clearly identify the financial statements and distinguish them from other information in the same published document. ▪ To give information about the name of the entity, whether financial statements are of individual entity of group of entities, presentation currency and level of rounding off.	
6.	Balance sheet	▪ Prescribes certain line items to be presented in the balance sheet and permits presentation of additional line items. ▪ Ind AS 1 requires presentation and provides criteria for classification of Current / Non- Current assets / liabilities. ▪ Ind AS 1 requires presentation of balance sheet as at the beginning of the earliest period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in the financial statements, or when it reclassifies items in its financial statements.	Not covered in any AS
7.	Statement of profit and loss	▪ Ind AS 1 requires that an entity shall present a single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed	Not covered in any AS

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S.No.	Particulars	Ind AS 1	AS 1
		directly by the other comprehensive income section. ▪ Ind AS 1 prohibits presentation of any item as 'Extraordinary Item' in the statement of profit and loss or in the notes. ▪ Ind AS 1 requires classification of expenses to be presented based on nature of expenses.	
8.	Reclassification of items	Ind AS 1 requires disclosure of nature, amount and reason for reclassification in the notes to financial statements.	Not covered in any AS
9.	Statement of Changes in Equity	Ind AS 1 requires the financial statements to include a 'Statement of Changes in Equity' to be shown as a separate statement, which, inter alia, includes reconciliation between opening and closing balance for each component of equity.	Not covered in any AS
10.	Comparative information	As per Ind AS 1, an entity shall include certain comparative information for understanding the current period's financial statements.	Not covered in any AS
11.	Classification of long-term loan arrangement	Ind AS 1 clarifies that long-term loan arrangement need not be classified as current on account of breach of a material provision, for which the lender has agreed to waive before the approval of financial statements for issue. (Paragraph 74 of Ind AS 1)	Not covered in any AS

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S.No.	Particulars	Ind AS 1	AS 1
II.	Part 2 Ind AS 1 requirements vis-a-vis AS 1		
1.	Fundamental accounting assumptions	Ind AS 1 requires adherence to accrual basis of accounting.	AS 1 only requires disclosure if this fundamental accounting assumption, among others like going concerns and consistency, is not followed by the entity.
2.	Rectification of accounting policies	Ind AS 1 explicitly states that an entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.	
3.	Sources of estimation uncertainty	Ind AS 1 requires to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.	

1.10 CARVE OUT IN IND AS 1 FROM IAS 1

As per IFRS

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

Carve Out

Ind AS 1 clarifies that where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes

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payable on demand on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach. Consequent to this, requirements of paragraph 76 of IAS 1 to treat such events as non-adjusting events are also deleted.

Reason

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

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

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

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

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

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

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

   (a) As on 31st March, 20X2, how should the entity classify the loan?

   (b) Assume that in anticipation that it may not be able to get the promoter's contribution by due date, in February 20X2, the entity approached the bank and got the compliance

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date extended upto 30th June, 20X2 for getting promoter's contribution. In this case will the loan classification as on 31st March, 20X2 be different from (a) above?

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

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

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

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

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

S. No.	Matters
(i)	There are qualifications in the audit report of the Company with reference to two Ind AS.

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

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

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

   With reference to above background, answer the following:

   (i) Can management present the third statement of profit and loss as an additional comparative in the general-purpose financial statements?

   (ii) If management present third statement of profit and loss in the general-purpose financial statement as comparative, is it necessary that this statement should- be compliant of Ind AS?

   (iii) Can management present third statement of profit and loss only as additional comparative in the general-purpose financial statements without furnishing other components (like balance sheet, statement of cash flows, statement of change in equity) of financial statements?

7. A company, while preparing the financial statements for financial year 20X1-20X2, erroneously booked excess revenue of ₹ 10 crore. The total revenue reported in financial year 20X1-20X2 was ₹ 80 crore. However, while preparing the financial statements for 20X2-20X3, it discovered that excess revenue was booked in financial year 20X1-20X2 which

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it now wants to correct in the financial statements. However, the management of the company is not sure whether it need to present the third balance sheet as additional comparative.

With regard to the above background, answer the following:

(i) Is it necessary to provide the third balance sheet at the beginning of the preceding period in this case?

(ii) The company wants to correct the errors during financial year 20X2-20X3 by giving impact in the figures of current year only. Is the contention of the management, correct?

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

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

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

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	contract term of 18 months, then it becomes payable immediately. However, the Company does not expect the cancellation of the contract.

Considering the above items/transactions answer the following:

(i) The company wants to present the trade receivable as current despite the fact that these are receivables in 15 months' time. Does the decision of presenting the same as current is correct?

(ii) The company wants to present the trade payables as non-current despite the fact that these are due within the operating cycle of the company. Does the decision of presenting the same as non-current is correct?

(iii) Can the security deposit of ₹ 5 crore made by the company with the customers be presented as current?

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

9. Is offsetting permitted under the following circumstances?

(a) Expenses incurred by a holding company on behalf of subsidiary, which is reimbursed by the subsidiary - whether in the separate books of the holding company, the expenditure and related reimbursement of expenses can be offset?

(b) Whether profit on sale of an asset against loss on sale of another asset can be offset?

(c) When services are rendered in a transaction with an entity and services are received from the same entity in two different arrangements, can the receivable and payable be offset?

Answers

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

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

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

2. (a) Ind AS 1, inter alia, provides, "An entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment." In the present case, following the default, grace period within which an entity can rectify the breach is less than twelve months after the reporting period. Hence as on 31st March, 20X2, the loan will be classified as current.

(b) Ind AS 1 deals with classification of liability as current or non-current in case of breach of a loan covenant and does not deal with the classification in case of expectation of breach. In this case, whether actual breach has taken place or not is to be assessed on 30th June, 20X2, i.e., after the reporting date. Consequently, in the absence of actual breach of the loan covenant as on 31st March, 20X2, the loan will retain its classification as non-current.

3. As per para 74 of Ind AS 1 "Presentation of Financial Statements", where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

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

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

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

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

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

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

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

5. (i) Yes, an entity whose financial statements comply with Ind AS shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with Ind AS unless they comply with all the requirements of Ind AS. (Refer Para 16 of Ind AS 1)

(ii) No, but need to disclose in the financial statement that these are individual financial statements of the Company. (Refer Para 51(b) of Ind AS 1)

(iii) Yes, Para 51(d) of Ind AS 1 inter alia states that an entity shall display the presentation currency, as defined in Ind AS 21 prominently, and repeat it when necessary for the information presented to be understandable.

(iv) No, as per Para 38 of Ind AS 1, except when Ind AS permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.

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6. (i) Yes, as per Para 38C of Ind AS 1, an entity may present comparative information in addition to the minimum comparative financial statements required by Ind AS, as long as that information is prepared in accordance with Ind AS. This comparative information may consist of one or more statements referred to in paragraph 10 but need not comprise a complete set of financial statements. When this is the case, the entity shall present related note information for those additional statements.

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

(iii) Yes, as per Para 38C of Ind AS 1, an entity may present comparative information in addition to the minimum comparative financial statements required by Ind AS, as long as that information is prepared in accordance with Ind AS. This comparative information may consist of one or more statements referred to in paragraph 10 but need not comprise a complete set of financial statements. When this is the case, the entity shall present related note information for those additional statements.

7. (i) No, as per Para 40A of Ind AS 1, an entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements required in paragraph 38A if:

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

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

(ii) No, management need to correct the previous year figures to correct the error but need not to furnish third balance sheet at the beginning of preceding period. (Refer Para 40A of Ind AS 1)

8. (i) Yes, but additionally the Company also need to disclose amounts that are receivable within a period of 12 months and after 12 months from the reporting date. (Refer Para 60 and 61 of Ind AS 1)

(ii) No, the Company cannot disclose these payables as non-current and the Company also need to disclose amounts that are payable within a period of 12 months and after 12 months from the reporting date. (Refer Para 60 and 61 of Ind AS 1)

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(iii) No, because the amount will be received after the operating cycle of the Company. (Refer Para 66 of Ind AS 1)

(iv) No, because the amount may be required to be paid before completion of the contract in case the contract is cancelled. (Refer Para 69 of Ind AS 1).

9. **(a)** As per paragraph 33 of Ind AS 1, offsetting is permitted only when the offsetting reflects the substance of the transaction.

In this case, the agreement/arrangement, if any, between the holding and subsidiary company needs to be considered. If the arrangement is to reimburse the cost incurred by the holding company on behalf of the subsidiary company, the same may be presented net. It should be ensured that the substance of the arrangement is that the payments are actually in the nature of reimbursement.

(b) Paragraph 35 of Ind AS 1 requires an entity to present on a net basis gains and losses arising from a group of similar transactions. Accordingly, gains or losses arising on disposal of various items of property, plant and equipment shall be presented on net basis. However, gains or losses should be presented separately if they are material.

(c) Ind AS 1 prescribes that assets and liabilities, and income and expenses should be reported separately, unless offsetting reflects the substance of the transaction. In addition to this, as per paragraph 42 of Ind AS 32, a financial asset and a financial liability should be offset if the entity has legally enforceable right to set off and the entity intends either to settle on net basis or to realise the asset and settle the liability simultaneously.

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

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UNIT 2:
INDIAN ACCOUNTING STANDARD 34: INTERIM FINANCIAL REPORTING

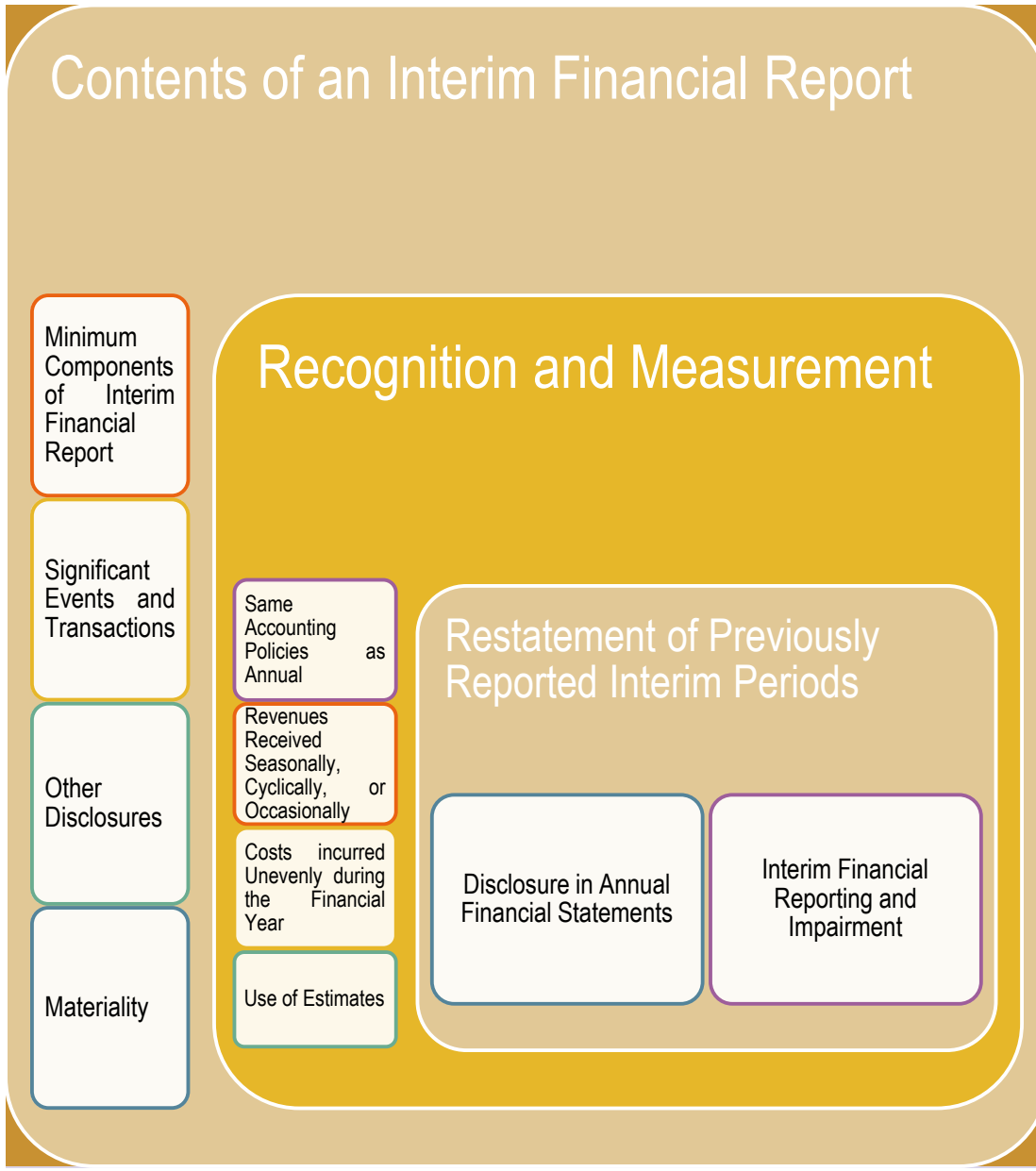
LEARNING OUTCOMES

After studying this unit, you will be able to:

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

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UNIT OVERVIEW



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2.1 INTRODUCTION

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

2.2 OBJECTIVE

The objective of this Standard is to prescribe

a) the minimum content of an interim financial report

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

2.3 SCOPE

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

2.4 DEFINITIONS

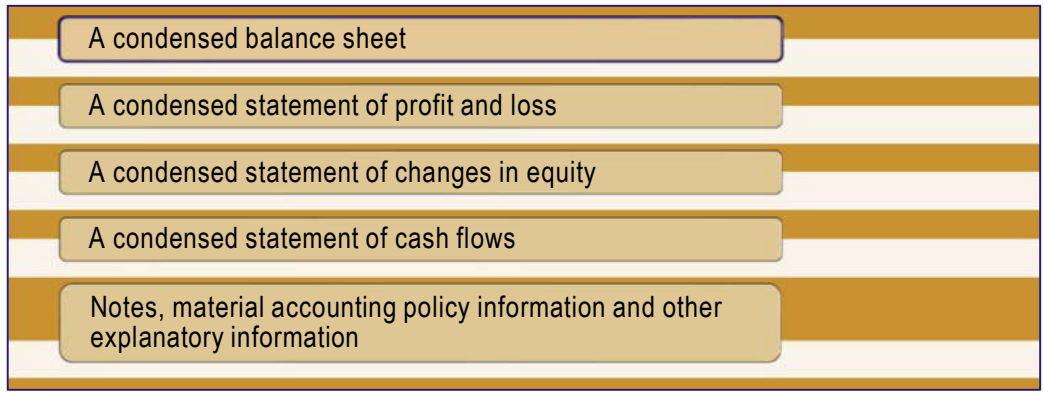
1. **Interim period** is a financial reporting period shorter than a full financial year.

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

2.5 CONTENTS OF AN INTERIM FINANCIAL REPORT

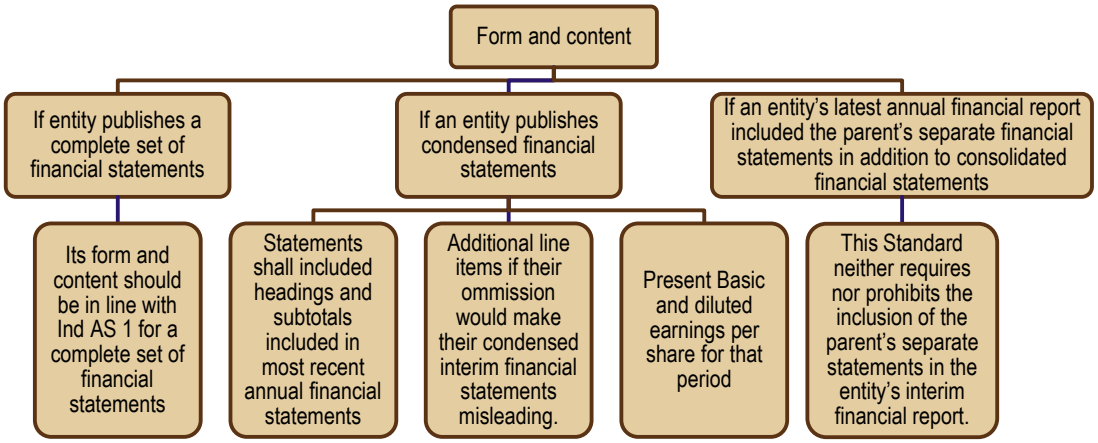
- An Interim Financial Report shall include, at minimum, the following:



- In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements.
- The interim financial report focuses on new activities, events, and circumstances and does not duplicate information previously reported.
- Nothing in this Standard is intended to prohibit or discourage an entity from publishing a complete set of financial statements (as described in Ind AS 1) in its interim financial report, rather than condensed financial statements and selected explanatory notes. Nor does this Standard prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes asset out in this Standard.

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2.5.1 Form and Content of Interim financial report



2.5.2 Significant events and transactions

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

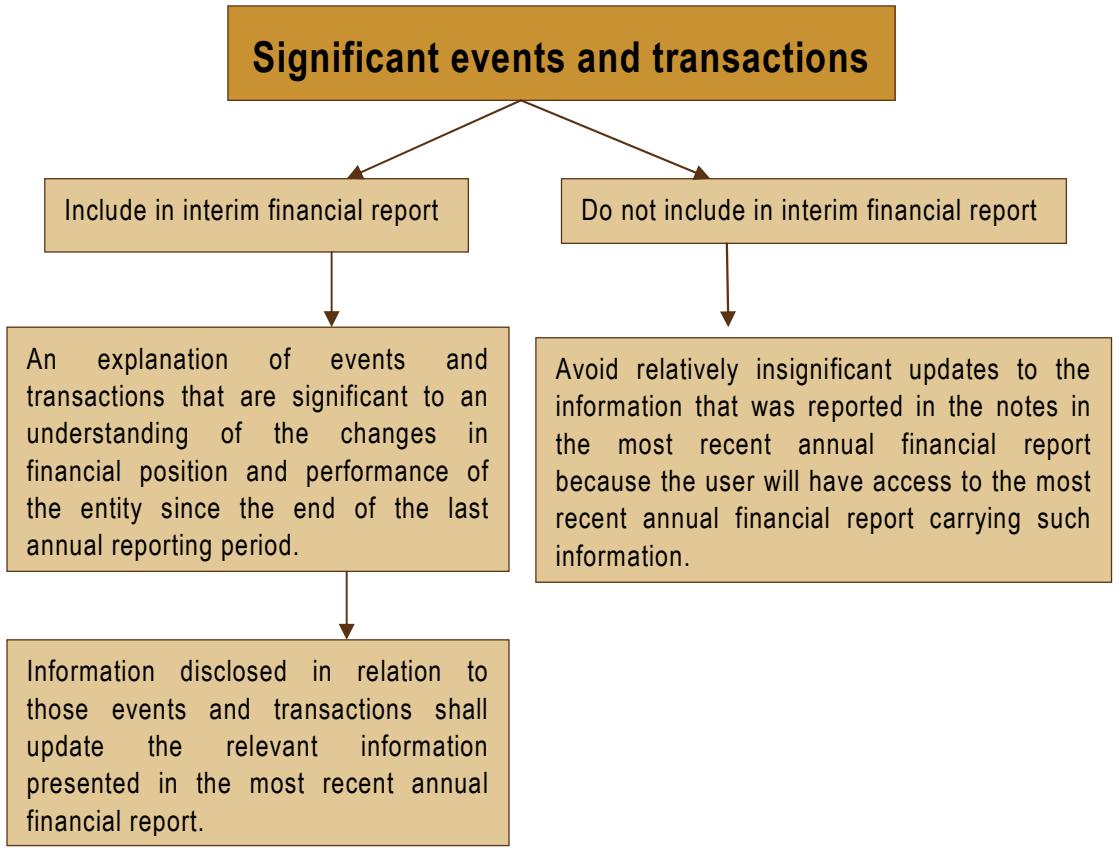
The following is a list of events and transactions for which disclosures would be required if they are significant: (The below list is not exhaustive)
1. the write-down of inventories to net realisable value and the reversal of such write-down;
2. recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, assets arising from contracts with customers, or other assets, and the reversal of such an impairment loss;
3. the reversal of any provisions for the costs of restructuring;
4. acquisitions and disposals of items of property, plant and equipment;

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5.	commitments for the purchase of property, plant and equipment;
6.	litigation settlements;
7.	corrections of prior period errors;
8.	changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost;
9.	any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;
10.	related party transactions;
11.	transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;
12.	changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and
13.	changes in contingent liabilities or contingent assets.

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

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2.5.3 Other disclosures

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

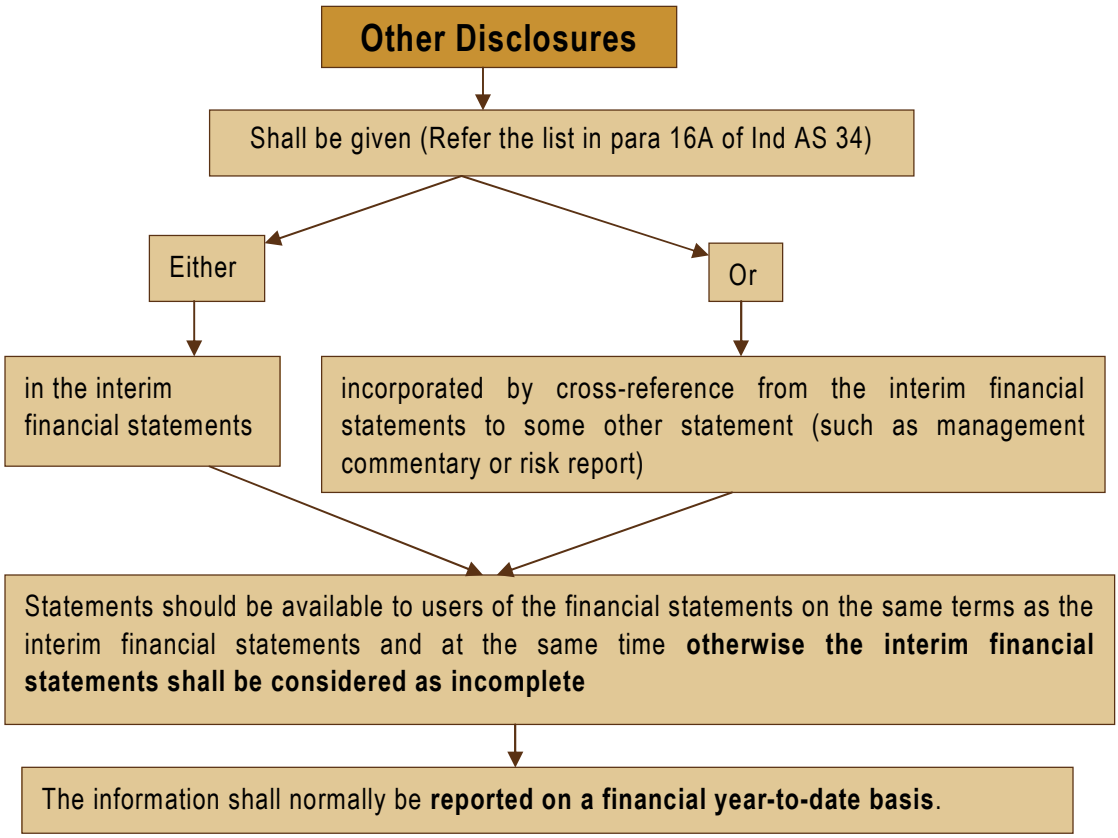
a) a statement that the same accounting policies and methods of computation are followed in the interim financial statements. If those recently used policies or methods have been changed, a description of the nature and effect of the change should also be given.

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b)	explanatory comments about the seasonality or cyclicality of interim operations.
c)	the nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their nature, size or incidence.
d)	the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years.
e)	issues, repurchases and repayments of debt and equity securities.
f)	dividends paid (aggregate or per share) separately for ordinary shares and other shares.
g)	the following segment information (disclosure of segment information is required in an entity's interim financial report only if Ind AS 108, *Operating Segments,* requires that entity to disclose segment information in its annual financial statements):
i.	revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
ii.	inter segment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
iii.	a measure of segment profit or loss.
iv.	a measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there has been a material change from the amount disclosed in the last annual financial statements for that reportable segment.
v.	a description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss.
vi.	a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items shall be separately identified and described in that reconciliation.
h)	events after the interim period that have not been reflected in the financial statements

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	for the interim period.
i)	the effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required by Ind AS 103, *Business Combinations*.
j)	for financial instruments, the disclosures about fair value of Ind AS 113, *Fair Value Measurement,* and Ind AS 107, *Financial Instruments: Disclosures*.
k)	for entities becoming, or ceasing to be, investment entities, as defined in Ind AS 110, *Consolidated Financial Statements*, the disclosures in Ind AS 112, *Disclosure of Interests in Other Entities*.
l)	the disaggregation of revenue from contracts with customers required by Ind AS 115, *Revenue from Contracts with Customers.*



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

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

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

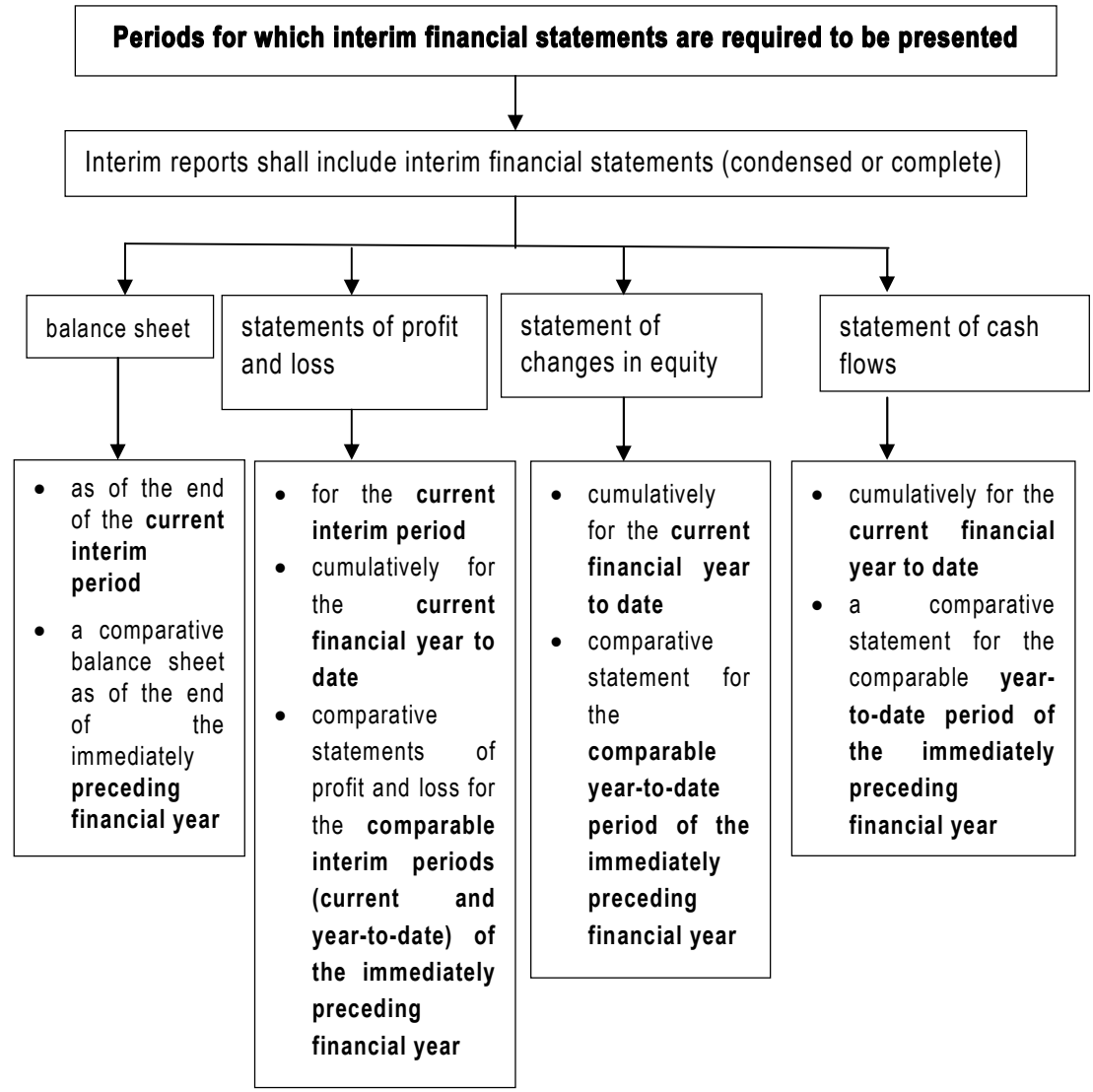
(b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.

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

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

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

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

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Following is the illustrative example to understand the periods for which interim financial statements are required to be presented.

Scenario (a) Entity publishes interim financial reports half-yearly

The entity's financial year ends 31 March (Financial year). The entity will present the following financial statements (condensed or complete) in its half-yearly interim financial report as of 30 September 20X2:

Name of the component	Current period	Comparative period
Balance sheet as at	30 September 20X2	31 March 20X2
Statement of profit and loss : 6 months ending	30 September 20X2	30 September 20X1
Statement of cash flows: 6 months ending	30 September 20X2	30 September 20X1
Statement of changes in equity: 6 months ending	30 September 20X2	30 September 20X1

Scenario (b) Entity publishes interim financial reports quarterly

The entity's financial year ends 31 March (Financial year). The entity will present the following financial statements (condensed or complete) in its quarterly interim financial report as of 30 September 20X2:

Name of the component	Current periods	Comparative periods
Balance sheet as at	30 September 20X2	31 March 20X2
Statement of profit and loss : 6 months ending; and 3 months ending	30 September 20X2; and 30 September 20X2	30 September 20X1; and 30 September 20X1
Statement of cash flows: 6 months ending	30 September 20X2	30 September 20X1
Statement of changes in equity: 6 months ending	30 September 20X2	30 September 20X1

2.5.5 Materiality

- In deciding how to recognise, measure, classify, or disclose an item for interim financial

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reporting purposes, materiality shall be assessed in relation to the interim period financial data.

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

2.6 DISCLOSURE IN ANNUAL FINANCIAL STATEMENTS

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

2.7 RECOGNITION AND MEASUREMENT

S. No.	Criteria	Recognition and Measurement
1	Same accounting policies as annual	1. 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. The frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of

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		its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis. 3. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.
2	Revenues received cyclically, occasionally or seasonally	1. Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year. **Example:** Dividend revenue, royalties, and government grants. 2. Certain entities earn more revenue in certain interim periods of a financial year than other interim periods. Such revenues are recognised when they occur. **Example:** seasonal revenues of retaile₹
3	Costs incurred unevenly during the financial year	Costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.
4	Use of estimates	1. To ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. 2. The preparation of interim financial reports requires a greater use of estimation methods than annual financial reports.

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Employer payroll taxes and insurance contributions

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

Major planned periodic maintenance or overhaul

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

Provisions

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

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

Year-end bonuses

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

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

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Variable lease payments

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

Intangible assets

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

Vacations, holidays, and other short-term compensated absences

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

Other planned but irregularly occurring costs

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

Measuring interim income tax expense

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

This is consistent with the basic concept set out in the Standard that the same accounting

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

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

Contractual or anticipated purchase price changes

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

Depreciation and amortisation

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

Inventories

Inventories are measured for interim financial reporting by the same principles as at financial year-end. Ind AS 2, *Inventories* establishes standards for recognising and measuring

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

- **Net realisable value of inventories**

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

- **Interim period manufacturing cost variances**

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

Foreign currency translation gains and losses

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

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

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

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Inventories

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

Provisions

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

Pensions

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

Contingencies

The measurement of contingencies may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not also be needed at interim dates.

Inter-company reconciliations

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

Illustration 1

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

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Solution

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

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

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

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

	Q1	Q2	Q3	Q4
Profit / (Loss) before tax	60,000	(15,000)	(15,000)	(15,000)
Tax charge / (credit)	12,000	(3,000)	(3,000)	(3,000)

*****

Illustration 2

ABC Ltd. presents interim financial report quarterly. On 1.4.20X1, ABC Ltd. has carried forward loss of ₹ 600 lakhs for income-tax purpose for which deferred tax asset has not been recognized. ABC Ltd. earns ₹ 900 lakhs in each quarter ending on 30.6.20X1, 30.9.20X1, 31.12.20X1 and 31.3.20X2 excluding the carried forward loss. Income-tax rate is expected to be 40%. Calculate the amount of tax expense to be reported in each quarter.

Solution

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

The estimated payment of the annual tax on earnings for the current year:

₹ 3,000* x 40 / 100 = ₹ 1,200 lakhs.

*(3,600 lakhs - ₹ 600 lakhs) = ₹ 3,000 lakhs

Average annual effective tax rate = (1,200 / 3,600) × 100 = 33.33%

Tax expense to be shown in each quarter = 900 x 33.33% = ₹ 300 lakhs

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Illustration 3

Innovative Corporation Private Limited (or "ICPL") is dealing in seasonal product and the sales pattern of the product, quarter wise is as under during the financial year 20X1-20X2:

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Qtr. I	Qtr. II	Qtr. III	Qtr. IV
ending 30 June	ending 30 September	ending 31 December	ending 31 March
10%	10%	60%	20%

For the first quarter ending on 30 June, 20X1, ICPL has provided the following information :

Particulars	Amounts (in crore)
Sales	70
Employees benefits expenses	25
Administrative and other expenses	12
Finance cost	4

ICPL while preparing interim financial report for first quarter wants to defer ₹ 16 crores expenditure to third quarter on the argument that third quarter is having more sales therefore third quarter should be debited by more expenditure. Considering the seasonal nature of business and that the expenditures are uniform throughout all quarte₹

Calculate the result of first quarter as per Ind AS 34 and comment on the company's view.

Solution

Result of the first quarter ending 30 June

Particulars	Amounts (in crore)
Sales	70
Total Revenue (A)	**70**
Less: Employees benefits expenses	(25)
Administrative and other expenses	(12)
Finance cost	(4)
Total Expense (B)	**(41)**
Profit (A-B)	**29**

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Note- As per Ind AS 34, the income and expense should be recognized when they are earned and incurred respectively. Seasonal incomes will be recognized when they occur. Therefore, the argument of ICPL is not correct considering the priciples of Ind AS 34.

*****

Illustration 4

Fixed production overheads for the financial year is ₹ 10,000. Normal expected production for the year, after considering planned maintenance and normal breakdown, also considering the future demand of the product is 2,000 MT. It is considered that there are no quarterly / seasonal variations. Therefore, the normal expected production for each quarter is 500 MT and the fixed production overheads for the quarter are ₹ 2,500.

Actual production achieved	***Quantity (In MT)***
First quarter	*400*
Second quarter	*600*
Third quarter	*500*
Fourth quarter	*400*
Total	***1,900***

Presuming that there are no quarterly / seasonal variation, calculate the allocation of fixed production overheads for all the four quarters as per Ind AS 34 read with Ind AS 2. Will the quarterly results affect the annual results?

Solution

If it is considered that there is no quarterly / seasonal variation, therefore normal expected production for each quarter is 500 MT and fixed production overheads for the quarter are ₹ 2,500.

Fixed production overhead to be allocated per unit of production in every quarter will be ₹ 5 per MT (Fixed overheads / Normal production).

Quarters	Allocations
First Quarter	➢ Actual fixed production overheads = ₹ 2,500 ➢ Fixed production overheads based on the allocation rate of ₹ 5 per unit allocated to actual production = ₹ 5 x 400 = ₹ 2,000

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	➢ Unallocated fixed production overheads to be charged as expense as per Ind AS 2 and consequently as per Ind AS 34 = ₹ 500
Second Quarter	➢ Actual fixed production overheads on year-to-date basis = ₹ 5,000 ➢ Fixed production overheads to be absorbed on year-to-date basis = 1,000 x ₹ 5 = ₹ 5,000 ➢ Earlier, ₹ 500 was not allocated to production in the 1st quarter. To give effect to the entire ₹ 5,000 to be allocated in the second quarter, as per Ind AS 34, ₹ 500 are reversed by way of a credit to the statement of profit and loss of the 2nd quarter.
Third Quarter	➢ Actual production overheads on year-to-date basis = ₹ 7,500 ➢ Fixed production overheads to be allocated on year-to-date basis = 1,500 x 5 = ₹ 7,500 ➢ There is no under or over recovery of allocated overheads. Hence, no further action is required.
Fourth Quarter	➢ Actual fixed production overheads on year-to-date basis = ₹ 10,000 ➢ Fixed production overheads to be allocated on year-to-date basis 1,900 x 5 = ₹ 9,500 ➢ ₹ 500, i.e., [₹ 2,500 – (₹ 5 x 400)] unallocated fixed production overheads in the 4th quarter, are to be expensed off as per the principles of Ind AS 2 and Ind AS 34 by way of a charge to the statement of profit and loss. ➢ Unallocated productions overheads for the year ₹ 500 (i.e ₹ 10,000 – ₹ 9,500) are expensed in the Statement of profit and loss as per Ind AS 2.

The cumulative result of all the quarters would also result in unallocated overheads of ₹ 500, thus, meeting the requirements of Ind AS 34 that the quarterly results should not affect the measurement of the annual results.

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2.8 RESTATEMENT OF PREVIOUSLY REPORTED INTERIM PERIODS

A change in accounting policy, other than one for which the transition is specified by a new

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Ind AS, shall be reflected by:

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

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

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

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

2.9 INTERIM FINANCIAL REPORTING AND IMPAIRMENT

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

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

Illustration 5

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

Following adjustments are made while computing the net profit:

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

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

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depreciation.

(iii) Exceptional loss of ₹ 28,000 incurred during the third quarter. 50% of exceptional loss have been deferred to next quarter.

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

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

Solution

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

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

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

(iii) Treatment of exceptional loss is not as per the principles of Ind AS 34, as the entire amount of ₹ 28,000 incurred during the third quarter should be recognized in the same quarter. Hence ₹ 14,000 which was deferred should be deducted from the profits of third quarter only.

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

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

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

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

Thus considering the above, the correct net profits to be shown in Interim Financial Report of the third quarter shall be ₹ 14,36,000 (₹ 20,00,000 - ₹ 50,000 - ₹ 14,000 - ₹ 5,00,000).

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

S. No.	Particular	Ind AS 34	AS 25
1.	Disclosures	Ind AS 34 requires disclosure by way of an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period.	AS 25 does not specifically requires such disclosure.
2.	*Reversal of Impairment Loss*	Ind AS 34 prohibits reversal of impairment loss recognised in a previous interim period in respect of goodwill (in harmony with paragraph 124 of Ind AS 36, which prohibits reversal of impairment loss recognised for goodwill in a subsequent period) or an investment in either an equity instrument or a financial asset carried at cost. Ind AS 34 includes Appendix A which addresses the interaction between the requirements of Ind AS 34 and the recognition of impairment losses on goodwill in Ind AS 36 and the effect of that interaction on subsequent interim and annual financial statements	There is no such specific prohibition in the AS 25.
3.	*Inclusion of the Parent's Separate*	Ind AS 34 states that it neither requires nor prohibits the inclusion of the parent's separate statements	Under AS 25, if an entity's annual financial report included the consolidated financial

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	Statements and the Consolidated Financial Statements in the Entity's Interim Report	inthe entity's interim report if an entity's annual financial report included the parent's separate financial statements in addition to consolidated financial statements.	statements in addition to the separate financial statements, the interim financial report should include both the consolidated financial statements and separate financial statements, complete or condensed.
4.	*Accounting Policies*	Ind AS 34 additionally requires the information in respect of methods of computation followed.	AS 25 requires the Notes to interim financial statements, (if material and not disclosed elsewhere in the interim financial report), to contain a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, in case of change in those policies, a description of the nature and effect of the change.
5.	*Contingent Liabilities and Contingent Assets*	Ind AS 34 requires furnishing of information on both contingent liabilities and contingent assets, if they are significant.	AS 25 requires furnishing of information on contingent liabilities only.
6.	*Interim Financial Statements prepared on Complete Basis*	Ind AS 34 requires that, where an interim financial report has been prepared in accordance with the requirements of Ind AS 34, that fact should be disclosed. Further, an interim financial report should not be described as complying with Ind AS unless it complies with allofthe requirements	AS 25 does not contain these requirements.

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		of Ind AS. (The latter statement is applicable when interim financial statements are prepared on complete basis instead of 'condensed basis').	
7.	*Transitional provision*	Ind AS 34 does not have this transitional provision.	Under AS 25, when an interim financial report is presented for the first time in accordance with that Standard, an entity need not present, in respect of all the interim periods of the current financial year, comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year and comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. The entity's financial year ends on 31st March. What are the "reporting periods" for which financial statements (condensed or complete) in the interim financial report of the entity as on 30th September, 20X1 are required to be presented, if:

   (i) Entity publishes interim financial reports quarterly

   (ii) Entity publishes interim financial reports half-yearly.

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

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

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

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

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

   The management believes that since the entity has zero income for the year, its income-tax expense for the year will be zero. State whether the management's views are correct or

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not? If not, then calculate the tax expense for each quarter as well as for the year as per Ind AS 34.

4. Due to decline in market price in second quarter, Happy India Ltd. incurred an inventory loss. The Market price is expected to return to previous levels by the end of the year. At the end of year, the decline had not reversed. When should the loss be reported in interim statement of profit and loss of Happy India Ltd.?

5. An entity's accounting year ends is 31st December, but its tax year end is 31st March. The entity publishes an interim financial report for each quarter of the year ended 31st December, 2019. The entity's profit before tax is steady at ₹10,000 each quarter, and the estimated effective tax rate is 25% for the year ended 31st March, 2019 and 30% for the year ended 31st March, 2020.

   How the related tax charge would be calculated for the year 2019 and its quarters.

6. PQR Ltd. is preparing its interim financial statements for quarter 3 of the year. How the following transactions and events should be dealt with while preparing its interim financials:

   (i) It makes employer contributions to government-sponsored insurance funds that are assessed on an annual basis. During Quarter 1 and Quarter 2 larger amount of payments for this contribution were made, while during the Quarter 3 minor payments were made (since contribution is made upto a certain maximum level of earnings per employee and hence for higher income employees, the maximum income reaches before year end).

   (ii) The entity intends to incur major repair and renovation expense for the office building. For this purpose, it has started seeking quotations from vendors. It also has tentatively identified a vendor and expected costs that will be incurred for this work.

   (iii) The company has a practice of declaring bonus of 10% of its annual operating profits every year. It has a history of doing so.

Answers

1. Paragraph 20 of Ind AS 34, Interim Financial Reporting states as follows:

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

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

b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the

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comparable interim periods (current and year-to-date) of the immediately preceding financial year.

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

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

Accordingly, periods for which interim financial statements are required to be presented are provided herein below:

(i) Entity publishes interim financial reports quarterly

The entity will present the following financial statements (condensed or complete) in its interim financial report of 30th September, 20X1:

Balance sheet at	**30th September 20X1**	**31st March 20X1**	**-**	**-**
Statement of profit and loss for	3 months ended 30th September 20X1	3 months ended 30th September 20X0	6 months ended 30th September 20X1	6 months ended 30th September 20X0
Statement of changes in equity for	6 months ended 30th September 20X1	6 months ended 30th September 20X0		
Statement of cash flows for	6 months ended 30th September 20X1	6 months ended 30th September 20X0	-	-

(ii) Entity publishes interim financial reports half-yearly

The entity's financial year ends 31st March. The entity will present the following financial statements (condensed or complete) in its half-yearly interim financial report of 30th September, 20X1:

Balance sheet at	**30th September, 20X1**	**31st March, 20X1**
Statement of profit and loss for	6 months ending 30th September, 20X1	6 months ending 30th September, 20X0

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Statement of changes in equity for	6 months ending 30th September 20X1	6 months ending 30th September 20X0
Statement of cash flows for	6 months ending 30th September 20X1	6 months ending 30th September 20X0

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

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

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

Tax expense to be recognised in each of the quarterly reports

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

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

Accordingly, the management's contention that since the net income for the year will be zero no income tax expense shall be charged quarterly in the interim financial report, is not correct. Since the effective tax rate or average annual income tax rate is already given in the question as 30%, the income tax expense will be recognised in each interim quarter based on this rate only. The following table shows the correct income tax expense to be reported each quarter in accordance with Ind AS 34:

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

4. Loss should be recognised in the second quarter of the year.

5. **Table showing computation of tax charge:**

	Quarter ending 31st March, 2019	Quarter ending 30th June, 2019	Quarter ending 30th September, 2019	Quarter ending 31st December, 2019	Year ending 31st December, 2019
	₹	₹	₹	₹	₹
Profit before tax	10,000	10,000	10,000	10,000	40,000
Tax charge	(2,500)	(3,000)	(3,000)	(3,000)	(11,500)
	7,500	7,000	7,000	7,000	28,500

Since an entity's accounting year is not same as the tax year, more than one tax rate might apply during the accounting year. Accordingly, the entity should apply the effective tax rate for each interim period to the pre-tax result for that period.

6. Paragraph 28 of Ind AS 34, Interim Financial Reporting states that an entity shall apply the same accounting recognition and measurement principles in its interim financial statements as are applied in its annual financial statements.

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Further, paragraphs 32 and 33 of Ind AS 34, Interim Financial Reporting state that for assets, the same tests of future economic benefits apply at interim dates and at the end of an entity's financial year. Costs that, by their nature, would not qualify as assets at financial year-end would not qualify at interim dates either. Similarly, a liability at the end of an interim reporting period must represent an existing obligation at that date, just as it must at the end of an annual reporting period.

An essential characteristic of income (revenue) and expenses is that the related inflows and outflows of assets and liabilities have already taken place. If those inflows or outflows have taken place, the related revenue and expense are recognised otherwise not. The Conceptual Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

Considering the above guidance, while preparing its interim financials, the transactions and events of the given case should be dealt with as follows:

(i) If employer contributions to government-sponsored insurance funds are assessed on an annual basis, the employer's related expense is recognised using an estimated average annual effective contribution rate in its interim financial statements, even though a large portion of the payments have been made early in the financial year. Accordingly, it should work out an average effective contribution rate and account for the same accordingly, in its interim financials.

(ii) The cost of a planned overhaul expenditure that is expected to occur in later part of the year is not anticipated for interim reporting purposes unless an event has caused the entity to have a legal or constructive obligation. The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.

(iii) A bonus is anticipated for interim reporting purposes, if and only if,

  (a) the bonus is a legal obligation or past practice would make the bonus a constructive obligation for which the entity has no realistic alternative but to make the payments, and

  (b) a reliable estimate of the obligation can be made. Ind AS 19, Employee Benefits provides guidance in this regard.

A liability for bonus may arise out of legal agreement or constructive obligation because of which it has no alternative but to pay the bonus and accordingly, needs to be accrued in the annual financial statements.

Bonus liability is accrued in interim financial statements on the same basis as they are accrued for annual financial statements. In the instant case, bonus liability of 10% of operating profit for the year to date may be accrued.

In the given case, since the company has past record of declaring annual bonus every year, the same may be accrued using a reasonable estimate (applying the principles of Ind AS 19, Employee Benefits) while preparing its interim results.

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

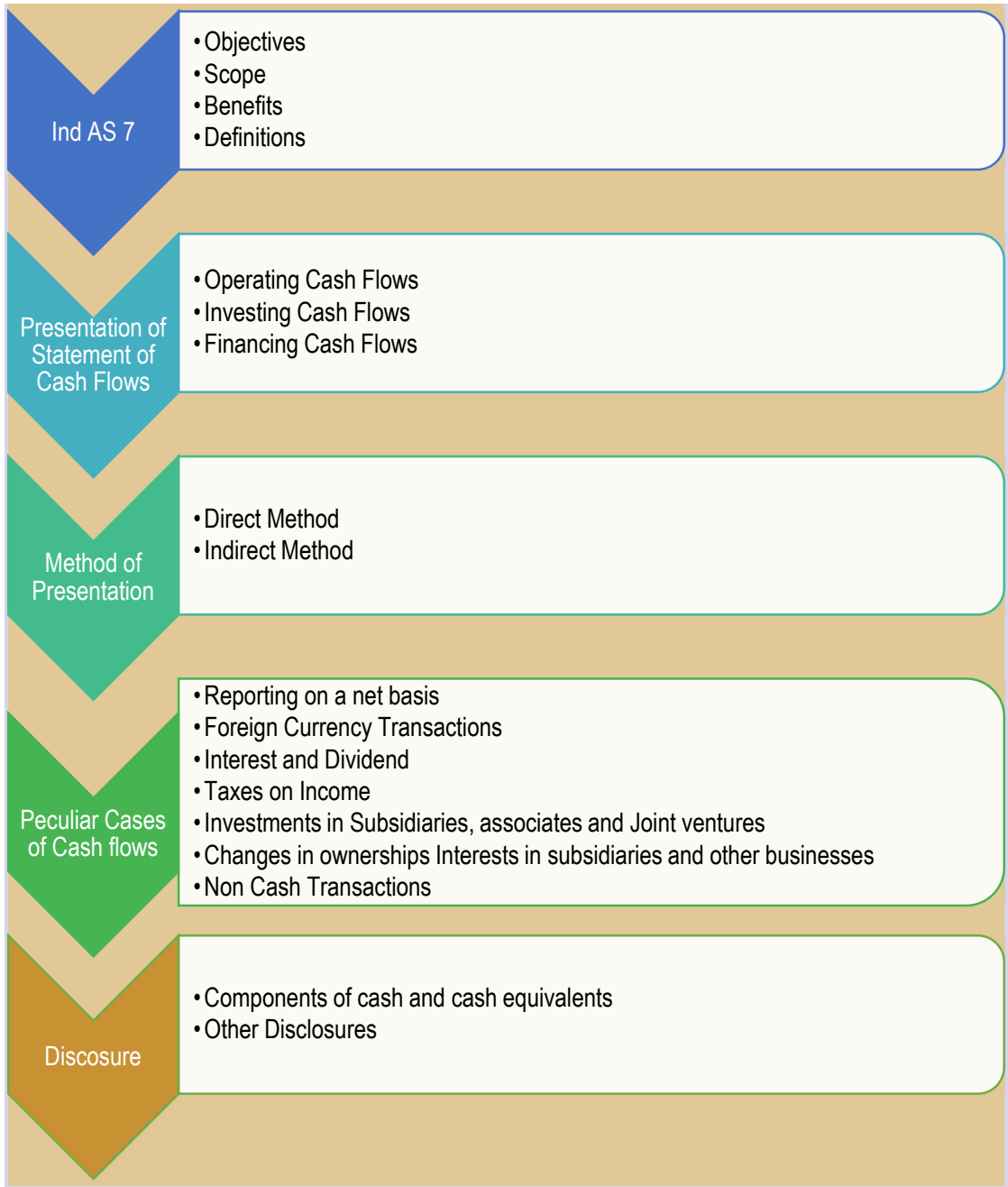
LEARNING OUTCOMES

After studying this unit, you will be able to:

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

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UNIT OVERVIEW



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3.1 INTRODUCTION

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

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

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

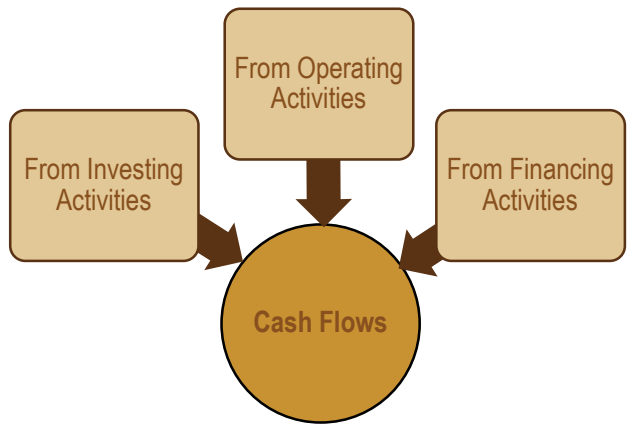
3.2 MEANING OF STATEMENT OF CASH FLOWS

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

(a) Cash flows from Operating Activities

(b) Cash flows from Investing Activities

(c) Cash flows from Financing Activities



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

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

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

3.3 OBJECTIVE

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

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

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

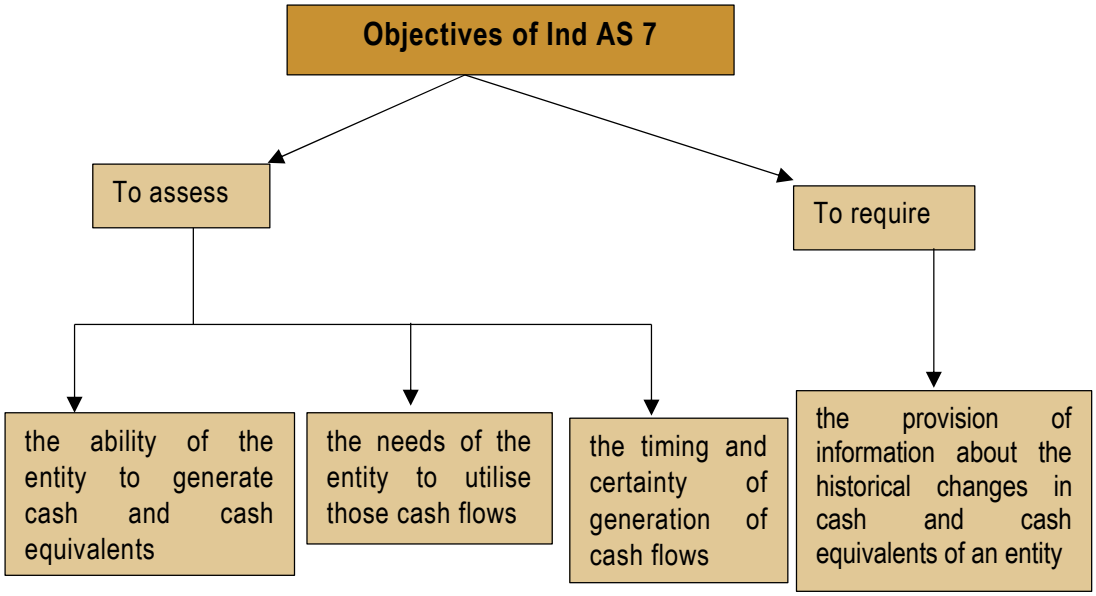
3.3.2 To assess the ability to generate cash and cash equivalents

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

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3.3.3 To understand the timing and certainty of their generation

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



3.4 BENEFITS OF CASH FLOW INFORMATION

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

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

3.4.2 Assesses the ability to manage the cash

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

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

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

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

3.4.3 Assess and compare the present value of future cash flows

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

3.4.4 Compares the efficiency of different entities

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

3.5 SCOPE

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

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

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

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

3.6 DEFINITIONS

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

1. ***Cash*** comprises cash on hand and demand deposits.

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

3.7 CASH AND CASH EQUIVALENTS

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

1. **Purpose:** Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.
2. **Known amount of cash:** This means that the cash amount that will be received on redemption should be known at the time of the initial investment. It is not sufficient that the instrument itself is readily convertible into cash and has a determinable market value. Instead, it means that, at the time of the initial investment, the entity is satisfied that the risk of changes in value is insignificant and that therefore the amount of cash to be received on redemption is known.
3. **Liquidity and Risk:** For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the **date of acquisition**.
4. **Equity investments** are excluded from cash equivalents unless they are, in substance, cash equivalents.
5. **Bank borrowings** are generally considered to be financing activities. However, the bank overdrafts may be an integral part of an entity's cash management in which case they will be included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn. .
6. **Cash Management:** Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

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Illustration 1

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

Sr.No.	*Name of the Security*	*Additional Information*
1.	*Fixed deposit with SBI*	*12%, 3 years maturity on 1st January 20X4*
2.	*Fixed deposit with HDFC*	*10%, original term was for 2 years, but due for maturity on 30th June 20X1*
3.	*Redeemable Preference shares in ABC ltd*	*Acquired on 31st January 20X1 and the redemption is due on 30th April 20X1*
4.	*Cash balances at various banks*	*All branches of all banks in India*
5.	*Cash balances at various banks*	*All international branches of Indian banks*
6.	*Cash balances at various banks*	*Branches of foreign banks outside India*
7.	*Bank overdraft of SBI Fort branch*	*Temporary overdraft, which is payable on demand*
8.	*Treasury Bills*	*90 days maturity*

Solution

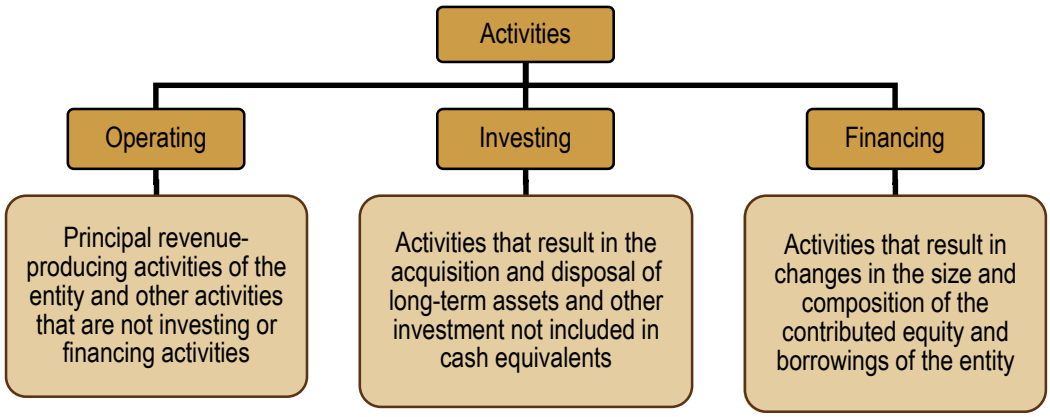
Sr. No.	Name of the Security	Decision
1.	Fixed deposit with SBI	Not to be considered – long term
2.	Fixed deposit with HDFC	Exclude as original maturity is not less than 90 days from the date of acquisition
3.	Redeemable Preference shares in ABC Ltd.	Include as due within 90 days from the date of acquisition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

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3.8 PRESENTATION OF STATEMENT OF CASH FLOWS

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



3.8.1 Operating Activities

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

Examples of cash flows from operating activities are:

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

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Illustration 2

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

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

Solution

Sr. No.	Nature of Transaction	Included / Excluded with reason
1	Receipt from sale of mobile phones	Include – main revenue generating activity
2	Purchases of mobile phones from various companies	Include – expenses related to main operations of business
3	Employees expenses paid	Include – expenses related to main operations of business
4	Advertisement expenses paid	Include – expenses related to main operations of business
5	Credit sales of mobile	Do not include – Credit transaction will not be included in cash flow (receipts from customers will be included)
6	Misc. charges received from customers for repairs of mobiles	Include – supplementary revenue generating activity
7	Loss due to decrease in market value of the closing stock of old mobile phones	Do not include - Non cash transaction

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8	Payment to suppliers of mobile phones	Include – cash outflow related to main operations of business
9	Depreciation on furniture of sales showrooms	Do not include – non cash item
10	Interest paid on cash credit facility of the bank	Do not include – cost of finance
11	Profit on sale of old computers and printers, in exchange of new laptop and printer	Do not include – non cash item
12	Advance received from customers	Include – Related to operations of business
13	Sales tax and excise duty paid	Include – related to operations of business

*****

- The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows or not. If the cash flow from operations is positive, it will be treated as positive indicator whereas negative cash flow from operations will denote that company's ability to generate the revenue from its main operations is very weak. The companies in the initial stage of their business or the companies which are facing economic problems will generally have the negative cash flow from operations.
- Cash flow from operations are used to maintain the operating capability of the entity, pay dividends and make new investment without recourse to external sources of financing. Therefore, it is necessary to assess how much cash is generated by the business from operations? Are they sufficient to take care of their future investment plans? Can loans be repaid in time without default from such cash flows? Is there sufficient amount for payment of preference dividend? Is anything left for equity shareholders after making all these payments? Answers to all these questions will depend on whether the entity has generated enough cash or not.

3.8.1.1 Certain Specific Issues

1. **Profit/ Loss on Sale of Assets :** Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities.
2. **Properties built for let out :** Cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

3.8.2 Investing Activities

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

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

Examples of cash flows arising from investing activities are:

Cash Inflow from Investing Activities	Cash Outflow from Investing Activities
Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets	Cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment
Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes)	Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);
Cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution)	Cash advances and loans made to other parties (other than advances and loans made by a financial institution)
Cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities	Cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities

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

Illustration 3

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

S. No.	*Nature of transaction paid*
1	*Interest received on loans*
2	*Interest paid on Deposits*

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3	*Deposits accepted*
4	*Loans given to customers*
5	*Loans repaid by the customers*
6	*Deposits repaid*
7	*Commission received*
8	*Lease rentals paid for various branches*
9	*Service tax paid*
10	*Furniture purchased for new branches*
11	*Implementation of upgraded banking software*
12	*Purchase of shares in 100% subsidiary for opening a branch in Abu Dhabi*
13	*New cars purchased from Honda dealer, in exchange of old cars and remaining amount paid in cash*
14	*Provident fund paid for the employees*
15	*Issued employee stock options*

Solution

Sr. No.	Nature of transaction paid	Operating / Investing / Not to be considered
1	Interest received on loans	Operating – Main revenue generating activity
2	Interest paid on Deposits	Operating – Main expenses of operations
3	Deposits accepted	Operating – in case of financial institutes
4	Loans given to customers	Operating – in case of financial institutes
5	Loans repaid by the customers	Operating – in case of financial institutes
6	Deposits repaid	Operating – in case of financial institutes
7	Commission received	Operating – Main revenue generating activity
8	Lease rentals paid for various branches	Operating – Main expenses of operations
9	Service tax paid	Operating – Main expenses of operations
10	Furniture for new branches	Investing – Assets purchased
11	Implementation of upgraded banking software	Investing – Purchased for long term purpose
12	Purchase of shares in 100%	Investing – strategic investment

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	subsidiary for opening a branch in Abu Dhabi	
13	New cars purchased from Honda dealer, in exchange of old cars and cash payment	Investing-for cash payment
14	Provident fund paid for the employees	Operating
15	Issued employee stock options	Not to be considered. No cash flow

*****

3.8.3 Financing Activities

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

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

Cash Inflows from Financing Activity	Cash Outflows from Financing Activity
Cash proceeds from issuing shares or other equity instruments;	Cash payments to owners to acquire or redeem the entity's shares;
Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other	Cash repayments of amounts borrowed; and
Short-term or long-term borrowings;	Cash payments by a lessee for the reduction of the outstanding liability relating to a lease.

Illustration 4

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

Sr. No.	*Nature of transaction*
1	*Issued preference shares*
2	*Purchased the shares of 100% subsidiary company*
3	*Dividend received from shares of subsidiaries*
4	*Dividend received from other companies*

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

Solution

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

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Illustration 5

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

Solution

Under factoring arrangement, it needs to be assessed whether the arrangement is recourse or non-recourse.

Recourse factoring:

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

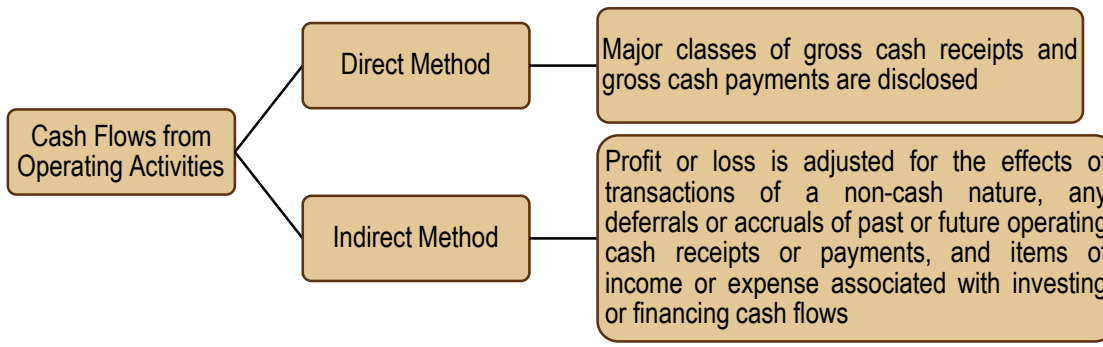
When the cash is collected by the factor, the liability and the receivables are de-recognized. It is acceptable for this to be disclosed as a non-cash transaction, because the settlement of the liability and the factored receivables does not result in cash flows. The net impact of these transactions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

Non-recourse factoring:

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

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3.9 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES



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

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

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

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

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

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

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

    (ii) other non-cash items; and

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

Analysis

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

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

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

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

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

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

Analysis

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

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

Illustration 6

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

Operating statement of ABC Ltd. for the year ended 31.3.20X2

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

Balance Sheet as on 31st March

	20X2	*20X1*
Assets		
Non-current Assets		
Property, Plant and Equipment	*75,000.00*	*65,000.00*
Investment	*12,000.00*	*10,000.00*
Current Assets		
Inventories	*12,000.00*	*13,000.00*
Trade receivables	*10,000.00*	*7,000.00*
Cash and cash equivalents	*6,000.00*	*5,000.00*

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Total	***1,15,000.00***	***1,00,000.00***
Equity and Liabilities		
Shareholders' Funds	*60,000.00*	*50,000.00*
Non-current Liabilities	*33,000.00*	*35,000.00*
Current Liabilities		
Trade Payables	*12,000.00*	*8,000.00*
Payables for Expenses	*10,000.00*	*7,000.00*
Total	***1,15,000.00***	***1,00,000.00***

Solution

1. Cash flow from Operations by Direct Method

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

Note No 1 - Cash Receipts from Sales and Trade receivables

Particulars	₹
Sales	5,00,000.00
Add : Opening Trade receivables	7,000.00
Less : Closing Trade receivables	(10,000.00)
Cash Receipts	**4,97,000.00**

Note No 2 :- Payment to Trade Payables for Purchases

Particulars	₹
Cost of goods sold	3,50,000.00
Closing inventories	12,000.00
Less: Opening inventories	(13,000.00)
Purchases	3,49,000.00
Add: Opening Trade Payables	8,000.00

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Less: Closing Trade Payables	(12,000.00)
Payment to creditors	**3,45,000.00**
Particulars	**₹**
Overheads	55,000.00
Add: Opening payables	7,000.00
Less: Closing payables	(10,000.00)
Payment for Overheads	**52,000.00**

2. Cash flow from Operations by Indirect Method

Indirect Method	**₹**
Profit After Tax	53,000.00
Add back/(Less): Depreciation	7,000.00
Loss on sale of asset	2,000.00
Interest paid	3,000.00
Decrease in Inventory	1,000.00
Increase in Trade Receivables	(3,000.00)
Increase in Trade Payables	4,000.00
Increase in Payables for expenses	3,000.00
Net cash generated from operating activities	**70,000.00**

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

*****

3.10 REPORTING CASH FLOWS FROM INVESTING AND FINANCING ACTIVITIES

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

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3.11 REPORTING CASH FLOWS ON A NET BASIS

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

Example 1

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

The above base has following exceptions

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

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

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

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

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

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

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

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

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

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

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

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3.12 FOREIGN CURRENCY CASH FLOWS

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

Example 2

Suppose the money is received on account of exports on 15th January 20X1 in US$. The company prepares the accounts in rupees. In such case the exchange rate between USD and Rupee as on 15th January 20X1 need to be applied for conversion.

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

3.12.1 Treatment of foreign exchange differences arising from unsettled transactions relating to operating activities

Under indirect method of preparation of statement of cash flows, the exchange differences that arise on translation at the balance sheet date, for monetary items that form part of operating activities, will require no adjustment in the reconciliation of profit to net cash flow from operating activities.

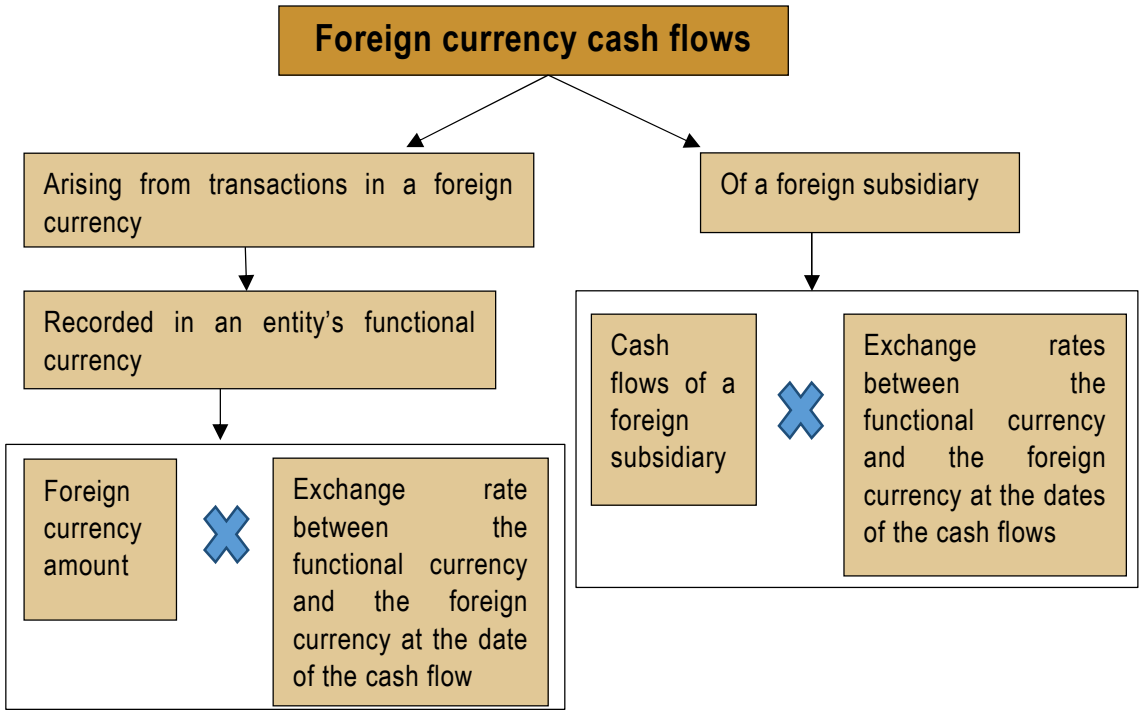
Example 3

Entity A (Indian Company) purchased goods for resale from France during January for EUR 10,000 (Exchange rate: 1 EUR = ₹ 70) on a credit period of 4 months. It accounted for the purchase of inventory at ₹ 7,00,000 (10,000 x 70). On 31st March, the exchange rate has changed to 1 EUR = ₹ 65. This would mean an unrealised gain due to exchange fluctuation of ₹ 50,000 (since the payables will be recorded at ₹ 6,50,000 (at closing exchange rate).

Assuming that the inventory is unsold at that date, the movement is reported as under:

Profit	₹ 50,000
Less: Increase in Inventory	₹ (7,00,000)
Add: Increase in Payables	₹ 6,50,000
Net Cash flows from operating activities	₹ 0

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Note:

1. Cash flows denominated in a foreign currency are reported in a manner consistent with Ind AS 21.
2. A weighted average exchange rate for a period may be used for recording foreign currency transactions or the translation of the cash flows of a foreign subsidiary
3. Ind AS 21 does not permit use of the exchange rate at the end of the reporting period when translating the cash flows of a foreign subsidiary

3.13 INTEREST AND DIVIDENDS

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

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

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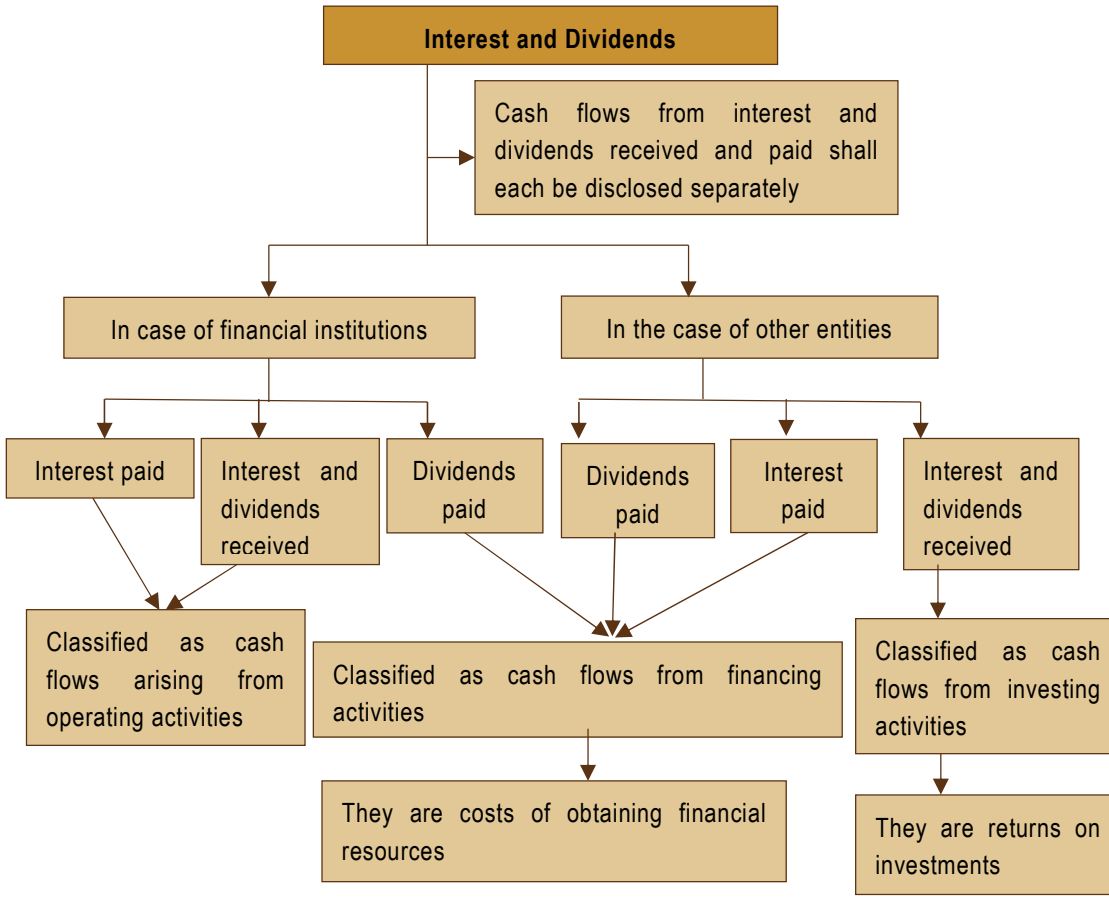


Illustration 7

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

Based on the above information answer the following question:

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

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

Solution

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

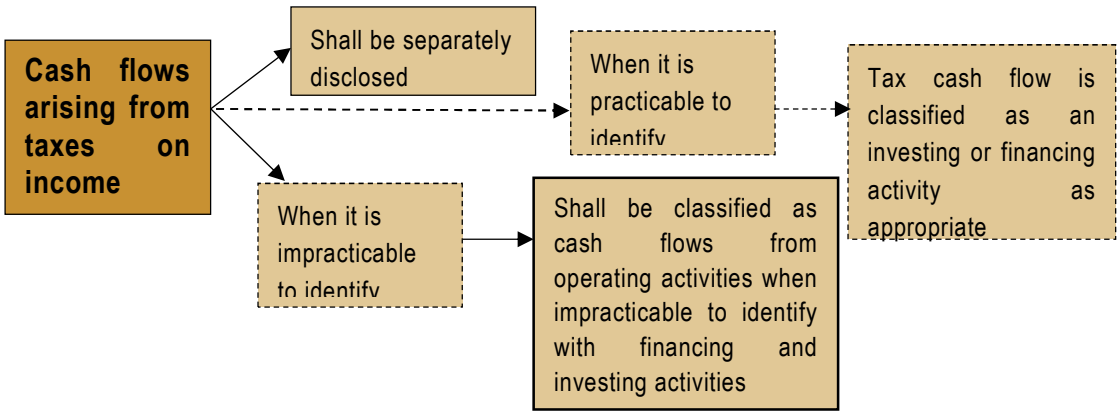
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3.14 TAXES ON INCOME

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

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



Note: When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Illustration 8

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

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

Solution

Cash flows arising from taxes on income should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. In the case of X Limited, the tax amount of ₹ 30,000 is specifically related with investing activities. ₹ 5,00,000 to be shown under operating activities. ₹ 30,000 to be shown under investing activities.

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3.15 INVESTMENTS IN SUBSIDIARIES, ASSOCIATES AND JOINT VENTURES

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

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

Investments in subsidiaries, associates and joint ventures	When accounted for by use of the equity or cost method	an investor restricts its reporting in the statement of cash flows to the cash flows between itself and the investee, for example, to dividends and advances.
	When reporting its interest in an associate or a joint venture using the equity method	Includes in its statement of cash flows the cash flows in respect of its investments in the associate or joint venture, and distributions and other payments or receipts between it and the associate or joint venture.

3.16 CHANGES IN OWNERSHIP INTERESTS IN SUBSIDIARIES AND OTHER BUSINESSES

3.16.1 Classification of Cash Flows as Investing Activity

- The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.
- An entity shall disclose, in aggregate, in respect of both obtaining and losing control of subsidiaries or other businesses during the period each of the following:
  (a) the total consideration paid or received;
  (b) the portion of the consideration consisting of cash and cash equivalents;
  (c) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and

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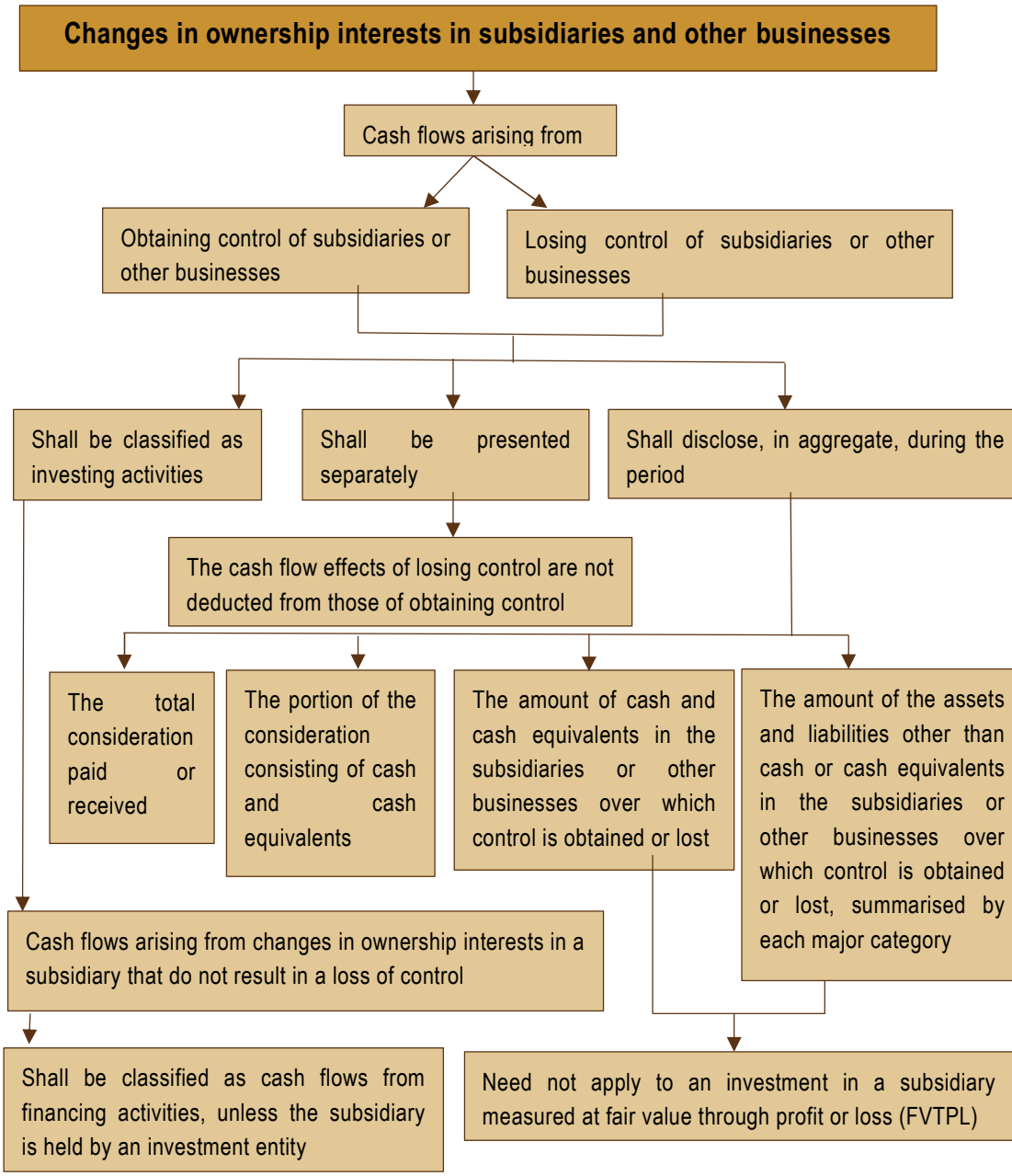
(d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category.

- The separate presentation of the cash flow effects of obtaining or losing control of subsidiaries or other businesses as single line items, together with the separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities. The cash flow effects of losing control are not deducted from those of obtaining control.
- The aggregate amount of the cash paid or received as consideration for obtaining or losing control of subsidiaries or other businesses is reported in the statement of cash flows net of cash and cash equivalents acquired or disposed of as part of such transactions, events or changes in circumstances.

3.16.2 Classification of Cash Flows as Financing Activity

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

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3.17 NON-CASH TRANSACTIONS

- Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows.

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- Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.
- Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. Such non-cash items will not form part of the cash flow statement.

  Examples of non-cash transactions are:

  (a) the acquisition of assets either by assuming directly related liabilities or by means of a lease;

  (b) the acquisition of an entity by means of an equity issue; and

  (c) the conversion of debt to equity

Illustration 9

X Limited acquires fixed asset of ₹ 10,00,000 from Y Limited by accepting the liabilities of ₹ 8,00,000 of Y Limited and balance amount it paid in cash. How X Limited will treat all those items in its cash flow statements?

Solution

Investing and financing transactions that do not require the use of cash and cash equivalents shall be excluded from a statement of cash flows. X Limited should classify cash payment of ₹ 2,00,000 under investing activities. The non-cash transactions –liabilities and asset should be disclosed in the notes to the financial statements.

*****

3.17.1 Changes in liabilities arising from financing activities

- An entity shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.
- To the extent necessary to satisfy the above requirement, an entity shall disclose the following changes in liabilities arising from financing activities:

  (a) changes from financing cash flows;

  (b) changes arising from obtaining or losing control of subsidiaries or other businesses;

  (c) the effect of changes in foreign exchange rates;

  (d) changes in fair values; and

  (e) other changes.

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- Liabilities arising from financing activities are liabilities for which cash flows were, or future cash flows will be, classified in the statement of cash flows as cash flows from financing activities.
- In addition, the disclosure requirement also applies to changes in financial assets (for example, assets that hedge liabilities arising from financing activities) if cash flows from those financial assets were, or future cash flows will be, included in cash flows from financing activities.
- One way to fulfil the disclosure requirement is by providing a reconciliation between the opening and closing balances in the balance sheet for liabilities arising from financing activities, including the changes identified.
- If an entity provides the disclosure required in combination with disclosures of changes in other assets and liabilities, it shall disclose the changes in liabilities arising from financing activities separately from changes in those other assets and liabilities.

3.18 COMPONENTS OF CASH AND CASH EQUIVALENTS

- An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet.
- Company will provide a policy which it adopts in determining the composition of cash and cash equivalents (As per Ind AS 1).

It has been clarified, that there should not be a difference in the amount of cash and cash equivalent as per Ind AS 1 and as per Ind AS 7. However, as per Ind AS 7 "where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, **bank overdrafts are included as a component of cash and cash equivalents.** A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn." Although Ind AS 7 permits bank overdrafts to be included as cash and cash equivalent, for the purpose of presentation in the balance sheet, it would not be appropriate to include bank overdraft in the line item cash and cash equivalents unless the netting off conditions as given in paragraph 42 of Ind AS 32, Financial Instruments: Presentation are complied with.

Bank overdraft, in the balance sheet, will be included within financial liabilities. Just because the bank overdraft is included in cash and cash equivalents for the purpose of Ind AS 7, does not mean that the same should be netted off against the cash and cash equivalent balance in the balance sheet. Instead Ind AS 7 requires a disclosure of the components of cash and cash equivalent and a reconciliation of amounts presented in the cash flow statements.

Another element on account of which there could be difference between the cash and cash equivalents presented in the balance sheet and the statement of cash flows is unrealised

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gains or losses arising from changes in foreign currency exchange rates, which are not considered to be cash flows. The following illustration would explain the issue:

Illustration 10

An entity has bank balance in foreign currency aggregating to USD 100 (equivalent to ₹ 4,500) at the beginning of the year. Presuming no other transaction taking place, the entity reported a profit before tax of ₹ 100 on account of exchange gain on the bank balance in foreign currency at the end of the year. What would be the closing cash and cash equivalents as per the balance sheet?

Solution

For the purpose of statement of cash flows, the entity shall present the following:

	Amount (₹)
Profit before tax	100
Less: Unrealised exchange gain	(100)
Cash flow from operating activities	Nil
Cash flow from investing activities	Nil
Cash flow from financing activities	Nil
Net increase in cash and cash equivalents during the year	Nil
Add: Opening balance of cash and cash equivalents	4,500
Cash and cash equivalents as at the year-end	4,500

Reconciliation of cash and cash equivalents

Cash and cash equivalents as per statement of cash flows	4,500
Add: Unrealised gain on cash and cash equivalents	100
Cash and cash equivalents as per the balance sheet	4,600

If any changes in the policies take place, that will be dealt with as per the provisions of Ind AS 8.

*****

3.19 OTHER DISCLOSURES

An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.

There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the group. Examples include cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the parentor other subsidiaries.

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Additional information may be relevant to users in understanding the financial position and liquidity of an entity. It may include:

1. The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.
2. The aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity it will help the stakeholders to know whether entity is paying proper attention for maintenance also;
3. The amount of the cash flows arising from the operating, investing and financing activities of each reportable segment (see Ind AS 108, *Operating Segments)*. This will provide the idea about the company as a whole as well as the various parts of the company and their efficiencies.

Investing and financing transactions that do not require the use of cash or cash equivalents	shall be excluded from a statement of cash flows
	disclosed elsewhere in the financial statements
Components of cash and cash equivalents	disclose the components of cash and cash equivalents
	shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet
	discloses the policy which entity adopts in determining the composition of cash and cash equivalents.
Other disclosures	disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held and are not available for use by the group **Note:** The requirements shall be equally applicable to the entities in case of separate financial statements also.

Illustration 11

Following is the balance sheet of Kuber Limited for the year ended 31 March, 20X2 *(₹ in lacs)*

	20X2	*20X1*
ASSETS		
Non-current assets		
Property, plant and equipment	*13,000*	*12,500*

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Intangible assets	*50*	*30*
Other financial assets	*145*	*170*
Deferred Tax Asset (net)	*855*	*750*
Other non-current assets	*800*	*770*
Total non-current assets	*14,850*	*14,220*
Current assets		
Financial assets		
Investments	*2,300*	*2,500*
Cash and cash equivalents	*220*	*460*
Other current assets	*195*	*85*
Total current assets	*2,715*	*3,045*
Total assets	*17,565*	*17,265*
EQUITY AND LIABILITIES		
Equity		
Equity share capital	*300*	*300*
Other equity	*12,000*	*8,000*
Total equity	*12,300*	*8,300*
Liabilities		
Non-current liabilities		
Financial liabilities		
Long-term borrowings	*2,000*	*5,000*
Other non-current liabilities	*2,740*	*3,615*
Total non-current liabilities	*4,740*	*8,615*
Current liabilities		
Financial liabilities		
Trade payables	*150*	*90*
Bank overdraft	*75*	*60*
Other current liabilities	*300*	*200*
Total current liabilities	*525*	*350*
Total liabilities	*5,265*	*8,965*
Total equity and liabilities	*17,565*	*17,265*

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Additional Information:

(1) Profit after tax for the year ended March 31, 20X2 - ₹ 4,450 lacs

(2) Interim dividend paid during the year - ₹ 450 lacs

(3) Depreciation and amortisation charged in the statement of profit and loss during the current year are as under

(a) Property, Plant and Equipment - ₹ 500 lacs

(b) Intangible Assets - ₹ 20 lacs

(4) During the year ended March 31, 20X2 two machineries were sold for ₹ 70 lacs. The carrying amount of these machineries as on March 31, 20X2 is ₹ 60 lacs.

(5) Income taxes paid during the year ₹ 105 lacs

(6) Other non-current / current assets and liabilities are related to operations of Kuber Ltd. and do not contain any element of financing and investing activities.

Using the above information of Kuber Limited, construct a statement of cash flows under indirect method.

Solution

Statement of Cash Flows

		₹ in lacs
Cash flows from Operating Activities		
Net Profit after Tax	4,450	
Add: Tax Paid	105	
	4,555	
Add: Depreciation & Amortisation (500 + 20)	520	
Less: Gain on Sale of Machine (70-60)	(10)	
Less: Increase in Deferred Tax Asset (855-750)	(105)	
	4,960	
Change in operating assets and liabilities		
Add: Decrease in financial asset (170 - 145)	25	
Less: Increase in other non-current asset (800 - 770)	(30)	
Less: Increase in other current asset (195 - 85)	(110)	
Less: Decrease in other non-current liabilities (3,615 – 2,740)	(875)	
Add: Increase in other current liabilities (300 - 200)	100	
Add: Increase in trade payables (150-90)	60	
	4,130	
Less: Income Tax	(105)	

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Cash generated from Operating Activities		**4,025**
Cash flows from Investing Activities		
Sale of Machinery	70	
Purchase of Machinery [13,000-(12,500 – 500-60)]	(1,060)	
Purchase of Intangible Asset [50-(30-20)]	(40)	
Sale of Financial asset - Investment (2,500 – 2,300)	200	
Cash outflow from Investing Activities		**(830)**
Cash flows from Financing Activities		
Dividend Paid	(450)	
Long term borrowings paid (5,000 – 2,000)	(3,000)	
Cash outflow from Financing Activities		**(3,450)**
Net Cash outflow from all the activities		**(255)**
Opening cash and cash equivalents (460 – 60)		**400**
Closing cash and cash equivalents (220 – 75)		**145**

*****

Illustration 12

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

Consolidated Statement of Cash Flows

	For the year ended (₹ in Lac)	
	31st March 20X2	***31st March 20X1***
Assets		
Non-Current Assets		
Property, Plant and Equipment	*4,750*	*4,650*
Investment in Associate	*800*	*-*
Financial Assets	*2,150*	*1,800*
Current Assets		
Inventories	*1,550*	*1,900*
Trade Receivables	*1,250*	*1,800*
Cash and Cash Equivalents	*4,650*	*3,550*
Liabilities		
Current Liabilities		
Trade Payables	*1,550*	*3,610*

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

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

The below information is relevant for A Ltd Group.

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

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

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

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

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

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

4. *A Ltd. purchased 30% interest in an Associate (G Ltd) for cash on 1st April 20X1. The associate reported profit after tax of ₹ 400 Lac and paid a dividend of ₹ 100 Lac for the year.*

5. *Impairment test was conducted on 31st March 20X2. The following were impaired as under:*

Goodwill impairment loss:	*₹ 265 Lac*
Intangible Assets impairment loss	*₹ 900 Lac*

The goodwill impairment relates to 100% subsidiaries.

Assume that interest cost is all paid in cash.

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

Solution

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

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

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Working Notes:

1. Profit before tax

Amount in ₹ Lacs

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

2. Changes in Trade Receivables

Amount in ₹ Lacs

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

3. Changes in Inventories

Amount in ₹ Lacs

Opening Balance	1,900
Add: Inventories of S Ltd.	60
	1,960
Less: Closing Balance	(1,550)
	410

4. Changes in Trade Payables

Amount in ₹ Lacs

Opening Balance	3,610
Add: Trade Payables of S Ltd.	50
	3,660
Less: Closing Balance	(1,550)
	2,110

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3.20 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'ITC Limited' for the financial year 2021-2022 with respect to 'Cash Flow Statement'.

Cash Flow Statement for the year ended 31st March, 2022

	For the year ended 31st March, 2022 (₹ in Crores)		For the year ended 31st March, 2021 (₹ in Crores)	
A. Cash Flow from Operating Activities				
PROFIT BEFORE TAX		**19829.53**		**17164.19**
ADJUSTMENTS FOR:				
Depreciation and amortization expense	1652.15		1561.83	
Share based payments to employees	32.51		27.15	
Finance costs	41.95		47.47	
Interest Income	(1004.59)		(1224.82)	
Dividend Income	(857.46)		(723.94)	
(Gain)/Loss on sale of property, plant and equipment, lease termination - Net	(59.05)		55.04	
Doubtful and bad debts	10.64		25.98	
Doubtful and bad advances, loans and deposits	1.15		33.04	
Net (gain)/loss arising on financial instruments mandatorily measured at fair value through profit or loss	(524.19)		(1107.53)	
Foreign currency translations and transactions - Net	11.07	(695.82)	(13.00)	(1318.78)
OPERATING PROFIT BEFORE WORKING CAPITAL CHANGES		19133.71		15845.41
ADJUSTMENTS FOR:				
Trade receivables, advances and other assets	(235.39)		(99.11)	
Inventories	(526.90)		(1350.89)	
Trade payables, other liabilities and provisions	946.39	184.10	1055.07	(394.93)
CASH GENERATED FROM OPERATIONS		19317.81		15450.48
Income tax paid		(4510.02)		(3956.62)
NET CASH FROM OPERATING ACTIVITIES		**14807.79**		**11493.86**

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B. Cash Flow from Investing Activities				
Purchase of property, plant and equipment, Intangibles, ROU asset etc.	(1812.03)		(1582.09)	
Sale of property, plant and equipment	137.22		2.66	
Purchase of current investments	(60325.53)		(51625.18)	
Sale/redemption of current investments	63554.78		56785.92	
Payment towards business combination/contingent purchase consideration	(71.25)		(2189.22)	
Investment in subsidiaries	(427.24)		(361.57)	
Investment in associate	(1.87)		(1.87)	
Purchase of non-current investments	(4777.02)		(1488.71)	
Redemption proceeds of non-current investments	2731.24		1712.05	
Dividend Income	857.46		723.94	
Interest received	962.97		1199.36	
Investment in bank deposits (original maturity more than 3 months)	(3525.01)		(3706.02)	
Redemption/maturity of bank deposits (original maturity more than 3 months)	3617.42		6259.37	
Investment in deposit with housing finance company	(3011.37)		(78.38)	
Redemption/maturity of deposit with housing finance companies	578.82		844.43	
Loans given	(12.51)		(2.12)	
Loans realised	6.86		5.32	
NET CASH FROM/(USED IN) INVESTING ACTIVITIES		**(1517.06)**		**6497.89**

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Cash Flow Statement for the year ended 31st March, 2022

	For the year ended 31st March, 2022 (₹ in Crores)	For the year ended 31st March, 2021 (₹ in Crores)
C. Cash Flow from Financing Activities		
Proceeds from issue of share capital	291.82	290.65
Repayment of non-current borrowings	(0.35)	(2.26)
Payment of lease liabilities	(54.42)	(49.67)
Interest paid	(42.14)	(43.47)
Net increase in statutory restricted accounts balances	15.13	41.17
Dividend paid	(13547.07)	(18629.29)
Dividend distribution tax refund received	-	13.98
NET CASH USED IN FINANCING ACTIVITIES	**(13337.03)**	**(18378.89)**
NET DECREASE IN CASH AND CASH EQUIVALENTS	**(46.30)**	**(387.14)**
OPENING CASH AND CASH EQUIVALENTS	**231.28**	**561.35**
CASH AND CASH EQUIVALENTS ACQUIRED ON BUSINESS COMBINATION [See Note 3 below]	**-**	**57.07**
CLOSING CASH AND CASH EQUIVALENTS	**184.98**	**231.28**

Notes:

1. The above Cash Flow Statement has been prepared under the "Indirect Method" as set out in Ind AS - 7 "Statement of Cash Flows"

2. **CASH AND CASH EQUIVALENTS:**

Cash and cash equivalents as above	184.98	231.28
Unrealised gain/(loss) on foreign currency cash and cash equivalents	(0.01)	...
Cash and cash equivalents (Note 11)	184.97	231.28

3. Cash and Cash Equivalents include ₹ Nil (2021 - ₹ 57.07 Crores) on acquisition of erstwhile Sunrise Foods Private Limited and its two wholly owned subsidiaries.

4. Net Cash Flow from Operating Activities includes an amount of ₹ 340.96 Crores (2021- ₹ 368.18 Crores) spent towards Corporate Social Responsibility.

(Source: Annual Report 2021-2022 - 'ITC Limited')

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3.21 SIGNIFICANT DIFFERENCES IN IND AS 7 VIS-À-VIS AS 3

S.No.	Particulars	Ind AS 7	AS 3
1.	*Bank Overdraft Repayable on Demand*	Ind AS 7 specifically includes bank overdrafts which are repayable on demand as a part of cash and cash equivalents (Refer Para 8 of Ind AS 7)	AS 3 is silent on this aspect.
2.	*Treatment of Cash Payments in Specific Cases*	Ind AS 7 provides the treatment of cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale in the ordinary course of business as cash flows from operating activities. Further, treatment of cash receipts from rent and subsequent sale of such assets as cash flow from operating activity is also provided. (Refer Para 14 of Ind AS 7)	AS 3 does not contain such requirements.
3.	*Examples of cash flows arising from financing activities*	Ind AS 7 includes following examples of cash flows arising from financing activities (paragraph 17 of Ind AS 7): (a) cash payments to owners to acquire or redeem the entity's shares; (b) cash proceeds from mortgages; (c) cash payments by a lessee for the reduction of the outstanding liability relating to a lease.	These examples are not mentioned in AS 3
4.	*Adjustment of the Profit or Loss for the Effects of Undistributed Profits of*	Ind AS 7 specifically requires adjustment of the profit or loss for the effects of 'undistributed profits of associates and non-controlling interests' while determining the net	AS 3 does not contain such requirements.

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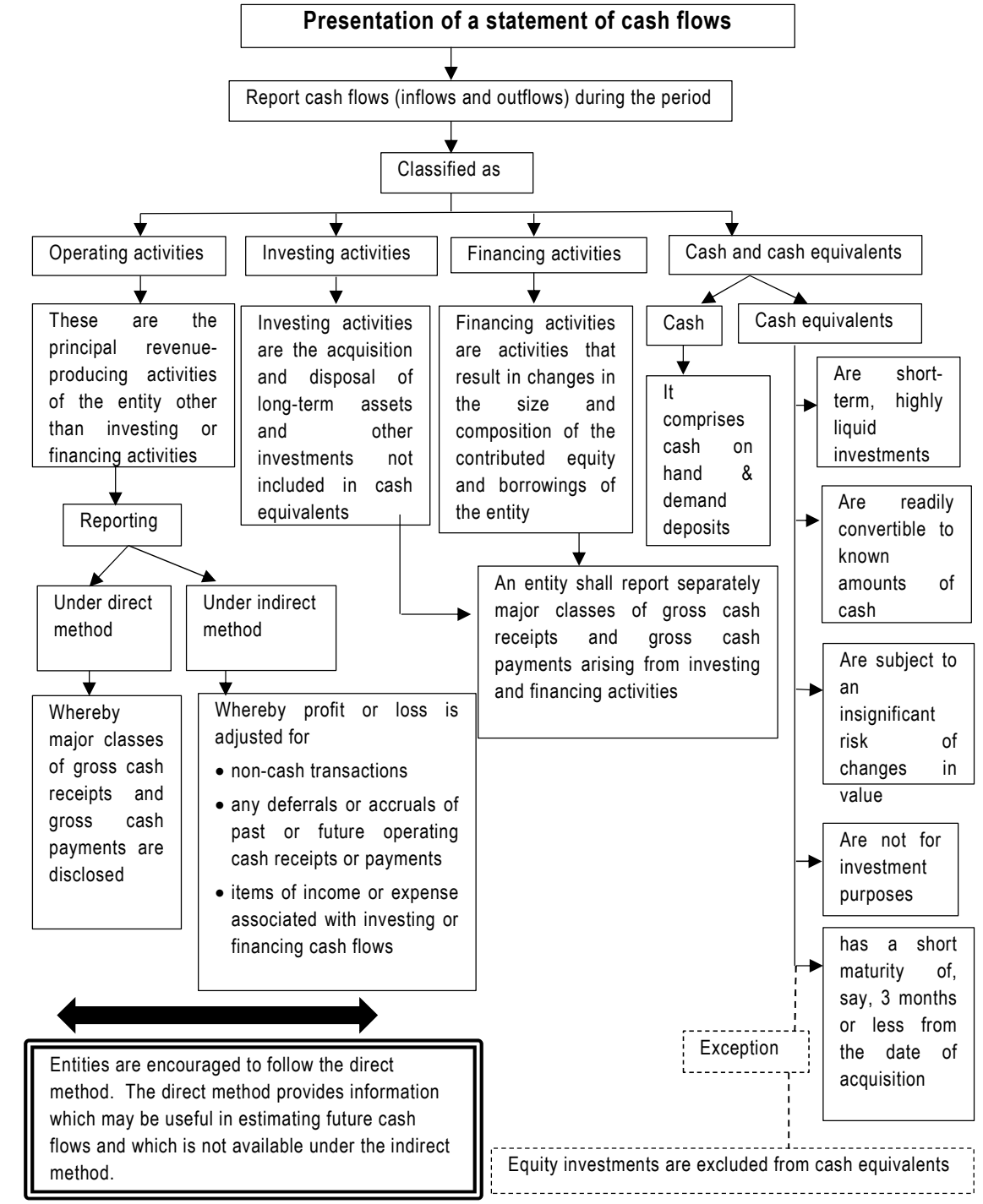
	Associates and Non-controlling Interests	cash flow from operating activities using the indirect method. (Refer Para 20(b) of Ind AS 7)	
5.	*Cash Flows associated with Extraordinary Activities*	Ind AS 7 does not contain this requirement.	AS 3 requires cash flows associated with extraordinary activities to be separately classified as arising from operating, investing and financing activities
6.	*Disclosure of the Amount of Cash and Cash Equivalents in Specific Situations*	Ind AS 7 requires an entity (except an investment entity) to disclose the amount of cash and cash equivalents and other assets and liabilities in the subsidiaries or other businesses over which control is obtained or lost (Refer Para 40(c) and (d) of Ind AS 7). It also requires to report the aggregate amount of the cash paid or received as consideration for obtaining or losing control of subsidiaries or other businesses in the statement of cash flows, net of cash and cash equivalents acquired or disposed of as a part of such transactions, events or changes in circumstances (Refer Para 42 of Ind AS 7).	AS 3 does not contain such requirements.
7.	*Cash Flows arising from Changes in Ownership Interests in a Subsidiary*	Ind AS 7 requires to classify cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control as cash flows from financing activities (Refer Para 42A and 42B of Ind AS 7).	AS 3 does not contain such a requirement.

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8.	*Investment in an associate, joint venture or a subsidiary*	Ind AS 7 mentions the use of equity or cost method while accounting for an investment in an associate, joint venture or a subsidiary (refer paragraph 37 of Ind AS 7). It also specifically deals with the reporting of interest in an associate or a joint venture using equity method (refer paragraph 38 of Ind AS 7).	AS 3 does not contain such requirements.
9.	*Cash flows arising from transaction in a foreign currency*	With regard to cash flows arising from transaction in a foreign currency, Ind AS 7 requires it to be recorded in an entity's functional currency. Ind AS 7 also deals with translation of cash flows of a foreign subsidiary (refer paragraphs 25 to 27 of Ind AS 7)	AS 3 requires it to be recorded in an entity's 'reporting currency'. AS 3 does not deal with it.
10.	*Disclosure of changes in liabilities*	Ind AS 7 requires disclosure of changes in liabilities arising from financing activities, both changes i.e. changes arising from cash flows and non-cash changes.	AS 3 does not contain such requirement.
11.	*Disclosures*	Ind AS 7 requires more disclosures, i.e. additional information that may be relevant to understanding the financial position and liquidity of an entity (Refer Paragraph 50 of the Ind AS 7)	In comparison to Ind AS 7, AS 3 does not have that many disclosure requirements.

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QUICK RECAP



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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Use the following data of ABC Ltd. to construct a statement of cash flows using the direct and indirect methods: (Amount in ₹)

	20X2	20X1
Cash	4,000	14,000
Accounts Receivable	25,000	32,500
Prepaid Insurance	5,000	7,000
Inventory	37,000	34,000
Fixed Assets	3,16,000	2,70,000
Accumulated Depreciation	(45,000)	(30,000)
Total Assets	3,42,000	3,27,500
Accounts Payable	18,000	16,000
Wages Payable	4,000	7,000
Debentures	1,73,000	1,60,000
Equity Shares	88,000	84,000
Retained Earnings	59,000	60,500
Total Liabilities & Equity	3,42,000	3,27,500
	20X2	
Sales	2,00,000	
Cost of Goods Sold	(1,23,000)	

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Depreciation	(15,000)	
Insurance Expense	(11,000)	
Wages	(50,000)	
Net Profit	1,000	

During the financial year 20X2 company ABC Ltd. declared and paid dividend of ₹ 2,500.

During 20X2, ABC Ltd. paid ₹ 46,000 in cash to acquire new fixed assets. The accounts payable was used only for inventory. No debt was retired during 20X2.

2. From the following summary cash account of XYZ Ltd, prepare cash flow statement for the year ended March 31, 20X1 in accordance with Ind AS 7 using direct method.

Summary of Bank Account for the year ended March 31, 20X1

	₹ '000		₹ '000
Balance on 1.4.20X0	50	Payment to creditors	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from customers	2,800	Overhead Expenses	200
Sale of Fixed Assets	100	Payroll	100
		Tax Payment	250
		Dividend	50
		Repayment of Bank loan	300
		Balance on 31.3.20X1	150
	3,250		3,250

3. Z Ltd. has no foreign currency cash flow for the year 20X1. It holds some deposit in a bank in the USA. The balances as on 31.12.20X1 and 31.12.20X2 were US$ 100,000 and US$ 102,000 respectively. The exchange rate on December 31, 20X1 was US$1 = ₹ 45. The same on 31.12.20X2 was US$1 = ₹ 50. The increase in the balance was on account of interest credited on 31.12.20X2. Thus, the deposit was reported at ₹ 45,00,000 in the balance sheet as on December 31, 20X1. It was reported at ₹ 51,00,000 in the balance sheet as on 31.12.20X2. How these transactions should be presented in cash flow for the year ended 31.12.20X2 as per Ind AS 7?

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

   (a) Cash consideration of ₹ 15,00,000

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

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

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

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

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

Consolidated Statement of Profit and Loss

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

Consolidated balance sheet

	20X2	20X1
Assets	**Amount (₹)**	**Amount (₹)**
Cash and cash equivalents	8,000	5,000
Trade receivables	54,000	50,000
Inventories	30,000	35,000
Property, plant and equipment	1,60,000	80,000
Goodwill	18,000	—
Total assets	**2,70,000**	**1,70,000**
Liabilities		
Trade payables	68,000	60,000

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Income tax payable	12,000	11,000
Long term debt	1,00,000	64,000
Total liabilities	**1,80,000**	**1,35,000**
Shareholders' equity	**90,000**	**35,000**
Total liabilities and shareholders'	**2,70,000**	**1,70,000**

Other information

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

Particulars	Amount (₹)
Inventories	4,000
Trade receivables	8,000
Cash	2,000
Property, plant and equipment	1,10,000
Trade payables	(32,000)
Long term debt	(36,000)
Goodwill	18,000
Cash consideration paid	**74,000**

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

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

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

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

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

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

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

Additional information:

(i) Trade receivables and Trade payables include amounts relating to credit sale and credit purchase only.

(ii) Foreign exchange loss represents increment in liability of a long-term borrowing due to exchange rate fluctuation between acquisition date and balance sheet date.

8. What will be the classification for following items in the statement of cash flows of both (i) Banks / Financial institutions and (ii) Other Entities?

S. No.	Particulars
1	Interest received on loans and advances given
2	Interest paid on deposits and other borrowings
3	Interest and dividend received on investments in subsidiaries, associates and in

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	other entities
4	Dividend paid on preference and equity shares, including tax on dividend paid on preference and equity shares by other entities
5	Finance charges paid by lessee under finance lease
6	Payment towards reduction of outstanding finance lease liability
7	Interest paid to vendor for acquiring fixed asset under deferred payment basis
8	Principal sum payment under deferred payment basis for acquisition of fixed assets
9	Penal interest received from customers for late payments
10	Penal interest paid to suppliers for late payments
11	Interest paid on delayed tax payments
12	Interest received on tax refunds

Answers

1. A. DIRECT METHOD

Cash flows from operating activities		20X2
Cash received from customers	2,07,500	
Cash paid for inventory	(1,24,000)	
Cash paid for insurance	(9,000)	
Cash paid for wages	(53,000)	
Net cash flow from operating activities		21,500
Cash flows from investing activities		
Purchase of fixed assets		(46,000)
Cash flows from financing activities		
Dividend paid	(2,500)	
Proceeds from issuance of debentures	13,000	
Proceeds from issue of equity	4,000	
Net cash flows from financing activities		14,500
Net decrease in cash and cash equivalents		**(10,000)**
Opening Cash Balance		**14,000**
Closing Cash Balance		**4,000**

B. INDIRECT METHOD

Cash flows from operating activities		20X2
Net Profit	1,000	
Adjustments for Depreciation	15,000	

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	16,000	
Decrease in accounts receivable	7,500	
Decrease in prepaid insurance	2,000	
Increase in inventory	(3,000)	
Increase in accounts payable	2,000	
Decrease in wages payable	(3,000)	
Net cash flow from operating activities		21,500
Cash flows from investing activities		
Purchase of fixed assets		(46,000)
Cash flows from financing activities		
Dividend paid	(2,500)	
Proceeds from issue of debentures	13,000	
Proceeds from issue of equity	4,000	
Net cash flows from financing activities		14,500
Net decrease in cash and cash equivalents		**(10,000)**
Opening Cash Balance		**14,000**
Closing Cash Balance		**4,000**

Working Notes:

Fixed Assets Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	2,70,000	By Balance c/d	3,16,000
To Cash (Purchase of Fixed Assets)	46,000		
	3,16,000		3,16,000

Inventory Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	34,000	By Cost of goods sold	1,23,000
To Creditors account (credit purchase)	2,000	By Balance c/d	37,000
To Purchase (Bal. Figure)	1,24,000		
	1,60,000		**1,60,000**

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Accounts Payable Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	18,000	By Balance b/d	16,000
		By Inventory Account (credit purchase) (Bal.Fig.)	2,000
	18,000		18,000

Equity Share Capital Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	88,000	By Balance b/d	84,000
		By Bank account (Proceeds from equity share issued)	4,000
	88,000		88,000

2. **XYZ Ltd.**

Cash Flow Statement for the year ended March 31, 20X1 (Using the Direct Method)

Cash flows from operating activities	₹ '000	₹ '000
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flow from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	

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Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		**100**
Cash at the beginning of the period		**50**
Cash at end of the period		**150**

3. The profit and loss account was credited by ₹ 1,00,000 (US $ 2,000 × ₹ 50) towards interest income. It was credited by the exchange difference of US$ 1,00,000 × (₹ 50 - ₹ 45) that is, ₹ 500,000. In preparing the cash flow statement, ₹ 5,00,000, the exchange difference, should be deducted from the 'net profit before taxes'. However, in order to reconcile the opening balance of the cash and cash equivalents with its closing balance, the exchange difference ₹ 5,00,000, should be added to the opening balance in note to cash flow statement.

Cash flows arising from transactions in a foreign currency shall be recorded in Z Ltd.'s functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.

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

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

Further, investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

As per para 42A of Ind AS 7, cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from financing activities, unless the subsidiary is held by an investment entity, as defined in Ind AS 110, and is required to be measured at fair value through profit or loss. Such transactions are accounted for as equity transactions and accordingly, the resulting cash flows are classified in the same way as other transactions with owners.

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

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

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

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

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

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

Working Notes:

1.

Calculation of change in inventory during the year	₹
Total inventories of the Group at the end of the year	30,000
Inventories acquired during the year from subsidiary	(4,000)

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	26,000
Opening inventories	35,000
Decrease in inventories	9,000

2.

Calculation of change in Trade Receivables during the year	₹
Total trade receivables of the Group at the end of the year	54,000
Trade receivables acquired during the year from subsidiary	(8,000)
	46,000
Opening trade receivables	50,000
Decrease in trade receivables	4,000

3.

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

6. Para 36 of Ind AS 7 inter alia states that when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Accordingly, the transactions are analysed as follows:

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

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

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

Particulars	₹	₹
Operating Activities:		
Cash received from Trade receivables (W.N. 3)		85,33,000
Less: Cash paid to Suppliers (W.N.2)	55,75,000	
Payment for Administration and Selling expenses	15,40,000	
Payment for Income Tax (W.N.4)	1,12,000	(72,27,000)
		13,06,000
Adjustment for exceptional items (fire insurance claim)		1,10,000
Net cash generated from operating activities		14,16,000

Working Notes:

1. Calculation of total purchases

Cost of Sales = Opening stock + Purchases – Closing Stock

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

Purchases = ₹ 55,55,000

2. Calculation of cash paid to Suppliers

Trade Payables

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

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3. Calculation of cash received from Customers

Trade Receivables

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

4. Calculation of tax paid during the year in cash

Provision for tax

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

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

S. No.	Particulars	Classification for reporting cash flows	
		Banks / financial institutions	Other entities
1	Interest received on loans and advances given	Operating Activities	Investing activities
2	Interest paid on deposits and other borrowings	Operating Activities	Financing activities
3	Interest and dividend received on investments in subsidiaries, associates and in other entities	Investing activities	Investing activities
4	Dividend paid on preference and equity shares, including tax on dividend paid on preference and equity shares by other entities	Financing activities	Financing activities
5	Finance charges paid by lessee under finance lease	Financing activities	Financing activities
6	Payment towards reduction of outstanding finance lease liability	Financing activities	Financing activities

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7	Interest paid to vendor for acquiring fixed asset under deferred payment basis	Financing activities	Financing activities
8	Principal sum payment under deferred payment basis for acquisition of fixed assets	Investing activities	Investing activities
9	Penal interest received from customers for late payments	Operating Activities	Operating Activities
10	Penal interest paid to suppliers for late payments	Operating Activities	Operating Activities
11	Interest paid on delayed tax payments	Operating Activities	Operating Activities
12	Interest received on tax refunds	Operating Activities	Operating Activities

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NOTES

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CHAPTER 4

IND AS ON MEASUREMENT BASED ON ACCOUNTING POLICIES



UNIT 1:
INDIAN ACCOUNTING STANDARD 8 : ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

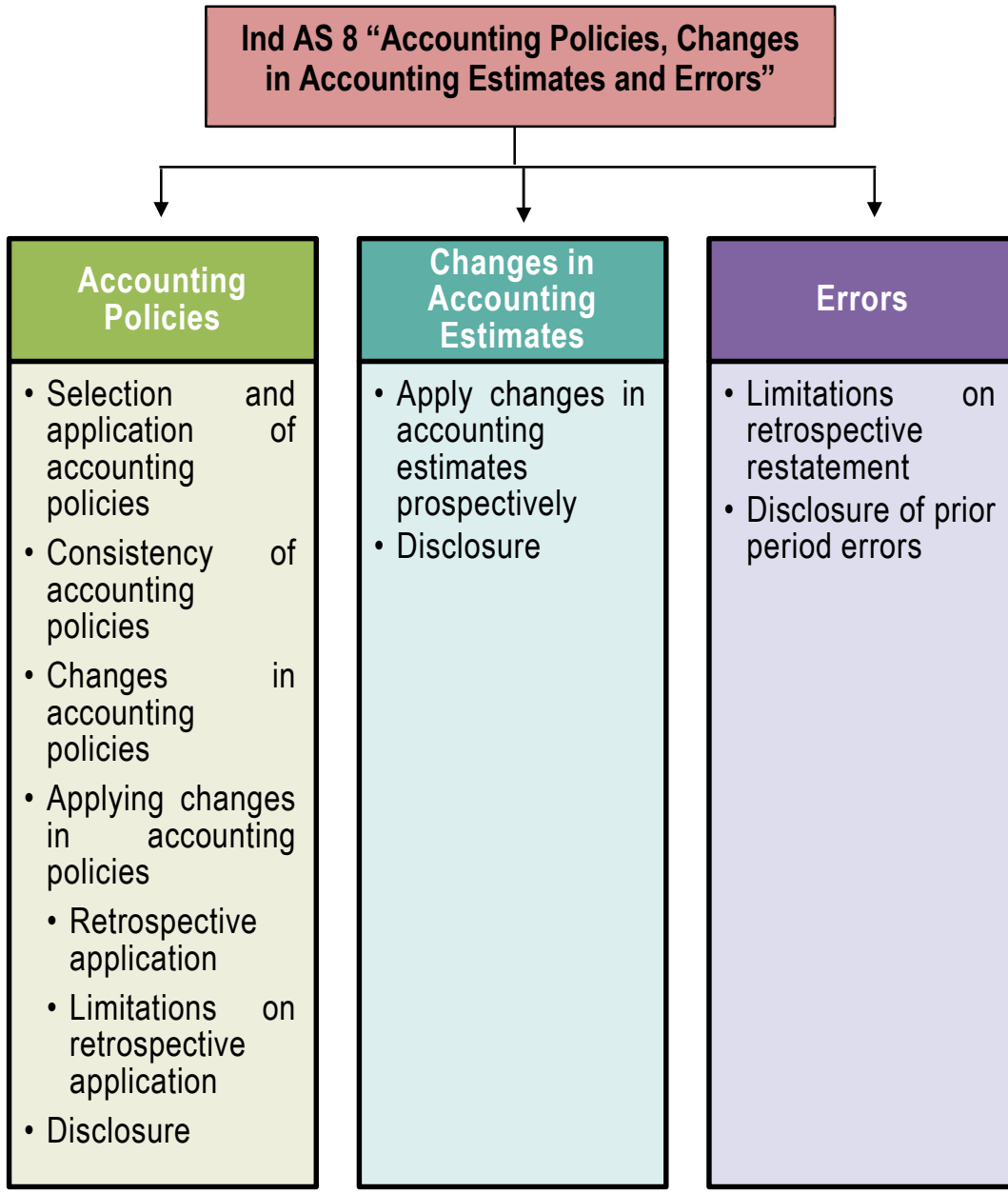
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Apply the principles laid down for selection of accounting policies.
- Explain the treatment of changes in accounting policies, changes in accounting estimates and correction of prior period errors.
- Distinguish between accounting policies, estimates, changes in them and errors.
- Assess the limitations of giving retrospective effect while accounting.
- Judge the impracticability of a requirement for giving retrospective effect.

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UNIT OVERVIEW



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1.1 INTRODUCTION

Ind AS 1, Presentation of Financial Statements, lays down the foundation for an entity regarding how the financial statements need to be presented. Ind AS 1 gives equal importance to the disclosure, in notes, of significant accounting policies and other explanatory information besides balance sheet, statement of profit and loss, statement of changes in equity and statement of cash flows.

Accounting policies, estimates and correction of errors play a major role in the presentation of financial statements. That is why Ind AS 1 states that an entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material. If there is any change in accounting policies, that needs to be dealt with due diligence and not just by mere note or explanation.

Further, Ind AS 1 makes it mandatory for the entity to present a third balance sheet as at the beginning of the preceding period, if it applies an accounting policy retrospectively, which has a material effect on the information in the balance sheet at that date.

Further, Ind AS 1 provides detail guidance about the proper disclosure of accounting policies and estimates.

Therefore, in the current chapter we are going to see, how to select the accounting policies, how to make the changes in accounting policies if needed, how to deal with changes in the estimates, how to rectify errors, etc., as all these elements will have impact on the true and fair position of the financial statements.

1.2 OBJECTIVE

1.2.1 To prescribe the criteria for selecting and changing accounting policies

As per Ind AS 1, an entity is required to disclose the significant accounting policies. However, it does not specify which accounting policies are to be disclosed. Depending upon the nature of business and types of transactions, the entity is supposed to decide whether an accounting policy is to be disclosed. In this regard, Ind AS 1 lays emphasis on usefulness of the disclosure in assisting the users in understanding financial statements, nature of an entity's operations and expectations of users. Ind AS 8 further provides some criteria / guidelines which will facilitate the entity to take a decision on selection and application of accounting policies and also making changes in them.

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1.2.2 To prescribe the accounting treatment and disclosure of changes in accounting policies

At certain times, there is a need to make the changes in the policies in the light of changing circumstances of business, changing nature of business, new guidelines issued by regulatory authorities, enforcement of new laws etc. In such cases, an entity needs guidance as to whether the changes need to be affected retrospectively or only prospectively and how to present and disclose the effect of the same in the financial statements. Ind AS 8 provides guidance to the entity in such areas.

1.2.3 To prescribe the accounting treatment and disclosure of changes in accounting estimates

In business, there are many things which are uncertain. For example, how many trade receivables will turn bad? What will be the estimated life of property, plant and equipment? What will be the value of investments? Will the net realisable value of closing inventory be more or less than the actual realised value less actual costs of completion and actual costs necessary to make the sale? And so on. In such cases, the entity will have to make few assumptions and make an estimate. Ind AS 1 allows an entity to do the estimation. Ind AS 8 takes it further and deals with how to incorporate the changes in the accounting estimates already made in the past. Is it possible to change such estimates with changing circumstances and available new information? If yes, how would the entity incorporate the effect of the changes? Such questions are addressed in Ind AS 8.

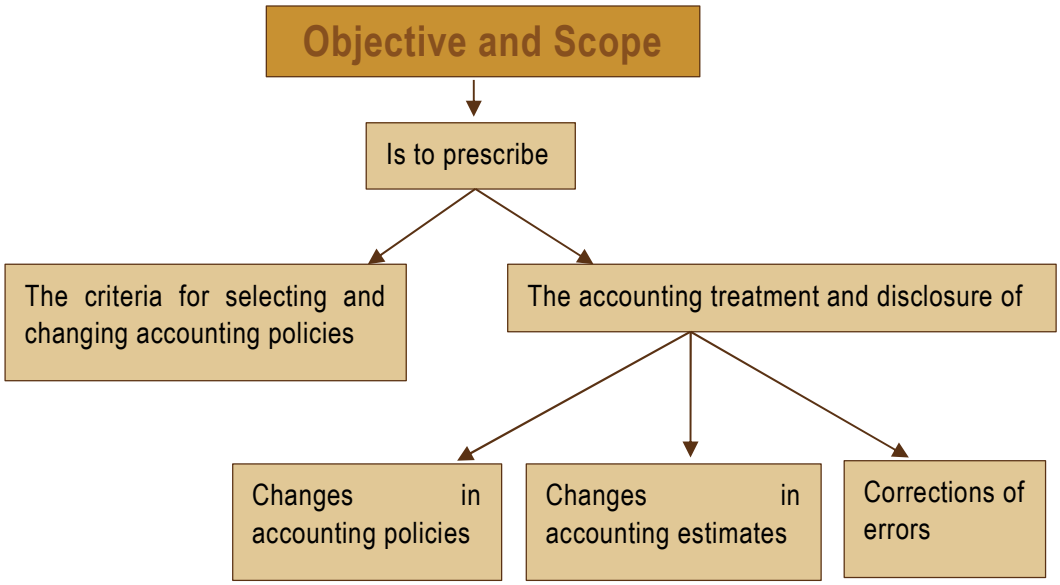
1.2.4 To prescribe the accounting treatment and disclosure of corrections of errors

It is said that 'to err is human'. Making mistakes is an integral part of life and the possibility of having some errors in the financial statements already published cannot be ruled out. In such cases, the question arises as to how to rectify the errors and provide the true and fair position to the stakeholders of financial statements. Should the entity rectify the error by way of retrospective restatement or should it rectify the same in the current reporting period? Such questions are addressed in Ind AS 8.

1.2.5 To provide better base for inter-firm and intra-firm comparison

The standard is intended to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.

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1.3 SCOPE

This standard shall be applied in

- selecting and applying accounting policies;
- accounting for changes in accounting policies;
- accounting for changes in accounting estimates; and
- accounting for corrections of prior period errors.

However, tax effects of retrospective application of accounting policy changes and correction of prior period errors are not dealt with in this standard. The tax effects of these items are dealt with Ind AS 12, 'Income Taxes'.

Note: Requirements of Ind AS 8 in respect of changes in accounting policies do not apply in an entity's first Ind AS financial statements.

1.4 DEFINITIONS

1. ***Accounting policies*** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
2. ***Accounting estimates*** are monetary amounts in financial statements that are subject to measurement uncertainty.

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3. ***Indian Accounting Standards (Ind AS)*** are Standards prescribed under Section 133 of the Companies Act, 2013 read with Companies (Indian Accounting Standards) Rules, 2015 (as amended from time to time).

4. **Material –** (As per Ind AS 1) Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

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

   Information is obscured if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or misstating that information. The following are examples of circumstances that may result in material information being obscured:

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

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

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

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

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

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

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

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The application of the concept of materiality is set out in two Standards. Ind AS 1 continues to specify its application to disclosures and Ind AS 8 specifies the application of materiality in applying accounting policies and correcting errors (including errors in measuring items).

5. ***Prior period errors*** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

   (a) was available when financial statements for those periods were approved for issue; and

   (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

6. ***Retrospective application*** is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

7. ***Retrospective restatement*** is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

8. ***Impracticable:*** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

   (a) the effects of the retrospective application or retrospective restatement are not determinable;

   (b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

   (c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

      (i) provides evidence of circumstances that existed on the date(s)as at which those amounts are to be recognised, measured or disclosed; and

      (ii) would have been available when the financial statements for that prior period were approved for issue from other information.

9. ***Prospective application*** of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

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(a) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and

(b) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

1.5 ACCOUNTING POLICIES

1.5.1 Selection and application of accounting policies

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

Ind AS 1 narrates the importance of accounting policies but Ind AS 8 goes a step further and gives guidance to the entity as to how to select and apply accounting policies.

Let us take few examples of accounting policies:

(a) Basis of accounting – Cash or accrual or hybrid?

(b) Method of determination of cost of inventories – FIFO or specific identification or Weighted Average?

(c) What is included in cash equivalents and what is excluded from cash equivalents?

(d) When should revenue be recognised?

Thus, one will notice that while preparing the financial statements, the entity has to make numerous assumptions and define the base for measurement of particular transactions, other events or conditions. If every entity follows a different base or a different rule or a different convention according to their convenience/ interpretation, then it will be impossible to compare the financial statements across entities having similar nature of business. Therefore, the role of Ind AS is very important in selection and application of the policies.

As per Ind AS 8, if any of the Ind AS already specifies the guidelines about following a particular policy then entity **must** follow that standard and apply the policy as per the guidance provided. Moreover, an entity can also refer to guidance notes which are published by ICAI, along with the relevant Ind AS, if there is an ambiguity or there is need to go into the depth of a particular transaction.

1.5.2 Is it compulsory to apply accounting policies?

- Ind AS set out accounting policies that result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply.
- Those policies need not be applied when the effect of applying them is immaterial.

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- However, it is inappropriate to make, or leave uncorrected, immaterial departures from Ind AS to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

Analysis

Ind AS leaves the judgement to the entity to decide whether it would be material or not material to apply any accounting policy. Users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

1.5.3 How to select and apply an accounting policy when specific Ind AS is not available on the particular transaction / condition / event?

- In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:

  (a) relevant to the economic decision-making needs of users; and

  (b) reliable in that the financial statements:

    (i) represent faithfully the financial position, financial performance and cash flows of the entity;

    (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

    (iii) are neutral, i.e. free from bias;

    (iv) are prudent; and

    (v) are complete in all material respects.

  Analysis

  The businesses may have large variety of transactions in terms of their nature and size. Though Ind AS cover most of the transactions which are of general nature for any type of business, there is possibility of new business models coming into picture and new technologies changing the face of the business, resulting in some new and complex types of transactions. In such circumstances it will be difficult to find the appropriate accounting standard for such specific transactions.

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Example 1

Before the wake of online transactions of capital markets, the trading of shares used to take place mainly through brokers and stock exchanges. However, OTC online terminals changed the face of the capital markets, giving direct access to the layman to trading transactions. Even if the basic nature of business was same, the technology changed the face of the business, and many giant financial institutions became the dominant players in the market as brokerage firms. In view of the changing circumstances, SEBI and ICAI have come up with new guidelines and new standards which will cater to the need of new business models, such as trading in derivatives. However, there was a period of transformation when new transactions were slowly creeping in, but the guidelines were in the preparatory phase.

In such circumstances, Ind AS 8 provides the following guiding principles for selecting and applying the accounting policies. The main two objectives to be kept in mind while making the decision for selecting an accounting policy would be:

(i) **Whether it is relevant?** The basic purpose of presenting financial statements is to facilitate the economic decision making of the stakeholders, which would be based on the information provided in the financial statements. So, if the management is of the opinion that an accounting policy related to a particular transaction/ condition / event results in information that is going to help the users to make the economic decisions, then the entity must select and apply such accounting policy as it is relevant for decision making.

(ii) **Whether it is reliable?** The information will be said to be reliable if it makes a faithful representation, unbiased, prudent, complete in all material respects and it reflects substance of the transaction and is not presented solely with a purpose of adhering to the law.

- In making the judgement, management shall refer to, and consider the applicability of, the following sources in descending order:

  (a) the requirements in Ind AS dealing with similar and related issues; and

  (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework for Financial Reporting under Indian Accounting Standards (Conceptual Framework).

- Management may also first consider the most recent pronouncements of International Accounting Standards Board (IASB) and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources mentioned above.

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Analysis

There is a need to have some authentic base for selecting and applying the accounting policy. Even if it is left to the judgement of the entity, there has to be some basis for making the judgement. It cannot be left to the personal opinions/ understanding/ intuitions of the people working for the entity. In view of this, Ind AS 8 requires that in absence of specific Ind AS, the entity should refer to the following material, in their descending order. Accordingly, Ind AS 8 provides the following list:

(i) Check if there are any other Ind AS available which are dealing with **similar and related** issues

(ii) Check the basic Conceptual Framework of Ind AS, which provides the general principles

(iii) Check the pronouncements of International Accounting Standard Board

(iv) Check the pronouncements of other standard setting bodies having a similar conceptual framework

(v) Check the accounting literature and accepted industry practices.

1.5.4 Consistency of accounting policies

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate. If an Ind AS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

Analysis

Accounting policies are the bases or principles or conventions or rules which are followed by an entity while preparing the financial statements. If the entity keeps on changing the base from year to year, it will not reflect the true and fair financial position of the entity. Secondly the results of earlier years cannot be compared with the latest year as the base of the measurement is changed. Therefore, it is utmost necessity that the entity follows the accounting policies consistently.

Examples 2 & 3

2. An entity has grouped its property, plant and equipment into four classes viz., land, factory building, plant and machinery and furniture. The entity may propose to apply revaluation model only to land. It need not apply this model to building or plant and machinery.

3. Ind AS 2 'Inventories' requires that inventory be valued at lower of cost and net realizable value. In identifying cost, it allows alternative cost formulas; FIFO and Weighted average.

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The same cost formula must be applied to items of inventory having similar nature or use, but a different cost formula can be applied to a different classification of inventory.

1.5.5 Changes in accounting policies

- An entity shall change an accounting policy only if the change:

  (a) is required by an Ind AS; or

  (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Example 4 - Voluntary change in accounting policy

As per Ind AS 27 'Separate Financial Statements', investment in subsidiaries, associates and joint ventures are accounted for in an entity's separate financial statements at cost or in accordance with Ind AS 109 (i.e., at fair value). The same accounting is required to be applied for each category of investment.

Assume that an entity decides to change its policy of measuring investment in subsidiaries (or associates or joint ventures) from cost to fair value in accordance with Ind AS 109, as this will result in the financial statements providing reliable and more relevant information.

This would constitute a voluntary change in accounting policy.

- Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the above criteria.

Analysis

Continuing with the same rationale, the frequent changes in accounting policies are not permitted by Ind AS 8. Frequent changes in accounting policies will make it impossible for a stakeholder to make the economic decisions properly.

For example, suppose an entity has been following the FIFO method of determination of cost for inventories. In the current year, it shifts from FIFO to weighted average method. Assuming that cost is less than NRV, it means the opening stock is valued at FIFO method whereas closing stock is valued at Weighted Average Method, if retrospective application of the change is impracticable. This will directly impact the gross profit measurement of the entity. Additionally, the opening inventories and closing inventories will not be comparable. Moreover, if the investment companies and banks are using the information for calculation of liquidity, then, the liquidity ratios based on opening inventory and closing inventory may

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show major discrepancies. Thus, changing the base will not only affect the true and fair position of the financial statements but it will also affect the decision making of the stakeholders.

In view of the above, Ind AS 8 allows the entity to change the accounting policy only in following circumstances:

(a) when the change is required by an Ind AS; or

(b) when the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

- The following are not changes in accounting policies:

(a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and

(b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

Analysis

Ind AS 8 clearly states that if the entity applies an accounting policy which is different from the previous one to a transaction, other event or condition that differs in substance from a previously occurring transaction, other event or condition, the application of the new policy will not be considered as a change in accounting policy.

Example 5

A company owns several hotels and provides significant ancillary services to occupants of rooms. These hotels are, therefore, treated as owner-occupied properties and classified as property, plant and equipment in accordance with Ind AS 16. The company acquires a new hotel but outsources entire management of the same to an outside agency and remains as a passive investor. The selection and application of an accounting policy for this new hotel in line with Ind AS 40 is not a change in accounting policy simply because the new hotel rooms are also let out for rent. This is because the way in which the new hotel is managed differs in substance from the way other existing hotels have been managed so far.

Similarly, if an entity is not applying the accounting policy currently and starts applying the accounting policy newly, that will also not be treated as a change in accounting policy.

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Example 6

An entity has classified as investment property, an owner-occupied property previously classified as part of property, plant and equipment where it was measured after initial recognition applying the revaluation model. Ind AS 40 on investment property permits only cost model. The entity now measures this investment property using the cost model. This is not a change in accounting policy.

- The initial application of a policy to revalue assets in accordance with Ind AS 16 'Property, Plant and Equipment', or Ind AS 38 'Intangible Assets', is a change in an accounting policy to be dealt with as a revaluation in accordance with Ind AS 16 or Ind AS 38, rather than in accordance with Ind AS 8.
- As per Ind AS 16, a change in depreciation method should be accounted for as a change in accounting estimate in accordance with Ind AS 8. Similarly, as per Ind AS 38, a change in amortisation method should be accounted for as a change in accounting estimate in accordance with Ind AS 8. These changes are, therefore, not changes in accounting policies.

Illustration 1

Can an entity voluntarily change one or more of its accounting policies?

Solution

A change in an accounting policy can be made only if the change is required or permitted by Ind AS 8.

As per para 14 of Ind AS 8, an entity shall change an accounting policy only if the change:

(a) is required by an Ind AS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Para 15 of the standard states that the users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the above criteria.

Paragraph 14(b) lays down two requirements that must be complied with in order to make a voluntary change in an accounting policy. First, the information resulting from application of the changed (i.e., the new) accounting policy must be reliable. Second, the changed accounting policy must result in "more relevant" information being presented in the financial statements.

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Whether a changed accounting policy results in reliable and more relevant financial information is a matter of assessment in the particular facts and circumstances of each case. In order to ensure that such an assessment is made judiciously (such that a voluntary change in an accounting policy does not effectively become a matter of free choice), paragraph 29 of Ind AS 8 requires an entity making a voluntary change in an accounting policy to disclose, inter alia, "the reasons why applying the new accounting policy provides reliable and more relevant information."

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Illustration 2

Entity ABC acquired a building for its administrative purposes and presented the same as property, plant and equipment (PPE) in the financial year 20X1-20X2. During the financial year 20X2-20X3, it relocated the office to a new building and leased the said building to a third party. Following the change in the usage of the building, Entity ABC reclassified it from PPE to investment property in the financial year 20X2-20X3. Should Entity ABC account for the change as a change in accounting policy?

Solution

Paragraph 16(a) of Ind AS 8 provides that the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring are not changes in accounting policies.

As per Ind AS 16, 'property, plant and equipment' are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period."

As per Ind AS 40, 'investment property' is property (land or a building—or part of a building—or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business."

As per the above definitions, whether a building is an item of property, plant and equipment (PPE) or an investment property for an entity depends on the purpose for which it is held by the entity. It is thus possible that due to a change in the purpose for which it is held, a building that was previously classified as an item of property, plant and equipment may warrant reclassification as an investment property, or vice versa. Whether a building is in the nature of PPE or investment property is determined by applying the definitions of these terms from the perspective of that entity. Thus, the classification of a building as an item of property, plant and equipment or as an investment property is not a matter of an accounting policy choice.

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Accordingly, a change in classification of a building from property, plant and equipment to investment property due to change in the purpose for which it is held by the entity is **not** a change in an accounting policy.

*****

Illustration 3

Whether change in functional currency of an entity represents a change in accounting policy?

Solution

Paragraph 16(a) of Ind AS 8 provides that the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring are not changes in accounting policies.

As per Ind AS 21, 'functional currency' is the currency of the primary economic environment in which the entity operates.

Paragraphs 9-12 of Ind AS 21 list factors to be considered by an entity in determining its functional currency. It is recognised that there may be cases where the functional currency is not obvious. In such cases, Ind AS 21 requires the management to use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Paragraph 13 of Ind AS 21 specifically notes that an entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions. Thus, functional currency of an entity is not a matter of an accounting policy choice.

In view of the above, a change in functional currency of an entity does not represent a change in accounting policy and Ind AS 8, therefore, does not apply to such a change. Ind AS 21 requires that when there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.

*****

1.5.5.1 How to apply the changes in accounting policies?

While discussing the process for application of changes of accounting policies, Ind AS 8, deals with two situations:

1. An entity shall account for a change in accounting policy resulting from the initial application of an Ind AS in accordance with the specific transitional provisions, if any, in that Ind AS.

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If a change in accounting policy is due to a new Ind AS, then, generally the standard itself provides the transitional provisions i.e., provisions applicable on initial application of the standard, such as method of application (retrospective or prospective or modified retrospective), availability of any transitional relief etc. In such cases, the entity needs to follow the transitional provisions accordingly.

2. When an entity changes an accounting policy upon initial application of an Ind AS that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the change retrospectively.

   If the change in accounting policy is made voluntarily or where the Ind AS is not containing transitional provisions, then the accounting policy needs to be applied retrospectively.

Note: Early application of an Ind AS is not a voluntary change in accounting policy.

In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management may apply an accounting policy from the most recent pronouncements of IASB and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards.

If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy.

Suppose in absence of any specific Ind AS to a particular transaction, a company follows an accounting policy as per the relevant IFRS which addresses that transaction and, subsequently there is an amendment to that IFRS, then, the company may change its accounting policy as per that amendment. In such cases, it will be considered as if the company is making the change voluntarily and, accordingly, change in the accounting policy should be applied retrospectively.

Illustration 4

An entity developed one of its accounting policies by considering a pronouncement of an overseas national standard-setting body in accordance with Ind AS 8. Would it be permissible for the entity to change the said policy to reflect a subsequent amendment in that pronouncement?

Solution

In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management may apply an accounting policy from the most recent pronouncements of International Accounting Standards Board and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards. If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy. As such a change is a voluntary change in accounting policy, it can be made only if it results in information that is reliable and more relevant (and does not conflict with the sources in Ind AS 8).

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1.5.5.2 Retrospective application

When a change in accounting policy is applied retrospectively, the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

Analysis

The word retrospective application is defined in Ind AS 8 as applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied. This means that comparative information for all prior periods presented will be adjusted for the effect of change in the policy. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with an Ind AS).

Example 7

An entity which is trading in goods (and not a manufacturer) was incorporated in the year 20X1-20X2 and is a regular user of Ind AS from that year. It has been using weighted average cost formula for determining cost of inventories. In 20X8-20X9, it decides to change the above accounting policy. It wants to use FIFO cost formula. The change in the policy is justified because that formula reflects the actual flow of inventories and, hence, provides reliable and more relevant information to the users of financial statements. The entity presents one year comparative period in its financial statements. Its purchase bills include freight etc., and quantities of inventories as on 1st April, 20X7 and 31st March, 20X8 are such that latest invoices for the relevant years can be attributed to them. Further, other purchase incidental expenses are immaterial. Due to these reasons, retrospective application of change in accounting policy is practicable.

The entity trades in goods, both purchases of stock-in-trade and increase/decrease in inventories of stock-in-trade will appear in the statement of profit and loss. This is because Ind AS 1 permits nature-wise presentation only, which is also the position in Schedule III to the Companies Act, 2013. The change in accounting policy, however, will affect only the carrying amount of inventories and consequently, increase/decrease in inventories, if cost is below NRV, but will not affect amount of purchases.

In the above situation, the entity should apply the change in the accounting policy retrospectively. For this purpose, the entity should recalculate inventory value at the lower of cost determined on FIFO basis and NRV as at 1st April, 20X7 and 31st March, 20X8. The difference between previously presented opening inventory value as at 1st April, 20X7 (which would have been presented in the balance sheet as at 31st March, 20X7) and the recalculated

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value as on that date as above is the cumulative effect of change in accounting policy on the opening balance sheet for the comparative year 20X7-20X8. The difference between previously presented closing inventory value as at 31st March, 20X8 and the recalculated value as on that date as above is the cumulative effect of change in accounting policy on the closing balance sheet for the comparative year 20X7-20X8. The difference between the cumulative effects on the opening and closing balance sheets for the comparative year 20X7-20X8 as arrived at above is the period-specific effect of change in the policy for that comparative year. Accordingly, while preparing the financial statements for the year 20X8-20X9, the entity should adjust the opening inventory as at 1st April, 20X7 and adjust retained earnings on that date for the cumulative effect of change in accounting policy and restate comparative amount in respect of increase/decrease in inventories in the statement of profit and loss for the comparative year 20X7-20X8. This results in consequential restatement of profit or loss, total comprehensive income, closing balances of retained earnings and inventories for that comparative year. The said restated closing balances of retained earnings and inventories become opening balances of these items for the year 20X8-20X9, which is the year of change in accounting policy. Income tax effect due to change in accounting policy will be accounted for in accordance with Ind AS 12.

1.5.5.3 Limitations on retrospective application

- The intention of the standard is, as far as possible, that the companies should follow the same accounting policies consistently year after year to ensure the relevance and reliability of financial statements.
- There are some advantages of making the process of change in accounting policy so tedious as outlined below.
  - i. Companies will not make the frequent changes in their accounting policies just to do the window dressing of their financial statements.
  - ii. The comparison of financial statements over time and with other entities will be possible, in a reliable way.
- Having said this, there can be practical difficulties in making the retrospective changes in policies, when the company wants to change the policy.

Example 8

A company has been incorporated 25 years ago and since then doing the business on pan India basis. Now, is it supposed to incorporate the changes in accounting policy for last 25 years? Will it be practicable? Will it be worth doing it? Will it be material? Such questions arise when one wants to change the accounting policy, since voluntary change in policy is required to be applied retrospectively.

- When retrospective application is required, a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

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- The term 'Impracticability' is defined under Ind AS 8 as follows:

  Impracticable **-** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

  (a) the effects of the retrospective application or retrospective restatement are not determinable;

  (b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

  (c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

    (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

    (ii) would have been available when the financial statements for that prior period were approved for issue from other information.

- After going through the above-mentioned definition of impractical, it is clear that the Ind AS 8 does provide some relief if there are practical difficulties in applying the policy retrospectively.
- Ind AS 8 talks about two types of effects which one need to understand:

  i. Period Specific: Period specific means for each financial year.

  ii. Cumulative: Cumulative is the sum total of the period specific effects.

- When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, then the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.
- Thus, if it is impracticable for an entity to change the policy from day 1, because it is impracticable to determine period-specific effects for one or more comparative prior periods presented, it can apply the changed policy from the earliest period for which it would be practicable to make the changes in policies retrospectively which may be the current period.

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Example 9

In the example given in the section 1.5.5.2 above, if comparative information is presented for two years i.e., 20X6-20X7 and 20X7-20X8 and if it is not practicable to apply the changed policy retrospectively from 20X6-20X7, then, the entity can apply the changed policy retrospectively from 20X7-20X8. This may happen if it is not practicable to compute the inventory value in accordance with the changed policy as on 1st April, 20X6, for example, due to loss of latest purchase bills for the year 20X5-20X6 and computer records of the same are also lost.

In the above example, if comparative information is presented for one year and if it is not practicable to compute the opening inventory value as at 1st April, 20X7, the entity can apply the changed policy retrospectively from 20X8-20X9.

- When an entity applies a new accounting policy retrospectively, it applies the new accounting policy to comparative information for prior periods as far back as is practicable. Retrospective application to a prior period is not practicable unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing balance sheets for that period. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually, the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with an Ind AS). Any other information about prior periods, such as historical summaries of financial data, is also adjusted as far back as is practicable.
- When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable. It therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity arising before that date. Changing an accounting policy is permitted even if it is impracticable to apply the policy retrospectively for any prior period.

Example 10

In 20X6, an entity changes 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

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impracticable to determine the cumulative effect of change in policy at the beginning of 20X6. The entity will apply the change in accounting policy prospectively from 20X6 only. Since the change in policy is applied prospectively from 20X6, the question of adjusting comparative information for any prior period(s) presented does not arise at all. Cost of closing inventories for 20X6 alone will be determined using weighted average cost formula. The carrying amount of closing inventories for 20X5 will simply be carried as carrying amount of opening inventories for 20X6. Cost of closing inventories for 20X5 determined on FIFO basis will be the starting point for applying weighted average cost formula during 20X6.

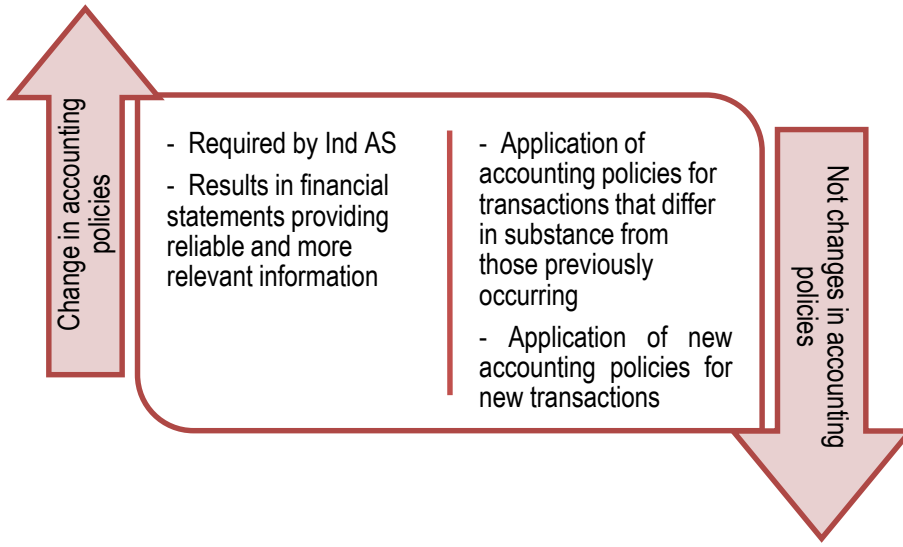


Illustration 5

Whether an entity can change its accounting policy of subsequent measurement of property, plant and equipment (PPE) from revaluation model to cost model?

Solution

Paragraph 29 of Ind AS 16 provides that an entity shall choose either the cost model or the revaluation model as its accounting policy for subsequent measurement of an entire class of PPE.

A change from revaluation model to cost model for a class of PPE can be made only if it meets the condition specified in Ind AS 8 paragraph 14(b) i.e. the change results in the financial statements providing reliable and more relevant information to the users of financial statements. For example, an unlisted entity planning IPO may change its accounting policy from revaluation model to cost model for some or all classes of PPE to align the entity's accounting policy with that of listed markets participants within that industry so as to enhance the comparability of its

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financial statements with those of other listed market participants within the industry. Such a change – from revaluation model to cost model is not expected to be frequent.

Where the change in accounting policy from revaluation model to cost model is considered permissible in accordance with Ind AS 8 paragraph 14(b), it shall be accounted for retrospectively, in accordance with Ind AS 8.

*****

1.5.6 Disclosure regarding the changes in accounting policies

- When initial application of an Ind AS has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

  (a) the title of the Ind AS;

  (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;

  (c) the nature of the change in accounting policy;

  (d) when applicable, a description of the transitional provisions;

  (e) when applicable, the transitional provisions that might have an effect on future periods;

  (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

    (i) for each financial statement line item affected; and

    (ii) if Ind AS 33, 'Earnings per Share', applies to the entity, for basic and diluted earnings per share;

  (g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

  (h) if retrospective application required by paragraph 19(a) or (b) of Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

- When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

  (a) the nature of the change in accounting policy;

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(b) the reasons why applying the new accounting policy provides reliable and more relevant information;

(c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

(i) for each financial statement line item affected; and

(ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

(d) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

(e) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Note:

- Financial statements of subsequent periods need not repeat these disclosures.
- These disclosures will form part of Notes to Accounts.

- When an entity has not applied a new Ind AS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact; and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Ind AS will have on the entity's financial statements in the period of initial application.

- In complying with the above requirement, an entity considers disclosing:

(a) the title of the new Ind AS;

(b) the nature of the impending change or changes in accounting policy;

(c) the date by which application of the Ind AS is required;

(d) the date as at which it plans to apply the Ind AS initially;

(e) either:

(i) a discussion of the impact that initial application of the Ind AS is expected to have on the entity's financial statements; or

(ii) if that impact is not known or reasonably estimable, a statement to that effect.

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Illustration 6

Whether an entity is required to disclose the impact of any new Ind AS which is issued but not yet effective in its financial statements as per Ind AS 8?

Solution

Paragraph 30 of Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors, states as follows:

"When an entity has not applied a new Ind AS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact; and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Ind AS will have on the entity's financial statements in the period of initial application."

Accordingly, it may be noted that an entity is required to disclose the impact of Ind AS which has been issued but is not yet effective.

*****

1.6 CHANGE IN ACCOUNTING ESTIMATES

1.6.1 Meaning

- An accounting policy may require items in financial statements to be measured in a way that involves measurement uncertainty — that is, the accounting policy may require such items to be measured at monetary amounts that cannot be observed directly and must instead be estimated. In such a case, an entity develops an accounting estimate to achieve the objective set out by the accounting policy. Developing accounting estimates involves the use of judgements or assumptions based on the latest available, reliable information. Examples of accounting estimates include:

  (a) a loss allowance for expected credit losses, applying Ind AS 109, Financial Instruments;

  (b) the net realisable value of an item of inventory, applying Ind AS 2 Inventories;

  (c) the fair value of an asset or liability, applying Ind AS 113, Fair Value Measurement;

  (d) the depreciation expense for an item of property, plant and equipment, applying Ind AS 16; and

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(e) a provision for warranty obligations, applying Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

- An entity uses measurement techniques and inputs to develop an accounting estimate. Measurement techniques include estimation techniques (for example, techniques used to measure a loss allowance for expected credit losses applying Ind AS 109) and valuation techniques (for example, techniques used to measure the fair value of an asset or liability applying Ind AS 113).
- The term 'estimate' in Ind AS sometimes refers to an estimate that is not an accounting estimate as defined in this Standard. For example, it sometimes refers to an input used in developing accounting estimates.
- The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

1.6.2 Can changes in estimates be related to prior periods?

- An entity may need to change an accounting estimate if changes occur in the circumstances on which the accounting estimate was based or as a result of new information, new developments or more experience.
- By its nature, a change in an accounting estimate does not relate to prior periods and is not the correction of an error.
- The effects on an accounting estimate of a change in an input or a change in a measurement technique are changes in accounting estimates unless they result from the correction of prior period errors.

1.6.3 Change in the basis of measurement – Whether a change in accounting policy or change in estimate?

A change in the measurement basis applied is a change in an accounting policy and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

Illustration 7

Whether a change in inventory cost formula is a change in accounting policy or a change in accounting estimate?

Solution

As per Ind AS 8, accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Further,

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paragraph 36(a) of Ind AS 2, 'Inventories', specifically requires disclosure of 'cost formula used' as a part of disclosure of accounting policies adopted in measurement of inventories.

Accordingly, a change in cost formula is a change in accounting policy.

*****

1.6.4 Accounting treatment for applying changes in accounting estimates

- The effect of change in an accounting estimate, except to the extent that the change results in change in assets, liabilities or relates to an item of equity, shall be recognised prospectively by including it in profit or loss in:

  (a) the period of the change, if the change affects that period only; or

  (b) the period of the change and future periods, if the change affects both.

  A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods.

- To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

- Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of that change. A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods. For example, a change in a loss allowance for expected credit losses affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods.

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Relevant extract from Annual Report of Indus Towers Limited for Financial Year 2020-2021 on change in accounting estimates

The Company has revised the useful life of property, plant and equipment and useful life and estimation of ARO and taken the impact prospectively from the date of change.

During the period ended March 31, 2021, the Company has revised the useful life of civil work included in Plant and machinery from 15 years to 20 years with effect from December 1, 2020. Set out below is impact of such change on future period depreciation:

Particulars	Year ended March 31, 2021	Year ended March 31, 2022
Decrease in Depreciation	405	1043

Further, the Company has also reassessed useful life from 15 years to 20 years and estimate of dismantling obligation for Asset retirement obligation w.e.f. December 1, 2020 and has taken the credit of ₹ 184 Mn in the Statement of Profit and Loss.

Examples 11 and 12

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

12. During the financial year ended 31st March, 20X2, Entity ABC introduced a new range of electric motors. It sold the motors with a standard warranty of two years. Warranty provides assurance that a product will function as expected and in accordance with certain specifications and it has been assessed that it is not a separate performance obligation under Ind AS 115.

    Based on results of testing of the motors during trials prior to commercial production, Entity ABC made a provision for warranty costs amounting to ₹ 1,00,000 for motors sold during the year ended 31st March, 20X2.

    During financial year 20X2-20X3, a defect was discovered in the motors that had not come to light during the trials. The defect resulted in the entity incurring an amount of

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₹ 2,00,000 during the financial year 20X2-20X3 on repairs of motors sold during the financial year 20X1-20X2. Besides, the entity expects to incur ₹ 1,50,000 as costs during the year 20X3-20X4 on meeting its warranty obligations in respect of motors sold during the financial year 20X2-20X3.

In preparing its financial statements for the year ended 31st March, 20X3, the entity would carry forward a warranty provision of ₹ 1,50,000 in respect of motors sold during the financial year 20X1-20X2. It would recognise an amount of ₹ 2,50,000 (₹ 2,00,000 plus ₹ 1,50,000 minus ₹ 1,00,000) in respect of motors sold during the financial year 20X1-20X2 as an expense in profit or loss for the financial year 20X2-20X3. The warranty provision included in the comparatives for financial year ended 31st March, 20X2 would not be adjusted.

The provision for warranty costs in respect of motors sold during the financial year 20X2-20X3 would be made by considering the information concerning the defect in motors that came to light during the financial year 20X2-20X3.

1.6.5 Disclosure of changes in estimates

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

Thus, to summarise the above-mentioned provisions, the entity should disclose:

i. Effect of change in estimate on the current period

ii. If applicable and practicable, effect of change in estimate on the future periods

iii. If applicable but impracticable, the fact that it is impracticable to estimate the effect on future periods.

1.7 ERRORS

1.7.1 Meaning

- Ind AS 8 deals with the treatment of errors that have taken place in past but were not discovered at that time. Subsequently, when they are discovered, it is necessary to correct

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such errors in the financial statements and make sure that the financial statements present relevant and reliable information in the period in which they are discovered.

As per the definition given in Ind AS 8, ***Prior period errors*** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were approved for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

- Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

1.7.2 Common types of errors

(i) **Mathematical Mistakes:** In accounting terms, generally the errors are called as error of commission. Wrong calculations, carry forward of wrong balances and errors in totals are few examples of mathematical errors.

(ii) **Mistakes in applying policies:** Specific standards may prescribe method of applying specific policies for particular nature of transaction. For example, as a general rule, assets and liabilities and income and expenses should not be offset, unless otherwise specifically required or permitted in an Ind AS. If a receivable from another entity and payable to that entity are offset without any currently existing legally enforceable right to set off the recognised amounts, then, it will be an error while applying the policies, since it is against the principles of offset prescribed in Ind AS 32, 'Financial Instruments: Presentation'.

(iii) **Misinterpretations of facts:** Ind AS 10 deals with treatment of the events after the reporting period. Whether the event is an adjusting event or a non-adjusting event depends on whether that event provides evidence of a condition existing at the end of the reporting period. Sometimes, this requires judgement of the management and may result into misinterpretation of facts, if not dealt with properly.

(iv) **Omissions:** The mistakes that happened due to omission to record a material transaction, perhaps, due to oversight.

(v) **Frauds:** Major theft undetected in the past.

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The abovementioned errors and any other error may happen while recognising the transaction, or while measuring the transaction, or while presenting it in financial statements or it might be possible that proper disclosure is not done.

Example 13

The following errors occurred in preparation of A Ltd.'s financial statements for the immediately preceding financial year –

(a) Depreciation on plant and machinery understated by an amount equal to 0.30% of sales;

(b) Warranty provisions understated by an amount equal to 0.15% of sales;

(c) Allowance for bad debts understated by an amount of 0.25% of sales.

Individually none of these errors may be material but could collectively influence the economic decision of the users of the financial statements. These are material prior period errors.

1.7.3 Treatment of errors

Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

1.7.3.1 Potential errors of current period

Potential current period errors discovered in that period are corrected before the financial statements are approved for issue.

1.7.3.2 Prior period errors discovered subsequently

Material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

Following is the snapshot of how the balance sheet and statement of profit and loss is presented after correction of prior period errors:

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Consolidated balance sheet

	Notes	31 March 2019	31 March 2018 Restated**	1 April 2017 Restated**
ASSETS				
Non-current assets				
Property, plant and equipment	3	137,048	97,023	88,145
Capital work-in-progress	3	17,450	3,100	-
Investment properties	4	7,419	7,179	7,255
Goodwill	5	8,670	4,530	4,530
Other intangible assets	5	12,033	10,895	11,210
Intangible assets under development*		-	-	-
Biological assets other than bearer plants*		-	-	-
Investments accounted for using the equity method	34(e)	2,776	2,128	1,604
Financial assets				
i. Investments	6(a)	38,165	32,253	32,299
ii. Loans	6(c)	3,084	2,601	2,182
iii. Other financial assets	6(e)	1,187	625	754
Deferred tax assets	7	4,598	2,774	2,054
Other non-current assets	8	21,586	10,565	7,466
Total non-current assets		**254,016**	**173,673**	**157,499**

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Consolidated statement of profit and loss

	Notes	Year ended 31 March 2019	Year ended 31 March 2018 Restated**
Continuing operations			
Revenue from operations [31]	20	221,783	201,107
Other income	21(a)	4,430	3,444
Other gains/(losses) – net [1]	21(b)	1,233	1,203
Total income		**227,446**	**205,754**
Expenses			
Cost of materials consumed	22(a)	78,382	76,039
Purchases of stock-in-trade		62,763	45,632
Changes in inventories of work-in-progress, stock-in-trade and finished goods	22(b)	(7,038)	(2,428)
Excise duty [1]		-	3,174
Employee benefit expense	23	20,237	17,786
Depreciation and amortisation expense	24	10,820	9,761
Impairment of goodwill and other non-current assets [1]	3, 5	2,100	-
Net impairment losses on financial and contract assets [30]	29	443	454
Other expenses	25	9,591	8,801
Finance costs	26	3,203	2,794
Total expenses		**180,501**	**162,013**

Situation 1: Error discovered relates to the comparative prior period presented:

Unless impracticable, an entity shall correct material prior period errors **retrospectively** in the first set of financial statements approved for issue after their discovery by **restating the comparative amounts for the prior period(s)** presented in which the error occurred;

Example 14

While preparing the financial statement for the financial year 20X2-20X3, the prior period presented would be financial year 20X1-20X2, if one year comparative period is presented. If the error occurred in the year 20X1-20X2 but discovered in year 20X2-20X3, then it should be corrected in the financial statements for the year 20X2-20X3 by restating the comparative amounts for the year 20X1-20X2. This will result in consequential restatement of opening balances for the year 20X2-20X3.

Situation 2: Error discovered relates to period before the earliest comparative prior period presented:

If the material error occurred before the earliest prior period presented, an entity shall, unless impracticable, correct the same retrospectively in the first set of financial statements approved

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for issue after their discovery by **restating the opening balances of assets, liabilities and equity for the earliest prior period presented**.

Examples 15-17

15. An entity presents one year comparative period in its financial statements. While preparing the financial statements for the financial year 20X4-20X5, if an error has been discovered which occurred in the year 20X1-20X2, i.e., for the period which was earlier than earliest prior period presented (which is 20X3-20X4 in this example), then, the error should be corrected by restating the opening balances of relevant assets and/or liabilities and relevant component of equity for the year 20X3-20X4. This will result in consequential restatement of balances as at 1st April, 20X3 (i.e, the third balance sheet).

16. A material error in depreciation provision of the preceding year ended 31st March, 20X2 was discovered when preparing the financial statements for the year ended 31st March, 20X3. The amount recognised in statement of profit and loss for the year ended 31st March, 20X2 was ₹ 1,00,000 instead of ₹ 50,000. In this case, when presenting the financial statements for the year ended 31st March, 20X3, depreciation for the comparative year 20X1-20X2 will be restated at ₹ 50,000. The carrying amount i.e., net book value of property, plant and equipment for the comparative year ending 31st March, 20X2 will be increased by ₹ 50,000 (due to restatement of accumulated depreciation). This will result in consequential restatement of opening balance of retained earnings and property, plant and equipment for the year 20X2-20X3.

17. Continuing with the aforesaid example, assume that the error relates to year ended 31st March, 20X1 and 20X0-20X1 is not the earliest period for which comparative information is presented. In this case, the error will be corrected by restating the opening balances of retained earnings and carrying amount i.e., net book value, of property, plant and equipment, for the year 20X1-20X2. This will result in restatement of balances as at 1st April, 20X1.

Illustration 8

An entity has presented certain material liabilities as non-current in its financial statements for periods upto 31st March, 20X1. While preparing annual financial statements for the year ended 31st March, 20X2, management discovers that these liabilities should have been classified as current. The management intends to restate the comparative amounts for the prior period presented (i.e., as at 31st March, 20X1). Would this reclassification of liabilities from non-current to current in the comparative amounts be considered to be correction of an error under Ind AS 8? Would the entity need to present a third balance sheet?

Solution

As per paragraph 41 of Ind AS 8, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not

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comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

In accordance with the above, the reclassification of liabilities from non-current to current would be considered as correction of an error under Ind AS 8. Accordingly, in the financial statements for the year ended 31st March, 20X2, the comparative amounts as at 31st March, 20X1 would be restated to reflect the correct classification.

Ind AS 1 requires an entity to present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements, if, inter alia, it makes a retrospective restatement of items in its financial statements and the restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

Accordingly, the entity should present a third balance sheet as at the beginning of the preceding period, i.e., as at 1st April, 20X0 in addition to the comparatives for the financial year 20X0-20X1.

*****

1.7.4 Limitations on retrospective restatement

We have already discussed in detail the treatment when there are the limitations on giving retrospective effect to changes in accounting policies. Similar provisions are included in Ind AS 8 to deal with limitations on retrospective restatement of prior period errors.

Step 1: A prior period error shall be corrected by retrospective restatement if it is practicable to determine both the period specific effects and cumulative effect of the error.

The correction of a prior period error is excluded from profit or loss for the period in which the error is discovered. Any information presented about prior periods, including any historical summaries of financial data, is restated as far back as is practicable.

Step 2: If it is not practicable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity shall first find out the earliest period for which retrospective restatement is practicable and then restate the opening balances of assets, liabilities and equity for that period. Ind AS 8 further states that such period can be the current period also.

For meaning of 'impracticable' for the purposes of Ind AS 8, see section 1.5.5.3.

Step 3: If it is not practicable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable.

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When it is impracticable to determine the amount of an error (e.g., a mistake in applying an accounting policy) for all prior periods, the entity restates the comparative information prospectively from the earliest date practicable. It therefore disregards the portion of the cumulative restatement of assets, liabilities and equity arising before that date.

Corrections of errors are distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need changing as additional information becomes known. For example, the gain or loss recognised on the outcome of a contingency is not the correction of an error.

1.8 DISCLOSURE OF PRIOR PERIOD ERRORS

An entity shall disclose the following:

(a) the nature of the prior period error;

(b) for each prior period presented, to the extent practicable, the amount of the correction:

  (i) for each financial statement line item affected; and

  (ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

(c) the amount of the correction at the beginning of the earliest prior period presented; and

(d) if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

Financial statements of subsequent periods need not repeat these disclosures.

1.9 IMPRACTICABILITY IN RESPECT OF RETROSPECTIVE APPLICATION AND RETROSPECTIVE RESTATEMENT

In some circumstances, it is impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period.

For example, data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy (including, its prospective application to prior periods) or retrospective restatement to correct a prior period error, and it may be impracticable to recreate the information.

It is frequently necessary to make estimates in applying an accounting policy to elements of financial statements recognised or disclosed in respect of transactions, other events or conditions. Estimation is inherently subjective, and estimates may be developed after the reporting period. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error,

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because of the longer period of time that might have passed since the affected transaction, other event or condition occurred. However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the transaction, other event or condition occurred.

Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that

(a) provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred, and

(b) would have been available when the financial statements for that prior period were approved for issue

from other information.

For some types of estimates (eg a fair value measurement that uses significant unobservable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.

Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with Ind AS 19, 'Employee Benefits', it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were approved for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

1.10 SIGNIFICANT DIFFERENCES BETWEEN IND AS 8 AND AS 5

S. No.	Particulars	Ind AS 8	AS 5
	Title	**Accounting Policies, Changes in Accounting Estimates and Errors**	**Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies**
1.	*Scope*	There are some differences in the scope of the two standards. For example, Ind AS 8 deals	Under AS, selection of accounting policies is dealt with in AS 1 'Disclosure of

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		with the criteria for selecting and applying accounting policies.	Accounting Policies'.
2.	*Extraordinary items*	Under Ind AS, presentation of any items of income or expense as extraordinary items is explicitly prohibited by Ind AS 1.	AS 5, on the other hand, requires separate presentation of extraordinary items in the statement of profit and loss. AS 5 defines extraordinary items as income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. As per AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.
3.	*Change in accounting policies*	Ind AS 8 does not deal with change in accounting policy on the basis of the requirement by the statute.	AS 5 allows change in accounting policy if required by the statute.
4.	*Accounting for changes in accounting policies*	Ind AS 8 requires that, subject to limited exceptions, changes in accounting policies should be accounted for retrospectively by restatement of comparative information. In	While AS 5 does not clearly specify how changes in accounting policies other than those dealt with by specific transitional provisions of an accounting standard should be

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		addition, a third balance sheet as of the beginning of the preceding period is also required to be presented by an entity where it applies an accounting policy retrospectively and the retrospective application has a material effect on the information in the balance sheet at the beginning of the preceding period.	accounted for (i.e., whether retrospectively or prospectively), it requires that the impact of, and the adjustments resulting from, a change in an accounting policy, if material, should be shown in the financial statements of the period in which the change is made.
5.	*Prior period items*	Ind AS refers to the term 'prior period errors' which is wider in scope as compared to 'prior period items' used in AS 5. Ind AS 8 definition of prior period errors include the effects of misinterpretations of facts and fraud as well.	AS 5 defines prior period items as incomes or expenses which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods.
6.	*Correction of material prior period errors*	Ind AS 8 requires, subject to limited exception, retrospective correction of material prior period errors, i.e., restatement of comparative information and presentation of a third balance sheet as in case of a retrospective change in an accounting policy where the retrospective correction has a material effect on the information in the balance sheet at the beginning of the preceding period. Thus, under Ind AS 8, material prior period errors are	Unlike Ind AS 8, AS 5 requires the correction of prior period items by including the required adjustments in the determination of net profit or loss for the current period, though the standard also permits an alternative approach under which the adjustments are included in the statement of profit and loss after determination of current net profit or loss.

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		corrected by correcting the recognition, measurement and disclosure of amounts of elements of financial statements retrospectively as if the prior period error had never occurred.	
7.	*Disclosure requirements*	Disclosure requirements of Ind AS 8 are more detailed as compared to those of AS 5. For e.g. in case of a voluntary change in accounting policy, an entity is required to disclose the reasons why applying the new accounting policy provides reliable and more relevant information.	Disclosure requirements of AS 5 are less as compared to those of Ind AS 8.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

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

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

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

2. Under what circumstances an entity is required to present a third balance sheet at the beginning of the preceding period?

3. During 20X2, Delta Ltd., changed its accounting policy for depreciating property, plant and equipment, so as to apply a component approach completely, whilst at the same time adopting the revaluation model.

   In years before 20X2, Delta Ltd.'s asset records were not sufficiently detailed to apply a component approach fully. At the end of 20X1, management commissioned an engineering survey, which provided information on the components held and their fair values, useful lives, estimated residual values and depreciable amounts at the beginning of 20X2. However, the survey did not provide a sufficient basis for reliably estimating the cost of those components that had not previously been accounted for separately, and the existing records before the survey did not permit this information to be reconstructed.

   Delta Ltd.'s management considered how to account for each of the two aspects of the accounting change. They determined that it was not practicable to account for the change to a fuller component approach retrospectively, or to account for that change prospectively from any earlier date than the start of 20X2. Also, the change from a cost model to a revaluation

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model is required to be accounted for prospectively. Therefore, management concluded that it should apply Delta Ltd.'s new policy prospectively from the start of 20X2.

Additional information:

(i) Delta Ltd.'s tax rate is 30%

(ii) Property, plant and equipment at the end of 20X1:

Cost	₹ 25,000
Depreciation	₹ 14,000
Net book value	₹ 11,000

(iii) Prospective depreciation expense for 20X2 (old basis) ₹ 1,500

(iv) Some results of the engineering survey:

Valuation	₹ 17,000
Estimated residual value	₹ 3,000
Average remaining asset life	7 years
Depreciation expense on existing property, plant and equipment for 20X2 (new basis)	₹ 2,000

You are required to prepare the relevant note for disclosure in accordance with Ind AS 8.

4. Is change in the depreciation method for an item of property, plant and equipment a change in accounting policy or a change in accounting estimate?

5. An entity charged off certain expenses as finance costs in its financial statements for the year ended 31st March, 20X1. While preparing annual financial statements for the year ended 31st March, 20X2, management discovered that these expenses should have been classified as other expenses instead of finance costs. The error occurred because the management inadvertently misinterpreted certain facts. The entity intends to restate the comparative amounts for the prior period presented in which the error occurred (i.e., year ended 31st March, 20X1). Would this reclassification of expenses from finance costs to other expenses in the comparative amounts will be considered as correction of an error under Ind AS 8? Would the entity need to present a third balance sheet?

6. While preparing the annual financial statements for the year ended 31st March, 20X3, an entity discovers that a provision for constructive obligation for payment of bonus to selected employees in corporate office (material in amount) which was required to be recognised in the annual financial statements for the year ended 31st March, 20X1 was not recognised due to oversight of facts. The bonus was paid during the financial year ended 31st March, 20X2 and was recognised as an expense in the annual financial statements for

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the said year. Would this situation require retrospective restatement of comparatives considering that the amount was material?

7. While preparing interim financial statements for the half-year ended 30th September, 20X1, an entity notes that there has been an under-accrual of certain expenses in the interim financial statements for the first quarter ended 30th June, 20X1. The amount of under accrual is assessed to be material in the context of interim financial statements. However, it is expected that the amount would be immaterial in the context of the annual financial statements. The management is of the view that there is no need to correct the error in the interim financial statements considering that the amount is expected to be immaterial from the point of view of the annual financial statements. Whether the management's view is acceptable?

8. ABC Ltd has an investment property with an original cost of ₹ 1,00,000 which it inadvertently omitted to depreciate in previous financial statements. The property was acquired on 1st April, 20X1. The property has a useful life of 10 years and is depreciated using straight line method. Estimated residual value at the end of 10 year is Nil.

   How should the error be corrected in the financial statements for the year ended 31st March, 20X4, assuming the impact of the same is considered material? For simplicity, ignore tax effects.

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

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

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

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

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

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

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You are required to present the impact of change in accounting policy in the profit or loss and produce an extract of the statement of changes in equity in accordance with Ind AS 8.

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

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

In 20X3-20X4, Cheery Limited reported:

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

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

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

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

11. In 20X3-20X4, after the entity's 31st March 20X3 annual financial statements were approved for issue, a latent defect in the composition of a new product manufactured by the entity was discovered (that is, a defect that could not be discovered by reasonable or customary inspection). As a result of the latent defect the entity incurred ₹ 1,00,000 of unanticipated costs for fulfilling its warranty obligation in respect of sales made before 31st March 20X3. An additional ₹ 20,000 was incurred to rectify the latent defect in products sold during 20X3-20X4 before the defect was detected and the production process rectified, ₹ 5,000 of which relates to items of inventory at 31st March 20X3. The defective inventory was reported at cost ₹ 15,000 in the 20X2-20X3 financial statements when its selling price less costs to complete and sell was estimated at ₹ 18,000. The accounting estimates made in preparing the 31st March 20X3 financial statements were appropriately made using all reliable information that the entity could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Analyse the above situation in accordance with relevant Ind AS.

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Answers

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

Therefore, there would not be any need to retrospectively change the prior period figures for revenue already recognized.

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

- it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and
- the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period.

3. Extract from the notes

From the start of 20X2, Delta Ltd., changed its accounting policy for depreciating property, plant and equipment, so as to apply much more fully a components approach, whilst at the same time adopting the revaluation model. Management takes the view that this policy provides reliable and more relevant information because it deals more accurately with the components of property, plant and equipment and is based on up-to-date values. The policy has been applied prospectively from the start of 20X2 because it was not practicable to estimate the effects of applying the policy either retrospectively, or prospectively from any earlier date. Accordingly, the adoption of the new policy has no effect on prior years. The effect on the current year is to increase the carrying amount of property, plant and equipment at the start of the year by ₹ 6,000; increase the opening deferred tax provision by ₹ 1,800; create a revaluation surplus at the start of the year of ₹ 4,200; increase depreciation expense by ₹ 500; and reduce tax expense by ₹ 150.

4. As per paragraphs 60 and 61 of Ind AS 16, Property, Plant and Equipment, the depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change is accounted for as a change in an accounting estimate in accordance with Ind AS 8.

As per the above, depreciation method for a depreciable asset has to reflect the expected pattern of consumption of future economic benefits embodied in the asset. Determination

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of depreciation method involves an accounting estimate and thus depreciation method is not a matter of an accounting policy.

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

5. As per paragraph 41 of Ind AS 8, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

In accordance with the above, the reclassification of expenses from finance costs to other expenses would be considered as correction of an error under Ind AS 8. Accordingly, in the financial statements for the year ended 31st March, 20X2, the comparative amounts for the year ended 31st March, 20X1 would be restated to reflect the correct classification.

Ind AS 1 requires an entity to present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements if, inter alia, it makes a retrospective restatement of items in its financial statements and the restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

In the given case, the retrospective restatement of relevant items in statement of profit and loss has no effect on the information in the balance sheet at the beginning of the preceding period (1st April, 20X0). Therefore, the entity is not required to present a third balance sheet.

6. As per paragraph 41 of Ind AS 8, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

As per paragraph 40A of Ind AS 1, an entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements if, inter alia, it makes a retrospective restatement of items in its financial

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statements and the retrospective restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

In the given case, expenses for the year ended 31st March, 20X1 and liabilities as at 31st March, 20X1 were understated because of non-recognition of bonus expense and related provision. Expenses for the year ended 31st March, 20X2, on the other hand, were overstated to the same extent because of recognition of the aforesaid bonus as expense for the year. To correct the above errors in the annual financial statements for the year ended 31st March, 20X3, the entity should:

(a) restate the comparative amounts (i.e., those for the year ended 31st March, 20X2) in the statement of profit and loss; and

(b) present a third balance sheet as at the beginning of the preceding period (i.e., as at 1st April, 20X1) wherein it should recognise the provision for bonus and restate the retained earnings.

7. Paragraph 41 of Ind AS 8, inter alia, states that financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

As regards the assessment of materiality of an item in preparing interim financial statements, paragraph 25 of Ind AS 34, Interim Financial Statements, states as follows:

"While judgement is always required in assessing materiality, this Standard bases the recognition and disclosure decision on data for the interim period by itself for reasons of understandability of the interim figures. Thus, for example, unusual items, changes in accounting policies or estimates, and errors are recognised and disclosed on the basis of materiality in relation to interim period data to avoid misleading inferences that might result from non-disclosure. The overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding of an entity's financial position and performance during the interim period."

As per the above, while materiality judgements always involve a degree of subjectivity, the overriding goal is to ensure that an interim financial report includes all the information that is relevant to an understanding of the financial position and performance of the entity during the interim period. It is therefore not appropriate to base quantitative assessments of materiality on projected annual figures when evaluating errors in interim financial statements.

Accordingly, the management is required to correct the error in the interim financial statements since it is assessed to be material in relation to interim period data.

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

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

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

Statement of changes in Equity (extract)

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

10. **Cheery Limited**
Extract from the Statement of profit and loss

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

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Cheery Limited
Statement of Changes in Equity

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

Extract from the Notes

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

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

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

11. Ind AS 8 is applied in selecting and applying accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset. This change in accounting estimate is an outcome of the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting

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estimates result from new information or new developments and, accordingly, are not corrections of errors.

Further, the effect of change in an accounting estimate, shall be recognised prospectively by including it in profit or loss in: (a) the period of the change, if the change affects that period only; or (b) the period of the change and future periods, if the change affects both.

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were approved for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

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

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

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

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

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

Working Note:

Inventory is measured at the lower of cost (i.e. ₹ 15,000) and fair value less costs to complete and sell (i.e. ₹ 18,000 originally estimated minus ₹ 5,000 costs to rectify latent defect) = ₹ 13,000.

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UNIT 2:
IND AS 10: EVENTS AFTER THE REPORTING PERIOD

LEARNING OUTCOMES

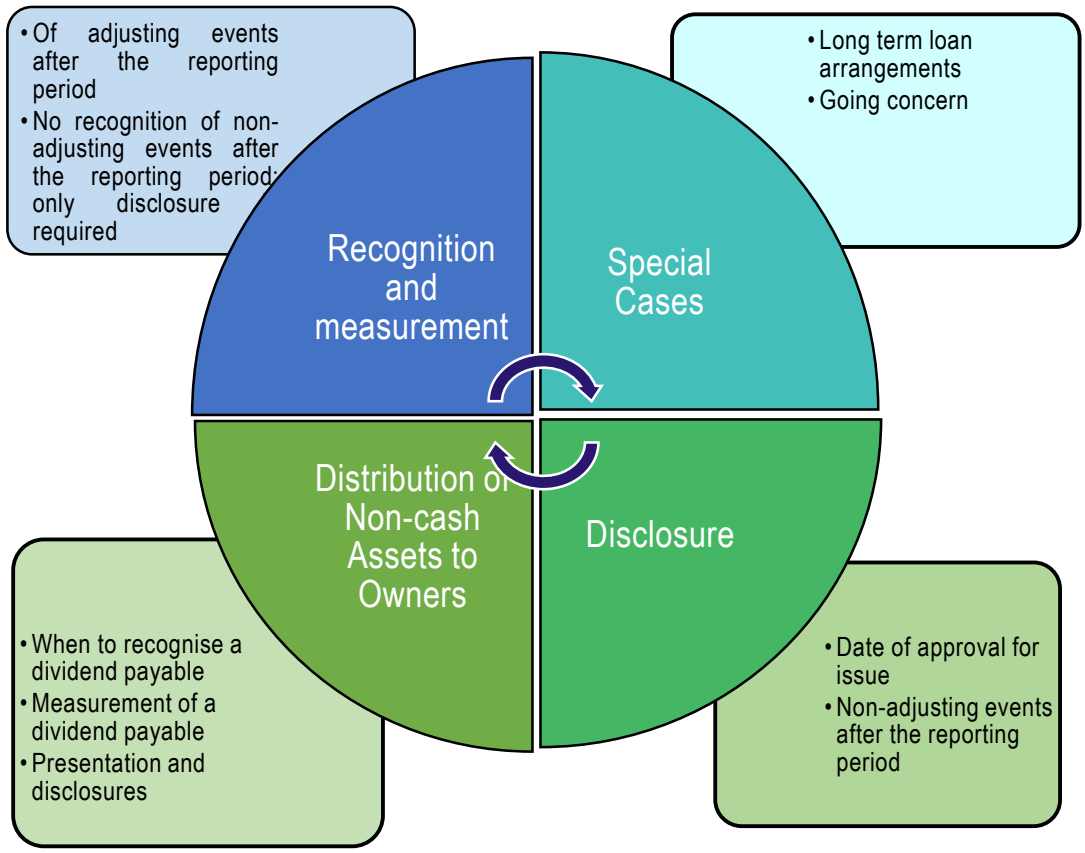
After studying this unit, you will be able to:

- Define the relevant terms like 'events after the reporting period', 'date of approval', 'adjusting events' and 'non-adjusting events'.
- Differentiate between adjusting events and non-adjusting events in terms of their treatment and disclosure.
- Recommend the accounting treatment for special cases like dividend, going concern, long-term loan arrangements.

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UNIT OVERVIEW

IND AS 10



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2.1 INTRODUCTION

It is impossible for any company to present the information on the same day, as the day of reporting. There would always be a gap between the end of the period for which financial statements are presented and the date on which the same will actually be made available to the public.

During this gap, there is a possibility of occurring of few events which will have far reaching effects on the business / existence of the company. Now the question arises: what view the company should take about such events? Should it leave it without any cognizance as they are taking place after the reporting period, or should it take cognizance of such events as at the time of preparation of the financial statement and making it available to the public? If the company is aware of the facts and is still not disclosing the same, it may mislead the users.

Ind AS 10 deals with such events and provides guidance about its treatment in the financial statements.

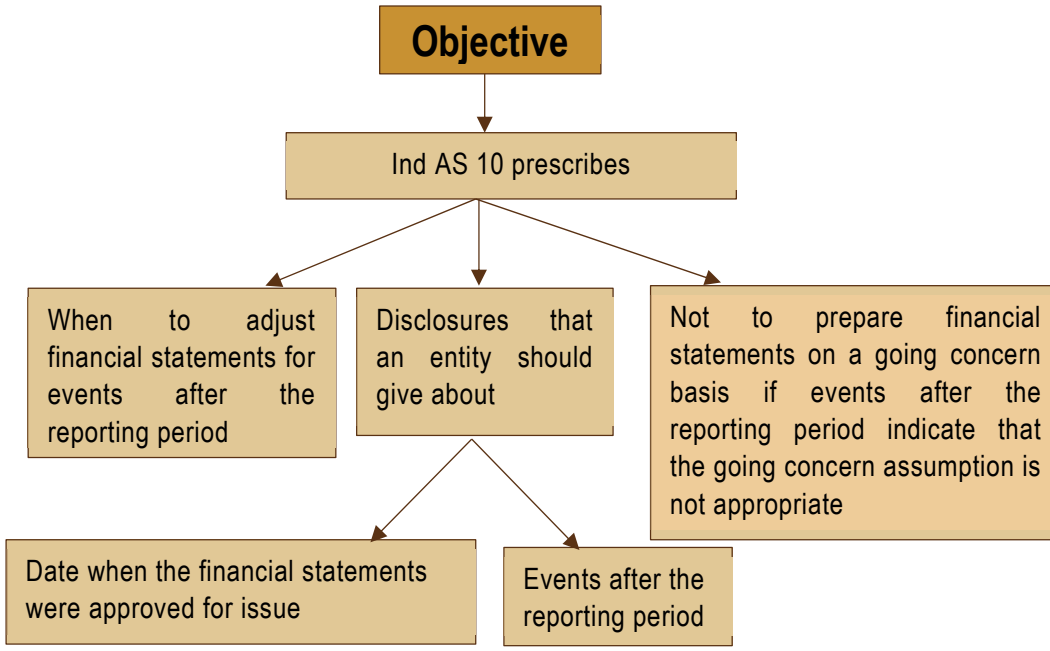
2.2 OBJECTIVE

The objective of this standard is to prescribe.

1. When an entity should adjust its financial statements for the events after the reporting period.
2. **The disclosures** that an entity should give about the date when the financial statements were approved for issue and about events after the reporting period.

The standard also requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is no longer appropriate.

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2.3 SCOPE

The Standard -shall be applied in:

1. **Accounting** for events after reporting period; and
2. **Disclosure** of events after the reporting period.



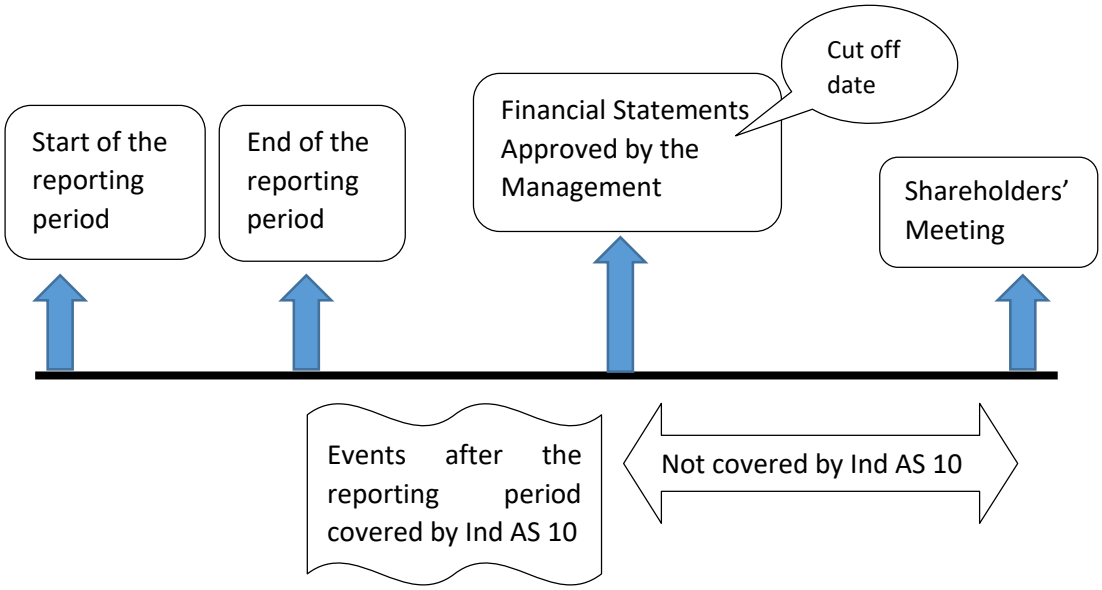
2.4 DEFINITIONS AND EXPLANATIONS

We have seen above that the main focus of the standard is **events after the reporting period.** Therefore, it is necessary to understand the meaning of it.

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2.4.1 Events after the Reporting Period

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors (in case of a company) and by the corresponding approving authority (in case of any other entity) for issue. This is depicted in the below chart:



Example 1

The financial year of an entity ends on 31st March, 20X2. If the board of directors approves the financial statements on 15th May, 20X2, 'after the reporting period' will be the period between 31st March, 20X2 and 15th May, 20X2 and the events occurring during this period should be considered as 'events after the reporting period'.

2.4.2 Approval of Financial statements

Now the question arises that what is meant by approval of financial statements? When can one say that the financial statements are approved? Which body needs to be considered as an approving authority? If there is a hierarchy of approvals, at what level one can assume that the financial statements are approved?

What is the date of approval of financial statements?

It is worthwhile to note that the process involved in approving the financial statements for issue will vary depending upon the (a) management structure, (b) statutory requirements and (c) procedures followed in preparing and finalising the financial statements.

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This standard prescribes,

(i) **In case of a company:** The financial statements will be treated as approved when board of directors approves the same;

(ii) **In the case of any other entity:** The financial statements will be treated as approved when the corresponding approving authority approves the same. The standard does not mention specifically what will constitute the approving authority in case of any other entity. But from the word **"Corresponding"** one can construe that it is the body which is authorised to manage the entity on behalf of all members.

It is pertinent to note that in some cases, an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been approved by the Board for issue. In such cases, as per paragraph 5 of Ind AS 10, even though shareholders' approval is needed, yet, for the purpose of deciding the events after the reporting period, the date of approval of financial statements will be considered as the date of approval by the board of directors only.

Example 2

The Board of Directors of ABC Ltd., in its meeting on 5th May, 20X1, reviews and approves the financial statements for the year ended 31st March, 20X1 and issues them to the shareholders. The financial statements are adopted by the shareholders in the annual general meeting on 23rd June, 20X1. The date of approval of financial statements for the is 5th May, 20X1 in accordance with the standard.

Likewise, in some cases, the management of an entity is required to issue its financial statements to **a supervisory board** (made up solely of non-executives) for approval. In such cases, as per paragraph 6 of Ind AS 10, the financial statements are approved for issue when the management approves them for issue to the supervisory board.

Example 3

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).

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2.4.3 When date of approval is after the public announcement of some other financial information

'Events after the reporting period' include all events up to the date when the financial statements are approved for issue, even if those events occur after the public announcement of profit or of other selected financial information.

Illustration 1

What is the date of approval for issue of the financial statements prepared for the reporting period from 1st April, 20X1 to 31st March, 20X2, in a situation where following dates are available? Completion of preparation of financial statements 28th May, 20X2 Board reviews and approves it for issue 19th June, 20X2.

Available to shareholders	*1st July, 20X2*
Annual General Meeting	*15th September, 20X2*
Filed with regulatory authority	*16th October, 20X2*

Will your answer differ if the entity is a partnership firm?

Solution

As per Ind AS 10 the date of approval for issue of financial statements is the date on which the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity. Accordingly, in the instant case, the date of approval is the date on which the financial statements are approved by the Board of Directors of the company, i.e., 19th June, 20X2.

If the entity is a partnership firm, the date of approval will be the date when the relevant approving authority of such entity approves the financial statements for issue i.e. the date when the partner(s) of the firm approve(s) the financial statements.

*****

Illustration 2

ABC Ltd. prepared interim financial report for the quarter ending 30th June, 20X1. The interim financial report was approved for issue by the Board of Directors on 15th July, 20X1. Whether events occurring between end of the interim financial report and date of approval by Board of Directors, i.e., events between 1st July, 20X1 and 15th July, 20X1 that provide evidence of conditions that existed at the end of the interim reporting period shall be adjusted in the interim financial report ending 30th June, 20X1?

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Solution

Paragraph 3 of Ind AS 10, *inter alia*, defines 'Events after the reporting period' as those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue.

What is reporting period has not been dealt with in Ind AS 10. Absence of any specific guidance regarding reporting period implies that any term for which reporting is done by preparing financial statements is the reporting period for the purpose of Ind AS 10. Accordingly, financial reporting done for interim period by preparing either complete set of financial statements or by preparing condensed financial statements will be treated as reporting period for the purpose of Ind AS 10.

Paragraph 2 of Ind AS 34, *inter alia*, provides that each financial report, annual or interim, is evaluated on its own for conformity with Ind AS. Further, paragraph 19 of Ind AS 34, provides that an interim financial report shall not be described as complying with Ind AS unless it complies with all of the requirements of Ind AS.

In accordance with the above, an entity describing that its interim financial report is in compliance with Ind AS, has to comply with all the provisions of Ind AS including Ind AS 10.

In order to comply with the requirements of Ind AS 10, each interim financial report should be adjusted for the adjusting events occurring between end of the interim financial report and the date of approval by Board of Directors. Therefore, in the instant case, events occurring between 1st July, 20X1 and 15th July, 20X1 that provide evidence of conditions that existed at the end of the interim reporting period should be adjusted in the interim financial report ending 30th June, 20X1.

*****

Illustration 3

The Board of Directors of ABC Ltd. approved the financial statements for the reporting period 20X1-20X2 for issue on 15th June, 20X2. The management of ABC Ltd. discovered a major fraud and decided to reopen the books of account. The financial statements were subsequently approved by the Board of Directors on 30th June, 20X2. What is the date of approval for issue as per Ind AS 10 in the given case?

Solution

As per paragraph 3 of Ind AS 10, the – date of approval is the date on which the financial

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statements are approved by the Board of Directors in case of a company, and by the corresponding approving authority in case of any other entity for issue. In the given case, there are two dates of approval by Board of Directors. The financial statements were reopened for further adjustments subsequent to initial approval. The date of approval should be taken as the date on which financial statements are finally approved by the Board of Directors. Therefore, in the given case, the date of approval for issue as per Ind AS 10 should be considered as 30th June, 20X2.

*****

2.4.4 Should the company report only unfavourable events?

The standard clearly states that events after reporting period can be favourable as well as unfavourable. Accordingly, an entity should report both favourable as well as unfavourable events after the reporting period.

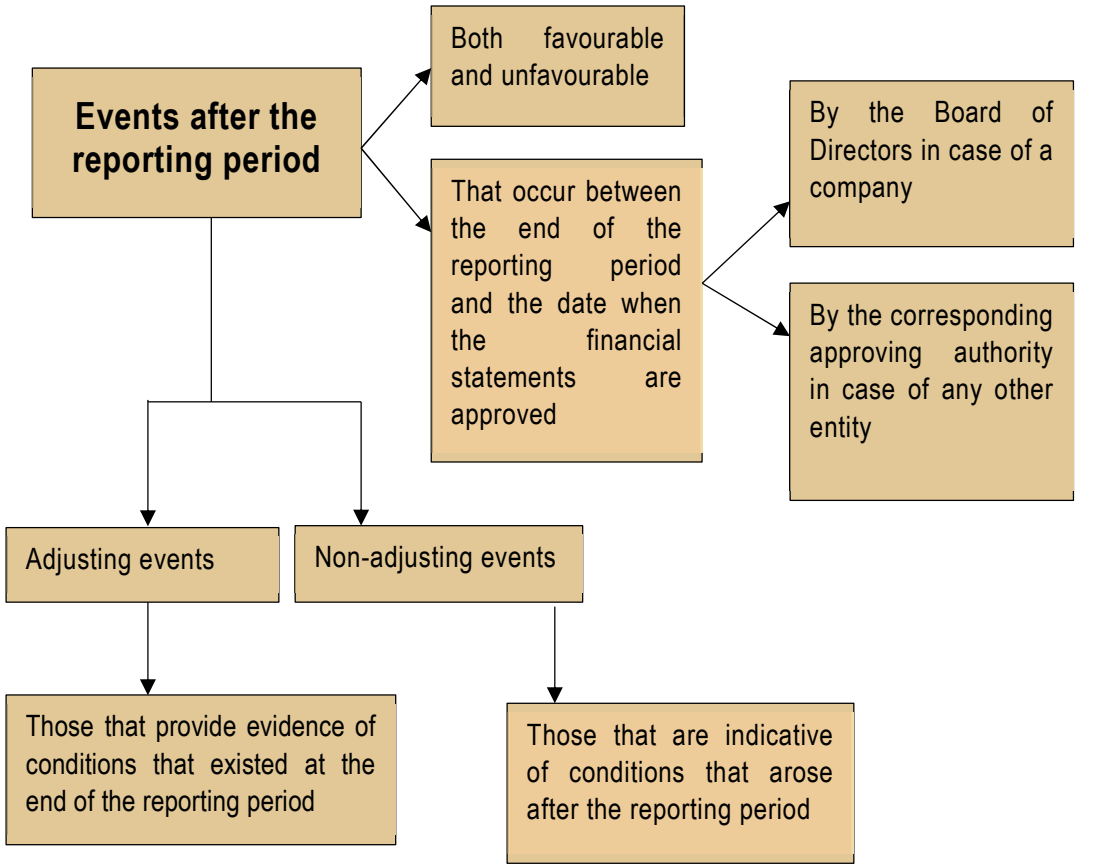
2.5 TYPES OF EVENTS

The 'events after the reporting period' are classified into two categories

(i) **Adjusting Events:** Adjusting events are those that provide **evidence** of conditions that existed **at the end of the reporting period** (adjusting events after the reporting period); and

(ii) **Non Adjusting Events:** Non-adjusting events are those that are **indicative** of conditions that arose **after the reporting period** (non-adjusting events after the reporting period).

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Ind AS 10 Carve Out: Where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the agreement by lender before the approval of the financial statements for issue, to not demand payment as a consequence of the breach, shall be considered as an **adjusting event.**

2.6 RECOGNITION AND MEASUREMENT OF ADJUSTING EVENTS

An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.

Examples of adjusting events after the reporting period

The following are examples of adjusting events after the reporting period that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

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(a) The settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. The entity adjusts any previously recognised provision related to this court case in accordance with Ind AS 37, *'Provisions, Contingent Liabilities and Contingent Assets'* or recognises a new provision.

The entity does not merely disclose a contingent liability because the settlement provides additional evidence that would be considered in accordance with paragraph 16 of Ind AS 37.

Illustration 4

A case is going on between ABC Ltd., and GST department on claiming some exemption for the year 20X1-20X2. The court issued the order on 15th April, 20X2 and rejected the claim of the company. Accordingly, the company is liable to pay additional tax. The financial statements of the company for the year 20X1-20X2 have been approved on 15th May, 20X2. Should the company account for such tax in the year 20X1-20X2 or should it account for the same in the year 20X2-20X3?

Solution

An event after the reporting period is an adjusting event, if it provides evidence of a condition existing at the end of the reporting period. Here, this condition is satisfied. Court order received after the reporting period (but before the financial statements are approved) provides evidence of the liability existing at the end of the reporting period. Therefore, the event will be considered as an adjusting event and, accordingly, the amounts will be adjusted in financial statements for 20X1-20X2.

*****

(b) The receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:

(i) The bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit-impaired at the end of the reporting period;

Example 4

Loss allowance for expected credit loss in respect of the amount due from a customer was recognised at the end of the reporting period in accordance with Ind AS 109, *'Financial Instruments'*. Subsequent liquidation order on the customer issued before the date of approval of financial statements for the reporting period indicates that nothing could be received from the customer. This confirms that the expected credit loss at the end of the reporting period on this particular trade receivable is equal to its

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gross carrying amount and, consequently, the entity needs to adjust the loss allowance for the expected credit loss at the end of the reporting period so that net carrying amount of this particular trade receivable at the end of the reporting period is zero.

Illustration 5

While preparing its financial statements for the year ended 31st March, 20X1, XYZ Ltd. made a general provision for bad debts @ 5% of its debtors. In the last week of February, 20X1 a debtor for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. Considering the event of earthquake, XYZ Ltd. made a provision @ 50% of the amount receivable from that debtor apart from the general provision of 5% on remaining debtors. In April, 20X1 the debtor became bankrupt. Can XYZ Ltd. provide for the full loss arising out of insolvency of the debtor in the financial statements for the year ended 31st March, 20X1?

Would the answer be different if earthquake had taken place after 31st March, 20X1, and therefore, XYZ Ltd. did not make any specific provision in context that debtor and made only general provision for bad debts @ 5% on total debtors?

Solution

As per the definition of 'Events after the Reporting Period' and paragraph 8 of Ind AS 10, *Events after the Reporting Period*, financial statements should be adjusted for events occurring after the reporting period that provide evidence of conditions that existed at the end of the reporting period. In the instant case, the earthquake took place in February 20X1 (i.e. before the end of the reporting period). Therefore, the condition exists at the end of the reporting date though the debtor is declared insolvent after the reporting period. Accordingly, full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the bankruptcy of the debtor in the financial statements for the year ended 31st March, 20X1. In this case, assuming that the financial statements are approved by the approving authority after April, 20X1, XYZ Ltd should provide for the remaining amount as a consequence of declaration of this debtor as bankrupt.

In case, the earthquake had taken place after the end of the reporting period, i.e., after 31st March, 20X1, and XYZ Ltd. had not made any specific provision for the debtor who was declared bankrupt later on, since the earthquake occurred after the end of the reporting period no condition existed at the end of the reporting period. The company had made only general provision for bad debts in the ordinary business

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course – without taking cognizance of the catastrophic situation of an earthquake. Accordingly, bankruptcy of the debtor in this case is a non-adjusting event.

As per para 21 of Ind AS 10, if non-adjusting events after the reporting period are material, their non-disclosure could influence the economic decisions that users make based on the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:

(a) the nature of the event; and

(b) an estimate of its financial effect, or a statement that such an estimate cannot be made."

If the amount of bad debt is considered to be material, the nature of this non-adjusting event, i.e., event of bankruptcy of the debtor should be disclosed along with the estimated financial effect of the same in the financial statements.

*****

(ii) The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.

While making the valuation of closing inventories, Ind AS 2, *Inventories*, prescribes the general principle that the inventories need to be valued at cost or net realisable value, whichever is less. In cases, where inventories are valued at net realisable value (and not 'at cost'), the estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise. However, when the inventories are actually sold during the period after the reporting date (but before approval of financial statements), the selling price of the actual sale transaction provides the evidence of net realisable value *provided* the market conditions remains unchanged. In contrast, if a change in the market conditions occur (say, due to surplus production, additional import, etc.), then the resultant changes to the selling price of inventories do not reflect the conditions that existed on the reporting date (when the inventories were valued).

Example 5

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 cost ₹ 500. All these items are sold subsequently but before the date of approval of financial statements for the reporting period at ₹ 450 per piece. The sale of inventories after the reporting period normally provides evidence about their net realisable value at the end of the reporting period.

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Illustration 6

The company has inventory of 100 finished cars on 31st March, 20X2, which are having a cost of ₹ 4,00,000 each. On 30th April, 20X2, as per the new government rules, higher road tax and penalties are to be paid by the buyers for such cars (which were already expected to come) and hence the selling price of a car has come down and the demand for such cars has dropped drastically. The selling price has come down to ₹ 3,00,000 each. The financial statements of the company for the year 20X1-20X2 are not yet approved. Should the company value its stock at ₹ 4,00,000 each or should it value at ₹ 3,00,000 each? Ignore estimated costs necessary to make the sale.

Solution

Events after the reporting period provide the evidence about the net realisable value of the cars at the end of the reporting period and, therefore, the amount of ₹ 3,00,000 should be considered for the valuation of stock.

*****

(c) The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.

Same principle can be applied for sale of assets as well.

Example 6

The sale of an asset took place in March, 20X2. However, the actual consideration was determined and collected after 31st March, 20X2, i.e., on 10th May, 20X2 (date of approval of financial statements was 15th May, 20X2). In such a situation, sale value recognised in the books as on 31st March, 20X2 should be adjusted.

Illustration 7

ABC Ltd. has purchased a new machinery during the year 20X1-20X2. The asset was finally installed and made ready for use on 15th March, 20X2. However, the company involved in installation and training, which was also the supplier, has not yet submitted the final bills for the same.

The supplier company sent the bills on 10th April, 20X2, when the financial statements were not yet approved. Should the company adjust the amount of capitalisation in the year 20X1-20X2 or in the year 20X2-20X3?

Solution

As per the provisions of the contract, the cost of installation and training of new machine is an integral part of the cost of asset purchased. Therefore, even if the details are available

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after reporting period, they provide proof about the circumstances that existed at the end of reporting period. Therefore, the cost of installation and training will be considered for capitalisation in the year 20X1-20X2.

*****

(d) The determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date (see Ind AS 19, *Employee Benefits*).

The careful reading of the above provision brings forth following two points:

(i) There is a legal or constructive obligation at the end of reporting period

(ii) The obligation is based on profit sharing or bonus payments.

Here one would understand that before the year end, one cannot determine the amount of profit. Unless one determines the final amount of profit, one cannot finalise the amount of profit sharing as the latter is related to the former. Therefore, such events must be considered for the adjustments in financial statements, provided, the contract already exists on the last day of reporting period.

(e) The discovery of fraud or errors that show that the financial statements are incorrect.

If any error or any fraud related to the reporting period is detected after the reporting period (but before approval of the financial statements), then the entity must adjust the financial statements appropriately by rectifying the same. This is because such fraud and errors provide evidence that the financial statements are *not correct as at the reporting date.* Discovery of such fraud and errors are adjusting events under Ind AS 10

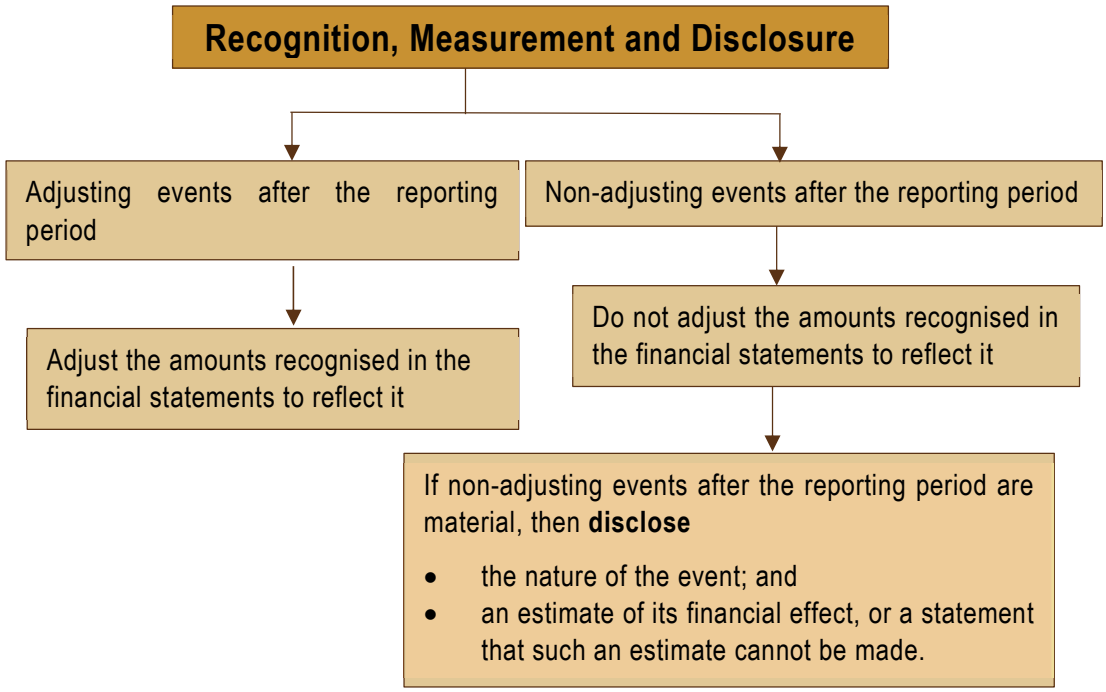
2.7 ACCOUNTING TREATMENT AND DISCLOSURE OF NON-ADJUSTING EVENTS AFTER THE REPORTING PERIOD

An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.

An example of a non-adjusting event after the reporting period is a decline in fair value of investments between the end of the reporting period and the date when the financial statements are approved for issue. The decline in fair value does not normally relate to the condition of the investments at the end of the reporting period but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial

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statements for the investments. Similarly, the entity does not update the amounts disclosed for the investments as at the end of the reporting period, although it may need to give additional disclosure as required under paragraph 21 of Ind AS 10.



2.8 SPECIAL CASES

2.8.1 Long-term Loan Arrangements

Notwithstanding anything contained in the definition of adjusting events and non-adjusting events in paragraph 3 of Ind AS 10, where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the agreement by lender before the approval of the financial statements for issue, to not demand payment as a consequence of the breach, shall be considered as an adjusting event.

Example 7

ABC Ltd., in order to raise funds, has privately placed debentures of ₹ 1 crore, on 1st January, 20X1, issued to PQR Ltd. As per the original terms of agreement, the debentures are to be redeemed on 31st March, 20X9. One of the conditions of the private placement of the debentures was that debt-equity ratio at the end of any reporting year should not exceed 2:1. If this condition is not fulfilled, then PQR Ltd., has a right to demand immediate redemption of the

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debentures. On 31st March, 20X6, debt-equity ratio of ABC Ltd., exceeds 2:1. Therefore, PQR Ltd., decides to return the debentures.

Thus, on 31st March, 20X6, the liability of the ABC Ltd., towards PQR Ltd., (which was originally a long-term liability) becomes a current liability, since it is now a liability on demand. However, ABC Ltd. enters into an agreement with PQR Ltd. on 15th April, 20X6 that PQR Ltd., will not demand the payment immediately. The financial statements are approved by the BOD on 30th April, 20X6.

In this case, the agreement that PQR Ltd., will not demand the money immediately is a subsequent event. Even though it is a subsequent event not affecting the condition existing at the balance sheet date, yet because of the specific provisions of paragraph 3 of Ind AS 10, it has to be given effect in the financial statements for the year 20X5-20X6. Accordingly, though as per original terms the liability would have been otherwise reclassified as a current liability as on 31st March, 20X6, by giving effect to the event after the reporting period due to the specific provisions of paragraph 3 of Ind AS 10, it would continue to be classified as a non-current liability as on 31st March, 20X6. In other words, the re-classification of debentures as current liability as at 31st March, 20X6 will be adjusted and once again classified as a non-current liability as at that date.

2.8.2 Going Concern

- An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.
- Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.
- Ind AS 1 specifies required disclosures if:

  (a) the financial statements are not prepared on a going concern basis; or

  (b) management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The events or conditions requiring disclosure may arise after the reporting period.

Going concern approach has a lot of importance in the financial statements. Going concern approach can be applied if and only if the entity has intentions to continue its operations. The

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carrying amount of assets and carrying amount of liabilities will be much different if the entity has plans to go in for liquidation.

Example 8

A going concern company assumes that the raw material inventory and work in progress will be completed in due course and the inventories of finished goods would be ready for sale. But, if the company has no intention to continue with the business, it may take a decision to sell the raw material and WIP at best available market price, may be at scrap value also.

If a company decides to go into liquidation, then the long-term liabilities of the company will turn into short-term liabilities as the company will have to pay all its debts before it closes down its operations. Thus, the overall approach of accounting will change when there is no going concern approach.

Therefore, Ind AS 10, specifically requires that if after the reporting period but before approval of the financial statements, there are any signs of not continuing the operations, or the decision is taken during that period not to continue with the operations, in spite of the fact that the decision was taken after the reporting period, still the entity should prepare the financial statements with a different approach and, accordingly, inform the stakeholders clearly that the is planning to cease operations.

Illustration 8

Company XYZ Ltd. was formed to secure the tenders floated by a telecom company for publication of telephone directories. It bagged the tender for publishing directories for Pune circle for 5 years. It has made a profit in 20X1- 20X2, 20X2-20X3, 20X3-20X4 and 20X4-20X5. It bid in tenders for publication of directories for other circles – Nagpur, Nashik, Mumbai, Hyderabad but as per the results declared on 23rd April, 20X5, the company failed to bag any of these. Its only activity till date is publication of Pune directory. The contract for publication of directories for Pune will expire on 31st December 20X5. The financial statements for the financial year 20X4-20X5 have been approved by the Board of Directors on 10th July, 20X5. Whether it is appropriate to prepare financial statements on going concern basis?

Solution

With regard to going concern basis to be followed for preparation of financial statements, paras 14 & 15 of Ind AS 10 states that-

An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern

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assumption is no longer appropriate, the effect is so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.

In accordance with the above, an entity needs to change the basis of accounting if the effect of deterioration in operating results and financial position is so pervasive that management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

In the instant case, since contract is expiring on 31st December 20X5 and it is confirmed on 23rd April, 20X5, (i.e., after the end of the reporting period and before the approval of the financial statements), that no further contact is secured, it implies that the entity's operations are expected to come to an end by 31st December 20X5. Accordingly, if entity's operations are expected to come to an end, the entity needs to make a judgement as to whether it has any realistic possibility to continue or not. In case, the entity determines that it has no realistic alternative of continuing the business, preparation of financial statements for 20X4-20X5 and thereafter going concern basis may not be appropriate.

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Illustration 9

In the plant of PQR Ltd., there was a fire on 10th May, 20X1 in which the entire plant was damaged and the loss of ₹ 40,00,000 is estimated. The claim with the insurance company has been filed and a recovery of ₹ 27,00,000 is expected.

The financial statements for the year ending 31st March, 20X1 were approved by the Board of Directors on 12th June, 20X1. Show how should it be disclosed?

Solution

In the instant case, since fire took place after the end of the reporting period, it is a non-adjusting event. However, in accordance with paragraph 21 of Ind AS 10, disclosures regarding material non-adjusting event should be made in the financial statements, i.e., the nature of the event and the expected financial effect of the same.

With regard to going concern basis followed for preparation of financial statements, the company needs to determine whether it is appropriate to prepare the financial statements on going concern basis, since there is only one plant which has been damaged due to fire. If the effect of deterioration in operating results and financial position is so pervasive that management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so, preparation of financial statements for the financial year 20X0-20X1 on going concern assumption may not be appropriate. In that case, the financial statements may have to be prepared on a basis other than going concern.

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However, if the going concern assumption is considered to be appropriate even after the fire, no adjustment is required in the financial statements for the year ending 31st March, 20X1.

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2.9 DIVIDENDS

- If an entity declares dividends to holders of equity instruments (as defined in Ind AS 32, *Financial Instruments: Presentation*) after the reporting period, the entity **shall not** recognise those dividends as a liability at the end of the reporting period.
- If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are **not recognised** as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are **disclosed** in the notes to accounts in Financial Statements.
- The crux of difference between adjusting event and non-adjusting event depends on the fact whether the event provides evidence for existence of a condition at the end of reporting period or not.

Illustration 10

ABC Ltd. declares the dividend on 15th July, 20X2 as the results of year 20X1-20X2 as well as Q1 ending 30th June, 20X2 are better than expected. The financial statements of the company are approved on 20th July, 20X2 for the financial year ending 31st March, 20X2. Will the dividend be accounted for in the financial year 20X2-20X3 or will it be accounted for in the year 20X1-20X2?

Solution

The dividend was declared in the year 20X2-20X3. Therefore, the obligation towards dividend did not exist at the end date of reporting period i.e., on 31st March, 20X2. Therefore, it will be accounted for in the year 20X2-20X3 and not in 20X1-20X2, even if financial statements for 20X1-20X2 were approved after the declaration of dividend. It will, however, be disclosed in the notes in the financial statements for the year 20X1-20X2 in accordance with Ind AS 1.

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Illustration 11

What would be the treatment for dividends declared to redeemable preference shareholders after the reporting period but before the financial statements are approved for issue for the year 20X1-20X2. Whether Ind AS 10 prescribes any accounting treatment for such dividends?

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Solution

Paragraph 12 of Ind AS 10 prescribes accounting treatment for dividends declared to holders of equity instruments. If an entity declares dividends to holders of equity instruments (as defined in Ind AS 32, *Financial Instruments: Presentations*) after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period.

However, Ind AS 10 does not prescribe accounting treatment for dividends declared to redeemable preference shareholders. As per the principles of Ind AS 32, *Financial Instruments: Presentation*, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. Thus, dividend payments to such preference shares are recognised as expense in the same way as interest on a bond. Since interest will be charged on time basis, the requirements of Ind AS 10 regarding date of declaration of dividend is not relevant for its recognition.

*****

2.10 DISCLOSURE REQUIRED UNDER IND AS 10

2.10.1 Date of approval for issue

- An entity shall disclose the date when the financial statements were approved for issue and who gave that approval. If the entity's owners or others have the power to amend the financial statements after issue, the entity shall disclose that fact.
- It is important for users to know when the financial statements were approved for issue, because the financial statements do not reflect events after this date.

Ind AS 10, underlines the importance of date of approval, by requiring a separate disclosure of the date of approval of financial statements. Note that this date is important because it gives a clear idea to the stakeholders about the period, which is covered after the reporting period, for providing information to the stakeholders. In a way, it determines the scope of the financial statements in terms of time.

2.10.2 Updating disclosure about conditions at the end of the reporting period

- If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information.

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In case of adjusting events, the entity is supposed to make the necessary adjustments in the financial statements. But just making the changes in the financial statements will not be sufficient as the stakeholders will not be in a position to understand why the adjustments are made. Therefore, in addition to adjustments in the financial statements, it is necessary to make the separate disclosure of the same.

- In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the reporting period, even when the information does not affect the amounts that it recognises in its financial statements. One example of the need to update disclosures is when evidence becomes available after the reporting period about a contingent liability that existed at the end of the reporting period. In addition to considering whether it should recognise or change a provision under Ind AS 37, an entity updates its disclosures about the contingent liability in the light of that evidence.

2.10.3 Disclosure of Non-adjusting events after the reporting period

If non-adjusting events after the reporting period are material, non-disclosure could reasonably be expected to influence the decisions that the primary users of general-purpose financial statements make on the basis of those financial statements., which provide financial information about a specific reporting entity. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:

(a) the nature of the event; and

(b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

Examples of non-adjusting events after the reporting period generally resulting in disclosure:

(a) a major business combination after the reporting period (Ind AS 103, *Business Combinations*, requires specific disclosures in such cases) or disposing of a major subsidiary;

(b) announcing a plan to discontinue an operation;

(c) major purchases of assets, classification of assets as held for sale in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*, other disposals of assets, or expropriation of major assets by government;

(d) the destruction of a major production plant by a fire after the reporting period;

(e) announcing, or commencing the implementation of, a major restructuring (see Ind AS 37);

(f) major ordinary share transactions and potential ordinary share transactions after the reporting period (Ind AS 33, Earnings per Share, requires an entity to disclose a description

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of such transactions, other than when such transactions involve capitalisation or bonus issues, share splits or reverse share splits all of which are required to be adjusted under Ind AS 33);

(g) abnormally large changes after the reporting period in asset prices or foreign exchange rates;

(h) changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities (see Ind AS 12, Income Taxes);

(i) entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and

(j) commencing major litigation arising solely out of events that occurred after the reporting period.

Important points to remember

S.No.	Item	Timing	Treatment	Reason
1.	Dividends	Declared after the reporting period but before approval of financial statements	• Do not recognise it as a liability at the end of the reporting period. • Disclosed in the notes to accounts	No obligation exists at that time
2.	Going concern	If management determines after the reporting period either that it intends to liquidate the entity or to cease trading	• Do not prepare the financial statements on a going concern basis; or • Make necessary disclosure of not following going concern basis or events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern	The deterioration in operating results and financial position after the reporting period may be so pervasive that it may require a fundamental change in the basis of accounting

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3.	Date of approval of financial statements for issue	Approved after the reporting period	Disclose the date when the financial statements were approved for issue **and** who gave that approval	Important for users to know when the financial statements were approved for issue because the financial statements do not reflect events after this date
4.	Updating disclosure about conditions at the end of the reporting period	Received information after the reporting period	Update disclosures that relate to new information / conditions	When the information does not affect the amounts that it recognises in its financial statements, disclosures are required

An extract from the annual report of JSW Steel Limited for the year ended 31st March, 2021:

53. Subsequent events

a) On 21 May 2021, the board of directors recommended a final dividend of ₹ 6.50 (Rupees six and paise fifty only) per equity share of ₹ 1 each to be paid to the shareholders for the financial year 2020-21, which is subject to approval by the shareholders at the Annual General Meeting to be held on 21 July 2021. If approved, the dividend would result in cash outflow of ₹ 1,571 crores.

b) On 13 April 2021, JSW Steel Italy S.r.L, a wholly owned subsidiary of the Company completed the acquisition of remaining 840,840 equity shares, representing 30.73% equity share capital of GSI Luchini S.p.A. for a consideration of EUR 1 million. Consequent to this, GSI Luchini S.p.A. has become a wholly owned subsidiary of the Company.

2.11 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.

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It may be recalled that paragraph 107 of Ind AS 1, *inter alia*, requires an entity to present the amount of dividends recognised as distributions to owners either in the statement of changes in equity or in the notes to the financial statements but does not prescribe how to measure it. Appendix A to Ind AS 10, *Distribution of Non-cash Assets to Owners* is relevant in this regard.

2.11.1 Applicability

- Appendix A to Ind AS 10 applies to the following types of non-reciprocal distributions of assets by an entity to its owners acting in their capacity as owners:

  (a) distributions of non-cash assets (e.g., items of property, plant and equipment, businesses as defined in Ind AS 103, ownership interests in another entity or disposal groups as defined in Ind AS 105); and

  (b) distributions that give owners a choice of receiving either non-cash assets or a cash alternative.

- It applies only to distributions in which all owners of the same class of equity instruments are treated equally.

2.11.2 Non-applicability

- This Appendix does not apply to a distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution.
- This exclusion applies to the separate, individual and consolidated financial statements of an entity that makes the distribution.
- For a distribution to be outside the scope of this Appendix on the basis that the same parties control the asset both before and after the distribution, a group of individual shareholders receiving the distribution must have, as a result of contractual arrangements, such ultimate collective power over the entity making the distribution.
- It does not apply when an entity distributes some of its ownership interests in a subsidiary but retains control of the subsidiary. The entity making a distribution that results in the entity recognising a non-controlling interest in its subsidiary accounts for the distribution in accordance with Ind AS 110, *Consolidated Financial Statements*.
- This Appendix addresses only the accounting by an entity that makes a non-cash asset distribution. It does not address the accounting by shareholders who receive such a distribution.

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2.11.3 Issues addressed by Appendix A to Ind AS 10

- When an entity declares a distribution (and hence, has an obligation to distribute the assets concerned to its owners), it must recognise a liability for the dividend payable.
- Accordingly, this Appendix addresses the following three questions:
  - **When** should the entity recognise the dividend payable?
  - **How** should an entity measure the dividend payable? and
  - When an entity settles the dividend payable, **how** should it account for any difference between (a) the carrying amount of the assets distributed and (b) the carrying amount of the dividend payable?

These issues have been discussed in the subsequent paragraphs.

2.11.4 Accounting Principles enunciated by Appendix A to Ind AS 10

When an entity declares a distribution and has an obligation to distribute the assets concerned to its owners, it must recognise a liability for the dividend payable.

2.11.4.1 When to recognise a dividend payable

- The liability to pay a dividend shall be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity
- This is the date:

  (a) when declaration of the dividend (e.g., by management or the board of directors), is approved by the relevant authority (e.g., the shareholders), if the jurisdiction requires such approval, or

  (b) when the dividend is declared, (e.g., by management or the board of directors), if the jurisdiction does not require further approval.

2.11.4.2 Measurement of a dividend payable

- An entity shall measure a liability to distribute non-cash assets as a dividend to its owners at the fair value of the assets to be distributed.
- If an entity gives its owners a choice of receiving either a non-cash asset or a cash alternative, the entity shall estimate the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative.
- At the end of each reporting period and at the date of settlement, the entity shall review and adjust the carrying amount of the dividend payable, with any changes in the carrying

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amount of the dividend payable recognised in equity as adjustments to the amount of the distribution.

Accounting for any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable when an entity settles the dividend payable.

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

2.11.4.3 Presentation and disclosures

An entity shall present the difference between carrying amount of the assets distributed and the carrying amount of the dividend payable at the time of settlement of the dividend payable as a separate line item in profit or loss.

An entity shall disclose the following information, if applicable:

(a) the carrying amount of the dividend payable at the beginning and end of the period; and

(b) the increase or decrease in the carrying amount recognised in the period as result of a change in the fair value of the assets to be distributed.

If after the end of a reporting period but before the financial statements are approved for issue, an entity declares a dividend to distribute a non-cash asset, it shall disclose:

(a) the nature of the asset to be distributed;

(b) the carrying amount of the asset to be distributed as of the end of the reporting period; and

(c) the fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount, and the information about the method(s)used to measure that fair value required to be disclosed by Ind AS 113, *Fair Value Measurement*.

2.12 EXTRACTS OF FINANCIAL STATEMENT OF LISTED ENTITIES

An extract from the annual report of JSW Steel Limited for the year ended March 31, 2021:

Subsequent Events

a) On 21 May 2021, the board of directors recommended a final dividend of ₹ 6.50 (Rupees six and paise fifty only) per equity share of ₹ 1 each to be paid to the shareholders for the financial year 2020-21, which is subject to approval by the shareholders at the Annual General Meeting to be held on 21 July 2021. If approved, the dividend would result in cash outflow of Rs. 1,571 crores.

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b) On 13 April 2021, JSW Steel Italy S.R.L, a wholly owned subsidiary of the Company completed the acquisition of remaining 840,840 equity shares, representing 30.73% equity share capital of GSI Luchini S.P.A. for a consideration of EUR 1 million. Consequent to this, GSI Luchini S.P.A. has become a wholly owned subsidiary of the Company.

(Source: https://www.jswsteel.in/)

2.13 SIGNIFICANT DIFFERENCES BETWEEN IND AS 10 AND AS 4

S. No	Particulars	Ind AS 10	AS 4
	Title	**Events after the Reporting Period**	**Contingencies and Events Occurring After the Balance Sheet Date**
1.	***Material non adjusting events***	The standard requires material non-adjusting events to be disclosed in the financial statements.	AS 4 requires the same to be disclosed in the report of approving authority.
2.	***Impact on going concern of the entity***	If after the reporting date it is determined that the fundamental accounting assumption of going concern is no longer appropriate, Ind AS 10 requires a fundamental change in the basis of accounting.	AS 4 requires assets and liabilities to be adjusted for events occurring after the balance sheet date that indicate that the fundamental accounting assumption of going concern is not appropriate.
		In this regard, Ind AS 10 refers to Ind AS 1, which requires an entity to make the following disclosures: • disclose the fact that the financial statements are not prepared on a going concern basis together with the basis on which the financial statements are prepared. • state the reason why the entity is not regarded as a going concern.	AS 4 does not require any such disclosure. However, AS 1 requires the disclosure of the fact in case going concern assumption is not followed.

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3.	***Breach of a material provision of a long-term loan arrangement***	Consequent to carve-out made in Ind AS 1, it has been provided in the definition of 'Events after the reporting period' that in case of breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.	No such guidance is given in AS 4
4.	***Distribution of non-cash assets to owners***	Ind AS 10 includes an Appendix *Distribution of Non-cash Assets to Owners* which deals, *inter alia,* with when to recognise dividends payable to its owners.	No such guidance is given in AS 4

2.14 CARVE OUT IN IND AS 10 FROM IAS 10

Ind AS 10 Carve Out: As a consequence to carve-out made in Ind AS 1, Ind AS 10 provides, in the definition of 'Events after the reporting period' that in case of breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.

However, under IAS 10 '*Events after the Reporting Period',* an agreement with the lender *after the reporting period but before the approval of the financial statements for issue* not to demand payment (say, arising out of breach of loan covenants) is not considered as an adjusting event.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

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

2. ABC Ltd. is in a legal suit against the GST department. The company gets a court order in its favour on 15th April, 20X2, which resulted into reducing the tax liability as on 31st March, 20X2. The financial statements for 20X1-20X2 were approved by the board of directors on 15th May, 20X2. The management has not considered the effect of the transaction as the event is favourable to the company. The company's view is that favourable events after the reporting period should not be considered as it would hamper the realisation concept of accounting. Comment on the company's views in the light of Ind AS 10.

3. ABC Ltd. trades in laptops. On 31st March, 20X2, the company has 50 laptops which were purchased at ₹ 45,000 each. The company has considered the same price for calculation of closing inventory valuation. On 15th April, 20X2, advanced version of same series of laptops is introduced in the market. Therefore, the price of the current laptops goes down to ₹ 35,000 each. The financial statements for 20X1-20X2 were approved by the board of directors on 15th May, 20X2. The company does not want to value the stock at ₹ 35,000

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less estimated costs necessary to make the sale as the event of reduction in selling price took place after 31st March, 20X2 and the reduced prices were not applicable as on 31st March, 20X2. Comment on the company's views.

4. XY Ltd took a large-sized civil construction contract, for a public sector undertaking, valued at ₹ 200 crores. The execution of the project started during 20X1-20X2 and continued in the next financial year also. During execution of the work on 29th May, 20X2, the company found while raising the foundation work that it had met a rocky surface and cost of contract would go up by an extra ₹ 50 crores, which would not be recoverable from the contractee as per the terms of the contract. The Company's financial year ended on 31st March, 20X2, and the financial statements were considered and approved by the Board of Directors on 15th June, 20X2. How will you treat the above in the financial statements for the year ended 31st March, 20X2?

5. A Ltd. was required to pay a penalty for a breach in the performance of a contract. A Ltd. believed that the penalty was payable at a lower amount than the amount demanded by the other party. A Ltd. created provision for the penalty but also approached the arbitrator with a submission that the case may be dismissed with costs. A Ltd. prepared the financial statements for the year 20X1-20X2, which were approved in May, 20X2. The arbitrator, in April, 20X2, awarded the case in favour of A Ltd. As a result of the award of the arbitrator, the provision earlier made by A Ltd. was required to be reduced. The arbitrator also decided that cost of the case should be borne by the other party. Now, whether A Ltd. is required to remeasure its provision and what would be the accounting treatment of the cost that will be recovered by A Ltd., which has already been charged to the Statement of Profit and Loss as an expense for the year 20X1-20X2?

6. A company manufacturing and supplying process control equipment is entitled to duty drawback if it exceeds its turnover above a specified limit. To claim duty drawback, the company needs to file an application within 15 days of meeting the specified turnover. If the application is not filed within stipulated time, the Department has discretionary power of giving duty draw back credit. For the year 20X1-20X2, the company has exceeded the specified limit of turnover by the end of the reporting period but the application for duty drawback is filed on 20th April, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition.

   Duty drawback has been credited by the Department on 28th June, 20X2 and financial statements have been approved by the Board of Directors of the company on 26th July, 20X2. Whether duty drawback credit should be treated as an adjusting event?

7. XYZ Ltd. sells goods to its customer with a promise to give a discount of 5% on list price of the goods provided that the payments are received from customer within 15 days. XYZ Ltd.

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sold goods for ₹ 5 lakhs to ABC Ltd. between 17th March, 20X2 and 31st March, 20X2. ABC Ltd. paid the dues by 15th April, 20X2 with respect to sales made between 17th March, 20X2 and 31st March, 20X2. Financial statements were approved for issue by Board of Directors on 31st May, 20X2.

State whether discount will be adjusted from the sales at the end of the reporting period.

8. Whether the fraud related to 20X1-20X2 discovered after the end of the reporting period but before the date of approval of financial statements for 20X3-20X4 is an adjusting event?

9. X Ltd. was having investment in the form of equity shares in another company as at the end of the reporting period, i.e., 31st March, 20X2. After the end of the reporting period but before the approval of the financial statements it has been found that value of investment was fraudulently inflated by committing a computation error. Whether such event should be adjusted in the financial statements for the year 20X1-20X2?

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

Answers

1. As per Ind AS 10, even if partial information has already been published, the reporting period will be considered as the period between the end of the reporting period and the date of approval of financial statements. In the above case, the financial statements for the year 20X1-20X2 were approved on 15th May, 20X2. Therefore, for the purposes of Ind AS 10, 'after the reporting period' would be the period between 31st March, 20X2 and 15th May, 20X2.

2. As per Ind AS 10, even favourable events need to be considered. What is important is whether a condition exists as at the end of the reporting period and there is evidence for the same.

3. As per Ind AS 10, the decrease in the net realizable value of the stock after the reporting period should normally be considered as an adjusting event.

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4. In the instant case, the execution of work started during the financial year 20X1-20X2 and the rocky surface was there at the end of the reporting period, though the existence of rocky surface is confirmed after the end of the reporting period as a result of which it became evident that the cost may escalate by ₹ 50 crores. In accordance with the definition of 'Events after the Reporting Period', since the rocky surface was there, the condition was existing at the end of the reporting period, therefore, it is an adjusting event. The cost of the project and profit should be accounted for accordingly.

5. In the instant case, A Ltd. approached the arbitrator before the end of the reporting period, who decided the award after the end of the reporting period but before approval of the financial statements for issue. Accordingly, the conditions were existing at the end of the reporting date because A Ltd. had approached the arbitrator before the end of the reporting period whose outcome has been confirmed by the award of the arbitrator. Therefore, it is an adjusting event.

Accordingly, the measurement of the provision is required to be adjusted for the event occurring after the reporting period. As far as the recovery of the cost by A Ltd. from the other party is concerned, this right to recover was a contingent asset as at the end of the reporting period.

As per para 35 of Ind AS 37, contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset.

On the basis of the above, a contingent asset should be recognised in the financial statements of the period in which the realisation of asset and the related income becomes virtually certain. In the instant case, the recovery of cost became certain when the arbitrator decided the award during financial year 20X2-20X3.

Accordingly, the recovery of cost should be recognised in the financial year 20X2-20X3.

6. In the instant case, the condition of exceeding the specified turnover was met at the end of the reporting period and the company was entitled to the duty draw back but the application for the same has been filed after the stipulated time. Therefore, credit of duty drawback is discretionary in the hands of the Department. Accordingly, the duty drawback credit is a contingent asset as at the end of the reporting period, which may be realized if the Department credits the same.

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As per para 35 of Ind AS 37, contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, asset and the related income are recognized in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset.

In accordance with the above, the duty draw-back credit which was contingent asset for the financial year 20X1-20X2 should be recognized as asset and related income should be recognized in the reporting period in which the change occurs. i.e., in the period in which realization becomes virtually certain, i.e., financial year 20X2-20X3.

7. As per Ind AS 115, if the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

In the instant case, the condition that sales have been made exists at the end of the reporting period and the receipt of payment within 15 days time after the end of the reporting period and before the approval of the financial statements confirms that the discount is to be provided on those sales. Therefore, it is an adjusting event. Accordingly, XYZ Ltd. should adjust the sales made to ABC Ltd. with respect to discount of 5% on the list price of the goods.

8. In the instant case, the fraud is discovered after the end of the reporting period of 20X3-20X4, which related to financial year 20X1-20X2. Since the fraud took place before the end of the reporting period, the condition was existing which has been confirmed by the detection of the same after the end of the reporting period but before the approval of financial statements. Therefore, it is an adjusting event.

Moreover, Ind AS 10 in paragraph 9, specifically provides that the discovery of fraud or error after the end of the reporting period, that shows that financial statements are incorrect, is an adjusting event. Such a discovery of fraud should be accounted for in accordance with Ind AS 8 if it meets the definition of prior period error.

9. Since it has been detected that a fraud has been made by committing an intentional error and as a result of the same financial statements present an incorrect picture, which has been detected after the end of the reporting period but before the approval of the financial statements. The same is an adjusting event. Accordingly, the value of investments in the financial statements should be adjusted for the fraudulent error in computation of value of investments.

10. Ind AS 10 defines 'Events after the Reporting Period' as follows:

Events after the reporting period are those events, favourable and unfavourable, that occur

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between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue. Two types of events can be identified:

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period)

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

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

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UNIT 3:
INDIAN ACCOUNTING STANDARD 113: FAIR VALUE MEASUREMENT

LEARNING OUTCOMES

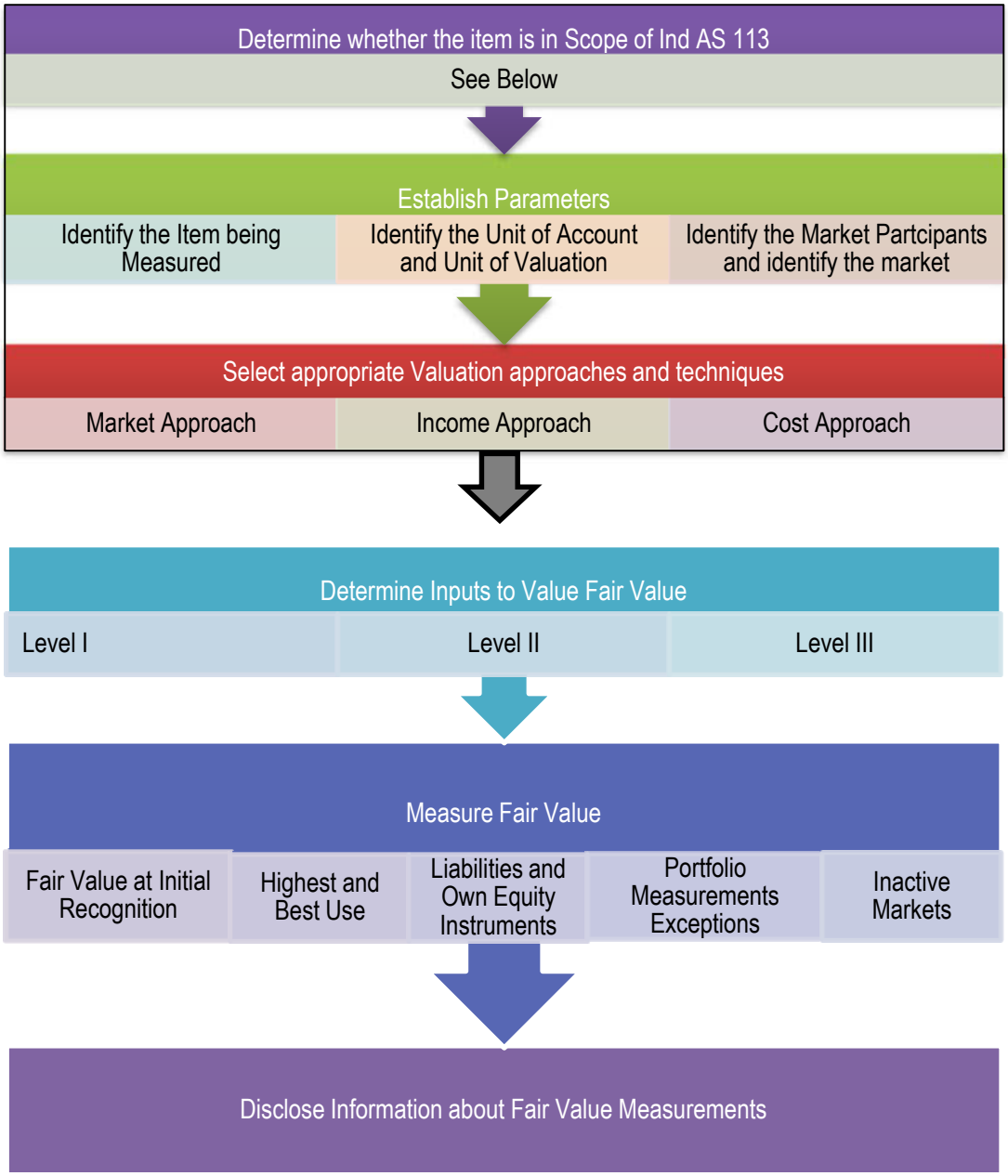
After studying this unit, you will be able to:

- Understand the need for issuance of Ind AS 113
- Define fair value
- Appreciate the scope and objective of this standard
- Apply the provisions of the standard on 'non-financial assets', 'liabilities' and an entity's 'own equity instruments'
- Measure fair value at 'initial recognition'
- Use valuation techniques prescribed in the standard
- Classify the fair value hierarchy under various level
- Disclose the information as per the requirements of the standards

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UNIT OVERVIEW

Ind AS 113



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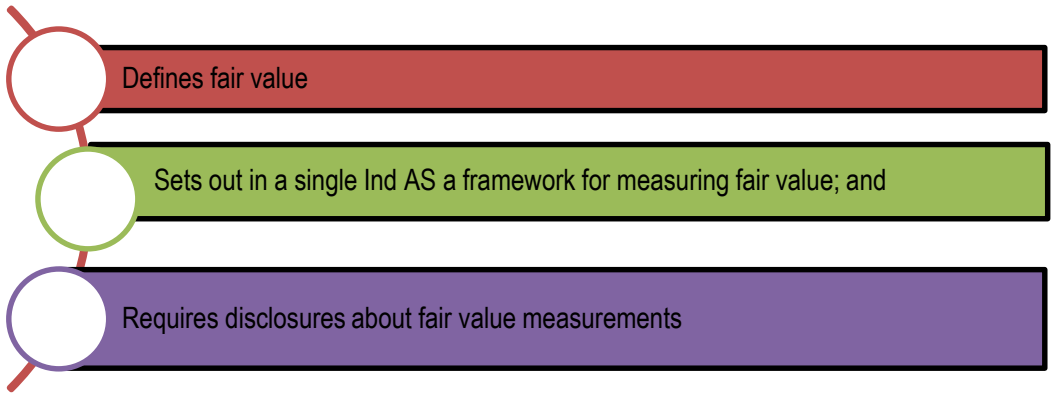
3.1 WHAT IS FAIR VALUE?



Normally assets and liabilities are being exchanged between parties at their agreed terms and conditions based on the prices which might be related to the entity or event based or in other words which is not at arm's length prices. To define fair value one has to ensure that the values reflect all assumptions/ adjustments to change from transaction specific/ entity specific to normal transaction which is common for all interested parties.

In other words, it is a market-based measurement not an entity specific measurement and this price should be received to sell an asset or paid to transfer a liability in a normal transaction (e.g. other than any stressed sale etc). Fair value is an exit price and not a price at which an asset/ liability sells / purchase otherwise.

3.2 OBJECTIVE



Fair value is a market-based measurement, not an entity-specific measurement.

The objective of a fair value measurement is—

- To estimate the price
- At which an orderly transaction to sell the asset or to transfer the liability would take place
- Between market participants
- At the measurement date
- Under current market conditions

(i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

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When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that:

- Maximises the use of relevant observable inputs and
- Minimises the use of unobservable inputs.

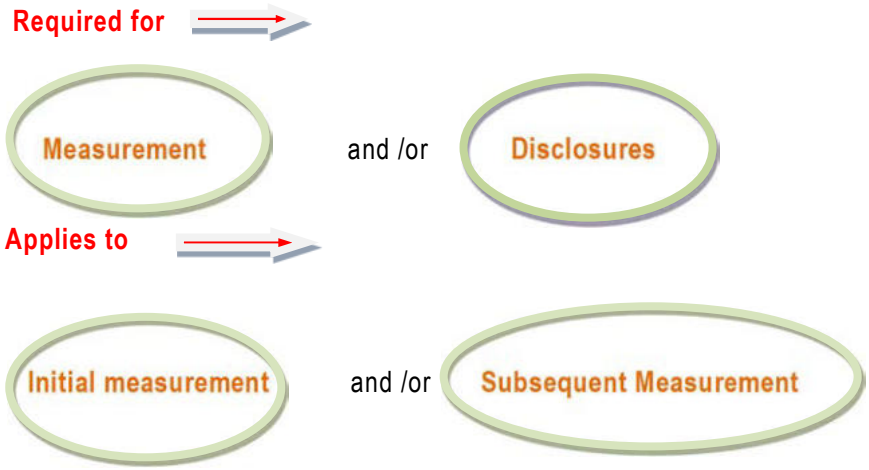
Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

The definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. In addition, this Ind AS shall be applied to an entity's own equity instruments measured at fair value.

3.3 SCOPE



There are many Ind AS which require measuring assets / liabilities at fair value and whenever it is required to be fair valued, one looks at Ind AS 113. It means that this Standard will cover all such requirements of another standard where fair value measurement and disclosure is needed. However, there are some specific scope exclusions. It applies to initial measurement and subsequent measurement as required by respective Accounting Standard.



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Example of items covered under Ind AS 113

- Fair value less cost to sell as required under Ind AS 105 for assets held for sale.
- Fair value through Profit and Loss or through Other Comprehensive Income as required under Ind AS 109 for Financial Instruments.
- Property, plant & equipment measured using revaluation modal as required under Ind AS 16.
- Biological assets measure at fair value under Ind AS 41 for biological assets.

3.3.1 What is not covered?

Standard specifically describes the below exceptions which are not covered by this Accounting Standard and hence one has to look at the respective standards to identify the process to calculate fair values of the items of that standard. The scope exclusion will be applied on below:

3.3.1.1 Measurement and Disclosure exclusion

(a) share-based payment transactions within the scope of Ind AS 102, Share based Payment;

(b) leasing transactions accounted in accordance with Ind AS 116, Leases; and

(c) measurements that have some similarities to fair value but are not fair value, such as net realisable value in Ind AS 2, Inventories, or value in use in Ind AS 36, Impairment of Assets.

3.3.1.2 Disclosure exclusion

(a) plan assets measured at fair value in accordance with Ind AS 19, Employee Benefits;

(b) assets for which recoverable amount is fair value less costs of disposal in accordance with Ind AS 36.

3.4 DEFINITION

This Ind AS defines fair value as **the price** that would be received to sell an asset or paid to transfer a liability in **an orderly transaction** between **market participants** at the measurement date.

Fair Value			
The price that would be received to sell an asset or paid to transfer a liability	In an orderly transaction	Between market participants	At the measurement date

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In order to understand the definition of the fair value, some of the major terms as used in the definition need to be understood which are as follows:

a. The asset or liability

b. The transaction

c. Market participants

d. The price

Example 1 - Settlement vs Transfer

A bank holds a debt obligation with a face value of ₹ 1,00,000 and a market value of ₹ 95,000. Assume that market interest rates are consistent with the amount in the note; however, there is ₹ 5,000 discount due to market concerns about the risk of non-performance by Counterparty I.

Settlement value

Counterparty I would be required to pay the face value of the note to settle the obligation, because the bank might not be willing to discount the note by the market discount or the credit risk adjustment. Therefore, the settlement value would equal the face value of the note.

Transfer value

In order to calculate the transfer value, Counterparty I must construct a hypothetical transaction in which another counterparty (Counterparty II), with a similar credit profile, is seeking financing on terms that are substantially the same as the note. Counterparty II could choose to enter into a new note agreement with the bank or receive the existing note from Counterparty I in a transfer transaction. In this hypothetical transaction, Counterparty II should be equally willing to obtain financing through a new bank note or assumption of the existing note in return for a payment of ₹ 95,000. Therefore, the transfer value would be ₹ 95,000, and thus the fair value.

3.5 ASSET OR LIABILITY SPECIFIC FAIR VALUE

Ind AS 113 states that a fair value measurement takes into account the characteristics of the asset or liability, e.g. the condition and location of the asset and restrictions, if any, on its sale or use.

The restriction or the condition relating to asset which can affect the future economic benefit from the asset need to be considered in determining the fair value of the asset.

The standard emphasis that in order to get a fair value of an asset/ liability, the restrictions or conditions that might be related to a particular entity should not be taken into account because a fair value will be based on market participant assumptions rather to an entity specific conditions or restriction which usually will not affect fair valuation of an asset/ liability.

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The restrictions could be entity specific or an asset/ liability specific hence all such restrictions which are asset/liability specific & being transfer to the buyer as it is, then these will be considered while calculating fair value. In contrast, if the restrictions are entity specific then it will not be considered.

	To consider in Fair Value
Entity specific restrictions	NO
Asset / liability specific restrictions	YES

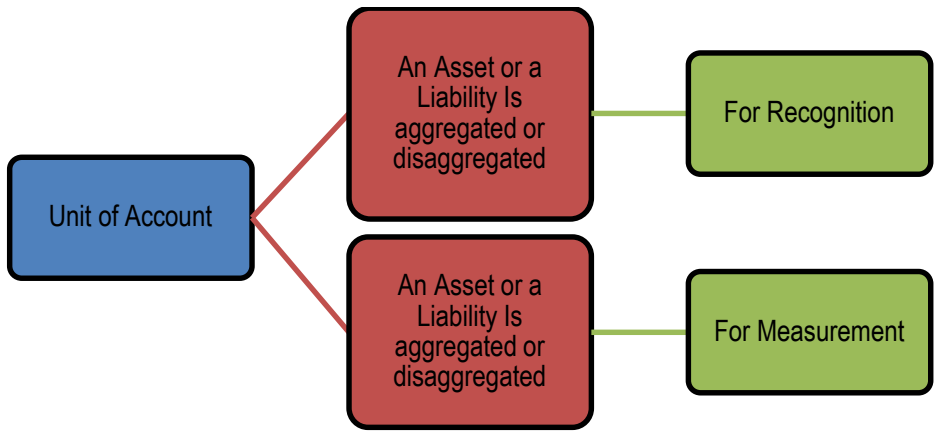
Example 2: Entity Specific restrictions

An entity is having a 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 fair value of the land.

Example 3: Asset / Liability specific restrictions

A car has been bought for private use and there is a restriction of not to use the car for any commercial purposes. Commercial vehicle is having more fair value than private vehicle. 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.

3.6 UNIT OF ACCOUNT



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Ind AS 113 describes how to measure fair value, not what is being measured at fair value. Other Ind AS specify whether a fair value measurement considers an individual asset or liability or a group of assets or liabilities (i.e. the unit of account).

Whether the asset or liability is a stand-alone asset or liability, a group of assets, a group of liabilities or a group of assets and liabilities for recognition or disclosure purposes depends on its unit of account.

The unit of account for the asset or liability shall be determined in accordance with the Ind AS that requires or permits the fair value measurement, except as provided in this Ind AS.

This essentially defines the level of aggregation or disaggregation while calculating fair values of the assets/ liabilities.

Examples 5 & 6

5. An entity having certain securities which are quoted at market and these are recognized at fair value in the balance sheet. Quoted prices **at individual level** will be used in order to find fair values of these investments.

6. In order to evaluate fair value of assets to identify impairment as per Ind AS 36, which requires to measure such fair value at CGU (cash generating unit) level, group of assets will be used to find fair values as per the requirement of such standard.

3.7 THE TRANSACTION

A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.

A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:

(a) in the principal market for the asset or liability; or

(b) in the absence of a principal market, in the most advantageous market for the asset or liability.

There could be different principal markets for different reporting entities even if they belong to the same group. The principal market / most advantageous market would separately be evaluated for different assets / liabilities under the fair valuation requirements.

3.7.1 Principal market

Market which is normally the place in which the assets / liabilities are being transacted with highest volume and with high level of activities comparing with any other market available for similar transactions.

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If there is principal market, the price in the market must be used even if the prices in the other market are more advantageous.

Because the principal market is the most liquid market for the asset or liability, that market will provide the most representative input for a fair value measurement.

Example 7

Shares of a company which is listed at BSE and NYSE have different closing prices at the year end. The price at BSE has greatest volume and activity whereas at NYSE it is less in terms of volume transacted in the period. Since BSE has got highest volume and significant level of activity comparing to other market although the closing price is higher at NYSE, the closing price at BSE would be taken.

3.7.2 Most advantageous market

- This is the market which either maximizes the amount that would be received when an entity sells an asset or minimize the amount that is to be paid while transferring the liability.
- In the absence of a principal market, this market is used for fair valuation of the assets / liabilities. In many cases Principal Market & Most Advantageous Market will be same.
- The market will be assessed based on net proceeds from the sale after deducting expenses associated with such sale in the most advantageous market.

Example 8

Diamond (a commodity) has got a domestic market where the prices are less compared to the price available for export of similar diamonds. The Government has a policy to cap the export of Diamond, maximum upto 10% of total output by any such manufacturer. The normal activities of diamond are being done in the domestic market only i.e. 90% and balance 10% only can be sold via export. The highest level of activities with the highest volume is being done in the domestic market. Hence, the principal market for diamond would be the domestic market. Export prices are more than the prices in the principal market, and it would give the highest return as compared to the domestic market. Therefore, the export market would be considered as the most advantageous market. However, if principal market is available, then its prices would be used for fair valuation of assets/ liabilities.

3.8 MARKET PARTICIPANTS

A fair value measurement is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement uses the assumptions that market participants would use when pricing the asset or liability.

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An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

3.8.1 What are market participants?

The parties which eventually transact the assets/ liabilities either in principal market or the most advantageous market in their best economic interest i.e.

- They should be independent and not related parties. However, if related parties have done similar transaction on arm's length price, then it can be between related parties as well.
- The parties should not be under any stress or force to enter into these transactions
- All parties should have reasonable and sufficient information about the same.

Example 9

A land has legal restriction to use it for commercial purposes in next 10 years irrespective of its holder. The fair value of the land will include this restriction about its usage because it is an asset related restriction and any buyer will need to take over with similar restriction to use the land for next 10 years. Now to evaluate its fair value, one has to consider the restriction based on the assumptions which normally would be taking into account by its market participants, mentioned as below

a) Whether the restriction is commonly imposed on each such type of land?

b) How useful it will be after the end of 10 years?

c) Whether there is any alternative use which may be considered normally by a participant for similar kind of deals?

d) How liquid the sale of land will be with such restrictions?

e) Comparing the price with similar kind of land without restrictions to arrive at its fair values.

3.9 THE PRICE

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

A fair value is being assessed based on principal market and if principal market is not available then based on the most advantageous market.

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Illustration 1

A Ltd. has invested in certain bonds. The fair value of these bonds in different markets to which A Ltd. has an access is as follows:

(i) Principal market ₹ 500

(ii) Highest and best use ₹ 600

(iii) Net present value of expected cash flows ₹ 550

(iv) Asset based valuation approach ₹ 450

What will be the fair value of bond as per Ind AS 113?

Solution

As per para 24 of Ind AS 113, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

Further, para 72 of the standard inter alia states that the fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

According to the above, the value of bond shall be ₹ 500 based on the principal market.

*****

3.9.1 Transaction cost

The transaction costs are not a characteristic of an asset or a liability, but a characteristic of the transaction.

Hence, it would not be appropriate to consider any transaction cost further while assessing fair values from such principal markets.

Note: Transaction costs do not include transport costs.

3.9.2 Transport cost

Transport costs are different from transaction costs. It is the cost that would be incurred to transport the asset from its current location to its principal (or most advantageous) market. Unlike transaction costs, which arise from a transaction and do not change the characteristics of the asset or liability, transport costs arise from an event (transport) that does change a characteristic of an asset (its location).

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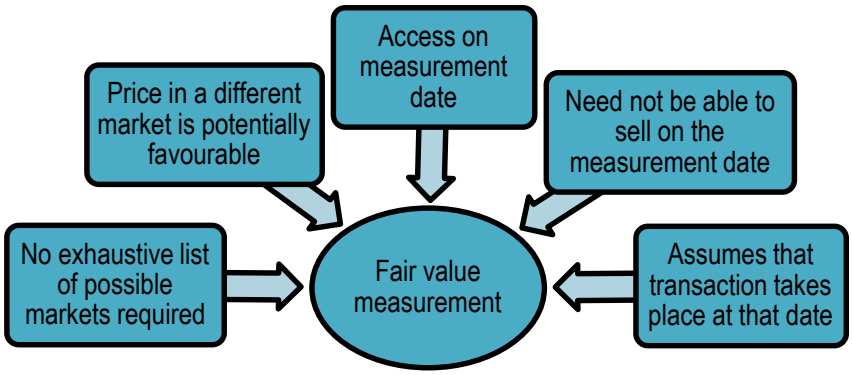
If location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

It would be considered, if in case it is an inherent part of the Assets/ Liability so transacted e.g. commodity.

	Principal market	Most advantageous market
Transaction Cost	NO	YES
Transport cost	YES	YES

Example 10

An entity sells certain commodity which are available actively at location A and which is considered to be its principal market (being significant volume of transactions and activities takes place). However, fair value of the commodity is required to be assessed for location B which is far from location A and requires a transport cost of ₹ 100. Since the transport cost is not a transaction cost and it is not specific to any transaction but it is inherent cost which required to be incurred while bringing such commodity from location A to location B, it will be considered while evaluating fair value from the principal market.



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3.10 APPLYING FAIR VALUE RULES ON NON-FINANCIAL ASSETS



The financial assets do not have alternative uses because they have specific contractual terms and can have a different use only if the characteristics of the financial assets (ie the contractual terms) are changed.

Fair valuation in case of non-financial assets especially buildings and other property, plant and equipment often require to look for the best and highest use by its market participants and that will be the reference point to evaluate fair value of such non-financial assets.

3.10.1 Highest and best use

The highest and best use is a valuation concept used to value many non-financial assets (eg real estate). The highest and best use of a non-financial asset must be physically possible, legally permissible and financially feasible.

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

The highest and the best use is determined from market participant perspective. It does not matter whether the entity intends to use the asset differently.

Analysis of Highest and best use for non-financial asset

- The highest and best use would determine an indicative price for a non-financial asset which usually do not have any frequently traded market unlike for other financial products.
- The concept emphasis that in order to find a fair value of such non-financial products, one has to define its best possible use which makes the non-financial asset separate from any specific entity who would like to use such asset in their own specific purposes which may or may not be its best use.

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- To find out the best possible use, one has to identify its market participants and then to find best legitimate use of this non- financial asset which one would normally do.
- All restrictions specific to any market participant would not be considered while finding out fair value of the non-financial asset.
- It is imperative to understand the best use while evaluating such fair values, as there is no need to exhaust all possible uses of such non-financial assets before concluding highest and best use.
- In the absence of potential best use which is not easily available, its current use would be considered as best use.

Examples 11, 12 & 13

11. An entity bought some land which is intended to be used for business purposes. However, the entity now wants to sell this piece of land at its fair value. One has to evaluate all possible uses of this land before determining its fair value. The land could be used to make a commercial place, which could be more in value as compared to when it is used for business purposes. The commercial place value would be considered its highest and best use if the same is allowed in its near locations and condition.

12. **Current use as Highest and Best Use**

A Ltd acquires a machine in a business combination by acquiring controlling stake in B Ltd. The machine will be held and used in A's operations. The machine was originally purchased by B Ltd from an outside vendor and, before the business combination, was customized by B Ltd for use in its operations. However, the customization of the machine was not extensive.

A Ltd determines that the asset would provide maximum value to market participants through its use in combination with other assets or with other assets and liabilities (as installed or otherwise configured for use). There is no evidence to suggest that the current use of the machine is not its highest and best use. Therefore, the highest and best use of the machine is its current use in combination with other assets or with other assets and liabilities.

13. **Potential use as Highest and Best Use**

A Ltd owns a property, which comprises land with an old warehouse on it. It has been determined that the land could be redeveloped into a leisure park. The land's market value would be higher if redeveloped than the market value under its current use. A Ltd is unclear about whether the investment property's fair value should be based on the market value of the property (land and warehouse) under its current use, or the land's potential market value if the leisure park redevelopment occurred.

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The property's fair value should be based on the land's market value for its potential use. The 'highest and best use' is the most appropriate model for fair value. Under this approach, the property's existing-use value is not the only basis considered. Fair value is the highest value, determined from market evidence, by considering any other use that is **physically possible, legally permissible and financially feasible.**

The highest and best use valuation assumes the site's redevelopment. This will involve demolishing the current warehouse and constructing a leisure park in its place. Therefore, none of the market value obtained for the land should be allocated to the building. So, the market value of the current building on the property's highest and best use (as a warehouse), is Nil. As a result, the building's current carrying amount should be written down to zero.

3.10.2 Valuation premise

Fair value measurement of non-financial assets would be based on either

1) In combination with other assets, or

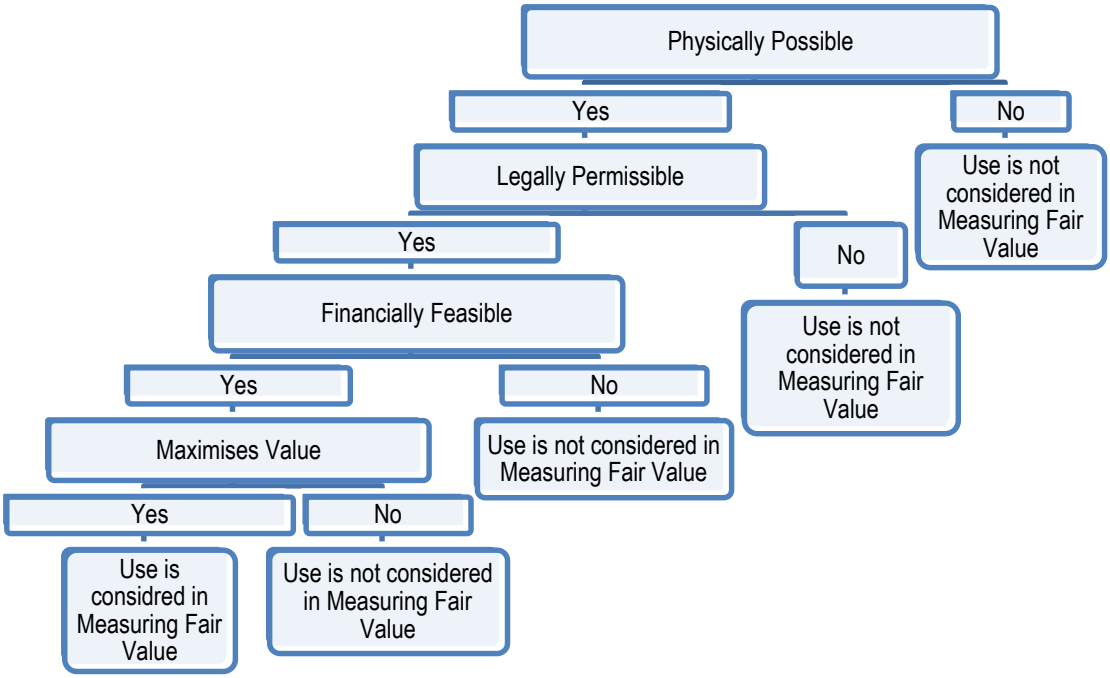
2) At standalone basis,

Standard requires to use best used value if such non-financial asset is used in combination with some other assets and it is demonstrated that the such combination is widely used by other market participants also in order to find best use for the non-financial asset.

Example 14

To find the fair value of customer relations where a right to receive all future technological updates/ researches is being provided as complementary (which is in a way another intangible asset) i.e. other than customer relations. The customer relations would be valued together with the right to receive all the future technological updates / researches, as it is likely to have less or no value for the customer relations without considering such right to receive all future technological updates/ researches which is being provided free to them.

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3.11 APPLYING FAIR VALUE RULES TO LIABILITIES AND AN ENTITY'S OWN EQUITY INSTRUMENTS

A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (eg equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date.

Many a times a liability or an equity instrument of an entity is being transferred to some other market participant as part of a transaction e.g. a business combination, where certain liabilities or equity instruments are being issued in consideration of such acquisitions.

The standard specifies an assumption that liabilities and /or equity instruments so transferred will remain outstanding on the date of measurement. Standard prescribes to use all observable inputs (if direct quoted prices are not available) and should minimize any un-observable inputs. The transaction considered to find fair value should be evaluated in line with an orderly transaction (not an entity specific).

The standard specifically provides guidance on the respective scenarios while evaluating fair values of the liabilities and own equity instruments in case direct quoted prices are not available.

Observable Inputs : Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

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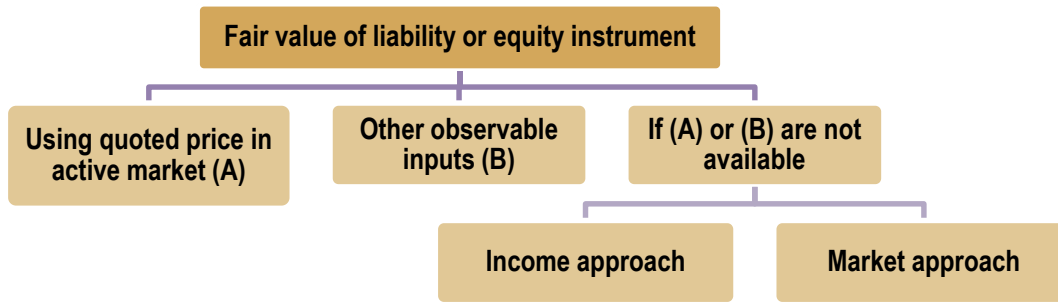
Unobservable Inputs : Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

3.11.1 When liability and equity instruments are held by other parties as assets

When directly quoted prices are not available for liabilities or equity instruments, then an entity should use an identical price of similar liabilities or equity instruments which is held by market participants as an asset. The quoted prices of such assets at the measurement date should be used. However, if quoted prices are not available then observable inputs can be used. In the absence of observable inputs, the valuation techniques such as income approach or market approach etc. may be used.

3.11.2 When liability and equity instruments are not held by other parties as assets

When these are not held by other parties then valuation techniques from the perspective of a market participant that owes the liability or has issued the claim on equity would be used to evaluate such fair values.



3.12 APPLYING FAIR VALUE RULES TO FINANCIAL ASSET & FINANCIAL LIABILITY WITH OFFSETTING POSITION IN MARKET RISK OR COUNTERPARTY RISK

Assets and liabilities that are being managed by an entity would be affected by its market risk i.e. interest rate risk, currency risk etc. and credit risk relating to its respective counterparties.

There are many situations where a group of assets and liabilities are being managed on net basis rather than individual basis by an entity.

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For example, certain contracts of derivatives which are being netted with all existing open positions from same counterparty etc.

If the entity manages that group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the entity is permitted to apply an exception to this Ind AS for measuring fair value.

That exception permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (ie an asset) for a particular risk exposure or paid to transfer a net short position (ie a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions. Accordingly, an entity shall measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date.

Analysis of applying offsetting position in market or credit risk

- This exception is allowed only in case the other market participants also manage the similar risk on net basis.
- There should ideally be same information and market practice available for making these assets/ liabilities on net basis.

All open position for derivatives are being normally evaluated on net exposure basis from each counterparty.

- Once the exception to fair value certain assets/ liabilities on net basis is being used, then unit of account to measure fair value would be considered as net.
- Market risk should be same while combining any asset/ liability.

An interest rate risk can not be netted with a commodity price risk.

- Duration of a market risk should be identical to use the exception for valuing assets/ liabilities on net basis.

1. An interest rate swap of longer period will only be allowed to value at net basis upto the duration of financial instrument of the same duration.
2. Certain Interest rate risk from counterparty Z is being managed on net basis considering the changes in interest rate amount receivable and amounts payable to counterparty Z from normal sale/ purchase basis. Hence such net exposure would be used to evaluate fair values as required by this standard. The netting should normally be followed by other market participants as well and should not be an entity specific.

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3.13 FAIR VALUE AT INITIAL RECOGNITION



When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an entry price).

In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

In many cases the transaction price will equal the fair value (eg that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold).

When determining whether fair value at initial recognition equals the transaction price, an entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

(a) The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

(b) The transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (eg in a business combination), the transaction includes unstated rights and privileges that are measured separately in accordance with another Ind AS, or the transaction price includes transaction costs.

(d) The market in which the transaction takes place is different from the principal market (or most advantageous market). For example, those markets might be different if the entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the dealer market.

If another Ind AS requires or permits an entity to measure an asset or a liability initially at fair value and the transaction price differs from fair value, the entity shall recognise the resulting gain or loss in profit or loss unless that Ind AS specifies otherwise.

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3.14 VALUATION TECHNIQUES

When measuring fair value, the objective of using a valuation technique is to estimate the price at which an orderly transaction would take place between market participants at the measurement date under current market conditions.

An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.

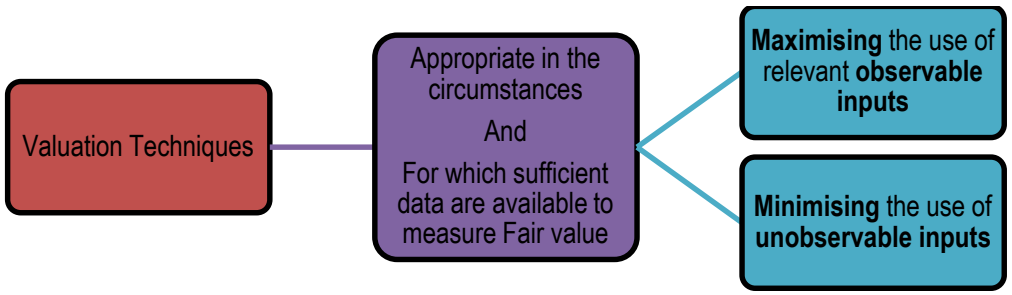
It is pertinent to note that the overall objective to use any valuation approach or technique is in accordance with all relevant data available related to the Asset/ liability which could utilize all directly observable inputs.

Note: It is worth to be noted that in case of availability of **quoted prices** which are being used in an active market, there is no need to consider any valuation approach further.

The standard requires and allows using one or combination of more than one approach to measure any fair value which corroborates all inputs available related to such asset/ liability. Selecting an appropriate approach is matter of judgment and based on the available inputs related to the asset / liability.

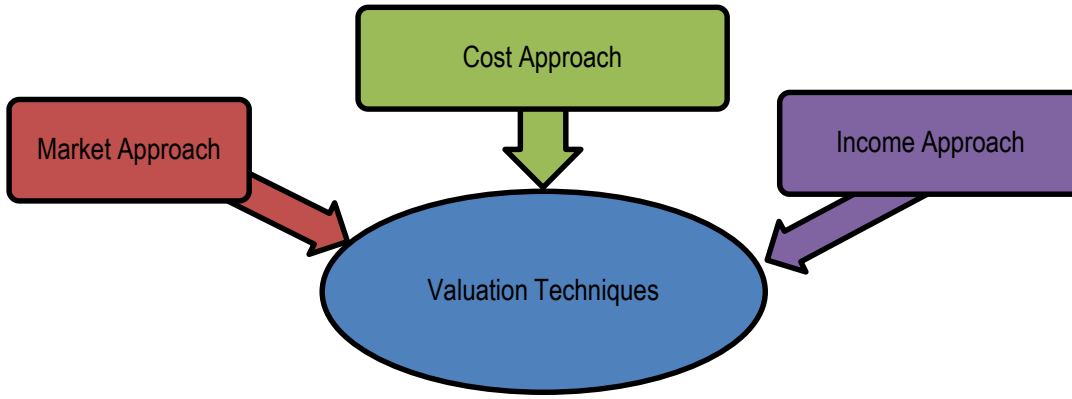
Example 15

An unquoted investment can be fair valued either by taking similar entity's quoted prices with appropriate adjustments or a valuation of business using DCF or some other technique. This would purely be dependent upon the available inputs and approach relevant for the asset/ liability.



Ind AS 113 specifies following three approaches to measure fair values:

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1. MARKET APPROACH : The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement.

Quoted prices are indicative values of any business if it exchanges in an active market. However, in the absence of such quoted prices, it is relevant to value the business based on market values and do some adjustment relevant to the assets/ liabilities. Standard specifies a valuation technique called "Matrix pricing" which is normally used to value debt securities. This technique relates the securities with some similar benchmarked securities including coupons, credit ratings etc. to derive at fair value of the debt.

An entity does not have any security which is quoted in an active market, however, its price to earnings ratio is being used to corroborate its enterprise value with certain adjustments relevant to the business e.g. there are some specific restrictions to use certain assets for some specific period being in a specialized industry.

2. INCOME APPROACH: The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

It is a present value of all future earnings from an entity whose fair values are being evaluated or in other words all future cash flows to be discounted at current date to get fair value of the asset / liability.

Assumption to the future cash flows and an appropriate discount rate would be based on the other market participant's views. Related risks and uncertainty would require to be considered and would be taken into either in cash flow or discount rate.

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Illustration 2

Discount Rate assessment to measure present value:

Investment 1 is a contractual right to receive ₹ 800 in 1 year. There is an established market for comparable assets, and information about those assets, including price information, is available. Of those comparable assets:

a. *Investment 2 is a contractual right to receive ₹ 1,200 in 1 year and has a market price of ₹ 1,083.*

b. *Investment 3 is a contractual right to receive ₹ 700 in 2 years and has a market price of ₹ 566.*

All three assets are comparable with respect to risk (that is, dispersion of possible payoffs and credit).

You are required to measure the fair value of Asset 1 basis above information.

Solution

On the basis of the timing of the contractual payments to be received for Investment 1 relative to the timing for Investment 2 and Investment 3 (that is, one year for Investment 2 versus two years for Investment 3), Investment 2 is deemed more comparable to Investment 1. Using the contractual payment to be received for Investment 1 (₹ 800) and the 1-year market rate derived from Investment 2, the fair value of Investment 1 is calculated as under:

Investment 2 Fair Value		₹ 1,083
Contractual Cash flows in 1 year		₹ 1,200
IRR	=	₹ 1,083 x (1 + r) = ₹ 1,200
	=	(1 + r) = (₹ 1,200 / ₹ 1,083) = 1.108
		r = 1.108 – 1 = 0.108 or 10.8%
Value of Investment 1		= ₹ 800 / 1.108 = ₹ 722

Alternatively, in the absence of available market information for Investment 2, the one-year market rate could be derived from Investment 3 using the build-up approach. In that case, the 2-year market rate indicated by Investment 3 would be adjusted to a 1-year market rate using the term structure of the risk-free yield curve. Additional information and analysis might be required to determine whether the risk premiums for one-year and two-year assets are the same. If it is determined that the risk premiums for one-year and two-year assets are not the same, the two-year market rate of return would be further adjusted for that effect.

*****

Standard defines the below techniques which may be considered while using Income approach

a) Present value techniques

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b) Option pricing modals e.g. Black-Scholes Merton modal or Binomial modal

c) The multi period excess earning method.

Example 16

An entity has estimated its next year's earnings (cash flows) based on certain probability as mentioned below:

Possible cash flows (₹)	Probability	Probability weighted cash flows
700	20%	140
800	40%	320
900	40%	360
	Total expected cash flow	820
	Risk free rate	6%
	Present value of cash flow (1 year)	820 / (1.06) = ₹ 773.58

3. COST APPROACH: This method describes how much cost is required to replace existing asset/ liability in order to make it in a working condition. All related costs will be its fair value. It actually considers replacement cost of the asset/ liability for which we need to find fair value.

3.15 INPUTS TO VALUATION TECHNIQUES

Valuation techniques used to measure fair value shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

It has widely been mentioned that observable inputs should be used to evaluate fair value of an asset/ liability and we should minimize using any unobservable inputs.

Standard describes the below instances where observable inputs are being used in case of certain Financial Instruments:

Markets (by nature)	Prices (observable)	Rationale	Ind AS 113 compliant
Exchange Markets	Closing prices	Readily available	Yes
Dealer Market	Bid & Ask prices	Readily available than closing prices	Yes

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Brokered Market	Buy & Sell order matching, commercial and residential markets	Broker knows better prices from both buy & Sell side	Yes
Principal to principal Markets	Negotiated prices with no intermediary	Little information available in market	Yes

The inputs refer broadly to the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

In order to establish comparability and consistency in fair value measurement, Ind AS 113 has made some hierarchy to define the level of inputs for fair value. The hierarchy is purely based on the level of inputs available for the specific Asset / liability for which the fair value is to be measured.

Some significant notes about the fair value hierarchy

- The hierarchy has been categorized in 3 levels which are based on the level of inputs that are being used to find out such fair values. There could be a situation where more than one level of fair value is being used, hence standard provides a guidance which states that in case of using more than one level of input, the entire class of asset / liability will be defined by its level which has significance on overall basis.

Note: Significance has not been defined anywhere and could be a matter of judgement.

- Standard defines the valuation techniques that could be used to evaluate fair values of Assets/ liabilities and its level of hierarchy will be depending upon the level of inputs that have been used while using such valuation techniques.
- If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorized within Level 3 of the fair value hierarchy.

Example 17

If a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a Level 2 input and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorised within Level 3 of the fair value hierarchy.

3.15.1 Level 1 Inputs

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

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A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available.

A Level 1 input will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets (e.g. on different exchanges). Therefore, the emphasis within Level 1 is on determining both of the following:

- The principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability
- Whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date

Example 18

An entity is holding investment which is quoted in BSE, India and NYSE, USA. However, significant activities are being done at BSE only. The fair value of the investment would be referenced to the quoted price at BSE India (which is Level 1 fair value- Direct quoted price with no adjustments).

3.15.1.1 Adjustment to Quoted Price when it does not reflect the fair price

In certain situations, a quoted price in an active market might not faithfully represent the fair value of an asset or liability, such as when significant events occur on the measurement date but after the close of trading. In these situations, companies should adjust the quoted price to incorporate this new information into the fair value measurement. However, if the quoted price is adjusted, the resulting fair value measurement would no longer be considered a Level 1 measurement. A company's valuation policies and procedures should address how these "after-hour" events will be identified and assessed. Controls should be put in place to ensure that any adjustments made to quoted prices are appropriate and are applied in a consistent manner.

Example 19

A Ltd., a large biotech company with shares traded publicly, has developed a new drug that is in the final phase of clinical trials. B Ltd. has an equity investment in A Ltd.'s shares. B Ltd. determines that the shares have a readily determinable fair value and accounts for the investment at fair value through profit and loss. B Ltd. assesses the fair value as of the measurement date of 31st March 20X3. Consider the following:

(i) On 31st March 20X3, the Drug Approval authority notifies A Ltd.'s management that the drug was not approved. A Ltd.'s shares closed at ₹ 36.00 on 31st March 20X3.

(ii) A Ltd. issued a press release after markets closed on 31st March 20X3 announcing the failed clinical trial.

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(iii) A Ltd.'s shares opened on next working day at ₹ 22.50.

The drug failure is a condition (or a characteristic of the asset being measured) that existed as of the measurement date. B Ltd. concludes the ₹ 36.00 closing price on the measurement date does not represent fair value of the A Ltd.'s shares at 31st March 20X3 because the price does not reflect the effect of the Authority's non-approval.

The subsequent transactions that take place when the market opens are relevant to the fair value measurement recorded as of the measurement date. The opening price of ₹ 22.50 indicates how market participants have incorporated the effect of the non-approval on A Ltd.'s stock price.

B Ltd. adjusts the 31st March 20X3 quoted price for the new information, records the shares at ₹ 22.50 per share at 31st March 20X3 and discloses the investment as a Level 2 measurement.

3.15.2 Level 2 Inputs

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

(a) quoted prices for similar assets or liabilities in active markets.

(b) quoted prices for identical or similar assets or liabilities in markets that are not active.

(c) inputs other than quoted prices that are observable for the asset or liability, for example:

  (i) interest rates and yield curves observable at commonly quoted intervals;

  (ii) implied volatilities; and

  (iii) credit spreads.

  (iv) market-corroborated inputs.

Examples 20-22

20. Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency. It requires rate of swap which is of 11 years. However, normally the rates are available only for the maximum period of 10 years. The rate for 11 years can be established using extrapolation or some other techniques which is based on 10 years' available rates of swap. The fair value of 11 years so derived would be level 2 fair value.

21. An entity has an investment in another entity which has no active market. However, some similar investment is being traded in an active market. Now, the fair valuation can be done based on either the prices based on the market which is not active or similar traded investment in an active market. This would be considered as level 2 inputs.

22. X and Y each enter into a contractual obligation to pay ₹ 500 in cash to D in five years. X has an AA credit rating and can borrow at 6%. Y has a BBB credit rating and can borrow at 12%.

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X will receive about ₹ 374 in exchange for its promise (the present value of ₹ 500 in five years at 6%). Y will receive about ₹ 284 in exchange for its promise (the present value of ₹ 500 in five years at 12%).

The fair value of the liability to each entity (that is, the proceeds) incorporates that entity's credit standing.

3.15.3 Level 3 Inputs

Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability.

For example - It might be necessary to include a risk adjustment when there is significant measurement uncertainty (e.g. when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value).

Examples 23 and 24

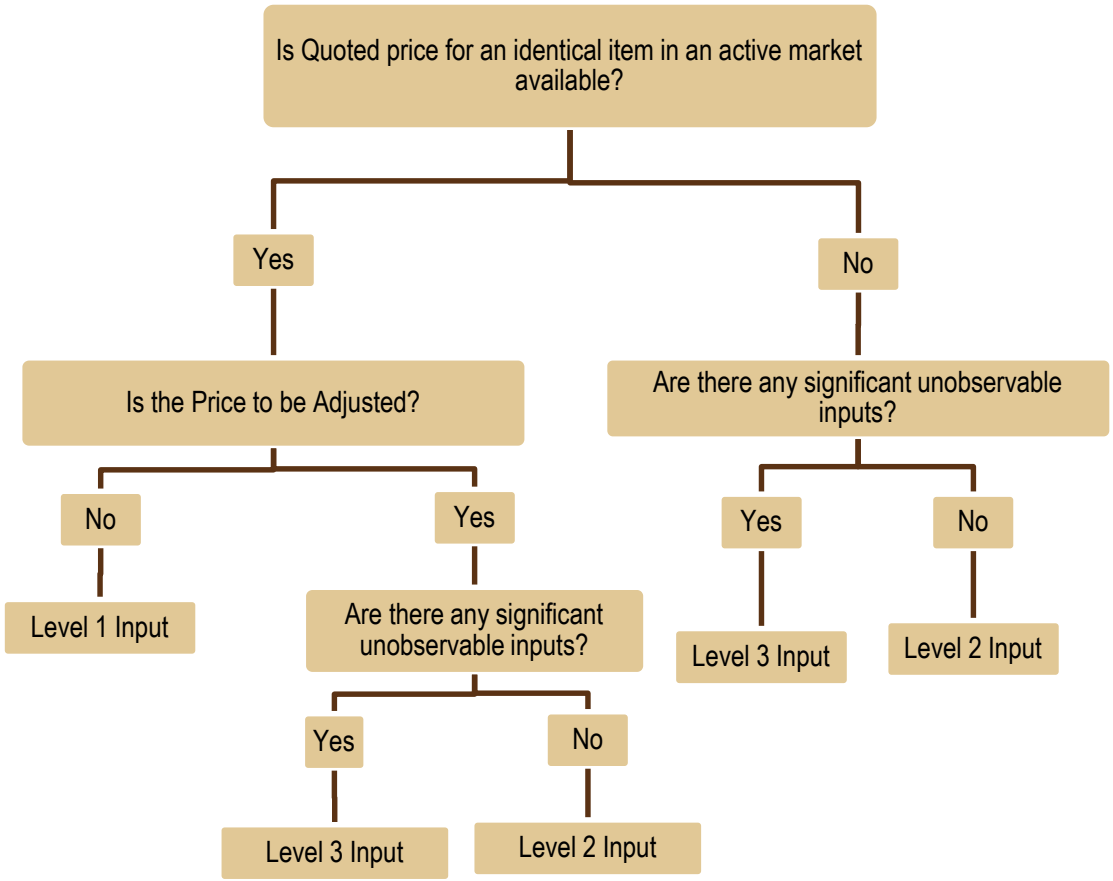
23. Interest rate swap

An adjustment to a mid-market consensus (non-binding) price for the swap is being developed using data that are not directly observable and cannot otherwise be corroborated by observable market data. This would be level 3 input for measurement of fair value.

24. Cash-generating unit

A Level 3 input would be a financial forecast (eg of cash flows or profit or loss) developed using the entity's own data, if there is no reasonably available information that indicates usage of different assumptions by market participants.

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3.16 DISCLOSURES

An entity shall disclose information that helps users of its financial statements assess both of the following:

(a) for assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the balance sheet after initial recognition, the valuation techniques and inputs used to develop those measurements.

(b) for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

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The disclosure requirements can be summarized as per the below table –

	Fair Value Measurement						Disclosure		
	Recurring			Non-recurring					
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Fair value at each reporting date	✓	✓	✓	✓	✓	✓			
Reasons for measurement				✓	✓	✓			
Level of hierarchy	✓	✓	✓	✓	✓	✓	✓	✓	✓
Transfers	✓	✓	✓						
Valuation techniques		✓	✓		✓	✓		✓	✓
If change in valuation techniques		✓	✓		✓	✓		✓	✓
Quantitative info about significant unobservable inputs			✓			✓			
Reconciliation of opening & closing			✓						
Unrealized gains/ losses from remeasurement			✓						
Valuation process & policies			✓			✓			
Sensitivity to changes in unobservable inputs			✓						
If highest & best use differs from actual	✓	✓	✓	✓	✓	✓	✓	✓	✓

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3.17 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Titan Company Limited' for the financial year 2021-2022 with respect to 'Fair Value Measurement' and accounting policy adopted by the company with respect to measurement technique.

34.2 (i) Fair value hierarchy

This note explains about basis for determination of fair values of various financial assets and liabilities:

₹ in crore

Particulars	As at 31st March 2022			
	Level 1	Level 2	Level 3	Total
a) Financial assets and liabilities measured at fair value				
Financial assets				
- Quoted investments at FVTPL	1	-	-	1
- Other unquoted investments	-	-	18	18
- Derivative instruments other than in designated hedge accounting relationships	-	1	-	1
Total financial assets	**1**	**1**	**18**	**20**
Financial liabilities				
- Gold on loan	5,161	-	-	5,161
Total financial liabilities	**5,161**	**-**	**-**	**5,161**

₹ in crore

Particulars	As at 31st March 2021			
	Level 1	Level 2	Level 3	Total
b) Financial assets and liabilities measured at fair value				
Financial assets				
- Quoted investments at FVTPL	-	2,753	-	2,753
- Other unquoted investments	-	-	10	10
- Derivative instruments other than in designated hedge accounting relationships	-	1	-	1
Total financial assets	**-**	**2,754**	**10**	**2,764**
Financial liabilities				
- Gold on loan	4,094	-	-	4,094
Total financial liabilities	**4,094**	**-**	**-**	**4,094**

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Notes to the Standalone Financial Statements

for the year ended 31st March 2022

(ii) Valuation technique used to determine fair value

Specific value techniques used to value financial instruments include:

- the use of quoted market prices for listed instruments.
- the fair value of forward foreign exchange contracts is determined using forward exchange rates at the balance sheet date.
- the fair value of foreign currency option contracts is determined using option prices obtained from banks.
- the fair value of remaining financial instruments is determined using market comparables, discounted cash flow analysis.

(iii) Fair value of financial assets and liabilities that are not measured at fair value but fair value disclosures are required

The carrying values of financial assets and liabilities approximate the fair values.

(Source: Annual Report 2021-2022 - 'Titan Company Limited')

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. An asset is sold in 2 different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date.

   In Market A:

   The price that would be received is ₹ 26, transaction costs in that market are ₹ 3 and the costs to transport the asset to that market are ₹ 2.

   In Market B:

   The price that would be received is ₹ 25, transaction costs in that market are ₹ 1 and the costs to transport the asset to that market are ₹ 2.

   You are required to calculate:

   (i) The fair value of the asset, if market A is the principal market, and

   (ii) The fair value of the asset, if none of the markets is principal market.

2. Company J acquires land in a business combination. The land is currently developed for industrial use as a factory site. Although the land's current use is presumed to be its highest and best use unless market or other factors suggest a different use, Company J considers the fact that nearby sites have recently been developed for residential use as high-rise apartment buildings.

   On the basis of that development and recent zoning and other changes to facilitate that development, Company J determines that the land currently used as a factory site could be developed as a residential site (e.g., for high-rise apartment buildings) and that market

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participants would take into account the potential to develop the site for residential use when pricing the land.

Determine the highest and best use of the land.

3. ABC Ltd. acquired 5% equity shares of XYZ Ltd. for ₹ 10 crores in the year 20X1-20X2. The company is in process of preparing the financial statements for the year 20X2-20X3 and is assessing the fair value at subsequent measurement of the investment made in XYZ Ltd. Based on the observable input, ABC Ltd. identified a similar nature of transaction in which PQR Ltd. acquired 20% equity shares in XYZ Ltd. for ₹ 60 crores. The price of such transaction was determined on the basis of Comparable Companies Method (CCM)- Enterprise Value (EV) / EBITDA which was 8. For the current year, the EBITDA of XYZ Ltd. is ₹ 40 crores. At the time of acquisition, the valuation was determined after considering 5% of liquidity discount and 5% of non-controlling stake discount. What will be the fair value of ABC Ltd.'s investment in XYZ Ltd. as on the balance sheet date?

4. UK Ltd. is in the process of acquisition of shares of PT Ltd. as part of business reorganization plan. The projected free cash flows of PT Ltd. for the next 5 years are as follows:

(₹ in crores)

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
Cash flows	187.1	187.6	121.8	269	278.8
Terminal Value					3,965

The weightage average cost of capital of PT Ltd. is 11%. The total debt as on measurement date is ₹ 1,465 crores and the surplus cash & cash equivalent is ₹ 106.14 crores.

The total numbers of shares of PT Ltd. as on the measurement date is 8,52,84,223 shares. Determine value per share of PT Ltd. as per Income Approach.

5. You are a senior consultant of your firm and are in process of determining the valuation of KK Ltd. You have determined the valuation of the company by two approaches i.e. Market Approach and Income approach and selected the highest as the final value. However, based upon the discussion with your partner you have been requested to assign equal weights to both the approaches and determine a fair value of shares of KK Ltd. The details of the KK Ltd. are as follows:

Particulars	₹ in crore
Valuation as per Market Approach	5268.2
Valuation as per Income Approach	3235.2
Debt obligation as on Measurement date	1465.9

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Surplus cash & cash equivalent	106.14
Fair value of surplus assets and Liabilities	312.4
Number of shares of KK Ltd.	8,52,84,223 shares

Determine the Equity value of KK Ltd. as on the measurement date on the basis of above details.

6. Comment on the following by quoting references from appropriate Ind AS.

(i) DS Limited holds some vacant land for which the use is not yet determined. The land is situated in a prominent area of the city where lot of commercial complexes are coming up and there is no legal restriction to convert the land into a commercial land.

The company is not interested in developing the land to a commercial complex as it is not its business objective. Currently the land has been let out as a parking lot for the commercial complexes around.

The Company has classified the above property as investment property. It has approached you, an expert in valuation, to obtain fair value of the land for the purpose of disclosure under Ind AS.

On what basis will the land be fair valued under Ind AS?

(ii) DS Limited holds equity shares of a private company. In order to determine the fair value' of the shares, the company used discounted cash flow method as there were no similar shares available in the market.

Under which level of fair value hierarchy will the above inputs be classified?

What will be your answer if the quoted price of similar companies were available and can be used for fair valuation of the shares?

7. On 1st January, 20X1, A Ltd assumes a decommissioning liability in a business combination. The reporting entity is legally required to dismantle and remove an offshore oil platform at the end of its useful life, which is estimated to be 10 years. The following information is relevant:

If A Ltd was contractually allowed to transfer its decommissioning liability to a market participant, it concludes that a market participant would use all of the following inputs, probability weighted as appropriate, when estimating the price it would expect to receive:

a. Labour costs

Labour costs are developed based on current marketplace wages, adjusted for expectations of future wage increases, required to hire contractors to dismantle and remove offshore oil platforms. A Ltd. assigns probability to a range of cash flow estimates as follows:

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Cash Flow Estimates:	100 Cr	125 Cr	175 Cr
Probability:	25%	50%	25%

b. Allocation of overhead costs:

Assigned at 80% of labour cost

c. The compensation that a market participant would require for undertaking the activity and for assuming the risk associated with the obligation to dismantle and remove the asset. Such compensation includes both of the following:

i. Profit on labour and overhead costs:

A profit mark-up of 20% is consistent with the rate that a market participant would require as compensation for undertaking the activity

ii. The risk that the actual cash outflows might differ from those expected, excluding inflation:

A Ltd. estimates the amount of that premium to be 5% of the expected cash flows. The expected cash flows are 'real cash flows' / 'cash flows in terms of monetary value today'.

d. Effect of inflation on estimated costs and profits

A Ltd. assumes a rate of inflation of 4 percent over the 10-year period based on available market data.

e. Time value of money, represented by the risk-free rate: 5%

f. Non-performance risk relating to the risk that Entity A will not fulfill the obligation, including A Ltd.'s own credit risk: 3.5%

A Ltd, concludes that its assumptions would be used by market participants. In addition, A Ltd. does not adjust its fair value measurement for the existence of a restriction preventing it from transferring the liability.

You are required to calculate the fair value of the asset retirement obligation.

8. (i) Entity A owns 250 ordinary shares in company XYZ, an unquoted company. Company XYZ has a total share capital of 5,000 shares with nominal value of ₹ 10. Entity XYZ's after-tax maintainable profits are estimated at ₹ 70,000 per year. An appropriate price/earnings ratio determined from published industry data is 15 (before lack of marketability adjustment). Entity A's management estimates that the discount for the lack of marketability of company XYZ's shares and restrictions on their transfer is 20%. Entity A values its holding in company XYZ's shares based on earnings. Determine the fair value of Entity A's investment in XYZ's shares.

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(ii) Based on the facts given in the aforementioned part (i), assume that, Entity A estimates the fair value of the shares it owns in company XYZ using a net asset valuation technique. The fair value of company XYZ's net assets including those recognised in its balance sheet and those that are not recognised is ₹ 8,50,000. Determine the fair value of Entity A's investment in XYZ's shares.

Answers

1. (i) If Market A is the principal market

If Market A is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs.

Fair Value will be

	₹
Price receivable	26
Less: Transportation cost	(2)
Fair value of the asset	24

(ii) If neither of the market is the principal market

If neither of the market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e., the net amount that would be received in the respective markets).

	₹	₹
	Market A	**Market B**
Price receivable	26	25
Less: Transaction cost	(3)	(1)
Less: Transportation cost	(2)	(2)
Fair value of the asset	21	22

Since the entity would maximise the net amount that would be received for the asset in Market B i.e. ₹ 22, the fair value of the asset would be measured using the price in Market B.

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Fair value

	₹
Price receivable	25
Less: Transportation cost	(2)
Fair value of the asset	23

2. The highest and best use of the land is determined by comparing the following:

- The value of the land as currently developed for industrial use (i.e., an assumption that the land would be used in combination with other assets, such as the factory, or with other assets and liabilities); and
- The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs necessary to convert the land to a vacant site. The value under this use would take into account risks and uncertainties about whether the entity would be able to convert the asset to the alternative use (i.e., an assumption that the land would be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of these values. In situations involving real estate appraisal, the determination of highest and best use might take into account factors relating to the factory operations (e.g., the factory's operating cash flows) and its assets and liabilities (e.g., the factory's working capital).

3. Determination of Enterprise Value of XYZ Ltd.

Particulars	**₹ in crore**
EBITDA as on the measurement date	40
EV/EBITDA multiple as on the date of valuation	8
Enterprise value of XYZ Ltd.	320

Determination of subsequent measurement of XYZ Ltd.

Particulars	**₹ in crore**
Enterprise Value of XYZ Ltd.	320
ABC Ltd.'s share based on percentage of holding (5% of 320)	16
Less: Liquidity discount & Non-controlling stake discount (5%+5%=10%)	(1.6)
Fair value of ABC Ltd.'s investment in XYZ Ltd.	14.4

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4. Determination of equity value of PT Ltd.

(₹ in crore)

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
Cash flows	187.1	187.6	121.8	269	278.8
Terminal Value					3,965
Discount rate factor	0.9009	0.8116	0.7312	0.6587	0.5935
Free Cash Flow available to the firm	168.56	152.26	89.06	177.19	2,518.69
Total of all years					3,105.76
Less: Debt					(1,465)
Add: Cash & Cash equivalent					106.14
Equity Value of PT Ltd.					1,746.90
No. of Shares					85,284,223.0
Per Share Value					204.83

5. Equity Valuation of KK Ltd.

Particulars	Weights	(₹ in crore)
As per Market Approach	50	5268.2
As per Income Approach	50	3235.2
Enterprise Valuation based on weights (5268.2 x 50%) + (3235.2 x 50%)		4,251.7
Less: Debt obligation as on measurement date		(1465.9)
Add: Surplus cash & cash equivalent		106.14
Add: Fair value of surplus assets and liabilities		312.40
Enterprise value of KK Ltd.		3204.33
No. of shares		85,284,223
Value per share		375.72

6. (i) As per Ind AS 113, a fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

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The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

(a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).

(b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).

(c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

Highest and best use is determined from the perspective of market participants, even if the entity intends a different use. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

To protect its competitive position, or for other reasons, an entity may intend not to use an acquired non-financial asset actively or it may intend not to use the asset according to its highest and best use. Nevertheless, the entity shall measure the fair value of a non-financial asset assuming its highest and best use by market participants.

In the given case, the highest best possible use of the land is to develop a commercial complex. Although developing a business complex is against the business objective of the entity, it does not affect the basis of fair valuation as Ind AS 113 does not consider an entity specific restriction for measuring the fair value.

Also, its current use as a parking lot is not the highest best use as the land has the potential of being used for building a commercial complex.

Therefore, the fair value of the land is the price that would be received when sold to a market participant who is interested in developing a commercial complex.

(ii) As per Ind AS 113, unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. The unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

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In the given case, DS Limited adopted discounted cash flow method, commonly used technique to value shares, to fair value the shares of the private company as there were no similar shares traded in the market. Hence, it falls under Level 3 of fair value hierarchy.

Level 2 inputs include the following:

(a) quoted prices for similar assets or liabilities in active markets.

(b) quoted prices for identical or similar assets or liabilities in markets that are not active.

(c) inputs other than quoted prices that are observable for the asset or liability.

If an entity can access quoted price in active markets for identical assets or liabilities of similar companies which can be used for fair valuation of the shares without any adjustment, at the measurement date, then it will be considered as observable input and would be considered as Level 2 inputs.

7.

		Amount (In Crore)
Expected Labour Cost (Refer W.N.)		131.25
Allocated Overheads	(80% x 131.25 Cr)	105.00
Profit markup on Cost	(131.25 + 105) x 20%	47.25
Total Expected Cash Flows before inflation		**283.50**
Inflation factor for next 10 years (4%)	$(1.04)^{10}$ =1.4802	
Expected cash flows adjusted for inflation	283.50 x 1.4802	419.65
Risk adjustment - uncertainty relating to cash flows	(5% x 419.64)	20.98
Total Expected Cash Flows	(419.65+20.98)	440.63
Discount rate to be considered = risk-free rate + entity's non-performance risk	5% + 3.5%	8.5%
Expected present value at 8.5% for 10 years	**(440.63 / (1.085^{10}))**	**194.97**

Working Note:

Expected labour cost:

Cash Flows Estimates	**Probability**	**Expected Cash Flows**
100 Cr	25%	25 Cr
125 Cr	50%	62.50 Cr
175 Cr	25%	43.75 Cr
Total		**131.25 Cr**

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8. **(i)** An earnings-based valuation of Entity A's holding of shares in company XYZ could be calculated as follows:

Particulars	Unit
Entity XYZ's after-tax maintainable profits (A)	₹ 70,000
Price/Earnings ratio (B)	15
Adjusted discount factor (C) (1- 0.20)	0.80
Value of Company XYZ (A) x (B) x (C)	₹ 8,40,000

Value of a share of XYZ = ₹ 8,40,000 ÷ 5,000 shares = ₹ 168

The fair value of Entity A's investment in XYZ's shares is estimated at ₹ 42,000 (that is, 250 shares x ₹ 168 per share).

(ii) Share price = ₹ 8,50,000 ÷ 5,000 shares = ₹ 170 per share.

The fair value of Entity A's investment in XYZ shares is estimated to be ₹ 42,500 (250 shares x ₹ 170 per share).

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NOTES

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CHAPTER 5

IND AS 115 REVENUE FROM CONTRACTS WITH CUSTOMERS



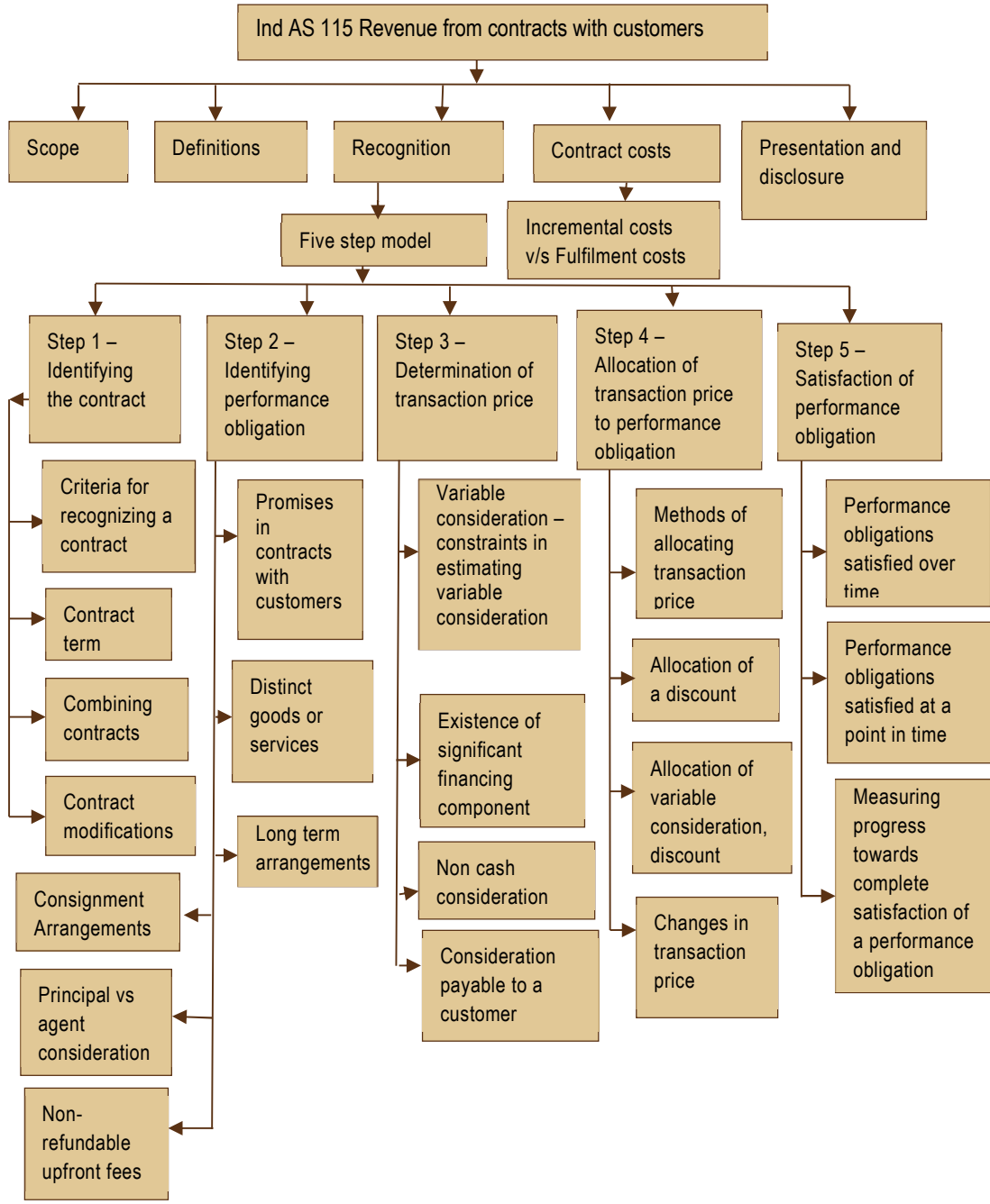
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Appreciate the scope and definition of the standard.
- Identify the contract.
- Comprehend the criteria for revenue recognition.
- Gain knowledge on accounting treatment of various aspects like combination of contracts, contract modifications etc.
- Identify performance obligations and when the performance obligation is satisfied.
- Determine the transaction price and allocate the performance obligation to transaction price.
- Allocate discount to various performance obligations in determining their transaction price.
- Account for the changes in the transaction price.
- Account for variable considerations while determining the transaction price.
- Deal with contract costs.
- Comply with the Presentation and disclosure requirements of the standard.

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CHAPTER OVERVIEW



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This standard establishes principles to report useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

The core principle is that an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

The standard specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this Standard to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects of applying the Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio.

1. SCOPE

Ind AS 115 applies to all contracts with customers to provide goods or services that are outputs of the entity's ordinary course of business in exchange for consideration, unless specifically excluded from the scope of the new guidance, as described below.

An entity shall apply this Standard to all contracts with customers, except the following:

(a) lease contracts within the scope of Ind AS 116, Leases;

(b) insurance contracts within the scope of Ind AS 104, Insurance Contracts

(c) financial instruments and other contractual rights or obligations within the scope of Ind AS 109, Financial Instruments, Ind AS 110, Consolidated Financial Statements, Ind AS 111, Joint Arrangements, Ind AS 27, Separate Financial Statements and Ind AS 28, Investments in Associates and Joint Ventures; and

(d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

This standard is applicable only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for a consideration.

A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as

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developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

A contract with a customer may be partially within the scope of Ind AS 115 and partially within the scope of other Ind AS. In such cases, the following steps should be followed to identify how it should be split between Ind AS 115 and other Ind AS:

(i) If the other Ind AS specifies how to separate and/or measure a portion of the contract, then that guidance should be applied first. The amounts measured under other Ind AS should be excluded from the transaction price that is allocated to performance obligations under Ind AS 115.

(ii) If the other Ind AS does not stipulate how to separate and/or measure a portion of the contract, then Ind AS 115 would be used to separate and/or measure that portion of the contract (refer discussion relating to Step 4 - Allocation of transaction price to performance obligation).

Ind AS 115 also specifies the accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfil a contract with a customer if those costs are not within the scope of another Standard (see section related to Contract Costs). An entity shall apply those paragraphs only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of this Standard.

2. DEFINITIONS

Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Contract asset	An entity's right to consideration in exchange for goods or services that the entity has transferred to a **customer** when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
Contract liability	An entity's obligation to transfer goods or services to a **customer** for which the entity has received consideration (or the amount is due) from the customer.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for a consideration.
Income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in

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	an increase in equity, other than those relating to contributions from equity participants.
Performance obligation	A promise in a **contract** with a **customer** to transfer to the customer either: (a) a goods or service (or a bundle of goods or services) that is distinct; or (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
Revenue	**Income** arising in the course of an entity's ordinary activities.
Stand-alone selling price (of goods or service)	The price at which an entity would sell a promised goods or service separately to a **customer**.
Transaction price (for a contract with a customer)	The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a **customer**, excluding amounts collected on behalf of third parties.

3. OVERVIEW

After more than a decade of work, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) had published their largely converged standards on revenue recognition in May, 2014. The IASB issued IFRS 15 Revenue from Contracts with Customers and FASB issued ASU 2014-09 with the same name.

In convergence with IFRS, the Ministry of Corporate Affairs (MCA) issued Ind AS 115, Revenue from Contracts with Customers vide its notification dated 28th March, 2018.

Ind AS 115 supersedes and replaces Ind AS 11 and Ind AS 18.

Ind AS 115 is based on a core principle that requires an entity to recognize revenue:

(a) In a manner that depicts the transfer of goods or services to customers

(b) At an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

To achieve the core principle, an entity should apply the following five-step model:

Step 1: Identify the contract with the customer.

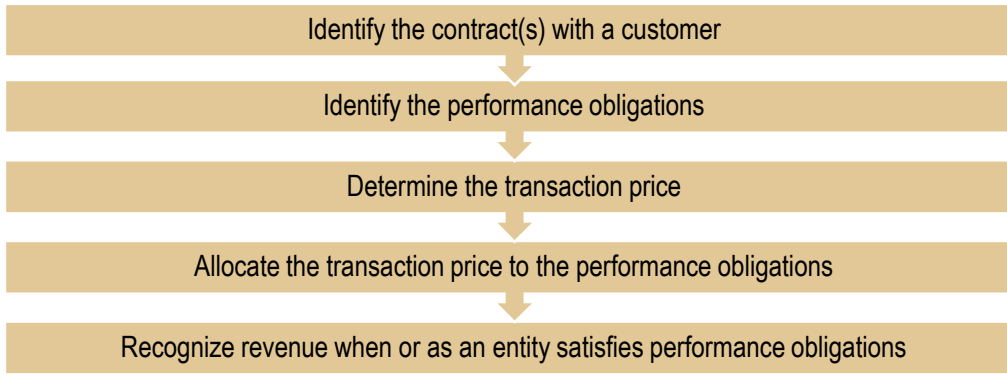
Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

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Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies its performance obligations.



Each of these steps, and some other related guidance, is discussed in details below.

Entities will need to exercise judgement when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. Entities will also have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances.

4. TRANSITION

Ind AS 115 is effective for annual reporting periods beginning on or after 1st April, 2018.

Entities are required to apply the new revenue standard using either of the following two approaches:

(a) Full retrospective approach: apply retrospectively to each prior period presented in accordance with Ind AS 8, subject to some practical expedients mentioned in the standard or

(b) Modified retrospective approach: apply retrospectively with the cumulative effect of initial application recognized at the date of initial application

When applying the full retrospective method, an entity shall restate all prior periods presented in accordance with Ind AS 8. This results in comparative statements in which all periods are presented as if Ind AS 115 had been in effect since the beginning of the earliest period presented.

When applying modified retrospective approach, an entity does not restate prior periods presented and the cumulative effect of initial application is recognized in the opening retained earnings of the first year of application of Ind AS 115.

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5. STEP 1: IDENTIFYING THE CONTRACT

As the guidance in Ind AS 115 applies only to contracts with customers, the first step in the model is to identify such contracts.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations. For example, if an entity has an established practice of starting performance based on oral agreements with its customers, it may determine that such oral agreements meet the definition of a contract. As a result, an entity may need to account for a contract as soon as performance begins, rather than delay revenue recognition until the arrangement is documented in a signed contract.

The guidance in Ind AS makes it clear that the rights and obligations in a contract must be "enforceable" in order for an entity to apply the five-step revenue model. Enforceability is a matter of law, so an entity needs to consider the local relevant legal environment to make that determination. That said, while the contract must be legally enforceable, oral or implied promises may give rise to performance obligations in the contract.

5.1 Criteria for recognizing a contract

Step 1 serves as a 'gateway' through which an entity must pass before proceeding to the later steps of the model. In other words, if at the inception of an arrangement, an entity concludes that the criteria below are not met, it should not apply Step 2 to 5 of the model until it determines that the Step 1 criteria are subsequently met. When a contract meets the five criteria and 'passes' Step 1, the entity will not reassess the Step 1 criteria unless there is an indication of a significant change in facts and circumstances.

Ind AS 115 requires an entity to account for a contract with a customer that is within the scope of the model in this standard only when **all** the following criteria are met:

(a) The parties have approved (in writing, orally or in accordance with other customary business practices) the contract and are committed to perform their contractual obligations

(b) The entity can identify each party's rights regarding the goods or services to be transferred

(c) The entity can identify the payment terms for the goods or services to be transferred

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(d) The contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract), and

(e) It is probable that the entity will collect substantially all of the consideration to which it expects to be entitled in exchange for the goods or services that will be transferred to the customer.

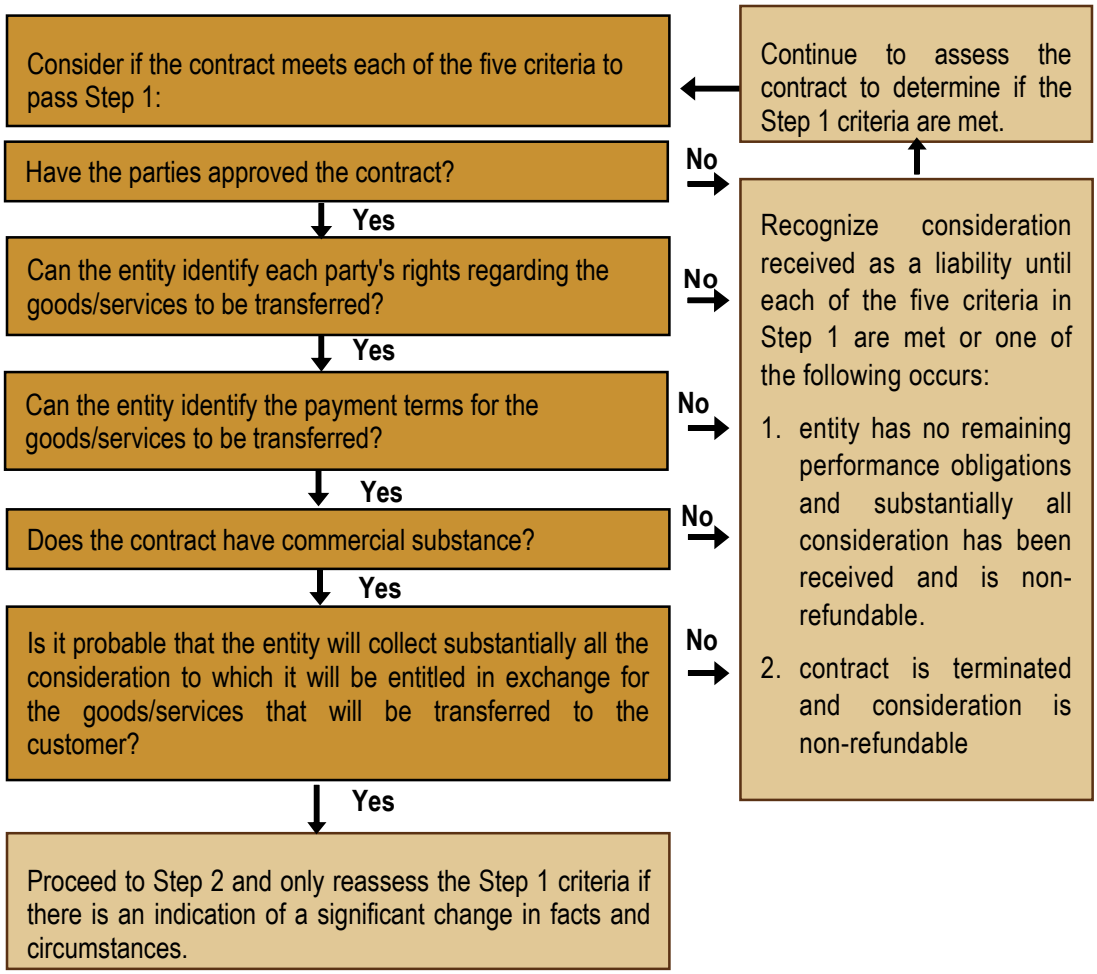
If the arrangement does not meet the five criteria at inception, an accounting contract, for purposes of applying Ind AS 115, does not exist, and the entity should continue to reassess whether the five criteria are subsequently met. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which it will be entitled in exchange for the remaining goods or services that will be transferred to the customer.

A contract may not pass Step 1, but the entity may still transfer goods or services to the customer and receive non-refundable consideration in exchange for those goods or services. In that circumstance, the entity cannot recognize revenue for the non-refundable consideration received until either the Step 1 criteria are subsequently met, or one of the events outlined below has occurred:

(a) The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable, or

(b) The contract has been terminated, and the consideration received from the customer is non-refundable.

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Each of the criteria mentioned above are discussed in more detail below:

5.1.1 Criteria 1: The parties have approved the contract and are committed to perform

To pass Step 1, the parties must approve the contract. This approval may be written, oral, or implied, as long as the parties intend to be bound by the terms and conditions of the contract. The form of the contract (i.e. oral, written or implied) is not determinative, in assessing whether the parties have approved the contract. Instead, an entity must consider all relevant facts and circumstances when assessing whether the parties intend to be bound by the terms and conditions of the contract. In some cases, the parties to an oral or implied contract may have the intent to fulfil their respective obligations. However, in other cases, a written contract may be required before an entity can conclude that the parties have approved the arrangement.

In addition to approving the contract, the entity must also be able to conclude that both parties

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are committed to performing their respective obligations under the contract. This does not mean that the parties need to be committed to fulfil all of their respective rights and obligations in order for this criterion to be met. For example, an entity may include a requirement in a contract for the customer to purchase a minimum quantity of goods each month, but the entity may have a history of not enforcing the requirement. In this example, the contract approval criterion can still be satisfied if evidence supports that the customer and the entity are both substantially committed to the contract. Termination clauses are also an important consideration when determining whether both parties are committed to perform under a contract and, consequently, whether a contract exists. See 5.3.1 below for further discussion of termination clauses and how they affect contract duration.

5.1.2 Criteria 2: The entity can identify each party's rights

An entity must be able to identify its rights, as well as the rights of all other parties to the contract. An entity cannot assess the transfer of goods or services if it cannot identify each party's rights regarding those goods or services.

5.1.3 Criteria 3: The entity can identify the payment terms for the goods or services

An entity must also be able to identify the payment terms for the promised goods or services within the contract. Identifying the payment terms does not require that the transaction price be fixed or stated in the contract with the customer. As long as there is an enforceable right to payment (i.e. enforceability as a matter of law) and the contract contains sufficient information to enable the entity to estimate the transaction price, the contract would meet this criterion. The entity cannot determine how much it will receive in exchange for the promised goods or services (the "transaction price" in Step 3 of the model) if it cannot identify the contractual payment terms.

5.1.4 Criteria 4: The contract has commercial substance

A contract has commercial substance if the risk, timing, or amount of the entity's cash flows is expected to change as a result of the contract. In other words, the contract must have economic consequences. This criterion was added to prevent entities from transferring goods or services back and forth to each other for little or no consideration to artificially inflate their revenue. This criterion is applicable for both monetary and non-monetary transactions, because without commercial substance, it is questionable whether an entity has entered into a transaction that has economic consequences. Determining whether a contract has commercial substance for the purposes of Ind AS 115 may require significant judgement. In all situations, the entity must be able to demonstrate that a substantive business purpose exists, considering the nature and structure of its transactions.

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5.1.5. Criteria 5: It is probable the entity will collect substantially all of the consideration

To pass Step 1, an entity must determine that it is probable that it will collect substantially all of the consideration to which it will be entitled under the contract in exchange for goods or services that it will transfer to the customer. This criterion is also referred to as the 'collectability assessment'. In determining whether collection is probable, the entity considers the customer's ability and intention to pay considering all relevant facts and circumstances, including past experiences with that customer or customer class. In making the determination of customer's ability to pay, the credit risk was an important thing to determine if the contract is valid. However, customer's credit risk should not affect the measurement or presentation of revenue. The standard requires an entity to evaluate at contract inception (and when significant facts and circumstances change) whether it is probable that it will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to a customer. For purposes of this analysis, the meaning of the term 'probable' means 'more likely than not'. If it is not probable that the entity will collect amounts to which it is entitled, the model in Ind AS 115 is not applied to the contract until the concerns about collectability have been resolved.

Illustration 1

New Way Ltd. decides to enter a new market that is currently experiencing economic difficulty and expects that in future the economy will improve. New Way Ltd. enters into an arrangement with a customer in the new region for networking products for promised consideration of ₹ 1,250,000. At contract inception, New Way Ltd. expects that it may not be able to collect the full amount from the customer.

Determine how New Way Ltd. will recognize this transaction?

Solution

Assuming the contract meets the other criteria covered within the scope of the model in Ind AS 115, New Way Ltd. need to assess whether collection is probable.

In making this assessment, New Way Ltd. considers whether the customer has the ability and intent to pay the estimated transaction price, which may be an amount less than the contract price.

*****

5.2 Contracts that do not pass Step 1: Reassessing the Step 1 criteria

When an entity determines that a contract passes Step 1, it should not reassess contract existence unless there is an indication of a significant change in facts and circumstances.

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For example, if the customer's ability to pay significantly deteriorates, an entity would have to reassess whether it is probable that the entity will collect the consideration to which it is entitled in exchange for transferring the remaining goods and services under the contract. The updated assessment is prospective in nature and would not change the conclusions associated with goods and services already transferred. That is, an entity would not reverse any receivables, revenue or contract assets already recognized under the contract.

However, the revenue related to the remaining goods or services yet to be transferred is impacted.

5.3 Contract term

An entity applies Ind AS 115 to the contractual period over which the parties to the contract have present enforceable rights and obligations.

Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply this Standard to the duration of the contract (ie the contractual period) in which the parties to the contract have present enforceable rights and obligations.

5.3.1 Termination provisions

Some contracts can be terminated by either party at any time while others may only be terminated by one party. The contract does not exist if each party to a contract has the unilateral enforceable right to terminate a wholly unperformed contract without paying a termination penalty. A 'wholly unperformed' contract means that the entity has not yet performed and is not entitled to any consideration.

In some situations, only the customer has the ability to terminate the contract without penalty. In those situations, the contract term for accounting purposes may be shorter than that stated in the contract.

However, a substantive termination penalty payable by a customer to the entity is evidence of enforceable rights and obligations of both parties throughout the period covered by the termination penalty. For example, consider a four-year service contract in which the customer has the right to cancel without cause at the end of each year, but for which the customer would incur a termination penalty that decreases each year and is determined to be substantive. Then, this arrangement would be treated as a four-year contract only and contract term should not be assessed less than four years unless the entity has past experience of having such contracts terminated by this customer or class of customer which may demand assessment of the contract term based on previous trend or experience.

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Illustration 2

A gymnasium enters into a contract with a new member to provide access to its gym for a 12-month period at ₹ 4,500 per month. The member can cancel his or her membership without penalty after three months. Specify the contract term.

Solution

The enforceable rights and obligations of this contract are for three months, and therefore the contract term is three months.

*****

Illustration 3

Contractor P enters into a manufacturing contract to produce 100 specialised CCTV cameras for Customer Q for a fixed price of ₹ 1,000 per sensor. Customer Q can cancel the contract without a penalty after receiving 10 CCTV cameras. Specify the contract units.

Solution

P determines that because there is no substantive compensation amount payable by Q on termination of the contract – i.e. no termination penalty in the contract – it is akin to a contract to produce 10 CCTV cameras that gives Customer Q an option to purchase additional 90 CCTV cameras. Hence, contract is for 10 units.

*****

5.4 Combining contracts

An entity should combine two or more contracts and account for them as a single contract in certain circumstances because the substance of the individual contracts cannot be understood without considering the entire arrangement. This evaluation takes place at contract inception.

Two or more contracts may need to be accounted for as a single contract if they are entered into at or near the same time with the same customer (or with related parties of the customer), and if one of the following conditions exists:

(a) The contracts are negotiated as a package with a single commercial objective;

(b) The amount of consideration paid in one contract depends on the price or performance in the other contract; or

(c) The goods or services promised in the contract are a single performance obligation.

Note: Entities will need to apply judgement to determine whether contracts are entered into at or near the same time because the standard does not provide a bright line for making this assessment.

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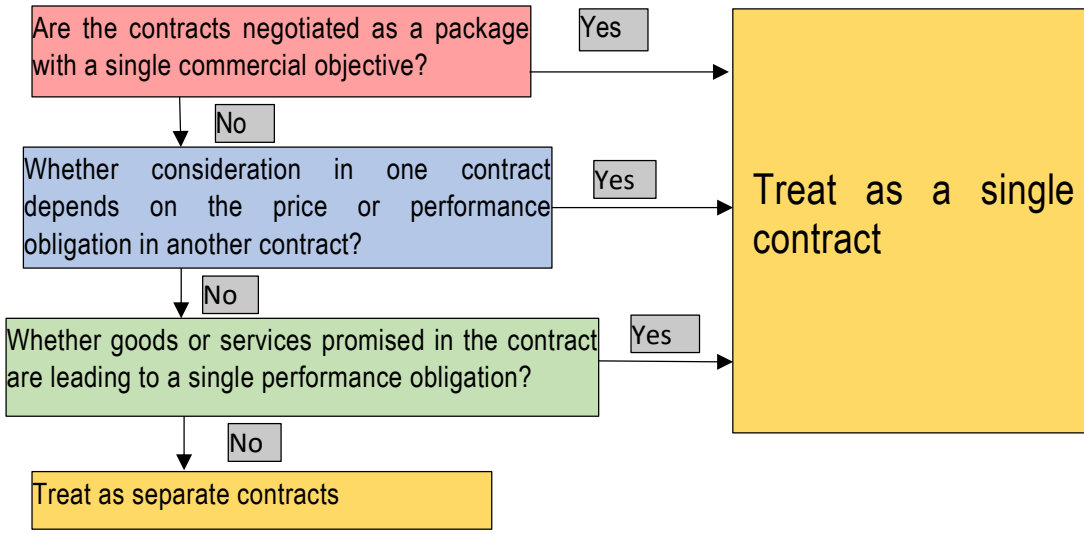


Illustration 4

Manufacturer of airplanes for the air force negotiates a contract to design and manufacture new fighter planes for a Kashmir air base. At the same meeting, the manufacturer enters into a separate contract to supply parts for existing planes at other bases.

Would these contracts be combined?

Solution

Contracts were negotiated at the same time, but they appear to have separate commercial objectives. Manufacturing and supply contracts are not dependent on one another, and the planes and the parts are not a single performance obligation. Therefore, contracts for supply of fighter planes and supply of parts shall not be combined and instead, they shall be accounted separately.

*****

Illustration 5

Software Company S enters into a contract to license its customer relationship management software to Customer B. Three days later, in a separate contract, S agrees to provide consulting services to significantly customise the licensed software to function in B's IT environment. B is unable to use the software until the customisation services are complete.

Would these contracts be combined?

Solution

S determines that the two contracts should be combined because they were entered into at nearly the same time with the same customer, and the goods or services in the contracts are a single performance obligation.

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Illustration 6

Manufacturer M enters into a contract to manufacture and sell a cyber security system to Government-related Entity P. One week later, in a separate contract, M enters into a contract to sell the same system to Government-related Entity Q. Both entities are controlled by the same government. During the negotiations, M agrees to sell the systems at a deep discount if both P and Q purchases the security system.

Should these contracts be combined or separately accounted?

Solution

M concludes that the said two contracts should be combined because, among other things, P is a related party of Q, the contracts were entered into at nearly the same time and the contracts were negotiated as a single commercial package, which is clearly evident from the fact that discount is being offered if both the parties purchase the security system, thereby also making the consideration in one contract dependent on the other contract.

*****

5.5 Contract Modifications

Modifications that change the terms of a contract are common in many industries, including manufacturing, telecommunications, defence, and construction. Depending upon the industry or jurisdiction, the modification may be better known as a change order, a variation, or an amendment.

The modification guidance under Ind AS 115 requires an entity to

(a) Identify if a contract has been modified.

(b) Determine if the modification results in a separate contract, a termination of the existing contract and the creation of a new contract, or a continuation of the existing contract.

(c) Account for the contract modification accordingly.

5.5.1 Identifying a modification

A contract modification exists if three conditions are met:

(a) There is a change in the scope, price, or both in a contract.

(b) That change is approved by both the entity and the customer.

(c) The change is enforceable.

Similar to the criterion discussed above, the approval of a contract modification may be written, oral, or implied by customary business practice.

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Contract modifications may take many forms and the following list includes some common examples:

(a) Partially terminating the contract

(b) Extending the contract term with or without a corresponding increase in price

(c) Adding new goods and/or services to the contract, with or without a corresponding change in price

(d) Reducing the contract price without a change in goods or services promised

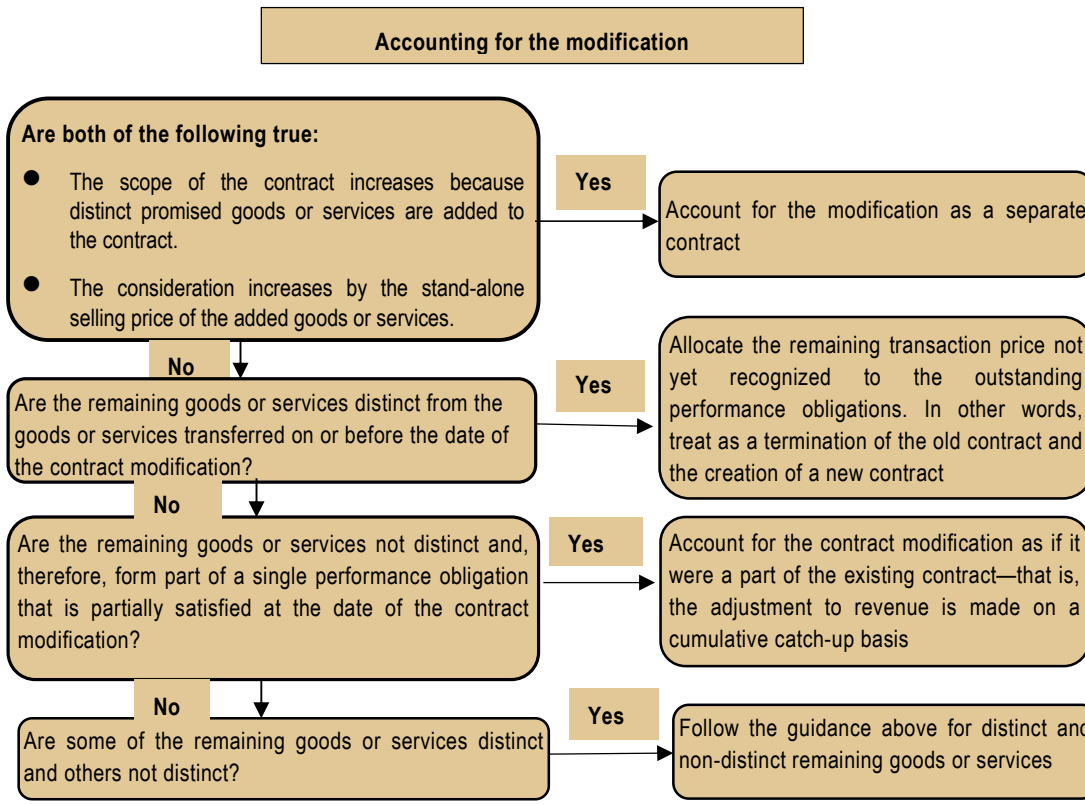
5.5.2 Accounting for the modification

Once an entity determines that a contract with a customer has been modified, it needs to determine whether the modification should be accounted for as a separate contract as discussed above. If the modification is not accounted for as a separate contract, it will be accounted for in one of the following three ways:

(a) As a termination of the old contract and the creation of a new contract

(b) By making a cumulative catch-up adjustment to the original contract

(c) A combination of the two



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5.5.2.1 Modifications that constitute separate contracts

An entity accounts for a contract modification as a separate contract if the modification both

(1) increases the scope of the work promised under the original contract by adding new promised goods or services that are considered distinct, and

(2) the increase in the contract price reflects the stand-alone selling price of the additional goods or services. An entity determines if the additional promised goods or services are distinct using the guidance in Section 6.1.

The logic behind this guidance is that there is no economic difference between the entity entering into a separate contract or modifying an existing contract for the additional goods or services.

When assessing whether the transaction price increases by an amount of consideration that reflects the stand-alone selling prices of the additional goods or services, an entity is allowed to adjust the stand-alone selling price for costs that it does not incur because it is contracting with a repeat customer. Therefore, if the stand-alone selling price in the original contract is ₹ 10 per unit, a modification that adds units for ₹ 9.50 per unit might reflect a stand-alone selling price of the additional units. For example, the selling effort and administration costs might be much lower when incremental units are added, in contrast to the effort and cost of the original quantity. The entity needs to exercise judgment to make that determination.

If a modification adds a distinct goods or service to a series of distinct goods or services that is accounted for as a single performance obligation, the modification is accounted for as a separate contract as long as the transaction price increases by the stand-alone selling price for those added goods or services.

Illustration 7

An entity promises to sell 120 products to a customer for ₹ 120,000 (₹ 1,000 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer at a price of ₹ 950 per product which is the standalone selling price for such additional products at the time of placing this additional order. The additional 30 products were not included in the initial contract.

It is assumed that additional products are contracted for a price that reflects the stand-alone selling price.

Determine the accounting for the modified contract?

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Solution

When the contract is modified, the price of the contract modification for the additional 30 products is an additional ₹ 28,500 or ₹ 950 per product. The pricing for the additional products reflects the stand-alone selling price of the products at the time of the contract modification and the additional products are distinct from the original products.

Accordingly, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract and ₹ 950 per product for the 30 products in the new contract.

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5.5.2.2 Modifications that do not constitute separate contracts

If a contract modification is not accounted for as a separate contract, the guidance provides the following three methods to account for the modification:

(a) First, account for the modification prospectively as long as the goods or services to be provided after the modification are distinct from the goods or services that were already provided to the customer. The logic behind this guidance is that accounting for these types of modifications on a cumulative catch-up basis could be complex and may not faithfully depict the economics of the modification since the modification is negotiated based on facts and circumstances that exist after the original contract's inception.

Illustration 8

On 1st April, 20X1, KLC Ltd. enters into a contract with Mr. K to provide

- *A machine for ₹ 2.5 million*
- *One year of maintenance services for ₹ 55,000 per month*

On 1st October, 20X1, KLC Ltd. and Mr. K agree to modify the contract to reduce the amount of services from ₹ 55,000 per month to ₹ 45,000 per month.

Determine the effect of change in the contract?

Solution

The next six months of services are distinct from the services provided in the first six months before modification in contract,

Therefore, KLC Ltd. will account for the contract modification as if it were a termination of the existing contract and the creation of a new contract.

The consideration allocated to remaining performance obligation is ₹ 270,000, which is the sum of

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- The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and had not yet been recognized as revenue. This amount is zero.
- The consideration promised as part of the contract modification i.e. ₹ 270,000.

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(b) Second, when the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied, the entity recognizes the effect of the modification on a cumulative catch-up basis. This is the case in many construction contracts where a modification does not result in the transfer of additional distinct goods or services.

Illustration 9

Growth Ltd enters into an arrangement with a customer for infrastructure outsourcing deal.

Based on its experience, Growth Ltd determines that customising the infrastructure will take approximately 200 hours in total to complete the project and charges ₹ 150 per hour.

After incurring 100 hours of time, Growth Ltd and the customer agree to change an aspect of the project and increase the estimate of labour hours by 50 hours at the rate of ₹ 100 per hour.

Determine how contract modification will be accounted for as per Ind AS 115?

Solution

Considering that the remaining goods or services are not distinct, the modification will be accounted for on a cumulative catch up basis, as given below:

Particulars	Hours	Rate (₹)	Amount (₹)
Initial contract amount	200	150	30,000
Modification in contract	50	100	5,000
Contract amount after modification	250	140*	35,000
Revenue to be recognized	100	140	14,000
Revenue already booked	100	150	15,000
Adjustment in revenue			(1,000)

*35,000 / 250 = 140

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(c) Third, there may be cases where the remaining goods or services provided after a modification are a combination of both distinct and non-distinct goods or services. In this case, the entity accounts for those remaining goods or services that are distinct on a prospective basis and for those goods and services that are not distinct on a cumulative catch-up basis.

6. STEP 2: IDENTIFYING PERFORMANCE OBLIGATIONS

Under the five-step model of Ind AS 115, the second step in accounting for a contract with a customer is identifying the performance obligations. Identifying performance obligations is a crucial process in the five-step model. Performance obligations are considered as unit of account for the purposes of applying the revenue standard. Identification of performance obligations requires high degree of judgment in cases where multiple goods or services are promised in a contract. Also, it needs to be determined whether those performance obligations should be accounted for separately or as in combination with other promised goods or services in the contract.

The concept of performance obligations is a cornerstone of the Ind AS 115 revenue recognition model. The timing of revenue recognition is based on satisfaction of performance obligations rather than the contract as a whole. This area is sometimes referred to as 'multiple element arrangements'.

6.1 Criteria for identifying performance obligation

At contract inception, an entity shall assess

(a) the goods or services promised in a contract with a customer and

(b) shall identify performance obligation under each promise to be transferred to the customer.

A contract with a customer generally states explicitly, the goods or services that an entity promises to transfer to the customer. However, the performance obligations identified in a contract with the customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises to create a valid expectation of the customer that the entity will transfer goods or service to the customer. Therefore, performance obligations under a contract with the customer are not always explicit or clearly mentioned in the contract, but there can be implied promises or performance obligation under the contract as well.

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Promises under the contract can be explicit or implicit if the same creates a valid expectation by the customer that the entity will provide those goods or service based on the customary business practices, published policies, or specific statements. Some of the examples of promised goods or services include:

Promise	Example
• Sale of manufactured goods	• A manufacturing entity sells inventory
• Resale of goods purchased	• A retail entity sells purchased merchandise
• Resale of rights to goods or services purchased by an entity	• A hospitality entity that purchased a concert ticket resells the ticket, acting as principal
• Performing tasks	• A professional services entity provides consulting services
• Providing goods or services to customers on stand-by basis i.e. as and when required	• A manufacturing entity provides maintenance services on machines sold to a customer when the customer decides it wants the services performed
• Construction of an asset for the customers	• A contractor builds a hospital
• Use or access to intellectual property rights of the entity	• An entity grants a license to use its trade name
• Right to purchase additional goods or services to the customer in the future	• A retailer grants a customer an option to buy three items and to receive 60 percent off of a fourth item at a later date

An entity, a manufacturer, sells a product to a distributor (i.e. its customer) who will then resell it to an end customer.

I Explicit promise of service

- The entity promises to the distributor to provide maintenance services for no additional consideration or free of cost to any party that purchases the product from the distributor. The entity in turn appoints the distributor and pays the distributor to provide the maintenance services on company's behalf to the customer for an agreed payment. In case no one avails those services, the company is not required to pay anything to the distributor.
- Under this contract promise to provide maintenance services in the future will be considered as a performance obligation. The entity has promised to provide

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maintenance services regardless of whether the entity, the distributor, or a third party provides the service.

II **Implicit promise of service**

- The entity has historically provided maintenance services for no additional consideration (i.e. 'free') to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor and the final contract between the entity and the distributor does not specify terms or conditions for those services.
- However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create valid expectations of the entity's customers (i.e. the distributor and end customers).

Performance obligations has been defined as a promise in a contract with a customer to transfer to the customer either:

(a) goods or service (or a bundle of goods or services) that is distinct; or

(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer the goods or service to a customer. For example, a service provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

A. Distinct performance obligations

A goods or service that is promised to a customer is distinct if both of the following criteria are met:

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Two-step model to identify which goods or services are distinct	
Step 1 - Focus on whether the good or service is **capable of being distinct**	**Step 2** - Focus on whether the good or service is **distinct in the context of the contract**
Customer can benefit from the individual good or service on its own **Or;** Customer can use good or service with other readily available resources	The good or service is not integrated with, highly dependent on, highly interrelated with, or significantly modifying or customising other promised goods or services in the contract

Each of the criteria mentioned above are discussed in more detail below:

6.1.1 Customer can benefit either on a stand-alone basis or with other readily available resources

The customer can benefit from the goods or service either on its own or with other resources readily available to them. A readily available resource is a goods or service that is sold separately (by the entity or by another entity) or that the customer has already obtained from the entity or from other transactions or events.

A customer can benefit from a goods or service if the goods or service could be used, consumed, sold for an amount that is greater than its scrap value or otherwise held in a way that generates economic benefits.

Sometimes, a customer can benefit from a goods or service only with other readily available resources. A readily available resource is a goods or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a goods or service either on its own or in conjunction with other readily available resources.

For e.g, the fact that the entity regularly sells a goods or service on its own is an indicator that the goods or service is capable of being distinct.

6.1.2 Separately identifiable from other promises in the contract

Factors that indicate that an entity's promise to transfer a goods or service to a customer is separately identifiable include, but are not limited to, the following:

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6.1.2.1 Significant integration service

It indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract if the entity provides significant integration services. Stated differently, the entity is using the goods or services as inputs to produce the combined output promised in the contract. When an entity provides a significant service of integrating a goods or service with other goods or services in a contract, the bundle of integrated goods or services represents a combined output or outputs. In other words, when an entity provides a significant integration service, the risk of transferring individual goods or services is inseparable from the bundle of integrated goods or services because a substantial part of an entity's promise to the customer is to make sure the individual goods or services are incorporated into the combined output or outputs.

For example, construction contracts in which a contractor provides an integration (or contract management) service to manage and coordinate the various construction tasks and to assume the risks associated with the integration of those tasks. An integration service provided by the contractor often includes coordinating the activities performed by any subcontractors and making sure the quality of the work performed is in compliance with the contract specifications and that the individual goods or services are appropriately integrated into the combined item that the customer has contracted to receive.

6.1.2.2 Significant modification or customization

It indicates that one or more of the goods or services significantly modifies or customises, or are significantly modified or customised by, one or more of the other goods or services promised in the contract.

In some industries, such as the software industry, the notion of inseparable risks is more clearly illustrated by assessing whether one goods or service significantly modifies or customizes another goods or service in the contract. In this case, the goods or services are used as inputs and are being assembled together to create a combined output — a customized product.

Example 1

An entity promises to provide a customer with software that it will significantly customise to make the software function with the customer's existing infrastructure. Based on its facts and circumstances, the entity determines that it is providing the customer with a fully integrated system and that the customisation service requires it to significantly modify the software in such a way that the risks of providing it and the customisation service are inseparable (i.e. the software and customisation service are not separately identifiable).

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6.1.2.3 Highly interdependent or highly interrelated

It indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract if the goods or services are highly interdependent or highly interrelated.

Sometimes it may be unclear whether the entity provides an integration service or whether the goods or services are significantly modified or customized; yet the individual goods or services are not separately identifiable from other goods or services because they are highly dependent on, or highly interrelated with, other promised goods or services in the contract.

The principle in evaluating whether promises are "distinct within the context of the contract" is to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. As a result, the entity must evaluate whether two or more promised goods or services significantly affect the other and are therefore highly interdependent or highly interrelated with other promised goods or services in the contract. An entity does not simply evaluate whether one item depends on another. There must be a two-way dependency. In other words, instead of concluding that an undelivered item would never be obtained by a customer absent the delivered item in the contract, the entity would consider whether the undelivered item and the delivered item each significantly affect the other and therefore are highly interdependent or highly interrelated.

Illustration 10

A construction services company enters into a contract with a customer to build a water purification plant. The company is responsible for all aspects of the plant including overall project management, engineering and design services, site preparation, physical construction of the plant, procurement of pumps and equipment for measuring and testing flow volumes and water quality, and the integration of all components.

Determine whether the company has a single or multiple performance obligations under the contract?

Solution

Determining whether a goods or service represents a performance obligation on its own or is required to be aggregated with other goods or services can have a significant impact on the timing of revenue recognition. In order to determine how many performance obligations are present in the contract, the company applies the guidance above. While the customer may be able to benefit from each promised goods or service on its own (or together with other readily available resources), they do not appear to be separately identifiable within the context of the contract. That is, the promised goods and services are subject to significant integration, and as a result will be treated as a single performance obligation.

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This is consistent with a view that the customer is primarily interested in acquiring a single asset (a water purification plant) rather than a collection of related components and services.

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Illustration 11

An entity provides broadband services to its customers along with voice call service.

Customer buys modem from the entity. However, customer can also get the connection from the entity and modem from any other vendor. The installation activity requires limited effort and the cost involved is almost insignificant. It has various plans where it provides either broadband services or voice call services or both.

Are the performance obligations under the contract distinct?

Solution

Entity promises to customer to provide

- Broadband Service
- Voice Call services
- Modem

Entity's promise to provide goods and services is distinct if

- customer can benefit from the goods or service either on its own or together with other resources that are readily available to the customer, and
- entity's promise to transfer the goods or service to the customer is separately identifiable from other promises in the contract

For broadband and voice call services -

- Broadband and voice services are separately identifiable from other promises as company has various plans to provide the two services separately. These two services are not dependant or interrelated. Also the customer can benefit on its own from the services received.

For sale of modem -

- Customer can either buy product from entity or third party. No significant customisation or modification is required for selling product.

Based on the evaluation we can say that there are three separate performance obligation: -

- Broadband Service
- Voice Call services
- Modem

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Illustration 12

An entity enters into a contract to build a power plant for a customer. The entity will be responsible for the overall management of the project including services to be provided like engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.

Determine how many performance obligations does the entity have?

Solution

Based on the discussion above it needs to be determined that the promised goods and services are capable of being distinct as per the principles of Ind AS 115. That is, whether the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling or holding those goods or services.

However, the goods and services are not distinct within the context of the contract. That is, the entity's promise to transfer individual goods and services in the contract are not separately identifiable from other promises in the contract. This is evidenced by the fact that the entity provides a significant service of putting together the various inputs or goods and services into the power plant or the output for which the customer has contracted.

Since both the criteria have not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

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B. Promise to transfer a series of distinct goods or services that are substantially the same and have the same pattern of transfer:

There might be cases, where distinct goods or services are provided continuously over a period of time. For e.g. security services, or bookkeeping services. This will be considered as single performance obligation if the consumption of those services by the customers is symmetrical.

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

(a) each distinct goods or service in the series that the entity promises to transfer to the customer would meet the criteria to be a performance obligation satisfied over time; and

(b) the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct goods or service in the series to the customer.

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If a series of distinct goods or services meets the criteria in paragraph 22(b) and paragraph 23 of Ind AS 115 (the series requirement), an entity is required to treat that series as a single performance obligation (i.e. it is not optional). Cleaning services, transaction processing services and delivering electricity to customers are some examples that meet the series requirement.

It is important to note that, even if, the underlying activities an entity performs to satisfy a promise vary significantly throughout the day and from day to day, that fact, by itself, does not mean the distinct goods or services are not substantially the same.

Example 2

A vendor enters into a 5-year contract with a customer to provide continuous access to its system and to process all transactions on behalf of the customer. The customer is obligated to use the vendor's system, but the ultimate quantity of transactions is unknown. The vendor concludes that the customer simultaneously receives and consumes the benefits as it performs.

If the vendor concludes that the nature of its promise is to provide continuous access to its system, rather than process a particular quantity of transactions, it might conclude that there is a single performance obligation to stand ready to process as many transactions as the customer requires. If that is the case, it would be reasonable to conclude that there are multiple distinct time increments of the service. Each day of access to the service provided to the customer could be considered substantially the same since the customer is deriving a consistent benefit from the access each day, even if a different number of transactions are processed each day.

If the vendor concludes that the nature of the promise is the processing of each transaction, then each transaction processed could be considered substantially the same even if there are multiple types of transactions that generate different payments. Furthermore, each transaction processed could be a distinct service because the customer could benefit from each transaction on its own and each transaction could be separately identifiable. Accordingly, it would be reasonable for an entity to conclude that this contract meets the series' requirement.

Illustration 13

Could the series requirement apply to hotel management services where day to day activities vary, involve employee management, procurement, accounting, etc?

Solution

The series guidance requires each distinct goods or service to be "substantially the same." Management should evaluate this requirement based on the nature of its promise to customer. For example, a promise to provide hotel management services for a specified contract term may meet the series criteria. This is because the entity is providing the same service of "hotel

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management" each period, even though some on underlying activities may vary each day. The underlying activities for e.g. reservation services, property maintenance services are activities to fulfil the hotel management service rather than separate promises. The distinct service within the series is each time increment of performing the service.

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6.2 Multiple Element Arrangements/ Goods and services that are not distinct

Once an entity determines whether the goods and services would be distinct based on their individual characteristics, the entity then has to consider if the manner in which the goods and services have been bundled in an arrangement would require the entity to account for two or more goods or services as one performance obligation. This determination would be required regardless of whether or not those goods and services were determined to be distinct on their own.

If the goods or services are not considered as distinct, those goods or services are combined with other goods or services under the contract till the time the entity identifies a bundle of distinct goods or services.

This combination would result in accounting of multiple goods or services in the contract as a single performance obligation. This could also result in an entity combining a goods or service that is not considered distinct with another goods or service that, on its own, would have met the criteria to be considered distinct. An entity may end up accounting for all the goods or services promised in a contract as a single performance obligation if the entire bundle of promised goods and services is the only distinct performance obligation identified.

It is important to note that the assessment of whether a goods or service is distinct must consider the specific contract with a customer. That is, an entity cannot assume that a particular goods or service is distinct (or not distinct) in all instances. The manner in which promised goods and services are bundled within a contract can affect the conclusion of whether a goods or service is distinct. Entities may treat the same goods and services differently, depending on how those goods and services are bundled within a contract.

Illustration 14

Entity A, a specialty construction firm, enters into a contract with Entity B to design and construct a multi-level shopping centre with a customer car parking facility located in sub-levels underneath the shopping centre. Entity B solicited bids from multiple firms on both phases of the project — design and construction.

The design and construction of the shopping centre and parking facility involves multiple goods and services from architectural consultation and engineering through procurement and

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installation of all the materials. Several of these goods and services could be considered separate performance obligations because Entity A frequently sells the services, such as architectural consulting and engineering services, as well as standalone construction services based on third party design, separately. Entity A may require to continually alter the design of the shopping centre and parking facility during construction as well as continually assess the propriety of the materials initially selected for the project.

Determine how many performance obligations does the entity A have?

Solution

Entity A analyses that it will be required to continually alter the design of the shopping centre and parking facility during construction as well as continually assess the propriety of the materials initially selected for the project. Therefore, the design and construction phases are highly dependent on one another (i.e., the two phases are highly interrelated). Entity A also determines that significant customisation and modification of the design and construction services is required in order to fulfil the performance obligation under the contract. As such, Entity A concludes that the design and construction services will be bundled and accounted for as one performance obligation.

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Illustration 15

An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

Determine how many performance obligations does the entity have?

Solution

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.

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The entity also considers the factors of Ind AS 115 and determines that the promise to transfer each goods and service to the customer is separately identifiable from each of the other promises. In particular, the entity observes that the installation service does not significantly modify or customise the software itself and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

- The software license
- An installation service
- Software updates
- Technical support

*****

Illustration 16 : Significant customisation

The promised goods and services are the same as in the above Illustration, except that the contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer. The customised installation service can be provided by other entities.

Determine how many performance obligations does the entity have?

Solution

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customised installation service as specified in the contract. In other words, the entity is using the license and the customised installation service as inputs to produce the combined output (i.e. a functional and integrated software system) specified in the contract. In addition, the software is significantly modified and customised by the service. Although the customised installation service can be provided by other entities, the entity determines that within the context of the contract, the promise to transfer the license is not separately identifiable from the customised installation service and, therefore, the criterion on the basis of the factors is not met. Thus, the software license and the customised installation service are not distinct.

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The entity concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to the customer are separately identifiable from each of the other promises.

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a) customised installation service (that includes the software license);

b) software updates; and

c) technical support.

*****

Illustration 17

Telco T Ltd. enters into a two-year contract for internet services with Customer C. C also buys a modem and a router from T Ltd. and obtains title to the equipment. T Ltd. does not require customers to purchase its modems and routers and will provide internet services to customers using other equipment that is compatible with T Ltd.'s network. There is a secondary market in which modems and routers can be bought or sold for amounts greater than scrap value.

Determine how many performance obligations does the entity T Ltd. have?

Solution

T Ltd. concludes that the modem and router are each distinct and that the arrangement includes three performance obligations (the modem, the router and the internet services) based on the following evaluation:

Criterion 1: Capable of being distinct

- C can benefit from the modem and router on their own because they can be resold for more than scrap value.
- C can benefit from the internet services in conjunction with readily available resources – i.e. either the modem and router are already delivered at the time of contract set- up, they could be bought from alternative retail vendors or the internet service could be used with different equipment.

Criterion 2: Distinct within the context of the contract

- T Ltd. does not provide a significant integration service.
- The modem, router and internet services do not modify or customise one another.

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- C could benefit from the internet services using routers and modems that are not sold by T Ltd. Therefore, the modem, router and internet services are not highly dependent on or highly inter-related with each other.

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Illustration 18

V Ltd. grants Customer C a three-year licence for anti-virus software. Under the contract, V Ltd. promises to provide C with when-and-if-available updates to that software during the licence period. The updates are critical to the continued use of the anti-virus software.

Determine how many performance obligations does the entity have?

Solution

V Ltd. concludes that the licence and the updates are capable of being distinct because the anti-virus software can still deliver its original functionality during the licence period without the updates. C can also benefit from the updates together with the licence transferred when the contract is signed.

However, V Ltd. concludes that the licence and the updates are not separately identifiable because the software and the service are inputs into a combined item in the contract − i.e. the nature of V Ltd.'s promise is to provide continuous anti-virus protection for the term of the contract. Therefore, V Ltd. accounts for the licence and the updates as a single performance obligation.

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Illustration 19

Media Company P Ltd. offers magazine subscriptions to customers. When customers subscribe, they receive a printed copy of the magazine each month and access to the magazine's online content.

Determine how many performance obligations does the entity have?

Solution

P evaluates whether the promises to provide printed copies and online access are separate performance obligations. P determines that the arrangement includes two performance obligations for the following reasons:

- The printed copies and online access are both capable of being distinct because the customer could use them on their own.

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- The printed copies and online access are distinct within the context of the contract because they are different formats, so they do not significantly customise or modify each other, nor is there any transformative relationship into a single output.

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Illustration 20-Implied promise to reseller's customers

Software Company K Ltd. enters into a contract with reseller D, which then sells software products to end users. K Ltd. has a customary business practice of providing free telephone support to end users without involving the reseller, and both reseller and the customer expect K Ltd. to continue to provide this support.

Determine how many performance obligations does the entity K Ltd. have?

Solution

In evaluating whether the telephone support is a separate performance obligation, K Ltd. notes that the promise to provide telephone support free of charge to end users is considered a service that meets the definition of a performance obligation when control of the software product transfers to D. As a result, K Ltd. accounts for the telephone support as a separate performance obligation in the transaction with D.

*****

Illustration 21-Implied performance obligation

Carmaker N Ltd. has a historical practice of offering free maintenance services – e.g. oil changes and tyre rotation – for two years to the end customers of dealers who buy its vehicles. However, the two years' free maintenance is not explicitly stated in the contract with its dealers, but it is typically stated in N's advertisements for the vehicles.

Determine how many performance obligations does the entity have?

Solution

The maintenance is treated as a separate performance obligation in the sale of the vehicle to the dealer. Revenue from the sale of the vehicle is recognized when control of the vehicle is transferred to the dealer. Revenue from the maintenance services is recognized separately as and when the maintenance services are provided to the retail customer.

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6.3 Customer options for additional goods or services

Retail and consumer products entities frequently give certain customers the option to purchase additional goods or services. These options come in many forms, including sales incentives

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(e.g., coupons with a limited distribution, competitor price matching programs aimed at only some customers, gift cards issued by a retailer as a promotion) and customer award credits (e.g., loyalty or reward programs).

The standard states that when an entity grants a customer the option to acquire additional goods or services, that option is only a separate performance obligation if it provides a material right to the customer. The right is material if it results in a discount that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

If the discounted price in the option reflects the stand-alone selling price (separate from any existing relationship or contract), the entity is deemed to have made a marketing offer rather than having granted a material right.

In such cases, the entity has made a marketing offer that it shall account for in accordance with this Standard only when the customer exercises the option to purchase the additional goods or services.

This standard requires an entity to allocate the transaction price to performance obligations on a relative stand-alone selling price basis. If the stand-alone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity shall estimate it. That estimate shall reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

(a) any discount that the customer could receive without exercising the option; and

(b) the likelihood that the option will be exercised.

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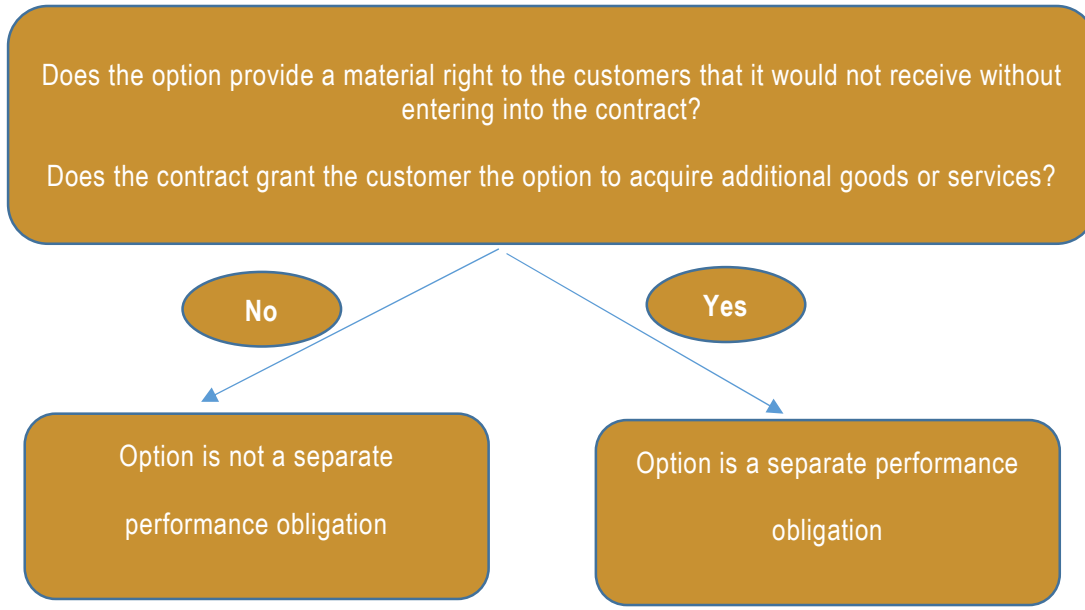


Illustration 22

Entity sells gym memberships for ₹ 7,500 per year to 100 customers, with an option to renew at a discount in 2nd and 3rd years at ₹ 6,000 per year. Entity estimates an annual attrition rate of 50% each year.

Determine the amount of revenue to be recognized in the first year and the amount of contract liability against the option given to the customer for renewing the membership at discount.

Solution

Allocated price per unit (year) is calculated as follows:

Total estimated memberships is 175 members (Year 1 = 100; Year 2 = 50; Year 3 = 25) = 175

Total consideration is ₹ 12,00,000 {(100 x 7,500) + (50 x 6,000) + (25 x 6,000)}

Allocated price per membership is ₹ 6,857 approx. (12,00,000 / 175)

Based on above, it is to be noted that although entity has collected ₹ 7,500 but revenue can be recognized at ₹ 6,857 approx. per membership and remaining ₹ 643 should be recorded as contract liability against option given to customer for renewing their membership at discount.

*****

Illustration 23

An entity enters into a contract for the sale of Product A for ₹ 1,000. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to ₹ 1,000 in the next 30 days. The entity intends to offer a 10% discount on all sales during the next 30 days as

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part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

The entity believes there is 80% likelihood that a customer will redeem the voucher and, on an average, a customer will purchase ₹ 500 of additional products.

Determine how many performance obligations does the entity have and their stand-alone selling price and allocated transaction price?

Solution

Since all customers will receive a 10% discount on purchases during the next 30 days, the only additional discount that provides the customer with a material right is the incremental discount of 30% on the products purchased. The entity accounts for the promise to provide the incremental discount as a separate performance obligation in the contract for the sale of Product A.

The entity believes there is 80% likelihood that a customer will redeem the voucher and, on an average, a customer will purchase ₹ 500 worth of additional products. Consequently, the entity's estimated stand-alone selling price of the discount voucher is ₹ 120 (₹ 500 average purchase price of additional products x 30% incremental discount x 80% likelihood of exercising the option). The stand-alone selling prices of Product A and the discount voucher and the resulting allocation of the ₹ 1,000 transaction price are as follows:

Performance obligations	Stand-alone selling price
Product A	₹ 1000
Discount voucher	₹ 120
Total	₹ 1120

Performance obligations		Allocated transaction price (to nearest ₹10)
Product A	(₹ 1000 ÷ ₹ 1120 × ₹ 1000)	₹ 890
Discount voucher	(₹ 120 ÷ ₹ 1120 × ₹ 1000)	₹ 110
Total		₹ 1000

The entity allocates ₹ 890 to Product A and recognizes revenue for Product A when control transfers. The entity allocates ₹ 110 to the discount voucher and recognizes revenue for the voucher when the customer redeems it for goods or services or when it expires.

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6.4 Long term arrangements

Entities frequently enter into arrangements to provide services on a long-term basis, such as maintenance services to be provided over a long period of time.

For example, should a three-year maintenance agreement be considered a single performance obligation representing the entire contractual period, or should it be broken into smaller periods (daily, monthly or yearly)? It may be appropriate to treat a three-year services contract as three separate one-year performance obligations, if the contract can be renewed or cancelled by either party at discrete points in time (that is, at the end of each service year).

The entity would separately account for its rights and obligations for each period in which the contract cannot be cancelled by either party.

In long-term service agreements when the consideration is fixed, the accounting generally will not change regardless of whether a single performance obligation or multiple performance obligations are identified.

Illustration 24

A cable company provides television services for a fixed rate fee of ₹ 800 per month for a period of 3 years. Cable services is satisfied overtime because customer consumes and receives benefit from services as it is provided i.e. customer generally benefits each day that they have access to cable service.

Determine how many performance obligations does the cable company have?

Solution

Cable company determines that each increment of its services e.g. day or month, is a distinct performance obligation because customer benefits from that period of services on its own. Additionally, each increment of service is separately identifiable from those preceding and following it i.e. one service period does not significantly affect, modify or customise another. Therefore, it can be concluded that its contract with customer is a single performance obligation to provide three years of cable service because each of the distinct increments of service is satisfied over time. Also, cable company uses the same measure of progress to recognize revenue on its cable television service regardless of the contract's time period.

*****

6.5 Consignment Arrangements

Entities frequently deliver inventory on a consignment basis to other parties (e.g. distributor, dealer). By shipping on a consignment basis, consignors are able to achieve better sales by moving them closer to the end-customer. However, they do so without selling the goods to the

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intermediary (consignee). A consignment agreement is an agreement between a consignee and consignor for the storage, transfer, sale or resale and use of the goods. The consignee may take goods from the consignment stock for use or resale subject to payment to the consignor agreeably to the terms bargained in the consignment agreement. Entities frequently deliver inventory on a consignment basis to other parties (e.g., distributor, dealer).

The following indicators have been provided to evaluate whether the arrangement is a consignment arrangement:

(a) the product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires;

(b) the entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and

(c) the dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Entities entering into a consignment arrangement must determine the nature of the performance obligation (i.e., whether the obligation is to transfer the inventory to the consignee or to transfer the inventory to the end customer). This determination is based on whether control of the inventory has passed to the consignee upon delivery. In case of consignment arrangement, a consignor will not relinquish control of consignment inventory until the inventory is sold to the consumer or on the expiry of an agreed period. Consignees does not have an obligation to pay, until the goods are sold to the ultimate or end consumer. As a result, revenue generally would not be recognized for consignment arrangements when the goods are delivered to the consignee because control has been not yet transferred. Revenue is recognized when the entity has transferred control of the goods to the consignor or the end consumer. A consignment sale differs from a sale with a right of return. The customer has control of the goods in a sale with right of return and can decide whether to put the goods back to the seller. In case of consignment sales, the consignee does not have the control over the goods.

Illustration 25

Manufacturer M enters into a 60-day consignment contract to ship 1,000 dresses to Retailer A's stores. Retailer A is obligated to pay Manufacturer M ₹ 20 per dress when the dress is sold to an end customer.

During the consignment period, Manufacturer M has the contractual right to require Retailer A to either return the dresses or transfer them to another retailer. Manufacturer M is also required to accept the return of the inventory. State when the control is transferred.

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Solution

Manufacturer M determines that control has not been transferred to Retailer A on delivery, for the following reasons:

(a) Retailer A does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;

(b) Manufacturer M is able to require that the dresses be transferred to another retailer at any time before Retailer A sells them to an end customer; and

(c) Manufacturer M is able to require the return of the dresses or transfer them to another retailer.

Manufacturer M determines that control of the dresses transfers when they are sold to an end customer i.e. when Retailer A has an unconditional obligation to pay Manufacturer M and can no longer return or otherwise transfer the dresses.

Manufacturer M recognizes revenue as the dresses are sold to the end customer.

*****

6.6 Principal vs agent consideration

Some contracts result in an entity's customer receiving goods or services from another entity that is not a direct party to the contract with the customer. The standard states that when other parties are involved in providing goods or services to an entity's customer, the entity must determine whether its performance obligation is to provide the goods or service itself (i.e., the entity is a principal) or to arrange for another party to provide the goods or service (i.e., the entity is an agent). The determination of whether the entity is acting as a principal, or an agent affects the amount of revenue the entity recognizes. That is,

- when the entity is the principal in the arrangement, the revenue recognized is the gross amount to which the entity expects to be entitled.
- when the entity is acting as an agent, the revenue recognized is the net amount i.e. the amount, entity is entitled to retain in return for its services under the contract. The entity's fee or commission may be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

A principal's performance obligations in an arrangement differ from an agent's performance obligations. For example, if an entity obtains control of the goods or services of another party before it transfers those goods or services to the customer, the entity's performance obligation may be to provide the goods or services itself. Hence, the entity likely is acting as a principal

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and would recognize revenue in the gross amount to which it is entitled. An entity that obtains legal title of a product only momentarily before legal title is transferred to the customer is not necessarily acting as a principal. In contrast, an agent facilitates the sale of goods or services to the customer in exchange for a fee or commission and generally does not control the goods or services for any length of time. Therefore, the agent's performance obligation is to arrange for another party to provide the goods or services to the customer. Since the identification of the principal in a contract is not always clear, Ind AS 115 provides indicators that a performance obligation involves an agency relationship.

Indicators that an entity is a principal (and therefore controls the goods or service before it is provided to a customer) include the following:

(a) the entity is primarily responsible for fulfilling the contract. This typically includes responsibility for the acceptability of the specified goods or service;

(b) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return).

(c) the entity has discretion in establishing prices for the goods or services.

After an entity identifies its promise and determines whether it is the principal or the agent, the entity recognizes revenue when it satisfies that performance obligation. In some contracts in which the entity is the agent, control of the goods or services promised by the agent might transfer before the customer receives the goods or services from the principal.

For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

(a) The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity

(b) The points entitle the customers to future discounted purchases with another party (i.e., the points represent a material right to a future discount)

(c) The entity determines that it is an agent (i.e., its promise is to arrange for the customers to be provided with points) and the entity does not control those points before they are transferred to the customer.

In contrast, if the points entitle the customers to future goods or services to be provided by the entity, the entity may conclude it is not an agent. This is because the entity's promise is to provide those future goods or services.

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Therefore, the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation may only be satisfied when the future goods or services are provided.

In other cases, the points may entitle customers to choose between future goods or services provided by either the entity or another party. In this situation, the nature of the entity's performance obligation may not be known until the customer makes its choice. That is, until the customer has chosen the goods or services to be provided (and, therefore, whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Therefore, the entity may not satisfy its performance obligation until it either delivers the goods or services or is no longer obliged to stand ready. If the customer subsequently chooses the goods or services from another party, the entity would need to consider whether it was acting as an agent. If so, it would recognize revenue, but only for the fee or commission that the entity receives in return for providing the services to the customer and the third party.

Following illustrations explain the application of the principal versus agent application guidance:

Illustration 26

An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and will pay for those tickets even if it is not able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance. The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are sold; therefore, there is no credit risk.

The entity also assists the customers in resolving complaints with the service provided by airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

Determine whether the entity is a principal or an agent.

Solution

To determine whether the entity's performance obligation is to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for another party to provide those goods or services (i.e. the entity is an agent), the entity considers the nature of its promise. The entity determines that its promise is to provide the customer with a ticket, which provides the right to fly on the specified flight or another flight if the specified flight is changed or cancelled. The entity considers the following indicators for assessment as principal or agent under the contract with the customers:

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(a) the entity is primarily responsible for fulfilling the contract, which provides the right to fly. However, the entity is not responsible for providing the flight itself, which will be provided by the airline.

(b) the entity has inventory risk for the tickets because they are purchased before, they are sold to the entity's customers and the entity is exposed to any loss as a result of not being able to sell the tickets for more than the entity's cost.

(c) the entity has discretion in setting the sales prices for tickets to its customers.

The entity concludes that its promise is to provide a ticket (i.e. a right to fly) to the customer. On the basis of the indicators, the entity concludes that it controls the ticket before it is transferred to the customer. Thus, the entity concludes that it is a principal in the transaction and recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred.

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Illustration 27

Company D Ltd. provides advertising services to customers. D Ltd. enters into a sub-contract with a multinational online video sharing company, F Ltd. Under the sub-contract, F Ltd. places all of D Ltd.'s customers' adverts.

D Ltd. notes the following:

– *D Ltd. works directly with customers to understand their advertising needs before placing adverts.*

– *D Ltd. is responsible for ensuring that the advert meets the customer's needs after the advert is placed.*

– *D Ltd. directs F Ltd. over which advert to place and when to place it.*

– *D Ltd. does not bear inventory risk because there is no minimum purchase requirement with F Ltd.*

– *D Ltd. does not have discretion in setting the price because fees are charged based on F Ltd.'s scheduled rates.*

D is Principal or an agent?

Solution

D Ltd. is primarily responsible for fulfilling the promise to provide advertising services. Although F Ltd. delivers the placement service, D Ltd. works directly with customers to ensure that the services are performed to their requirements. Even though D Ltd. does not bear inventory risk

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and does not have discretion in setting the price, it controls the advertising services before they are provided to the customer. Therefore, D Ltd. is the principal in this case.

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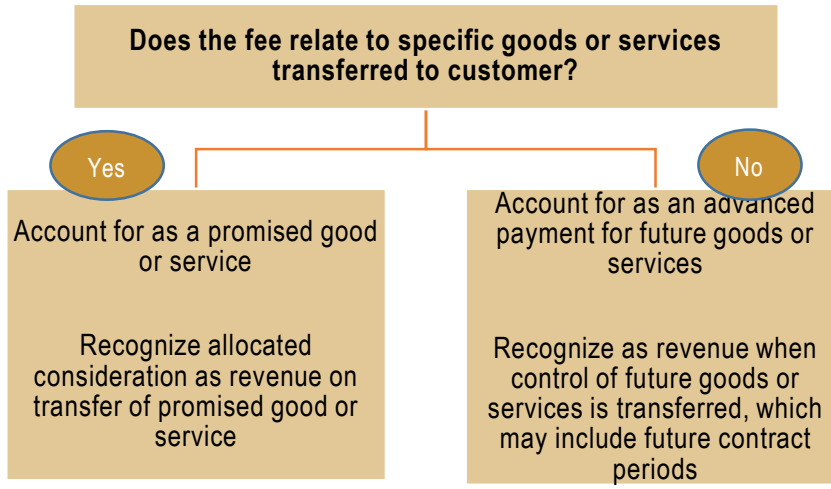
6.7 Non-refundable upfront fees

In some contracts, an entity charges the customer a non-refundable upfront fee. Examples include joining fees in health club membership, activation fees for telecom services, setup fees in certain service contracts and initial fees or joining fees in some supply contracts with the distributors or customers.

To identify performance obligations in such contracts, an entity shall assess whether the fee relates to an activity that the entity is required to undertake at the inception of the contract, or that activity does not result in the transfer of a promised goods or service to the customer.

In many cases, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised goods or service to the customer. Instead, the upfront fee is an advance payment for future goods and services and, therefore, would be recognized as revenue when those future goods and services are provided.

If the non-refundable upfront fee relates to a goods or service, the entity shall evaluate whether to account for the goods or services as a separate performance obligation. An entity may charge a non-refundable fee as a part of compensation of costs incurred in setting up a contract (or other administrative tasks). If those setup activities do not satisfy performance obligation, the entity shall disregard those activities (and related costs) when measuring progress. That is because the costs of setup activities do not depict transfer of services to customer.



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Illustration 28

A customer buy a new data connection from the telecom entity. It pays one-time registration and activation fees at the time of purchase of new connection. The customer will be charged based on the usage of the data services of the connection on monthly basis.

Are the performance obligations under the contract distinct?

Solution

By selling a new connection, the entity promises to supply data services to customer. Customer will not be able to benefit from just buying a data card and data services from third party. The activity of registering and activating connection is not a service to customer and therefore does not represent satisfaction of performance obligation.

Entity's obligation is to provide data service and hence activation is not a separate performance obligation.

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7. STEP 3: DETERMINING THE TRANSACTION PRICE

Measurement

"When (or as) a performance obligation is satisfied, an entity shall recognize as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained in accordance with paragraphs 56 – 58) that is allocated to that performance obligation."

After identifying the contract in Step 1 and the performance obligations in Step 2, an entity next applies Step 3 to **determine the transaction price** of the contract. The objective of Step 3 is to predict the total amount of consideration to which the entity will be entitled from the contract.

What is the transaction price?

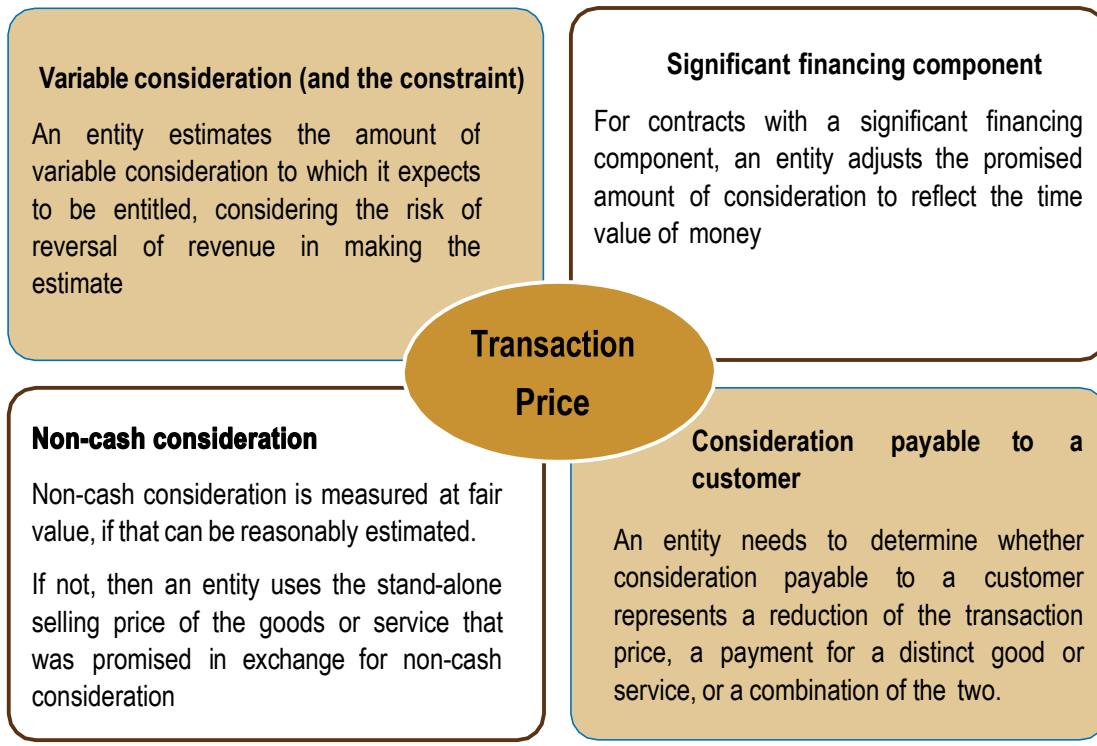
"The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)."

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. Further, an entity shall consider the terms of the contract and its customary business practices to determine the transaction price.

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For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:



Comparison with AS 7 and AS 9

Neither AS 7 nor AS 9 has any specific mention about significant financing component in a transaction price.

7.1 Variable consideration

What is variable consideration?

"If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer."

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Examples of variable consideration

"An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return, or a fixed amount is promised as a performance bonus on achievement of a specified milestone."

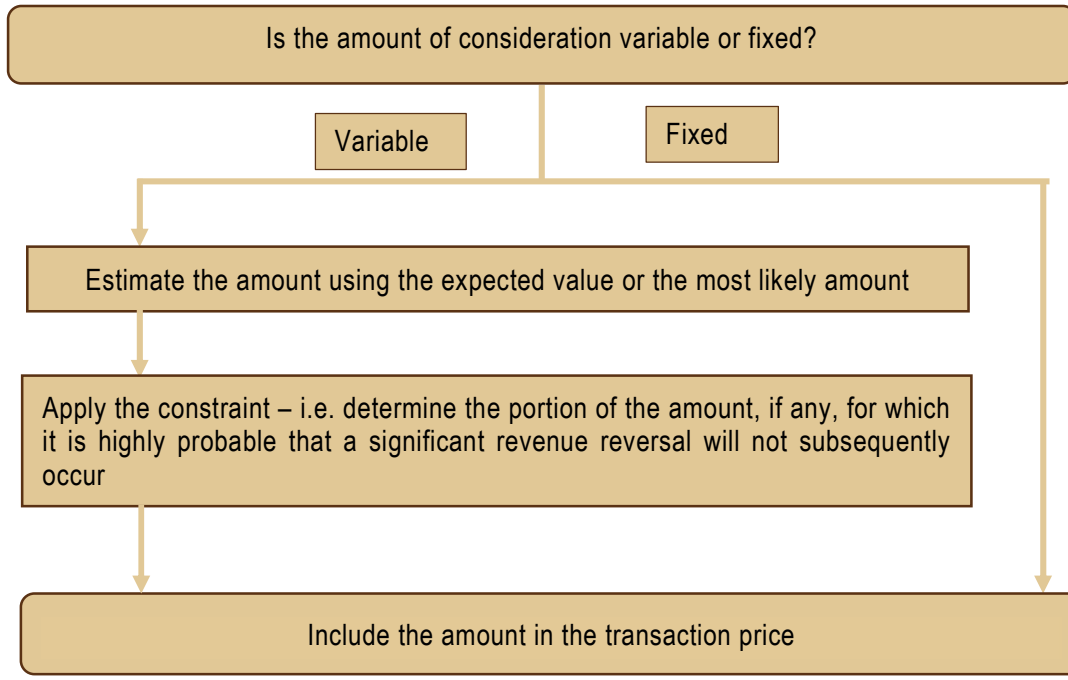
Variable consideration may be fixed in amount, but the entity's right to receive that consideration is contingent on a future outcome. For example, the amount of a performance bonus might be fixed, but because the entity is not entitled to that bonus until a performance target is met, the outcome is uncertain and therefore the amount is considered variable. Items such as discounts, rebates, refunds, rights of return, early settlement discounts, credits, price concessions, incentives, performance bonuses, penalties or similar items may result in variable consideration.

The variability relating to the consideration promised by a customer **may be explicitly stated** in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

(a) the customer has a **valid expectation arising from an entity's customary business practices**, published policies or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry or customer this offer may be referred to as a discount, rebate, refund or credit.

(b) other facts and circumstances indicate that the **entity's intention**, when entering into the contract with the customer, is to offer a price concession to the customer.

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7.1.1 Penalties

Penalties shall be accounted for as per the substance of the contract. Where the penalty is inherent in determination of transaction price, it shall form part of variable consideration.

Example 3

Where an entity agrees to transfer control of a goods or service in a contract with customer at the end of 30 days for ₹ 100,000 and if it exceeds 30 days, the entity is entitled to receive only ₹ 95,000, the reduction of ₹ 5,000 shall be regarded as variable consideration. In other cases, the transaction price shall be considered as fixed at ₹ 95,000.

7.1.2 Estimating the amount of variable consideration

As per Ind AS 115.53, an entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

(a) **The expected value** - the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

(b) **The most likely amount** - the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract).

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The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

An entity is required to choose between the expected value method and the most likely amount method. The choice is based on the method which better predicts the amount of consideration to be entitled. **That is, the method selected is not meant to be a 'free choice'**. Rather, an entity selects the method that is best suited, based on the specific facts and circumstances of the contract.

An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. An entity shall consider all the information that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts.

A contract may contain different types of variable consideration. It may be appropriate for an entity to use different methods (i.e. expected value or most likely amount) for estimating different types of variable consideration within a single contract.

Illustration 29 : Estimating variable consideration

XYZ Limited enters into a contract with a customer to build sophisticated machinery. The promise to transfer the asset is a performance obligation that is satisfied over time. The promised consideration is ₹ 2.5 crore, but that amount will be reduced or increased depending on the timing of completion of the asset. Specifically, for each day after 31st March, 20X1 that the asset is incomplete, the promised consideration is reduced by ₹ 1 lakh. For each day before 31st March, 20X1 that the asset is complete, the promised consideration increases by ₹ 1 lakh.

In addition, upon completion of the asset, a third party will inspect the asset and assign a rating based on metrics that are defined in the contract. If the asset receives a specified rating, the entity will be entitled to an incentive bonus of ₹ 15 lakh.

Determine the transaction price.

Solution

In determining the transaction price, the entity prepares a separate estimate for each element of variable consideration to which the entity will be entitled using the estimation methods described in paragraph 53 of Ind AS 115:

a) the entity decides to use the expected value method to estimate the variable consideration associated with the daily penalty or incentive (i.e. ₹ 2.5 crore, plus or minus ₹ 1 lakh per day). This is because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.

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b) the entity decides to use the most likely amount to estimate the variable consideration associated with the incentive bonus. This is because there are only two possible outcomes (₹ 15 lakh or Nil) and it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.

*****

The entity considers the requirements in paragraphs 56–58 of Ind AS 115 (discussed below) on constraining estimates of variable consideration to determine whether the XYZ Limited should include some or all of its estimate of variable consideration in the transaction price.

Illustration 30 : Estimating variable consideration

AST Limited enters into a contract with a customer to build a manufacturing facility. The entity determines that the contract contains one performance obligation satisfied over time.

Construction is scheduled to be completed by the end of the 36th month for an agreed-upon price of ₹ 25 crore.

The entity has the opportunity to earn a performance bonus for early completion as follows:

- *15 percent bonus of the contract price if completed by the 30th month (25% likelihood)*
- *10 percent bonus if completed by the 32nd month (40% likelihood)*
- *5 percent bonus if completed by the 34th month (15% likelihood)*

In addition to the potential performance bonus for early completion, AST Limited is entitled to a quality bonus of ₹ 2 crore if a health and safety inspector assigns the facility a gold star rating as defined by the agency in the terms of the contract. AST Limited concludes that it is 60% likely that it will receive the quality bonus.

Determine the transaction price.

Solution

In determining the transaction price, AST Limited separately estimates variable consideration for each element of variability i.e. the early completion bonus and the quality bonus.

AST Limited decides to use the expected value method to estimate the variable consideration associated with the early completion bonus because there is a range of possible outcomes, and the entity has experience with a large number of similar contracts that provide a reasonable basis to predict future outcomes. Therefore, the entity expects this method to best predict the amount of variable consideration associated with the early completion bonus. AST's best estimate of the early completion bonus is ₹ 2.13 crore, calculated as shown in the following table:

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Bonus %	Amount of bonus (₹ in crore)	Probability	Probability-weighted amount (₹ in crore)
15%	3.75	25%	0.9375
10%	2.50	40%	1.00
5%	1.25	15%	0.1875
0%	-	20%	-
			2.125

AST Limited decides to use the most likely amount to estimate the variable consideration associated with the potential quality bonus because there are only two possible outcomes (₹ 2 crore or Nil) and this method would best predict the amount of consideration associated with the quality bonus. AST Limited believes the most likely amount of the quality bonus is ₹ 2 crore.

*****

As per para 54 of Ind AS 115, an entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

7.1.3 Refund liabilities

An entity shall recognize a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (i.e. amounts not included in the transaction price). The refund liability (and corresponding change in the transaction price and, therefore, the *contract liability*) shall be updated at the end of each reporting period for changes in circumstances.

While the most common form of refund liabilities may be related to sales with a right of return, the refund liability requirements also apply when an entity expects that it will need to refund consideration received due to poor customer satisfaction with a service provided (i.e. there was no goods delivered or returned) and/or if an entity expects to have to provide retrospective price reductions to a customer (e.g. if a customer reaches a certain threshold of purchases, the unit price will be retrospectively adjusted).

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7.1.4 Constraining estimates of variable consideration

An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 53 only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

In assessing whether it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

(a) the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence of the promised goods or service.

(b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

(c) the entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

(d) the entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

(e) the contract has a large number and broad range of possible consideration amounts.

7.1.5 Reassessment of variable consideration

At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 87 – 90 of Ind AS 115.

Comparison with AS 7 and AS 9

AS 7 and AS 9 both are silent on a situation where revenue should be reversed as specified in Ind AS 115.

Illustration 31 : Volume discount incentive

HT Limited enters into a contract with a customer on 1st April, 20X1 to sell Product X for ₹ 1,000 per unit. If the customer purchases more than 100 units of Product A in a financial year, the

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contract specifies that the price per unit is retrospectively reduced to ₹ 900 per unit. Consequently, the consideration in the contract is variable.

For the first quarter ended 30th June, 20X1, the entity sells 10 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 100 unit threshold required for the volume discount in the financial year. HT Limited determines that it has significant experience with this product and with the purchasing pattern of the customer. Thus, HT Limited concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognized (i.e. ₹ 1,000 per unit) will not occur when the uncertainty is resolved (i.e. when the total amount of purchases is known).

Further, in May, 20X1, the customer acquires another company and in the second quarter ended 30th September, 20X1 the entity sells an additional 50 units of Product A to the customer. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 100-unit threshold for the financial year and therefore it will be required to retrospectively reduce the price per unit to ₹ 900.

Determine the amount of revenue to be recognize by HT Ltd. for the quarter ended 30th June, 20X1 and 30th September, 20X1.

Solution

The entity recognizes revenue of ₹ 10,000 (10 units × ₹ 1,000 per unit) for the quarter ended 30th June, 20X1.

HT Limited recognizes revenue of ₹ 44,000 for the quarter ended 30th September, 20X1. That amount is calculated from ₹ 45,000 for the sale of 50 units (50 units x ₹ 900 per unit) less the change in transaction price of ₹ 1,000 (10 units x ₹ 100 price reduction) for the reduction of revenue relating to units sold for the quarter ended 30th June, 20X1.

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Illustration 32 : Measurement of variable consideration

An entity has a fixed fee contract for ₹ 1 million to develop a product that meets specified performance criteria. Estimated cost to complete the contract is ₹ 9,50,000. The entity will transfer control of the product over five years, and the entity uses the cost-to-cost input method to measure progress on the contract. An incentive award is available if the product meets the following weight criteria:

Weight (kg)	*Award % of fixed fee*	*Incentive fee*
951 or greater	*0%*	—

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701–950	*10%*	*₹ 100,000*
700 or less	*25%*	*₹ 250,000*

The entity has extensive experience creating products that meet the specific performance criteria. Based on its experience, the entity has identified five engineering alternatives that will achieve the 10 percent incentive and two that will achieve the 25 percent incentive. In this case, the entity determined that it has 95 percent confidence that it will achieve the 10 percent incentive and 20 percent confidence that it will achieve the 25 percent incentive.

Based on this analysis, the entity believes 10 percent to be the most likely amount when estimating the transaction price. Therefore, the entity includes only the 10 percent award in the transaction price when calculating revenue because the entity has concluded it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved due to its 95 percent confidence in achieving the 10 percent award.

The entity reassesses its production status quarterly to determine whether it is on the track to meet the criteria for the incentive award. At the end of the year four, it becomes apparent that this contract will fully achieve the weight-based criterion. Therefore, the entity revises its estimate of variable consideration to include the entire 25 percent incentive fee in the year four because, at this point, it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when including the entire variable consideration in the transaction price.

Evaluate the impact of changes in variable consideration when cost incurred is as follows:

Year	₹
1	*50,000*
2	*1,75,000*
3	*4,00,000*
4	*2,75,000*
5	*50,000*

Solution

Note: For simplification purposes, the table calculates revenue for the year independently based on costs incurred during the year divided by total expected costs, with the assumption that total expected costs do not change.

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Fixed consideration	A	1,000,000				
Estimated costs to complete*	B	950,000				
		Year 1	Year 2	Year 3	Year 4	Year 5
Total estimated variable amount	C	100,000	100,000	100,000	250,000	250,000
Fixed revenue	D=A x H/B	52,632	184,211	421,053	289,474	52,632
Variable revenue	E=C x H/B	5,263	18,421	42,105	72,368	13,158
Cumulative revenue adjustment	F (see below)	—	—	—	99,370	—
Total revenue	G=D+E+F	57,895	202,632	463,158	461,212	65,790
Costs	H	50,000	175,000	400,000	275,000	50,000
Operating profit	I=G–H	7,895	27,632	63,158	186,212	15,790
Margin (rounded off)	J=I/G	14%	14%	14%	40%	24%

* For simplicity, it is assumed there is no change to the estimated costs to complete throughout the contract period.

* In practice, under the cost-to-cost measure of progress, total revenue for each period is determined by multiplying the total transaction price (fixed and variable) by the ratio of cumulative cost incurred to total estimated costs to complete, less revenue recognized to date.

Calculation of cumulative catch-up adjustment:			
Updated variable consideration	L		250,000
Percent complete in Year 4: (rounded off)	M=N/O		95%
Cumulative costs through Year 4	N	900,000	
Estimated costs to complete	O	950,000	
Cumulative variable revenue through Year 4:	P		138,157
Cumulative catch-up adjustment	F=L x M–P		99,343

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Illustration 33 : Management fees subject to the constraint

On 1st April, 20X1, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a two per cent quarterly management fee based on the client's assets under management at the end of each quarter. At 31st March, 20X2, the client's assets under management are ₹ 100 crore. In addition, the entity receives a performance-based incentive fee of 20 per cent of the fund's return in excess of the return of an observable market index over the five-year period. Consequently, both the management fee and the performance fee in the contract are variable considerations.

Analyse the revenue to be recognized on 31st March, 20X2.

Solution

The entity accounts for the services as a single performance obligation because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

The entity observes that the promised consideration is dependent on the market and thus is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception — the variability of the fee based on the market index indicates that the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price.

At 31st March, 20X2, the client's assets under management are ₹ 100 crore. Therefore, the resulting quarterly management fee and the transaction price is ₹ 2 crore.

At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter. This is because the fee relates specifically to the entity's

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efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters.

Consequently, the entity recognizes ₹ 2 crore as revenue for the quarter ended 31st March, 20X2.

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7.1.6 Sale with a right of return

In some contracts, an entity transfers control of a product to a customer (refer Step 5) and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

(a) a full or partial refund of any consideration paid;

(b) a credit that can be applied against amounts owed, or that will be owed, to the entity; and

(c) another product in exchange.

In some contracts, an entity transfers control of a product to a customer with an unconditional right of return. In such cases, the recognition of revenue shall be as per the substance of the arrangement. Where the substance is that of a consignment sale, the entity shall account for such a contract as per the provisions of Ind AS 115's application guidance related to consignment sales (refer paragraph B77 and B78 of Application Guidance to Ind AS 115). In other cases, the accounting for contracts with customers shall be as per provisions laid out below.

To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity shall recognize all of the following:

(a) revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned);

(b) a refund liability; and

(c) an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

An entity's promise to stand ready to accept a returned product during the return period shall not be accounted for as a performance obligation in addition to the obligation to provide a refund.

An entity shall apply the requirements in paragraphs 47 – 72 (including the requirements for constraining estimates of variable consideration in paragraphs 56 – 58) to determine the amount of consideration to which the entity expects to be entitled (i.e. excluding the products expected

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to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity shall not recognize revenue when it transfers products to customers but shall recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity shall update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognized.

An entity shall update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity shall recognize corresponding adjustments as revenue (or reductions of revenue).

An asset recognized for an entity's right to recover products from a customer on settling a refund liability shall initially be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity shall update the measurement of the asset arising from changes in expectations about products to be returned. An entity shall present the asset separately from the refund liability.

Exchanges by customers of one product for another of the same type, quality, condition and price (for example, one colour or size for another) are not considered returns for the purposes of applying this Standard.

Accounting for restocking fees for goods that are expected to be returned

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.

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 goods transfers.

Example 4

An entity enters into a contract with a customer to sell 10 units of a product for ₹ 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 ₹ 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 recognize revenue of ₹ 903 [(9 units not expected to be returned x ₹ 100 selling price) + (1 unit expected to be returned x ₹ 3 restocking fee per unit)]. A refund liability of ₹ 97 will also be recorded [1 unit expected to be returned x (₹ 100 selling price – ₹ 3 restocking fee)].

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Contracts in which a customer may return a defective product in exchange for a functioning product shall be evaluated in accordance with the guidance on warranties given below.

Illustration 34 : Right of return

An entity enters into contracts with 1,000 customers. Each contract includes the sale of one product for ₹ 50 (1,000 total products × ₹ 50 = ₹ 50,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is ₹ 30.

The entity applies the requirements in Ind AS 115 to the portfolio of 1,000 contracts because it reasonably expects that, in accordance with paragraph 4, the effects on the financial statements from applying these requirements to the portfolio would not differ materially from applying the requirements to the individual contracts within the portfolio. Since the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of Ind AS 115) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 970 products will not be returned.

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

Determine the amount of revenue, refund liability and the asset to be recognized by the entity for the said contracts.

Solution

The entity considers the requirements in paragraphs 56 – 58 of Ind AS 115 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of ₹ 48,500 (₹ 50 × 970 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 57 of Ind AS 115 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (ie the 30-day return period). Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognized (i.e. ₹ 48,500) will not occur as the uncertainty is resolved (i.e. over the return period).

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

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Upon transfer of control of the 1,000 products, the entity does not recognize revenue for the 30 products that it expects to be returned. Consequently, in accordance with paragraphs 55 and B21 of Ind AS 115, the entity recognizes the following:

(a) revenue of ₹ 48,500 (₹ 50 × 970 products not expected to be returned)

(b) a refund liability of ₹ 1,500 (₹ 50 refund × 30 products expected to be returned), and

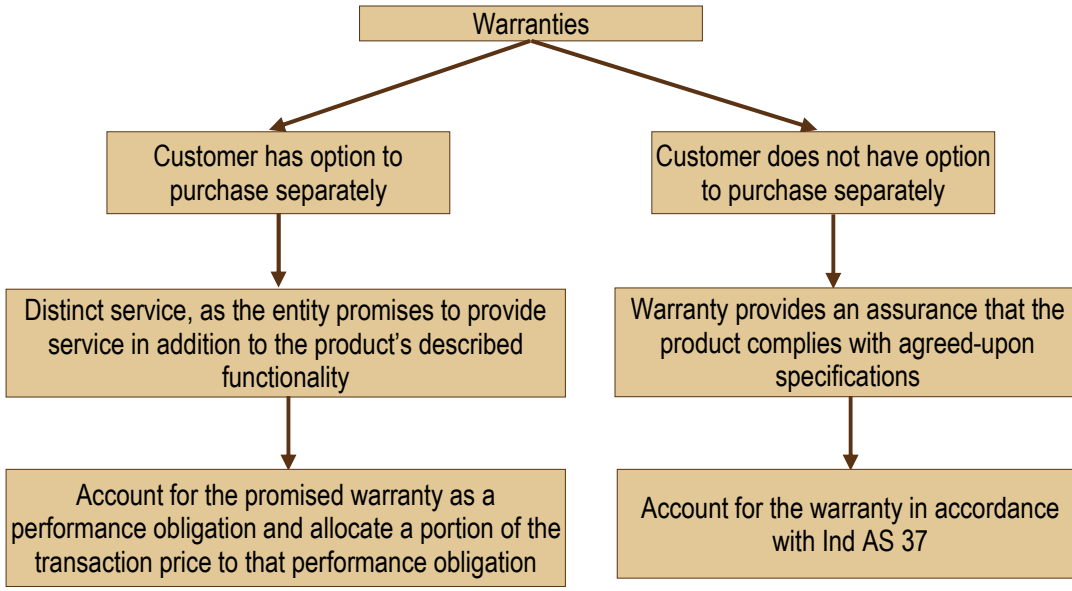
(c) an asset of ₹ 900 (₹ 30 × 30 products for its right to recover products from customers on settling the refund liability).

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7.1.7 Warranties

It is common for an entity to provide (in accordance with the contract, the law or the entity's customary business practices) a warranty in connection with the sale of a product (whether a goods or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with **assurance** that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a **service** in addition to the assurance that the product complies with agreed-upon specifications.

The flowchart below summarises the accounting treatment for the two broad types of warranties:



In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity shall consider factors such as:

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(a) Whether the warranty is required by law — if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

(b) The length of the warranty coverage period — the longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

(c) The nature of the tasks that the entity promises to perform — if it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity shall account for both of the warranties together as a single performance obligation.

A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark or other infringement by the entity's products does not give rise to a performance obligation. The entity shall account for such obligations in accordance with Ind AS 37.

Comparison with AS 7 and AS 9

Ind AS 115 deals with warrantees in two specific ways as discussed above. However, as per AS 9 only a general provision for warrantees is sufficient without revenue reversal or recognition of a contractual liability.

Illustration 35 : Warranty

An entity manufactures and sells computers that include an assurance-type warranty for the first 90 days. The entity offers an optional 'extended coverage' plan under which it will repair or replace any defective part for three years from the expiration of the assurance-type warranty. Since the optional 'extended coverage' plan is sold separately, the entity determines that the three years of extended coverage represent a separate performance obligation (i.e. a service-type warranty). The total transaction price for the sale of a computer and the extended warranty is ₹ 36,000. The entity determines that the stand-alone selling prices of the computer and the

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extended warranty are ₹ 32,000 and ₹ 4,000, respectively. The inventory value of the computer is ₹ 14,400. Furthermore, the entity estimates that, based on its experience, it will incur ₹ 2,000 in costs to repair defects that arise within the 90-day coverage period for the assurance-type warranty.

Pass required journal entries.

Solution

The entity will record the following journal entries:

		₹	₹
Cash / Trade receivables	Dr.	36,000	
Warranty expense	Dr.	2,000	
To Accrued warranty costs (assurance-type warranty)			2,000
To Contract liability (service-type warranty)			4,000
To Revenue			32,000
(To record revenue and contract liabilities related to warranties)			
Cost of goods sold	Dr.	14,400	
To Inventory			14,400
(To derecognize inventory and recognize cost of goods sold)			

The entity derecognizes the accrued warranty liability associated with the assurance-type warranty as actual warranty costs are incurred during the first 90 days after the customer receives the computer. The entity recognizes the contract liability associated with the service-type warranty as revenue during the contract warranty period and recognizes the costs associated with providing the service-type warranty as they are incurred. The entity had to determine whether the repair costs incurred are applied against the warranty reserve already established for claims that occur during the first 90 days or recognized as an expense as incurred.

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In the above illustration, the net effect of the accounting treatment can be seen as follows:

Accounting point	Treatment under Ind AS 115	Treatment as per AS 9
How warranty is accounted	Expense and liability effect created at the inception of contract with customer	Provision is made on past experience based on a certain percentage of total revenue to give effect to subsequent warranty costs, say 5% of revenue.

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Accounting treatment	Total cash inflow ₹ 36,000 Warranty expense ₹ 2000 Accrued warranty cost ₹ 2,000 Contract liability (for future service cost) ₹ 4000 Actual revenue ₹ 32,000	Total cash inflow ₹ 36,000 Provision for warranty (at 5% of transaction price) ₹ 1800 Contract liability – None Actual revenue ₹ 34,200

Illustration 36 : Warranty

Entity sells 100 ultra-life batteries for ₹ 2,000 each and provides the customer with a five-year guarantee that the batteries will withstand the elements and continue to perform to specifications. The entity, which normally provides a one-year guarantee to customer purchasing ultra-life batteries, determines that from the years 2 to 5 represent a separate performance obligation. The entity determines that ₹ 1,70,000 of the ₹ 2,00,000 transaction price should be allocated to the batteries and ₹ 30,000 to the service warranty (based on estimated stand-alone selling prices and a relative selling price allocation). The entity's normal one-year warranty cost is ₹ 100 per battery.

Pass required journal entries.

Solution

The entity will record the following journal entries:

Upon delivery of the batteries, the entity records the following entry:

Cash/Receivables	Dr.	2,00,000	
To Revenue			1,70,000
To Contract liability (service warranty)			30,000
Warranty expense	Dr.	10,000	
To Accrued warranty costs (assurance warranty)			10,000

The contract liability is recognized as revenue over the service warranty period (years 2 - 5). The costs of providing the service warranty are recognized as incurred. The assurance warranty obligation is used / derecognized as defective units are replaced / repaired during the initial year of the warranty. Upon expiration of the assurance warranty period, any remaining assurance warranty obligation is reversed.

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7.1.8 Sales-based or usage-based royalties

As per Ind AS 115.B63, notwithstanding the requirements of Ind AS 115 related to constraining estimate of variable consideration (discussed above), an entity shall recognize revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs:

(a) the subsequent sale or usage occurs; and

(b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

As per Ind AS 115.B63A, the accounting requirements for a sales-based or usage-based royalty discussed above apply when the royalty relates only to a licence of intellectual property or when a licence of intellectual property is the predominant item to which the royalty relates (for example, the licence of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates).

As per Ind AS 115.B63B, when the requirement in paragraph B63A is met, revenue from a sales-based or usage-based royalty shall be recognized wholly in accordance with paragraph B63. When the requirement in paragraph B63A is not met, the requirements on variable consideration discussed earlier apply to the sales-based or usage-based royalty.

7.2 Significant financing component

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. Either party may benefit from financing — that is, the customer may pay before the entity performs its obligation (a customer loan to the entity) or the customer may pay after the entity performs its obligation (a loan by the entity to the customer). In those circumstances, the contract contains a significant financing component.

A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a

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customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (ie the cash selling price).

An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including **both** of the following:

(a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and

(b) the combined effect of both of the following:

  (i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and

  (ii) the prevailing interest rates in the relevant market.

To meet the objective stated above, when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract.

An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

An entity considers the significance of a financing component only at a contract level and not whether the financing is material at a portfolio level. In other words, if the combined effects for a portfolio of similar contracts were material to the entity as a whole, but if the effects of the financing component were not material to the individual contract, such financing component shall not be considered significant and shall not be separately accounted for.

As mentioned above, when a significant financing component exists in a contract, the transaction price is adjusted so that the amount recognized as revenue is the 'cash selling price' of the underlying goods or services at the time of transfer. Essentially, a contract with a customer that has a significant financing component would be separated into a revenue component (for the notional cash sales price) and a loan component (for the effect of the deferred or advance payment terms). Consequently, the accounting for accounts receivable

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arising from a contract that has a significant financing component should be comparable to the accounting for a loan with the same features.

The amount allocated to the significant financing component would have to be presented separately from revenue recognized from contracts with customers. The financing component is recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). The interest income or expense is recognized over the financing period using the effective interest method described in Ind AS 109. The standard notes that interest is only recognized to the extent that a contract asset, contract liability or receivable is recognized in accordance with Ind AS 115. An entity may present interest income as revenue only when interest income represents income from an entity's ordinary activities.

Illustration 37 : Financing component: significant or insignificant?

A commercial airplane component supplier enters into a contract with a customer for a promised consideration of ₹ 70,00,000. Based on an evaluation of the facts and circumstances, the supplier concluded that ₹ 1,40,000 represented an insignificant financing component because of an advance payment received in excess of a year before the transfer of control of the product.

State whether company needs to make any adjustment in determining the transaction price.

What if the advance payment was larger and received further in advance, such that the entity concluded that ₹ 14,00,000 represented the financing component based on an analysis of the facts and circumstances.

Solution

The entity may conclude that ₹ 1,40,000, or 2 percent of the contract price, is not significant, and the entity may not need to adjust the consideration promised in determining the transaction price.

However, when the advance payment was larger and received further in advance, such that the entity may conclude that ₹ 14,00,000 represents the financing component based on an analysis of the facts and circumstances. In such a case, the entity may conclude that ₹ 14,00,000, or 20 percent of the contract price, is significant, and the entity should adjust the consideration promised in determining the transaction price.

Note: In this illustration, the entity's conclusion that 2 percent of the transaction price was not significant and 20 percent was significant is a judgment based on the entity's facts and circumstances. An entity may reach a different conclusion based on its facts and circumstances.

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Illustration 38 : Accounting for significant financing component

NKT Limited sells a product to a customer for ₹ 1,21,000 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new, and the entity has no relevant historical evidence of product returns or other available market evidence.

The cash selling price of the product is ₹ 1,00,000 which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is ₹ 80,000. The contract includes an implicit interest rate of 10 per cent (i.e. the interest rate that over 24 months discounts the promised consideration of ₹ 1,21,000 to the cash selling price of ₹ 1,00,000). Analyse the above transaction with respect to its financing component.

Solution

The contract includes a significant financing component. This is evident from the difference between the amount of promised consideration of ₹ 1,21,000 and the cash selling price of ₹ 1,00,000 at the date that the goods are transferred to the customer.

The contract includes an implicit interest rate of 10 per cent (i.e. the interest rate that over 24 months discounts the promised consideration of ₹ 1,21,000 to the cash selling price of ₹ 1,00,000). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception.

Until the entity receives the cash payment from the customer, interest revenue would be recognized in accordance with Ind AS 109. In determining the effective interest rate in accordance with Ind AS 109, the entity would consider the remaining contractual term.

*****

Comparison with AS 7 and AS 9

Point of accounting	Treatment under Ind AS 115	Treatment under AS 9
Cash selling price ₹ 1,00,000 Promised selling price of ₹ 1,21,000	Transaction price will be bifurcated as ₹ 1,00,000 and ₹ 21,000 ₹ 1,00,000 will be recognised as revenue and ₹ 21,000 shall be treated as interest income being a price difference due to financing arrangement involved in the transaction	Transaction price of ₹ 1,21,000 shall be treated as revenue once the risk and rewards are transferred to the customer. Here, there is no requirement to dissect the transaction price to look for multiple element arrangement like financing component.

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Revenue recognized	₹ 1,00,000	₹ 1,21,000
Other income (interest)	₹ 21,000 over 2 years as per Ind AS 109	No interest income is recognized.

*****

Illustration 39 : Determining the discount rate

VT Limited enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is ₹ 1 crore plus a 10% contractual rate of interest, payable in 60 monthly instalments of ₹ 2,12,470.

Determine the discounting rate and the transaction price when -

Case A — Contractual discount rate reflects the rate in a separate financing transaction.

Case B — Contractual discount rate does not reflect the rate in a separate financing transaction ie 14%.

Solution

Case A — Contractual discount rate reflects the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, VT Limited observes that the 10% contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (i.e. the contractual rate of interest of 10% reflects the credit characteristics of the customer).

The market terms of the financing mean that the cash selling price of the equipment is ₹ 1 crore. This amount is recognized as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with Ind AS 109.

Case B — Contractual discount rate does not reflect the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 10% contractual rate of interest is significantly lower than the 14% interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (i.e. the contractual rate of interest of 10% does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than ₹ 1 crore.

VT Limited determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 14% interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is

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₹ 9,131,346 (60 monthly payments of ₹ 212,470 discounted at 14%). The entity recognizes revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with Ind AS 109.

*****

Illustration 40 : Advance payment and assessment of discount rate

ST Limited enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (i.e. the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options:

1) Payment of ₹ 5,000 in two years when the customer obtains control of the asset or

2) Payment of ₹ 4,000 when the contract is signed. The customer elects to pay ₹ 4,000 when the contract is signed.

ST Limited concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

The interest rate implicit in the transaction is 11.8 per cent, which is the interest rate necessary to make the two alternative payment options economically equivalent. However, the entity determines that, the rate that should be used in adjusting the promised consideration is 6%, which is the entity's incremental borrowing rate.

Pass journal entries showing how the entity would account for the significant financing component.

Solution

Journal Entries showing accounting for the significant financing component:

(a) Recognize a contract liability for the ₹ 4,000 payment received at contract inception:

Cash	Dr.	₹ 4,000	
To Contract liability			₹ 4,000

(b) During the two years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration and accretes the contract liability by recognizing interest on ₹ 4,000 at 6% for two years:

Interest expense	Dr.	₹ 494*	
To Contract liability			₹ 494
* ₹ 494 = ₹ 4,000 contract liability × (6% interest per year for two years).			

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(c) Recognize revenue for the transfer of the asset:

Contract liability	Dr.	₹ 4,494	
To Revenue			₹ 4,494

*****

Ind AS 115.62 contains an overriding provision, which specifies that, a contract with a customer would not have a significant financing component if any of the following factors exist:

(a) the **customer paid for the goods or services in advance** and the timing of the transfer of those goods or services is at the discretion of the customer. For example, consider a prepaid card for mobile phone services, wherein the customer has the discretion to avail mobile services within a certain band of time.

(b) a **substantial amount of the consideration promised by the customer is variable** and the amount or **timing** of that consideration varies on the basis of the occurrence or non-occurrence of a future event that is **not substantially within the control of the customer or the entity** (for example, if the consideration is a sales-based royalty).

(c) the difference between the promised consideration and the cash selling price of the goods or service arises for **reasons other than the provision of finance to either the customer or the entity**, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

Illustration 41 : Withheld payments on a long-term contract

ABC Limited enters into a contract for the construction of a power plant that includes scheduled milestone payments for the performance by ABC Limited throughout the contract term of three years. The performance obligation will be satisfied over time and the milestone payments are scheduled to coincide with the expected performance by ABC Limited. The contract provides that a specified percentage of each milestone payment is to be withheld as retention money by the customer throughout the arrangement and paid to the entity only when the building is complete.

Analyse whether the contract contains any financing component.

Solution

ABC Limited concludes that the contract does not include a significant financing component since the milestone payments coincide with its performance and the contract requires amounts to be retained for reasons other than the provision of finance. The withholding of a specified

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percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

*****

Illustration 42 : Advance payment

XYZ Limited, a personal computer (PC) manufacturer, enters into a contract with a customer to provide global PC support and repair coverage for three years along with its PC. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional ₹ 3,000. Customers electing to buy this service must pay for it upfront (i.e. a monthly payment option is not available).

Analyse whether there is any significant financing component in the contract or not.

Solution

To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximise profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (i.e. customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

In assessing whether or not the contract contains a significant financing component, XYZ Limited determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. XYZ Limited charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks it assumes to provide the service and may make it uneconomical to provide the service. As a result of its analysis, XYZ Limited concludes that there is not a significant financing component.

*****

Illustration 43 : Advance payment

A computer hardware vendor enters into a three-year arrangement with a customer to provide support services. For customers with low credit ratings, the vendor requires the customer to pay

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for the entire arrangement in advance of the provision of service. Other customers pay overtime.

Analyse whether there is any significant financing component in the contract or not.

Solution

Due to this customer's credit rating, the customer pays in advance for the three-year term. Because there is no difference between the amount of promised consideration and the cash selling price (that is, the customer does not receive a discount for paying in advance), the vendor requires payment in advance only to protect against customer non-payment, and no other factors exist to suggest the arrangement contains a financing, the vendor concludes this contract does not provide the customer or the entity with a significant benefit of financing.

*****

Illustration 44 : Sales based royalty

A software vendor enters into a contract with a customer to provide a license solely in exchange for a sales-based royalty.

Analyse whether there is any significant financing component in the contract or not.

Solution

Although the payment will be made in arrears, because the total consideration varies based on the occurrence or non-occurrence of a future event that is not within the control of the customer or the entity, the software vendor concludes the contract does not provide the customer or the entity with a significant benefit of financing.

*****

Illustration 45 : Payment in arrears

An EPC contractor enters into a two-year contract to develop customized machine for a customer. The contractor concludes that the goods and services in this contract constitute a single performance obligation.

Based on the terms of the contract, the contractor determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to the customer. The customer agrees to provide the contractor monthly progress payments, with the final 25 percent payment (holdback payment) due upon contract completion. As a result of the holdback payment, there is a gap between when control transfers and when consideration is received, creating a financing component.

Analyse whether there is any significant financing component in the contract or not.

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Solution

There is no difference between the amount of promised consideration and the cash selling price (that is, the customer did not pay a premium for paying a portion of the consideration in arrears). The payment terms included a holdback payment only to ensure successful completion of the project, and no other factors exist to suggest the arrangement contains a financing. Hence, the contractor concludes this contract does not provide the customer or the contractor with a significant benefit of financing.

*****

Illustration 46 : Payment in arrears

Company Z is a developer and manufacturer of defence systems that is primarily a Tier-II supplier of parts and integrated systems to original equipment manufacturers (OEMs) in the commercial markets. Company Z enters into a contract with Company X for the development and delivery of 5,000 highly technical, specialized missiles for use in one of Company X's platforms.

As a part of the contract, Company X has agreed to pay Company Z for their cost plus an award fee up to ₹ 100 crore. The consideration will be paid by the customer related to costs incurred near the time Company Z incurs such costs. However, the ₹ 100 crore award fee is awarded upon successful completion of the development and test fire of a missile to occur in 16 months from the time the contract is executed.

The contract specifies Company Z will earn up to ₹ 100 crore based on Company X's assessment of Company Z's ability to develop and manufacture a missile that achieves multiple factors, including final weight, velocity, and accuracy.

Partial award fees may be awarded based on a pre-determined scale based on their success.

Assume Company Z has assessed the contract under Ind AS 115 and determined the award fee represents variable consideration. Based on their assessment, Company Z has estimated a total of ₹ 80 crore in the transaction price related to the variable consideration pursuant to guidance within Ind AS 115. Further, the entity has concluded it should recognize revenue over time for a single performance obligation using a cost-to-cost input method.

Analyse whether there is any significant financing component in the contract or not.

Solution

Company Z will transfer control over time beginning shortly after the contract is executed but will not receive the cash consideration related to the award fee component from Company X for more than one year in the future. Hence, Company Z should assess whether the award fee represents a significant financing component.

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The intention of the parties in negotiating the award fee due upon completion of the test fire, and based on the results of that test fire, was to provide incentive to Company Z to produce high functioning missiles that achieved successful scoring from Company X. Therefore, it was determined the contract does not contain a significant financing component, and Company Z should not adjust the transaction price.

*****

As per Ind AS 115.63, as a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between:

(a) when the entity transfers a promised goods or service to a customer and

(b) when the customer pays for that goods or service

will be one year or less.

Illustration 47 : Applying practical expedient

Company H enters into a two-year contract to develop customized software for Company C. Company H concludes that the goods and services in this contract constitute a single performance obligation.

Based on the terms of the contract, Company H determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to Company C.

Company C agrees to provide Company H monthly progress payments. Based on the expectation of the timing of costs to be incurred, Company H concludes that progress payments are being made such that the timing between the transfer of control and payment is never expected to exceed one year.

Analyse whether there is any significant financing component in the contract or not.

Solution

Company H concludes it will not need to further assess whether a significant financing component is present and does not adjust the promised consideration in determining the transaction price, as they are applying the practical expedient under Ind AS 115.

As per Ind AS 115.65, an entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of profit and loss. Interest revenue or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer.

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7.3 Non-cash consideration

Sometimes a customer promises to pay for a goods or service in a form other than cash, such as shares of common stock or other equity instruments, advertising, or equipment.

To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall:

- In the first instance, measure the non-cash consideration (or promise of non-cash consideration) at fair value.
- And, if it cannot reasonably estimate the fair value of the non-cash consideration, it shall measure the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer (or a class of customers) in exchange for the consideration.

The fair value of non-cash consideration may change both because of the form of consideration (e.g. a change in the price of a share an entity is entitled to receive from a customer) and for reasons other than the form of consideration (e.g. a change in the exercise price of a share option because of the entity's performance).

7.3.1 Subsequent measurement of non-cash consideration

- If the fair value of the non-cash consideration varies after contract inception because of its form (for example, a change in the price of a share to which an entity is entitled to receive from a customer), the entity does not adjust the transaction price for any changes in the fair value of the consideration.

Illustration 48 : Entitlement to non-cash consideration

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on 1st April, 20X1 and work begins immediately. The entity concludes that the service is a single performance obligation. This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

In exchange for the service, the customer promises its 100 equity shares per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

How should the entity decide the transaction price?

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Solution

The entity measures its progress towards complete satisfaction of the performance obligation as each week of service is complete. To determine the transaction price (and the amount of revenue to be recognized), the entity has to measure the fair value of 100 shares that are received upon completion of each weekly service. The entity shall not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

*****

- If the fair value of the non-cash consideration promised by a customer varies for reasons other than only the form of the consideration (for example, the fair value could vary because of the entity's performance), the entity is required to apply the guidance on variable consideration and the constraint when determining the transaction price.

Illustration 49 : Fair value of non-cash consideration varies for reasons other than the form of the consideration

RT Limited enters into a contract to build an office building for AT Limited over an 18-month period. AT Limited agrees to pay the construction entity ₹ 350 crore for the project. RT Limited will receive a bonus of 10 lakh equity shares of AT Limited if it completes construction of the office building within one year. Assume a fair value of ₹ 100 per share at contract inception.

Determine the transaction price.

Solution

The ultimate value of any shares the entity might receive could change for two reasons:

1) the entity earns or does not earn the shares and

2) the fair value per share may change during the contract term.

When determining the transaction price, the entity would reflect changes in the number of shares to be earned. However, the entity would not reflect changes in the fair value per share. Said another way, the share price of ₹ 100 is used to value the potential bonus throughout the life of the contract.

As a result, if the entity earns the bonus, its revenue would be ₹ 350 crore plus 10 lakh equity shares at ₹ 100 per share for total consideration of ₹ 360 crore.

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Illustration 50 : Non-cash consideration - Free advertising

Production Company Y sells a television show to Television Company X. The consideration under the arrangement is a fixed amount of ₹ 1,000 and 100 advertising slots. Y determines that the stand-alone selling price of the show would be ₹ 1,500. Based on market rates, Y determines that the fair value of the advertising slots is ₹ 600.

Determine the transaction price.

Solution

Y determines that the transaction price is ₹ 1,600, comprising of ₹ 1,000 fixed amount plus the fair value of the advertising slots ie ₹ 600.

If the fair value of the advertising slots could not be reasonably estimated, then the transaction price would be ₹ 1,500 i.e. Y would use the stand-alone selling price of the goods or services promised for the non-cash consideration.

*****

7.3.2 Customer-provided goods or services

If a customer contributes goods or services (for example, materials, equipment or labour) to facilitate an entity's fulfilment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as non-cash consideration received from the customer.

Illustration 51 : Customer-provided goods or services

MS Limited is a manufacturer of cars. It has a supplier of steering systems – SK Limited. MS Limited places an order of 10,000 steering systems on SK Limited. It also agrees to pay ₹ 25,000 per steering system and contributes tooling to be used in SK's production process.

The tooling has a fair value of ₹ 2 crore at contract inception. SK Limited determines that each steering system represents a single performance obligation and that control of the steering system transfers to MS Limited upon delivery.

SK Limited may use the tooling for other projects and determines that it obtains control of the tooling.

Determine the transaction price?

Solution

As a result, SK Limited includes the fair value of the tooling in the transaction price at contract inception, which it determines to be ₹ 27 crore (₹ 25 crore for the steering systems and ₹ 2 crore for the tooling).

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7.4 Consideration payable to a customer

The rationale behind the accounting provisions related to "consideration payable to a customer" is that an entity should not overstate its revenue by amounts given to customers in a contract that it will receive back through the purchase of its goods or services.

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer).

The key to appropriately accounting for consideration payable to a customer is determining whether the payment is made in exchange for a distinct goods or service:

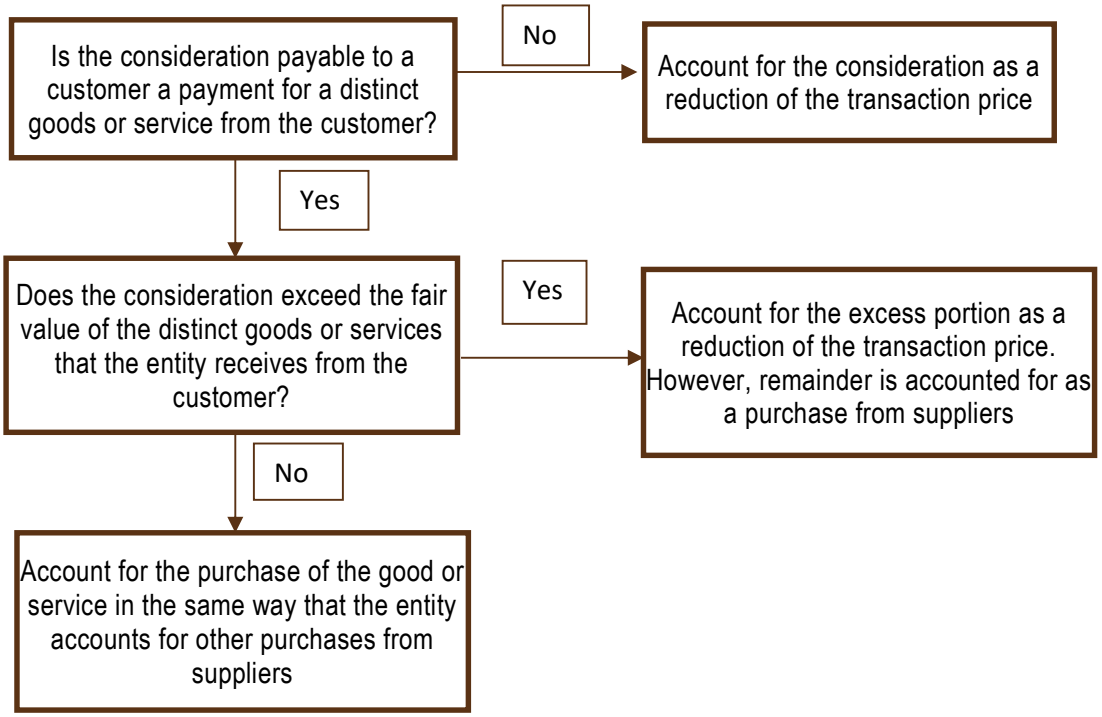
- When the entity receives a goods or service from the customer, it applies the guidance in Step 2 in identifying its performance obligations to determine if that goods or service is distinct.

  When an entity concludes that the consideration paid to a customer is in exchange for a distinct goods or service, it accounts for the distinct goods or service as it would any other purchase from a supplier, as long as the consideration paid does not exceed the fair value of the goods or services received. When the consideration exceeds the fair value of the distinct goods or services received, any excess is accounted for as a reduction in the transaction price. If the entity cannot reasonably estimate the fair value of the goods or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

- If, on the other hand, the entity concludes that the consideration paid to the customer is not in exchange for a distinct goods or service, the entity would reduce the transaction price by the amount it pays or owes the customer.

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The below diagram summarises the guidance above:



If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with accounting guidance on "variable consideration" discussed earlier.

As per Ind AS 115.72, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

(a) the entity recognizes revenue for the transfer of the related goods or services to the customer; and

(b) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

Consideration paid or payable to a customer can take many different forms. Therefore, entities will have to carefully evaluate each transaction to determine the appropriate treatment of such amounts. Some common examples of consideration paid to a customer are given below:

1. **Slotting fees –** Manufacturers of consumer products commonly pay retailers fees to have their goods displayed prominently on store shelves. Those shelves can be physical (i.e. in

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a building where the store is located) or virtual (i.e. they represent space in an internet reseller's online catalogue). Generally, such fees do not provide a distinct goods or service to the manufacturer and are treated as a reduction of the transaction price.

Example 5

A producer entity sells energy drinks to a retailer, a convenience store. Producer also pays Retailer a fee to ensure that its products receive prominent placement on store shelves, to attract the customer's eyeballs so that chances of sales of its products are higher. The fee is negotiated as part of the contract for sale of the energy drinks. In this case, Producer should reduce the transaction price for the sale of the energy drinks by the amount of slotting fees paid to Retailer. Producer does not receive a goods or service that is distinct in exchange for the payment to Retailer.

2. **Co-operative advertising arrangements –** In some arrangements, a vendor agrees to reimburse a reseller for a portion of costs incurred by the reseller to advertise the vendor's products. The determination of whether the payment from the vendor is in exchange for a distinct goods or service at fair value will depend on a careful analysis of the facts and circumstances of the contract.

Example 6

Mobile-Co sells 1,000 phones to Retailer for ₹ 10,00,000. The contract includes an advertising arrangement that requires Mobile-Co to pay ₹ 1,00,000 toward a specific advertising promotion that Retailer will provide. The retailer will provide the advertising on strategically located billboards and in local advertisements. Mobile-Co could have elected to engage a third party to provide similar advertising services at a cost of ₹ 1,00,000. In this case, Mobile-Co should account for the payment to Retailer consistent with other purchases of advertising services. The payment from Mobile-Co to the Retailer is consideration for a distinct service provided by Retailer and reflects fair value. The advertising is distinct because Mobile-Co could have engaged a third party who is not its customer to perform similar services. The transaction price is ₹ 10,00,000 and is not affected by the payment made by Retailer for the sale of the phones. However, it is to be noted here that, if price paid to retailer for this service is not the fair value of such advertising services, then any excess paid to retailer over the fair value of said services should be reduced from transaction price.

3. **Price protection –** A vendor may agree to reimburse a retailer up to a specified amount for shortfalls in the sales price received by the retailer for the vendor's products over a specified period of time. Normally such fees do not provide a distinct goods or service to the manufacturer and are treated as a reduction of the transaction price.

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Illustration 52 : Consideration payable to a customer

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least ₹ 15 crore of products during the year. The contract also requires the entity to make a non-refundable payment of ₹ 1.5 crore to the customer at the inception of the contract. The ₹ 1.5 crore payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products. The entity does not obtain control of any rights to the customer's shelves.

Determine the transaction price.

Solution

The entity considers the requirements in paragraphs 70 – 72 of Ind AS 115 and concludes that the payment to the customer is not in exchange for a distinct goods or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 70 of Ind AS 115, the ₹ 1.5 crore payment is a reduction of the transaction price.

The entity applies the requirements in paragraph 72 of Ind AS 115 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognizes revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each goods by 10 per cent [(₹ 1.5 crore ÷ ₹ 15 crore) x 100]. Therefore, in the first month in which the entity transfers goods to the customer, the entity recognizes revenue of ₹ 1.125 crore (₹ 1.25 crore invoiced amount less ₹ 0.125 crore of consideration payable to the customer).

*****

Illustration 53 : Credits to a new customer

Customer C is in the middle of a two-year contract with Telco B Ltd., its current wireless service provider, and would be required to pay an early termination penalty if it terminated the contract today. If C cancels the existing contract with B Ltd. and signs a two-year contract with Telco D Ltd. for ₹ 800 per month, then D Ltd. promises at contract inception to give C a one-time credit of ₹ 2,000 (referred to as a 'port-in credit'). The amount of the port-in credit does not depend on the volume of service subsequently purchased by C during the two-year contract.

Determine the transaction price.

Solution

D Ltd. determines that it should account for the port-in credit as consideration payable to a customer. This is because the credit will be applied against amounts owing to D Ltd. Since, D

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Ltd. does not receive any distinct goods or services in exchange for this credit, it will account for it as a reduction in the transaction price ₹ 17,200 [(₹ 800 x 24 month) – ₹ 2,000]. D Ltd. will recognize the reduction in the transaction price as the promised goods or services are transferred.

*****

8. STEP 4: ALLOCATING THE TRANSACTION PRICE TO PERFORMANCE OBLIGATIONS

Allocation objective- While allocating the transaction price, the objective of the entity should be to allocate the transaction price to each performance obligation (or distinct goods or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

To meet the above allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative stand-alone selling price basis as per the standard, except for allocating discounts and for allocating consideration that includes variable amounts.

Simply put, there are two exceptions to the general allocation guidance:

- allocating discounts, and
- allocating variable consideration

Under these exceptions, an entity allocates a disproportionate amount of the transaction price to specific performance obligations based on evidence that suggests the discount or variable consideration relates to those specific performance obligations.

8.1 Determining stand-alone selling price

To allocate the transaction price on a relative stand-alone selling price basis, an entity must first determine the stand-alone selling price of the distinct goods or service underlying each performance obligation. The stand-alone selling price is the price at which an entity would sell a promised goods or service separately to a customer.

The best evidence of a stand-alone selling price is - **the observable price of a goods or service when the entity sells that goods or service separately in similar circumstances and to similar customers**.

An entity shall determine the stand-alone selling price at contract inception of the distinct goods or service underlying each performance obligation in the contract and allocate the transaction

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price in proportion to those stand-alone selling prices, to allocate the transaction price to each performance obligation on a relative stand-alone selling price basis. Stand-alone selling prices are determined at contract inception and are not updated to reflect changes between contract inception and when performance is complete. Furthermore, if the contract is modified and that modification is treated as a termination of the existing contract and the creation of a new contract (see 5.5.2 above), the entity would update its estimate of the stand-alone selling price at the time of the modification. If the contract is modified and the modification is treated as a separate contract (see 5.5.2.1 above), the accounting for the original contact would not be affected (and the stand-alone selling prices of the underlying goods and services would not be updated), but the stand-alone selling prices of the distinct goods or services of the new, separate contract would have to be determined at the time of the modification.

A contractually stated price or a list price for a goods or service **may be (but shall not be presumed to be)** the stand-alone selling price of that goods or service.

If a stand-alone selling price is not directly observable, for example, the entity does not sell the goods or service separately, an entity shall estimate the stand-alone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 73 above. When estimating a stand-alone selling price, an entity shall consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximise the use of observable inputs and apply estimation methods consistently in similar circumstances.

Evaluating the evidence related to estimating a stand-alone selling price may require significant judgment.

An entity should establish policies and procedures for estimating stand-alone selling price and apply those policies and procedures consistently to similar performance obligations. As a best practice, an entity should document its evaluation of the market conditions and entity-specific factors considered in estimating each stand-alone selling price, including factors that it considers to be irrelevant and the reasons why.

Suitable methods for estimating the stand-alone selling price of a goods or service include, but are not limited to, the following:

(a) **Adjusted market assessment approach**—an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins. Applying this approach will likely be convenient when an entity has sold the goods or service for a period of time (such that it

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has data about customer demand), or a competitor offers similar goods or services that the entity can use as a basis for its analysis. However, applying this approach would be difficult when an entity is selling entirely new goods or service because in that case it may be difficult to anticipate market demand.

(b) **Expected cost plus a margin approach**—an entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that goods or service. When determining which costs to include in the selling price analysis, an entity should develop and consistently apply a methodology that considers direct and indirect costs, as well as other relevant costs considered in its normal pricing practices, such as research and development costs. Determining the margin to use when applying a cost-plus-a-margin approach requires significant judgment, particularly when the entity is not planning to separately sell a product or service. Furthermore, using an expected cost-plus-margin approach may not be appropriate in many circumstances, such as when direct fulfillment costs are not easily identifiable or when costs are not a significant input in setting the price for the goods or services.

(c) **Residual approach**—an entity may estimate the stand-alone selling price by reference to (1) the total transaction price, less (2) the sum of the observable stand-alone selling prices of other goods or services promised in the contract.

However, an entity may use a residual approach to estimate the stand-alone selling price of a goods or service only if one of the following criteria is met:

(i) the entity sells the same goods or service to different customers (at or near the same time) for a broad range of amounts (ie the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence); or

(ii) the entity has not yet established a price for that goods or service and the goods or service has not previously been sold on a stand-alone basis (ie the selling price is uncertain).

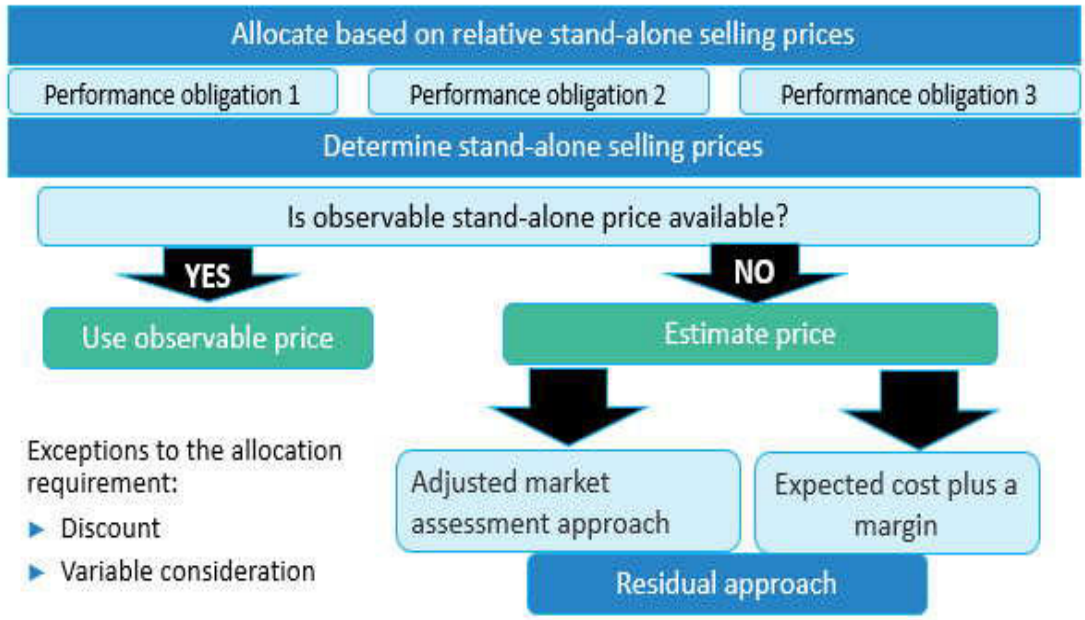
An entity shall allocate the discount before using the residual approach to estimate the stand-alone selling price of a goods or service where the discount is allocated entirely to one or more performance obligations in the contract.

A combination of methods may need to be used to estimate the stand-alone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain stand-alone selling prices. For example, an entity may use a residual approach to estimate the aggregate stand-alone selling price for those promised goods or services with highly variable or uncertain stand-alone selling prices and then use another

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method to estimate the stand-alone selling prices of the individual goods or services relative to that estimated aggregate stand-alone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the stand-alone selling price of each promised goods or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated stand-alone selling prices would be consistent with the allocation objective in paragraph 73 and the requirements for estimating stand-alone selling prices.

Below chart summarises the above concept:



8.1.1 Allocation of a discount

A customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract.

Unless an entity has observable evidence (if (c) criteria below are fulfilled) that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of the underlying distinct goods or services (as discussed earlier).

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When to allocate discount to 'less than all' performance obligations?

As per Ind AS 115.82, an entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract **if all of the following criteria are met**:

(a) the entity regularly sells each distinct goods or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;

(b) the entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and

(c) the discount attributable to each bundle of goods or services described in (b) above is substantially the same as the discount in the contract and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

Note: As a **first step**, always allocate the discount entirely to one or more performance obligations in the contract (if applicable), and then as a **second step**, use the residual approach to estimate the stand-alone selling price of a goods or service.

Illustration 54 : Allocation methodology

An entity enters into a contract with a customer to sell Products A, B and C in exchange for ₹ 10,000. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately and therefore the stand-alone selling price is directly observable. The stand-alone selling prices of Products B and C are not directly observable.

Because the stand-alone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the stand-alone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximises the use of observable inputs.

The entity estimates the stand-alone selling prices as follows:

Product	***Stand-alone selling price***	***Method***
	₹	
Product A	*5,000*	*Directly observable*
Product B	*2,500*	*Adjusted market assessment approach*

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Product C	*7,500*	*Expected cost plus a margin approach*
Total	*15,000*	

Determine the transaction price allocated to each product.

Solution

The customer receives a discount for purchasing the bundle of goods because the sum of the stand-alone selling prices (₹ 15,000) exceeds the promised consideration (₹ 10,000). The entity considers that there is no observable evidence about the performance obligation to which the entire discount belongs. The discount is allocated proportionately across Products A, B and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Allocated transaction price (to nearest ₹100)	
	₹	
Product A	3,300	(₹ 5,000 ÷ ₹ 15,000 × ₹ 10,000)
Product B	1,700	(₹ 2,500 ÷ ₹ 15,000 × ₹ 10,000)
Product C	5,000	(₹ 7,500 ÷ ₹ 15,000 × ₹ 10,000)
Total	10,000	

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Illustration 55 : Allocating a discount

An entity regularly sells Products X, Y and Z individually, thereby establishing the following stand-alone selling prices:

Product	*Stand-alone selling price*
	₹
Product X	*50,000*
Product Y	*25,000*
Product Z	*45,000*
Total	*1,20,000*

In addition, the entity regularly sells Products Y and Z together for ₹ 50,000.

Case A—Allocating a discount to one or more performance obligations

The entity enters into a contract with a customer to sell Products X, Y and Z in exchange for ₹ 100,000. The entity will satisfy the performance obligations for each of the products at different points in time; or Product Y and Z at same point of time. Determine the allocation of

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transaction price to Product Y and Z.

Case B—Residual approach is appropriate

The entity enters into a contract with a customer to sell Products X, Y and Z as described in Case A. The contract also includes a promise to transfer Product Alpha. Total consideration in the contract is ₹ 130,000. The stand-alone selling price for Product Alpha is highly variable because the entity sells Product Alpha to different customers for a broad range of amounts (₹ 15,000 – ₹ 45,000). Determine the stand-alone selling price of Products, X, Y, Z and Alpha using the residual approach.

Case C—Residual approach is inappropriate

The same facts as in Case B apply to Case C except the transaction price is ₹ 1,05,000 instead of ₹ 130,000.

Solution

Case A—Allocating a discount to one or more performance obligations

The contract includes a discount of ₹ 20,000 on the overall transaction, which would be allocated proportionately to all three performance obligations when allocating the transaction price using the relative stand-alone selling price method.

However, because the entity regularly sells Products Y and Z together for ₹ 50,000 and Product X for ₹ 50,000, it has evidence that the entire discount of ₹ 20,000 should be allocated to the promises to transfer Products Y and Z in accordance with paragraph 82 of Ind AS 115.

If the entity transfers control of Products Y and Z at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate ₹ 50,000 of the transaction price to the single performance obligation of Product X and recognize revenue of ₹ 50,000 when Products Y and Z simultaneously transfer to the customer.

If the contract requires the entity to transfer control of Products Y and Z at different points in time, then the allocated amount of ₹ 50,000 is individually allocated to the promises to transfer Product Y (stand-alone selling price of ₹ 25,000) and Product Z (stand-alone selling price of ₹ 45,000) as follows:

Product	Allocated transaction price	
	₹	
Product Y	17,857	(₹ 25,000 ÷ ₹ 70,000 total stand-alone selling price × ₹ 50,000)
Product Z	32,143	(₹ 45,000 ÷ ₹ 70,000 total stand-alone selling price × ₹ 50,000)
Total	50,000	

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Case B—Residual approach is appropriate

Before estimating the stand-alone selling price of Product Alpha using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract.

As in Case A, because the entity regularly sells Products Y and Z together for ₹ 50,000 and Product X for ₹ 50,000, it has observable evidence that ₹ 1,00,000 should be allocated to those three products and a ₹ 20,000 discount should be allocated to the promises to transfer Products Y and Z in accordance with paragraph 82 of Ind AS 115.

Using the residual approach, the entity estimates the stand-alone selling price of Product Alpha to be ₹ 30,000 as follows:

Product	Stand-alone selling price	Method
	₹	
Product X	50,000	Directly observable
Products Y and Z	50,000	Directly observable with discount
Product Alpha	30,000	Residual approach
Total	130,000	

The entity observes that the resulting ₹ 30,000 allocated to Product Alpha is within the range of its observable selling prices (₹ 15,000 – ₹ 45,000).

Case C—Residual approach is inappropriate

The same facts as in Case B apply to Case C except the transaction price is ₹ 1,05,000 instead of ₹ 1,30,000. Consequently, the application of the residual approach would result in a stand-alone selling price of ₹ 5,000 for Product Alpha (₹ 105,000 transaction price less ₹ 1,00,000 allocated to Products X, Y and Z).

The entity concludes that ₹ 5,000 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product Alpha, because ₹ 5,000 does not approximate the stand-alone selling price of Product Alpha, which ranges from ₹ 15,000 – ₹ 45,000.

Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the stand-alone selling price of Product Alpha using another suitable method. The entity allocates the transaction price of ₹ 1,05,000 to Products X, Y, Z and Alpha using the relative stand-alone selling prices of those products in accordance with paragraphs 73–80 of Ind AS 115.

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8.1.2 Allocation of variable consideration

Variable consideration may be attributable to (1) the entire contract or (2) a specific part of the contract, such as either of the following:

(a) one or more, but not all, performance obligations in the contract. For example, a contract may include two performance obligations: the construction of a building and the provision of services related to the ongoing maintenance of the property after construction. But a bonus for early completion may relate entirely to the construction of the building; or

(b) one or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).

How to allocate variable consideration?

In accordance with Ind AS 115.85, an entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct goods or service that forms part of a single performance obligation **if both of the following criteria are met**:

- the terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct goods or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct goods or service); and
- allocating the variable amount of consideration entirely to the performance obligation or the distinct goods or service is consistent with the allocation objective in paragraph 73 when considering all of the performance obligations and payment terms in the contract.

The general principles of allocation of transaction price shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 85 above.

Illustration 56 : Allocation of variable consideration

An entity enters into a contract with a customer for two intellectual property licences (Licences A and B), which the entity determines to represent two performance obligations each satisfied at a point in time. The stand-alone selling prices of Licences A and B are ₹ 16,00,000 and ₹ 20,00,000, respectively. The entity transfers Licence B at inception of the contract and transfers Licence A one month later.

Case A—Variable consideration allocated entirely to one performance obligation

The price stated in the contract for Licence A is a fixed amount of ₹ 16,00,000 and for Licence B the consideration is three per cent of the customer's future sales of products that use Licence B.

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For purposes of allocation, the entity estimates its sales-based royalties (ie the variable consideration) to be ₹ 20,00,000. Allocate the transaction price.

Case B — Variable consideration allocated on the basis of stand-alone selling prices

The price stated in the contract for Licence A is a fixed amount of ₹ 6,00,000 and for Licence B the consideration is five per cent of the customer's future sales of products that use Licence B. The entity's estimate of the sales-based royalties (ie the variable consideration) is ₹ 30,00,000. Here, Licence A is transferred 3 months later. The royalty due from the customer's first month of sale is ₹ 4,00,000.

Allocate the transaction price and determine the revenue to be recognized for each licence and the contract liability, if any.

Solution

Case A—Variable consideration allocated entirely to one performance obligation

To allocate the transaction price, the entity considers the criteria in paragraph 85 and concludes that the variable consideration (ie the sales-based royalties) should be allocated entirely to Licence B. The entity concludes that the criteria are met for the following reasons:

(a) the variable payment relates specifically to an outcome from the performance obligation to transfer Licence B (ie the customer's subsequent sales of products that use Licence B).

(b) allocating the expected royalty amounts of ₹ 20,00,000 entirely to Licence B is consistent with the allocation objective in paragraph 73 of Ind AS 115. This is because the entity's estimate of the amount of sales-based royalties (₹ 20,00,000) approximates the stand-alone selling price of Licence B and the fixed amount of ₹ 16,00,000 approximates the stand-alone selling price of Licence A. The entity allocates ₹ 16,00,000 to Licence A. This is because, based on an assessment of the facts and circumstances relating to both licences, allocating to Licence B some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 73 of Ind AS 115.

The entity transfers Licence B at inception of the contract and transfers Licence A one month later. Upon the transfer of Licence B, the entity does not recognize revenue because the consideration allocated to Licence B is in the form of a sales-based royalty. Therefore, the entity recognizes revenue for the sales-based royalty when those subsequent sales occur.

When Licence A is transferred, the entity recognizes as revenue the ₹ 16,00,000 allocated to Licence A.

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Case B—Variable consideration allocated on the basis of stand-alone selling prices

To allocate the transaction price, the entity applies the criteria in paragraph 85 of Ind AS 115 to determine whether to allocate the variable consideration (ie the sales-based royalties) entirely to Licence B.

In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer Licence B (ie the customer's subsequent sales of products that use Licence B), allocating the variable consideration entirely to Licence B would be inconsistent with the principle for allocating the transaction price. Allocating ₹ 6,00,000 to Licence A and ₹ 30,00,000 to Licence B does not reflect a reasonable allocation of the transaction price on the basis of the stand-alone selling prices of Licences A and B of ₹ 16,00,000 and ₹ 20,00,000, respectively. Consequently, the entity applies the general allocation requirements of Ind AS 115.

The entity allocates the transaction price of ₹ 6,00,000 to Licences A and B on the basis of relative stand-alone selling prices of ₹ 16,00,000 and ₹ 20,00,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative stand-alone selling price basis. However, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognize revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

Licence B is transferred to the customer at the inception of the contract and Licence A is transferred three months later. When Licence B is transferred, the entity recognizes as revenue ₹ 3,33,333 [(₹ 20,00,000 ÷ ₹ 36,00,000) × ₹ 6,00,000] allocated to Licence B. When Licence A is transferred, the entity recognizes as revenue ₹ 2,66,667 [(₹ 16,00,000 ÷ ₹ 36,00,000) × ₹ 6,00,000] allocated to Licence A.

In the first month, the royalty due from the customer's first month of sales is ₹ 4,00,000. Consequently, the entity recognizes as revenue ₹ 2,22,222 (₹ 20,00,000 ÷ ₹ 36,00,000 × ₹ 4,00,000) allocated to Licence B (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognizes a contract liability for the ₹ 1,77,778 (₹ 16,00,000 ÷ ₹ 36,00,000 × ₹ 4,00,000) allocated to Licence A. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

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8.2 Changes in the transaction price

After contract inception, the transaction price can change for various reasons, including the

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resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

The following principles should be noted:

- An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. **Consequently, an entity shall not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception.**
- Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

When reallocating consideration because of a change in the transaction price, the entity continues to allocate the variable amount entirely to a performance obligation or to a distinct goods or service that forms part of a single performance obligation if the criteria in Ind AS 115.85 (as discussed above) continue to be met.

If the change in transaction price is the result of a contract modification, the entity should follow the contract modification guidance.

However, when the transaction price changes after a modification, the entity should allocate the change in transaction price to the performance obligations identified before the modification if both:

- The change in the transaction price is attributable to variable consideration promised prior to the modification.
- The modification is accounted for as a termination of the old contract and the creation of a new contract.

An entity allocates all other changes in the transaction price to performance obligations under the modified contract (i.e. the performance obligations that were unsatisfied or partially satisfied immediately after the modification) as long as the modification was not accounted for as a separate contract.

Changes in the transaction price should be allocated entirely to one or more, but not all, distinct goods or services promised in a series that forms part of a single performance obligation if the criteria for allocating variable consideration are met.

Comparison with AS 7 and AS 9

Subsequent changes in transaction price are not specifically dealt with either AS 7 or AS 9 unlike in Ind AS 115.

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Illustration 57 : Allocating a change in transaction price

On 1st April, 20X0, a consultant enters into an arrangement to provide due diligence, valuation, and software implementation services to a customer for ₹ 2 crore. The consultant can earn ₹ 20 lakh bonus if it completes the software implementation by 30th September, 20X0 or ₹ 10 lakh bonus if it completes the software implementation by 31st December, 20X0.

The due diligence, valuation, and software implementation services are distinct and therefore are accounted for as separate performance obligations. The consultant allocates the transaction price, disregarding the potential bonus, on a relative stand-alone selling price basis as follows:

- *Due diligence – ₹ 80 lakh*
- *Valuation – ₹ 20 lakh*
- *Software implementation – ₹ 1 crore*

At contract inception, the consultant believes it will complete the software implementation by 30th January, 20X1. After considering the factors in Ind AS 115, the consultant cannot conclude that a significant reversal in the cumulative amount of revenue recognized would not occur when the uncertainty is resolved since the consultant lacks experience in completing similar projects. As a result, the consultant does not include the amount of the early completion bonus in its estimated transaction price at contract inception.

On 1st July, 20X0, the consultant notes that the project has progressed better than expected and believes that implementation will be completed by 30th September, 20X0 based on a revised forecast. As a result, the consultant updates its estimated transaction price to reflect a bonus of ₹ 20 lakh.

After reviewing its progress as of 1st July, 20X0, the consultant determines that it is 100 percent complete in satisfying its performance obligations for due diligence and valuation and 60 percent complete in satisfying its performance obligation for software implementation.

Determine the transaction price.

Solution

On 1st July, 20X0, the consultant allocates the bonus of ₹ 20 lakh to the software implementation performance obligation, for total consideration of ₹ 1.2 crore allocated to that performance obligation and adjusts the cumulative revenue to date for the software implementation services to ₹ 72 lakh (60 percent of ₹ 1.2 crore).

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Illustration 58 : Discretionary credit

Telco G Ltd. grants a one-time credit of ₹ 50 to a customer in Month 14 of a two-year contract. The credit is discretionary and is granted as a commercial gesture, not in response to prior service issues (often referred to as a 'retention credit'). The contract includes a subsidised handset and a voice and data plan. G Ltd. does not regularly provide these credits and therefore customers do not expect them to be granted.

How this will be accounted for under Ind AS 115?

Solution

G Ltd. concludes that this is a change in the transaction price and not a variable consideration. Since, the credit does not relate to a satisfied performance obligation, the change in transaction price resulting from the credit is accounted for as a contract modification and recognized over the remaining term of the contract. If, in this example, rather than providing a one-time credit, G Ltd. granted a discount of ₹ 5 per month for the remaining contract term, then also G Ltd. would conclude that it was a change in the transaction price. It would apply the contract modification guidance and recognize the credit over the remaining term of the contract.

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9. STEP 5: SATISFYING PERFORMANCE OBLIGATION

An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised goods or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains **control** of that asset.

In other words, the transfer of 'control' is the key determinant under Ind AS 115. Decision making on how 'control' will be transferred to the customer is done at the inception of transaction.

Following is a diagrammatic presentation of the aforesaid guidance:

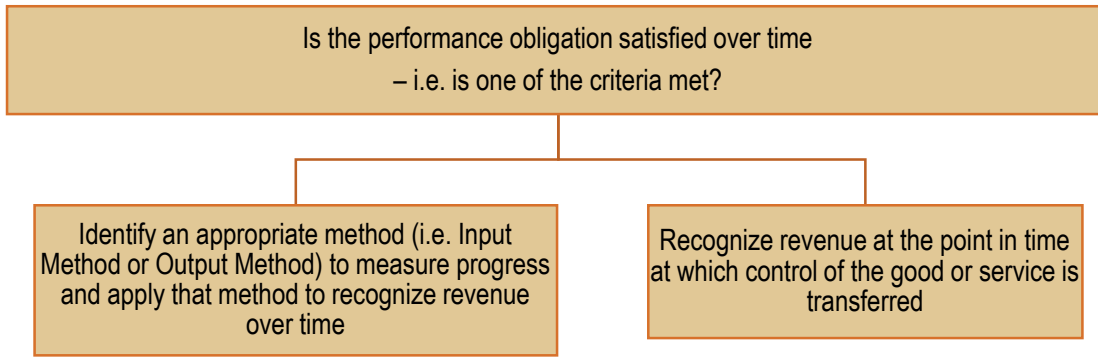


Therefore, the key questions that need to be answered at contract inception to determine if the seller has satisfied its performance obligation are –

- Establish **what does transfer of control mean** in the context of the arrangement between the parties?

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- Does the customer acquire **control over a period of time or at a point in time**?



9.1 What does transfer of control mean?

Control is...	
the ability	– The customer has a present right
to direct the use of	– The right enables it to: - deploy the asset in its activities - allow another entity to deploy the asset in its activities - prevent another entity from deploying the asset
and obtain the remaining benefits from	– The right also enables it to obtain potential cash flows directly or indirectly – e.g. through: - use of the asset - consumption of the asset - sale or exchange of the asset - pledging the asset - holding the asset
... an asset	

Control of an asset refers to –

(i) the **ability to direct the use** of, and obtain substantially all of the remaining benefits from, the asset.

(ii) Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

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- The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:
  (a) using the asset to produce goods or provide services (including public services);
  (b) using the asset to enhance the value of other assets;
  (c) using the asset to settle liabilities or reduce expenses;
  (d) selling or exchanging the asset;
  (e) pledging the asset to secure a loan; and
  (f) holding the asset.
- In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:
  (a) The entity has a present right to payment for the asset;
  (b) The customer has legal title to the asset;
  (c) The entity has transferred physical possession of the asset;
  (d) The customer has the significant risks and rewards of ownership of the asset;
  (e) The customer has accepted the asset.

The standard indicates that an entity must determine, at contract inception, whether it will transfer control of a promised goods or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

To help entities determine whether control transfers over time (rather than at a point in time), the standard states below guidance:

9.2 Does the customer acquire control over a period of time or at a point in time?

9.2.1 Transfer of control over a period of time:

Per para 35 of Ind AS 115, an entity transfers control of a goods or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if **any** of the following criteria is met:

Criteria (a) – The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

Or

Criteria (b) – the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced; or

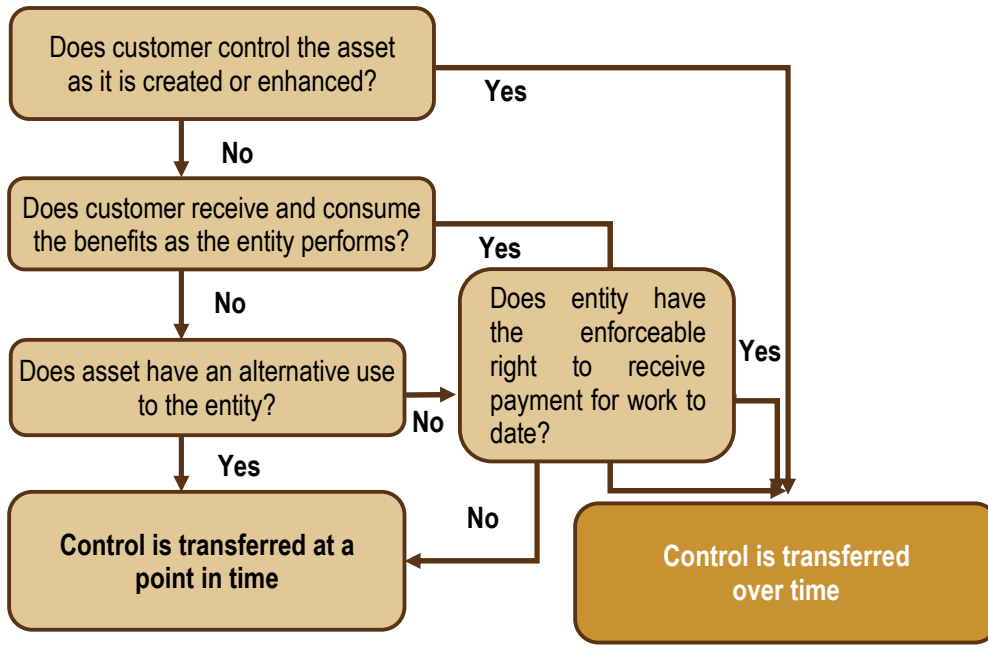
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Or

Criteria (c) – the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Following diagram below depicts if the control is transferred over a period of time.

- If any of the criteria are met, then revenue is recognized over a period of time.
- If none of the criteria are met, then revenue is recognized at a point in time.



In this regard, it is important to understand how each of the above criteria are evaluated –

Criteria (a) – Customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs

This criterion is ordinarily applied in situations in which the benefits of seller's performance are immediately consumed by the customer, for eg.: routine or recurring services in which the consumer consumes the benefits immediately as the services are performed, which means that the customer obtains control of seller entity's output as soon as the entity performs.

Hence, in such situations, entity's performance is said to be performed over a period of time.

Illustration 59

Minitek Ltd. is a payroll processing company. Minitek Ltd. enters into a contract to provide monthly payroll processing services to ABC limited for one year. Determine how entity will recognize the revenue?

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Solution

Payroll processing is a single performance obligation. On a monthly basis, as Minitek Ltd carries out the payroll processing –

- The customer, ie, ABC Limited simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction.
- Further, once the services have been performed for a particular month, in case of termination of the agreement before maturity and contract is transferred to another entity, then such new entity will not need to re-perform the services for expired months.

Therefore, it satisfies the first criterion, ie, services completed on a monthly basis are consumed by the entity at the same time and hence, revenue shall be recognized over the period of time.

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For certain performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In such cases, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date if that other entity were to fulfil the remaining performance obligation to the customer.

In making such determination, an entity shall make both of the following assumptions:

(a) disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity; and

(b) presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any work in progress.

Illustration 60

T&L Limited ('T&L') is a logistics company that provides inland and sea transportation services. A customer – Horizon Limited ('Horizon') enters into a contract with T&L for transportation of its goods from India to Sri Lanka through sea. The voyage is expected to take 20 days from Mumbai to Colombo. T&L is responsible for shipping the goods from Mumbai port to Colombo port.

Whether T&L's performance obligation is met over period of time?

Solution

T&L has a single performance to ship the goods from one port to another. The following factors are critical for assessing how services performed by T&L are consumed by the customer –

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- As the voyage is performed, the service undertaken by T&L is progressing, such that no other entity will need to re-perform the service till so far as the voyage has been performed, if T&L was to deliver only part-way.
- The customer is directly benefitting from the performance of the voyage as & when it progresses.

Therefore, such performance obligation is said to be met over a period of time.

*****

Criteria (b) – the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced. Refer guidance on "control" given at the beginning of this section.

- In such cases, the customer ordinarily obtains control of the asset whose work is in progress and therefore, the entity carrying out the work can recognize revenue over a period of time.
- Ordinarily, this criterion is applied to the following type of contracts with customers:

  (a) Construction contracts, wherein the contractor engages to construct a specific asset for the customer on customer's land;

  (b) Contracts with the government, wherein the government agency is ordinarily entitled to any work in process performed by the service provider.

Criteria (c) – the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Where a customer does not meet either criterion (a) or criterion (b), the seller entity evaluates the third and last criterion to determine if performance obligation is satisfied over a period of time.

- This criterion refers to situations in which an asset is created at customer's discretion, which the seller is restricted from using for any other purpose and at the same time, the seller entity reserves a right to seek payment for work in process. Therefore, this criterion is met if two factors exist simultaneously –

  (i) The asset so created does not have an alternate use to the entity; and

  (ii) Seller entity has a legally enforceable right to payment for performance completed to date.

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Asset has no alternate use to Seller entity	This evaluation is done at contract inception and involves consideration of following factors – ❖ For the asset created - Seller is restricted contractually from readily directing the asset for another use during its creation or enhancement; or ❖ The seller is limited practically from readily directing the asset in it completed state for another use.

And

Legally enforceable right to payment for work completed	❖ An entity has a right to payment at all times that at least compensates for performance completed to date, i.e, an amount that approximates selling price of goods which is equal to cost of goods plus a reasonable profit margin ❖ Legally enforceable right comes from operation of law or legal precedent that could supplement or override contractual terms. This may be affected if company's customary business practice is to not enforce payment if customer defaults, etc.

Let's take a closer look at each of the above-mentioned factors.

❖ **Asset does not have alternate use to the seller entity:**

This evaluation is carried out at inception of transaction and is not reassessed unless the contract is substantially modified. In doing this assessment, the entity shall consider the practical limitations and/ or contractual restrictions in redirecting the asset for another use, like selling to another customer.

➢ A ***contractual restriction*** referred to above must be substantive, ie, a customer should be able to enforce its right to the asset if at any time the seller tries to redirect the asset to another customer. Therefore, if any customer's right to an asset is inter-changeable with other equivalent assets, then the right is not substantive to restrict the seller entity from redirecting the use of the asset.

➢ A ***practical limitation*** exists when the seller entity would require incurring significant economic losses to direct the asset for another use, such that the seller is practically limited from doing so. This may occur, for example, if the costs of rework of the asset are significant to direct for another use, or a significant loss would occur upon selling the asset to another customer, etc.

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❖ **Right to payment for performance completed to date**

- An entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised.
- Such a right to enforce payment should result in **compensation for the costs incurred by the entity for work completed to date, plus a reasonable profit margin**. A meagre compensation for potential loss of profit, if the contract was to be terminated does not tantamount to legally enforceable right for work completed to date.
- Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

  (a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party); or

  (b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

- Sometimes, the right of the entity need not be a present unconditional right. Entity may have a right to seek payment only upon achievement of specific milestones or upon completion of entire performance obligation. In such case, entity would need to determine if it has a right to enforce payment, in case the contract was to be terminated prior to completion, for reasons other than company's failure to perform.
- Also, sometimes termination clauses in an agreement may not provide the customer with right to cancel or terminate. In such cases, if the customer seeks cancellation, the entity may still have a right to complete performance and seek payment for work carried out.
- Alternatively, if the contract provides for right to demand payment as work progresses, but customer may have a right to refund if he proposes to terminate the contract before completion. In such cases, entity cannot be said to have a right to enforce payment for work completed to date.

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Illustration 61

AFS Ltd. is a risk advisory firm and enters into a contract with a company – WBC Ltd to provide audit services that results in AFS issuing an audit opinion to the Company. The professional opinion relates to facts and circumstances that are specific to the company. If the Company was to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the Company to compensate the risk advisory firm for its costs incurred plus a 15 per cent margin. The 15 per cent margin approximates the profit margin that the entity earns from similar contracts.

Whether risk advisory firm's performance obligation is met over period of time?

Solution

AFS has a single performance to provide an opinion on the professional audit services proposed to be provided under the contract with the customer. Evaluating the criterion for recognizing revenue over a period of time or at a point in time, Ind AS 115 requires one of the following criteria to be met –

- Criterion (a) – whether the customer simultaneously receives and consumes the benefits from services provided by AFS: Company shall benefit only when the audit opinion is provided upon completion. Further, in case the contract was to be terminated, any other firm engaged to perform similar services will have to substantially re-perform.

  Hence, this criterion is not met.

- Criterion (b) – An asset created that customer controls: This is service contract and no asset created, over which customer acquires control.

- Criterion (c) – no alternate use to entity and right to seek payment:

  - ❖ The services provided by AFS are specific to the company – WBC and do not have any alternate use to AFS

  - ❖ Further, AFS has a right to enforce payment if the contract was early terminated, for reasons other than AFS's failure to perform. And the profit margin approximates what the entity otherwise earns.

Therefore, criterion (c) is met, and such performance obligation is said to be met over a period of time.

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Illustration 62

Space Ltd. enters into an arrangement with a government agency for construction of a space satellite. Although Space Ltd is in the business of building such satellites for various customers across the world, the specifications for each satellite may vary based on technology that is incorporated in the satellite. In the event of termination, Company has a right to enforce payment for work completed to date.

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time.

Solution

While evaluating the pattern of transfer of control to the customer, the Company shall evaluate conditions laid in para 35 of Ind AS 115 as follows:

- Criterion (a) – whether the customer simultaneously receives and consumes the benefits: Customer can benefit only when the satellite is fully constructed, and no benefits are consumed as its constructed. Hence, this criterion is not met.
- Criterion (b) – An asset created that customer controls: Per provided facts, the customer does not acquire control of the asset as its created.
- Criterion (c) – no alternate use to entity and right to seek payment:
  - ❖ The asset is being specifically created for the customer. The asset is customised to customer's requirements, such that any diversion for a different customer will require significant work. Therefore, the asset has practical limitation in being put to alternate use.
  - ❖ Further, Space Ltd. has a right to enforce payment if the contract was terminated early, for reasons other then Space Ltd.'s failure to perform.

  Therefore, criterion (c) is met and such performance obligation is said to be met over a period of time.

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Illustration 63

ABC enters into a contract with a customer to build an item of equipment. The customer pays 10% advance and then 80% in instalments of 10% each over the period of construction with balance 10% payable at the end of construction period. The payments are non-refundable unless the company fails to perform as per the contract. Further, if the customer terminates the contract, then entity is entitled to retain payments made. The company will have no further right to compensation from the customer.

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time.

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Solution

The Company shall evaluate conditions laid in para 35 of Ind AS 115 as follows:

- Criterion (a) – whether the customer simultaneously receives and consumes the benefits: Customer can benefit only when the asset is fully constructed and no benefits are consumed as its constructed. Hence, this criterion is not met.
- Criterion (b) – An asset created that customer controls: As per provided facts, the customer does not acquire control of the asset as it is created.
- Criterion (c) – no alternate use to entity and right to seek payment:
  - ❖ The customer has specific right over the asset and company does not have right to divert it for any alternate use. In other words, there is contractual restriction to use the asset for any alternate purpose.
  - ❖ In the event of early termination, Company has a right to retain any payments made by the customer. However, such payments need not necessarily compensate the selling price of the partially constructed asset, if the customer was to stop making payments.

  Therefore, Company does not have a legally enforceable right to payment for work completed to date and the criterion under para 35 is not satisfied. Thus, revenue cannot be recognized over a period of time.

*****

All above discussed three criteria can be summarized in below diagram:

	Criterion	Example
1.	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs	Routine or recurring services – e.g. cleaning services, Routine transaction processing services, Hotel management services.
2.	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced	Building an asset on a customer's site
3.	The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date	Building a specialized/highly customized asset that only the customer can use or building an asset according to a customer's specifications

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When an entity has determined that a performance obligation is satisfied over time, the standard requires the entity to select a single revenue recognition method for the relevant performance obligation. The objective is to faithfully depict an entity's performance in transferring control of goods or services promised to a customer (i.e. the satisfaction of an entity's performance obligation). The standard provides two methods for recognizing revenue on contracts involving the transfer of goods and services over time: input methods and output methods.

Methods of measuring progress of a performance obligation satisfied over time

Output Methods	Input Methods
Recognize revenue based on direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.	Recognize revenue based on the **entity's efforts or inputs** to the satisfaction of a performance obligation.
For Example: Surveys of performance completed to date, appraisals of results achieved	**For Example**: Resources consumed labour hours expended, costs incurred, time elapsed or machine hours used

A. Output methods:

- Output methods recognize revenue on the basis of direct measurements of the value, to the customer, of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed and units produced or units delivered. Output method is selected if it would faithfully depict the entity's performance towards complete satisfaction of the performance obligation. It may not be useful in depicting the entity's performance if it would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in progress or finished goods controlled by the customer that are not included in the measurement of the output.

- **As a practical expedient** – if a company has a right to consideration from a customer in an amount which corresponds directly with the value billed to the customer of the entity's performance completed to date, then company may recognize revenue for the amount to which the entity has a right to invoice. For eg.: a service contract in which entity bills a fixed amount for each hour of service provided, etc.

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B. Input methods:

- Input methods recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (e.g. resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

- While applying input method, a careful consideration should be given for events that do not depict a direct relationship between entity's inputs and transfer of control of goods or services. For example, when cost-based input method is used, an adjustment may be required in the following cases –

  (a) When any cost incurred does not contribute to an entity's progress in satisfying performance obligation – any excess costs incurred owing to entity's inefficiencies that were not reflected in the price of the contract must be ignored for measuring progress of work. For eg: cost of wasted materials, labour or other resources, etc.

  (b) When cost incurred is not proportionate to entity's progress in satisfying its performance obligation. In such cases, the best reflection is to adjust the input method to recognize revenue only to the extent of costs incurred. Such recognition of revenue to the extent of costs incurred is appropriate, if at contract inception, all the following conditions exist:

    (i) The goods do not represent a distinct performance obligation;

    (ii) Customer is expected to obtain control of the goods significantly before receiving the services;

    (iii) Cost of such goods is significant relative to the total expected costs to complete the performance obligation; and

    (iv) The entity procures the goods from a third party and does not significantly involve in designing / manufacturing the goods (even if the entity is a principal in the arrangement between the entity and end customer).

An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time.

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As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

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Illustration 64 : Measuring progress on straight line basis

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay CU100 per month. The entity's promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes.

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time. If yes, how should an entity measure its progress of service provided?

Solution

The entity shall determine if revenue should be recognized over a period of time by evaluating the conditions laid in para 35 of Ind AS 115.

- Applying the first criterion of para 35 to establish if the customer simultaneously receives and consumes the benefits, as the entity provides service – The health club provides access to services uniformly through the year. The extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The customer therefore simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available.
- Consequently, the entity's performance obligation is satisfied over time
- Once the pattern of satisfying performance obligation is defined, the Company then determines how progress should be measured. The services are uniformly provided to the customer through the year. Therefore, the best measure of progress is to recognize revenue on a straight line basis over the year.

*****

Illustration 65 : Uninstalled materials

On 1st January, 20X1, an entity contracts to renovate a building including the installation of new elevators. The entity estimates the following with respect to the contract:

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Particulars	*Amount (₹)*
Transaction price	*5,000,000*
Expected costs:	
(a) Elevators	*1,500,000*
(b) Other costs	*2,500,000*
Total	*4,000,000*

The entity purchases the elevators, and they are delivered to the site six months before they will be installed. The entity uses an input method based on cost to measure progress towards completion. The entity has incurred actual other costs of 500,000 by 31st March, 20X1.

How will the Company recognize revenue, if performance obligation is met over a period of time?

Solution

Costs to be incurred comprise two major components – elevators and cost of construction service.

(a) The elevators are part of the overall construction project and are not a distinct performance obligation

(b) The cost of elevators is substantial to the overall project and are incurred well in advance.

(c) Upon delivery at site, the customer acquires control of such elevators.

(d) And there is no modification made to the elevators, which the company only procures and delivers at site. Nevertheless, as part of materials used in overall construction project, the company is a principal in the transaction with the customer for such elevators also.

Therefore, applying the guidance on Input method –

- The measure of progress should be made based on the percentage of costs incurred relative to the total budgeted costs.
- The cost of elevators should be excluded when measuring such progress and revenue for such elevators should be recognized to the extent of costs incurred.

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The revenue to be recognized is measured as follows:

Particulars	Amount (₹)
Transaction price	5,000,000
Costs incurred:	
(a) Cost of elevators	1,500,000
(b) Other costs	500,000
Measure of progress:	500,000 / 2,500,000 = 20%
Revenue to be recognized:	
(a) For costs incurred (other than elevators)	Total attributable revenue = 3,500,000 % of work completed = 20% Revenue to be recognized = 700,000
(b) Revenue for elevators	1,500,000 (equal to costs incurred)
Total revenue to be recognized	1,500,000 + 700,000 = 2,200,000

Therefore, for the year ended 31st March, 20X1, the Company shall recognize revenue of ₹ 2,200,000 on the project.

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Other considerations in measuring progress of work:

Stand-Ready Obligations

When the nature of an entity's performance obligation is to stand ready to provide goods or services, it may be appropriate to utilize a time-based measure of progress.

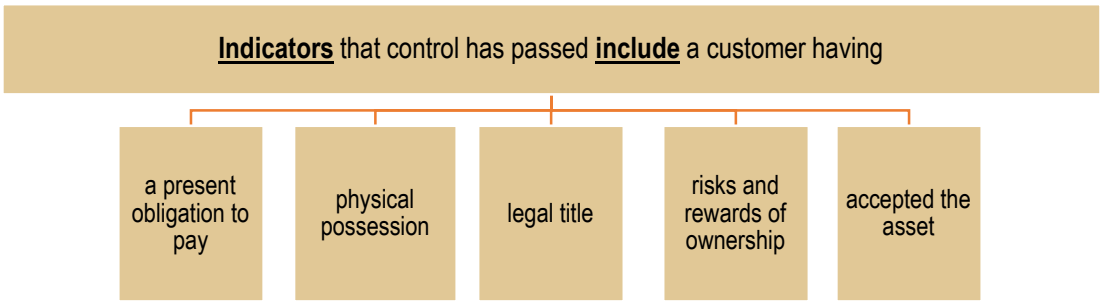
- When the pattern of benefit and the entity's efforts to fulfill the contract are not even throughout the contract period, a time-based method of measuring progress may not be appropriate.
- On the other hand, when an entity expects the customer will receive and consume the benefits of the entity's promise equally throughout the contract period, or if the entity does not know and cannot reasonably estimate how and when the customer will request performance, then a straight-line revenue attribution resulting from a time-based measure of progress may be appropriate.

9.2.2 Transfer of control at a point in time:

Where a company does not meet any of the aforementioned criteria for recognizing revenue over a period of time, then revenue shall be recognized at a point in time.

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The following is an **indicative list** of indicators which may exist, to imply the point of time at which control of goods has been passed to the customer. This is not an exhaustive list and there may be more factors that may be considered to determine the point in time at which revenue shall be recognized:



Indicator	Evaluation
The entity has a present right to payment	If a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
The customer has a legal title to the asset	- Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
The customer has physical possession of the asset	The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of the asset. - However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls.
The customer has assumed significant risks & rewards of owning the asset	- Transfer of risks & rewards for an asset may indicate that the customer has the ability to direct the use of and obtain substantially all of the benefits from the asset. When evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control

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	of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
The customer has accepted the asset	Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a goods or service does not meet agreed-upon specifications. An entity shall consider such clauses to evaluate when a customer obtains control of a goods or service. - If an entity can objectively determine that control of a goods or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the goods or service. - However, if an entity cannot objectively determine that the goods or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance.

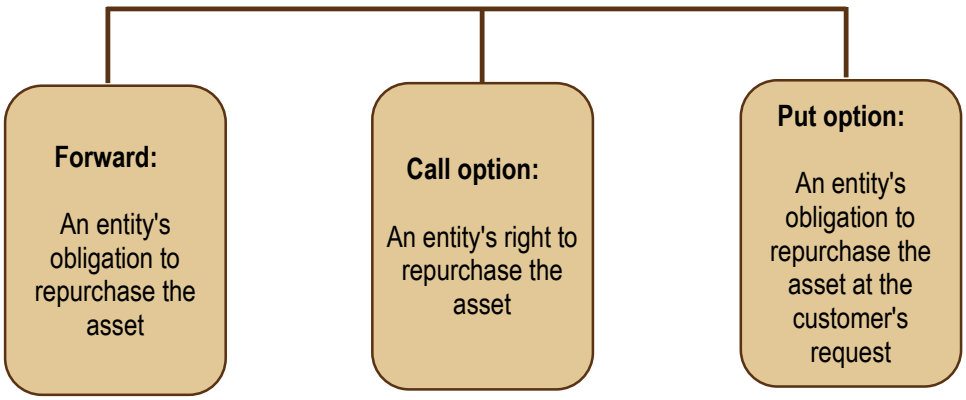
9.3 Repurchase agreements

When a company determines the timing of transfer of control, it is important to take into consideration any repurchase agreements that may have been executed by the Company.

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

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Repurchase agreements generally come in three forms:



A. Forward or call option:

- If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset.

  Consequently, the entity shall account for the contract as either of the following:

  (a) a lease in accordance with Ind AS 116, Leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset, unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity shall continue to recognize the asset and shall recognize financial liability for any consideration received from the customer. The entity shall account for the financial liability in accordance with Ind AS 109; or

  (b) a financing arrangement, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

- When comparing the repurchase price with the selling price, an entity shall consider the time value of money.

- If the repurchase agreement is a financing arrangement, the entity shall continue to recognize the asset and also recognize a financial liability for any consideration received from the customer.

- The entity shall recognize the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance).

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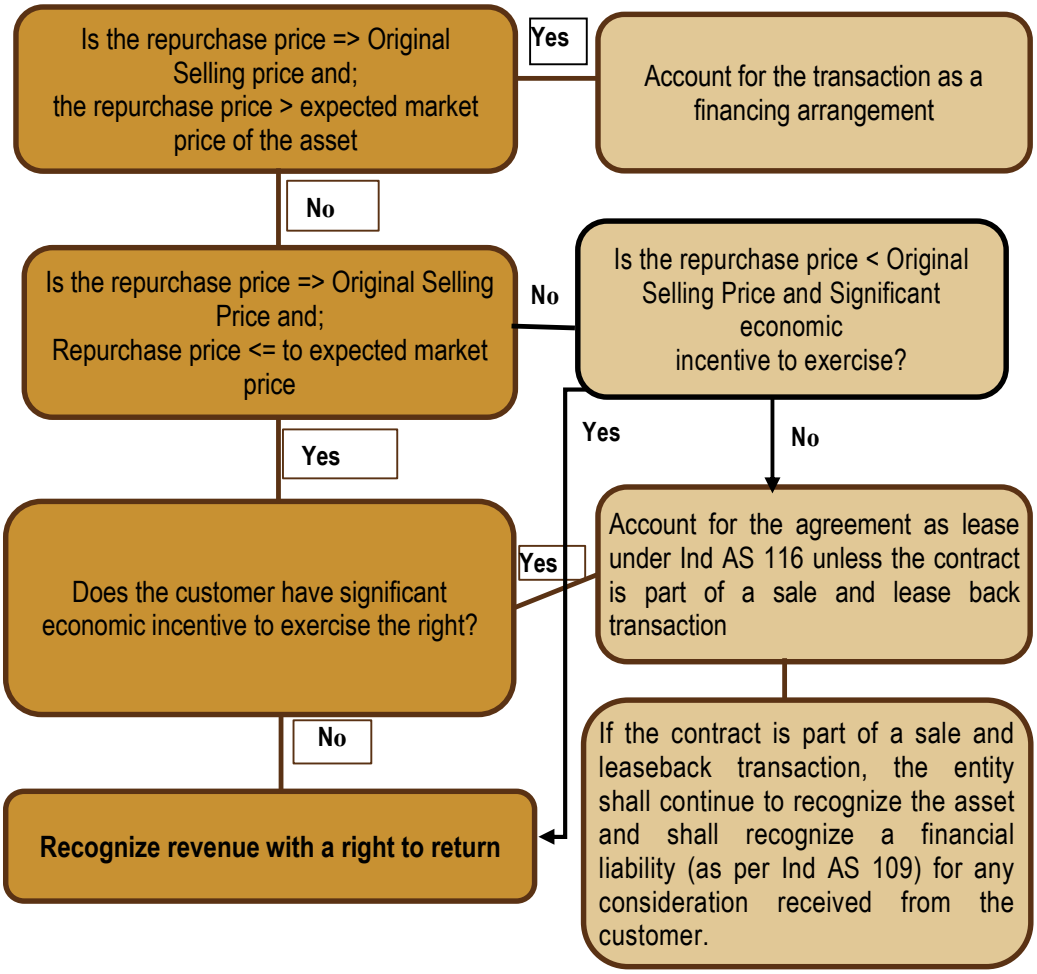
- If the option lapses unexercised, an entity shall derecognize the liability and recognize revenue.

B. Put option

- If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity shall consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, the entity shall account for the agreement as a lease in accordance with Ind AS 116, unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity shall continue to recognize the asset and shall recognize a financial liability for any consideration received from the customer. The entity shall account for the financial liability in accordance with Ind AS 109.
- To determine whether a customer has a significant economic incentive to exercise its right, an entity shall consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value of the asset, this may indicate that the customer has a significant economic incentive to exercise the put option and hence the customer is expected to ultimately return the asset to the entity.
- If the repurchase price is equal to or greater than original selling price and more than the expected market value of the asset, the contract is in effect a financing arrangement.
- If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity shall account for the agreement as if it were the sale of a product with a right of return.
- If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, the entity shall account for the agreement as if it were the sale of a product with a right of return.

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❖ The following decision tree may be useful to account for the arrangement –



❖ When comparing the repurchase price with the selling price, an entity shall consider the time value of money.

❖ If the option lapses unexercised, an entity shall derecognize the liability and recognize revenue.

Illustration 66

An entity enters into a contract with a customer for the sale of a tangible asset on 1st January, 20X1 for ₹ 1 million. The contract includes a call option that gives the entity the right to repurchase the asset for ₹ 1.1 million on or before 31st December, 20X1.

How would the entity account for this transaction?

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Solution

In the above case, where the entity has a right to call back the goods upto a certain date –

- The customer cannot be said to have acquired control, owing to the repurchase right with the seller entity
- Since the original selling price (₹ 1 million) is lower than the repurchase price (₹ 1.1 million), this is construed to be a financing arrangement and accounted as follows:
  - (a) Amount received shall be recognized as 'liability'
  - (b) Difference between sale price and repurchase price to be recognized as 'finance cost' and recognized over the repurchase term.

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Illustration 67

An entity enters into a contract with a customer for the sale of a tangible asset on 1st January, 20X1 for ₹ 10,00,000. The contract includes a put option that gives the customer the right to sell the asset for ₹ 9,00,000 on or before 31st December, 20X1. The market price for such goods is expected to be ₹ 7,50,000

How would the entity account for this transaction?

Solution

In the above case, where the entity has an obligation to buy back the goods upto a certain date–

- The entity shall evaluate if the customer has a significant economic incentive to return the goods. Since the repurchase price is significantly higher than market price, therefore, customer has a significant economic incentive to return the goods. There are no other factors which may affect this assessment.
- Therefore, company determines that 'control' of goods is not transferred to the customer till 31st December, 20X1, ie, till the put option expires.
- Against payment of ₹ 10,00,000; the customer only has a right to use the asset and put it back to the entity for ₹ 9,00,000. Therefore, this will be accounted as a lease transaction in which difference between original selling price (ie, ₹ 10,00,000) and repurchase price (ie, ₹ 9,00,000) shall be recognized as lease income over the period of lease.
- At the end of repurchase term, ie, 31st December, 20X1, if the customer does not exercise such right, then the control of goods would be passed to the customer at that time and revenue shall be recognized for sale of goods for repurchase price (ie, ₹ 9,00,000).

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9.4 Bill-and-hold

- A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.

- In such arrangements, the entity shall determine at which point does control transfer to the customer.

  In some cases, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). While in other cases, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset

- In addition, the indicators defined earlier in this chapter for establishing transfer of control, **all the following criteria must be met**:

  (a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);

  (b) the product must be identified separately as belonging to the customer;

  (c) the product currently must be ready for physical transfer to the customer; and

  (d) the entity cannot have the ability to use the product or to direct it to another customer.

- Where an entity recognizes revenue on bill & hold basis, the entity shall determine if it has any additional performance obligations forming part of the transaction price, which would need to be segregated and accounted separately, when such performance obligations are met. (for eg.: custodial services for goods held, extended warranty, etc.) For identification of performance obligations, refer step 2 – identifying performance obligations.

Illustration 68

An entity enters into a contract with a customer on 1st April, 20X1 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts

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meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On 31st March, 20X3, the customer pays for the machine and spare parts, but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.

How will the Company recognize revenue for sale of machine and spare parts? Is there any other performance obligation attached to this sale of goods?

Solution

In the facts provided above, the entity has made sale of two goods – machine and space parts, whose control is transferred at a point in time. Additionally, company agrees to hold the spare parts for the customer for a period of 2-4 years, which is a separate performance obligation. Therefore, total transaction price shall be divided amongst 3 performance obligations –

(i) Sale of machinery

(ii) Sale of spare parts

(iii) Custodial services for storing spare parts.

Recognition of revenue for each of the three performance obligations shall occur as follows:

- Sale of machinery: Machine has been sold to the customer and physical possession as well as legal title passed to the customer on 31st March, 20X3. Accordingly, revenue for sale of machinery shall be recognized on 31st March, 20X3.
- Sale of spare parts: The customer has made payment for the spare parts and legal title has been passed to specifically identified goods, but such spares continue to be physically held by the entity. In this regard, the company shall evaluate if revenue can be recognized on bill-and-hold basis if all below criteria are met:

(a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);	The customer has specifically requested for entity to store goods in their warehouse, owing to close proximity to customer's factory.

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(b) the product must be identified separately as belonging to the customer;	The spare parts have been specifically identified and inspected by the customer.
(c) the product currently must be ready for physical transfer to the customer; and	The spares are identified and segregated, therefore, ready for delivery.
(d) the entity cannot have the ability to use the product or to direct it to another customer	Spares have been segregated and cannot be redirected to any other customer.

Therefore, all conditions of bill-and-hold are met and hence, company can recognize revenue for sale of spare parts on 31st March, 20X3.

- Custodial services: Such services shall be given for a period of 2 to 4 years from 31st March, 20X3. Where services are given uniformly and customer receives & consumes benefits simultaneously, revenue for such service shall be recognized on a straight-line basis over a period of time.

*****

9.5 Licences of intellectual property

Ind AS 115 provides application guidance specific to the recognition of revenue for licences of intellectual property, which differs from the recognition model for other promised goods and services.

Considering the fact that licences include a wide range of features and economic characteristics, an entity will need to evaluate the nature of its promise to grant a licence of intellectual property in order to determine whether the promise is satisfied (and revenue is recognized) over time or at a point in time.

A licence will either provide:

- a right to access the entity's intellectual property throughout the licence period, which results in revenue that is recognized over time; or
- a right to use the entity's intellectual property as it exists at the point in time in which the licence is granted, which results in revenue that is recognized at a point in time.

The standard states that licences of intellectual property establish a customer's rights to the intellectual property of an entity and may include licences for any of the following: software and

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technology, media and entertainment (e.g. motion pictures and music), franchises, patents, trademarks and copyrights.

9.5.1 Right to access

A licence that provides an entity with the right to access intellectual property is satisfied over time 'because the customer simultaneously receives and consumes the benefit from the entity's performance as the performance occurs', including the related activities undertaken by entity. This conclusion is based on the determination that when a licence is subject to change (and the customer is exposed to the positive or negative effects of that change), the customer is not able to fully gain control over the licence of intellectual property at any given point in time, but rather gains control over the licence period.

Example 7

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 goods or service to Toy Manufacturer separate from the license. Hence, Pogo will recognize revenue over time.

9.5.2 Right to use

In contrast, when the licence represents a right to use the intellectual property as it exists at a specific point in time, the customer gains control over that intellectual property at the beginning of the period for which it has the right to use the intellectual property. This timing may differ from when the licence was granted.

Illustration 69

An entity, a music record label, licenses to a customer a 1975 recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio and online advertisements for two years in Country A. In exchange for providing the licence, the entity receives fixed consideration of ₹ 50,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is non-cancellable.

Determine how the revenue will be recognized?

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Solution

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of Ind AS 115. The entity concludes that its only performance obligation is to grant the licence. The entity does not have any contractual or implied obligations to change the licensed recording. The licensed recording has significant stand-alone functionality (i.e. the ability to be played) and, therefore, the ability of the customer to obtain the benefits of the recording is not substantially derived from the entity's ongoing activities. The entity therefore determines that the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the licensed recording. Consequently, the entity concludes that the nature of its promise in transferring the licence is to provide the customer with a right to use the entity's intellectual property as it exists at the point in time that it is granted. Therefore, the promise to grant the licence is a performance obligation satisfied at a point in time. The entity recognizes all of the revenue at the point in time when the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licensed intellectual property.

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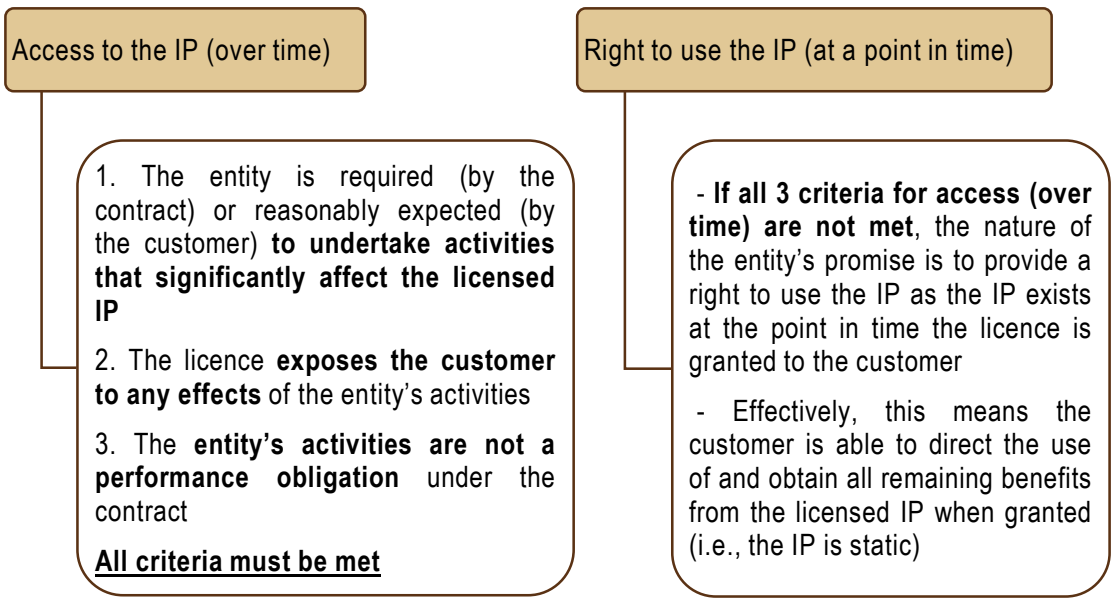


Illustration 70 : Assessing the nature of a software licence with unspecified upgrades

Software Company X licenses its software application to Customer Y. Under the agreement, X will provide updates or upgrades on a when-and-if-available basis; Y can choose whether to

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install them. Y expects that X will undertake no other activities that will change the functionality of the software.

Determine the nature of license.

Solution

Based on the facts given in question it can be concluded that, although the updates and upgrades will change the functionality of the software, they are not activities considered in determining the nature of the entity's promise in granting the licence. The activities of X to provide updates or upgrades are not considered because they transfer a promised goods or service to Y – i.e. updates or upgrades are distinct from the licence. Therefore, the software licence provides a right to use the IP that is satisfied at a point in time.

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Illustration 71 : Assessing the nature of a film licence and the effect of marketing activities

Film Studio C grants a licence to Customer D to show a completed film. C plans to undertake significant marketing activities that it expects will affect box office receipts for the film. The marketing activities will not change the functionality of the film, but they could affect its value.

Determine the nature of license.

Solution

C would probably conclude that the licence provides a right to use its IP and, therefore, is transferred at a point in time. There is no expectation that C will undertake activities to change the form or functionality of the film. Because the IP has significant stand-alone functionality, C's marketing activities do not significantly affect D's ability to obtain benefit from the film, nor do they affect the IP available to D.

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Illustration 72 : Assessing the nature of a team name and logo

Sports Team D enters into a three-year agreement to license its team name and logo to Apparel Maker M. The licence permits M to use the team name and logo on its products, including display products, and in its advertising or marketing materials.

(i) Determine the nature of license in the above case.

(ii) Modifying above facts that, Sports Team D has not played games in many years and the licensor is Brand Collector B, an entity that acquires IP such as old team or brand names and logos from defunct entities or those in financial distress. B's business model is to

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license the IP, or obtain settlements from entities that use the IP without permission, without undertaking any ongoing activities to promote or support the IP

Would the answer be different in this situation?

Solution

(i) The nature of D's promise in this contract is to provide M with the right to access the sports team's IP and, accordingly, revenue from the licence will be recognized over time. In reaching this conclusion, D considers all of the following facts:

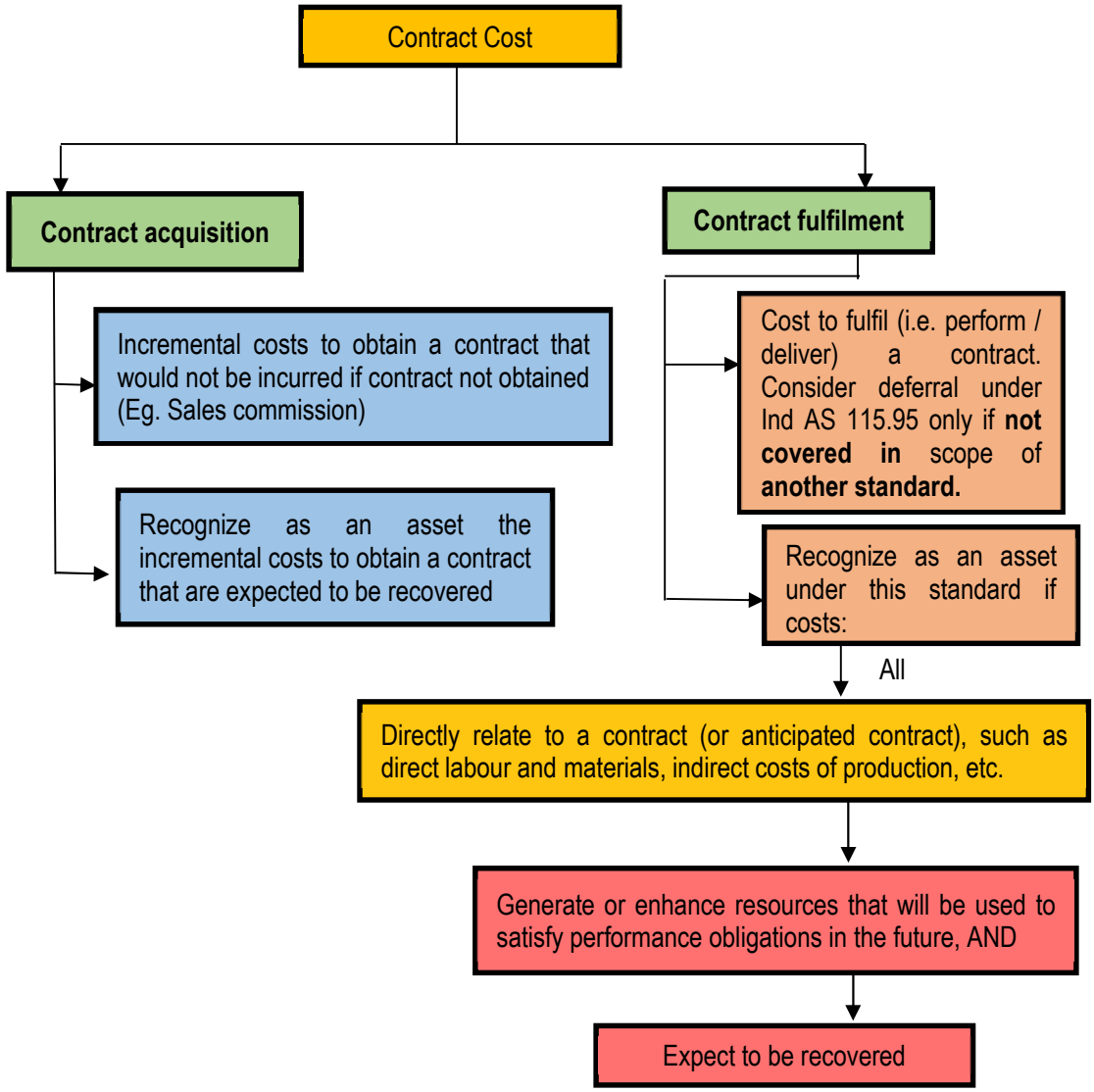
- M reasonably expects D to continue to undertake activities that support and maintain the value of the team name and logo by continuing to play games and field a competitive team throughout the licence period. These activities significantly affect the IP's ability to provide benefit to M because the value of the team name and logo is substantially derived from, or dependent on, those ongoing activities.
- The activities directly expose M to positive or negative effects (i.e. whether D plays games and fields a competitive team will have a direct effect on how successful M is in selling its products featuring the team's name and logo).
- D's ongoing activities do not result in the transfer of a goods or a service to M as they occur (i.e. the team playing games does not transfer a goods or service to M).

(ii) Based on B's customary business practices, Apparel Maker M probably does not reasonably expect B to undertake any activities to change the form of the IP or to support or maintain the IP. Therefore, B would probably conclude that the nature of its promise is to provide M with a right to use its IP as it exists at the point in time at which the licence is granted.

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10. CONTRACT COSTS



10.1 Costs to obtain a contract (contract acquisition costs)

Entities may incur various costs to obtain or acquire a contract with a customer, including, but not limited to, legal fees, advertising expenses, travel expenses, and salespersons' salaries and commissions.

Incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

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Once an entity has determined that costs incurred relate to a specific contract with a customer, it should then determine if the costs meet the conditions for capitalisation. Incremental costs to obtain a contract that an entity expects to recover should be capitalised, while costs to obtain a contract that do not qualify for capitalisation should be expensed as incurred.

The test to determine if a cost is incremental is to ask whether the entity would have incurred the cost had one or both of the parties decided to walk away just before signing the arrangement. In this context, any legal costs (for example, to draft or negotiate the contract) or salaries for salespeople would be incurred regardless of whether the contract is finalized. Therefore, these costs are not incremental. On the other hand, a commission paid only upon the successful signing of the contract would be incremental and should be capitalized.

As a practical expedient, Ind AS 115 allows an entity to expense the incremental costs of obtaining a contract as incurred if the amortisation period of the asset that the entity would have otherwise recognized is one year or less.

Cost	Capitalize or expense	Reason
Commission paid only upon successful signing of a contract	Capitalize	Assuming the entity expects to recover the cost, the commission is incremental since it would not have been paid if the parties decided not to enter into the arrangement just before signing.
Travel expenses for sales person pitching a new client contract	Expense	Because the costs are incurred regardless of whether the new contract is won or lost, the entity incurs the costs, unless they are expressly reimbursable.
Legal fees for drafting terms of arrangement for parties to approve and sign	Expense	If the parties walk away during negotiations, the costs would still be incurred and therefore are not incremental costs of obtaining the contract.
Salaries for sales people working exclusively on obtaining new clients	Expense	Salaries are incurred regardless of whether contracts are won or lost and therefore are not incremental costs to obtain the contract.
Bonus based on quarterly sales target	Capitalize	Bonuses based solely on sales are incremental costs to obtain a contract.
Commission paid to sales manager based on contracts obtained by the sales manager's local employees	Capitalize	The commissions are incremental costs that would not have been incurred had the entity not obtained the contract. Ind AS 115 does not differentiate costs based on the function or title of the employee that receives the commission.

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Comparison with AS 7 and AS 9

Contract acquisition cost is not specifically dealt with in either in AS 7 or AS 9. Let's take an illustration to understand the treatment in AS 7 / AS 9 and how it is different from Ind AS:

Example 8

A software company has agreed to pay a special commission of 1% of the contract value to a sales consultant who has agreed to work based on the successful bidding of the proposal to a customer. In case the contract is not signed by the company and the customer, for whatever reason, then there is no commission to be paid to the sales consultant.

The contract value is ₹ 1 crore over 3 years and the company has signed the contract with the customer after successful bidding with the help of the sales consultant.

In this context, the accounting differences will be as follows:

Particulars	Treatment under Ind AS 115	Treatment under AS 9
1st year of operations - Contract acquisition cost of ₹ 1 crore	• Amortization as expense of the year ₹ 33.33 lakhs • Contract asset ₹ 66.67 lakhs	Expense of ₹ 1 crore as sales commission
2nd year of operations - Contract acquisition cost of ₹ 1 crore	• Amortization as expense of the year ₹ 33.33 lakhs • Contract asset ₹ 33.34 lakhs	No accounting treatment
3rd year of operations - Contract acquisition cost of ₹ 1 crore	• Amortization as expense of the year ₹ 33.34 lakhs • Contract asset of nil	No accounting treatment

10.2 Costs to fulfil a contract (contract fulfilment costs)

If costs incurred in fulfilling a contract with a customer are covered under another Standard (such as Ind AS 2 'Inventories' and Ind AS 16 'Property, Plant, and Equipment'), an entity accounts for those costs in accordance with those Standards. If not, an entity recognizes an asset for such costs, provided all of the criteria mentioned below are met:

(a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved), including:

(i) direct labour

(ii) direct materials

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(iii) allocations that relate directly to the contract or contract activities (for example, contract management and supervision costs and depreciation of tools and equipment and right-of-use assets used in fulfilling the contract)

(iv) costs that are explicitly chargeable to the customer

(v) other costs that the entity incurs only because it entered into the contract (e.g. payments to subcontractors)

(b) the costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future

(c) the entity expects to recover the costs, for e.g. through the expected margin

The following costs should be expensed as incurred:

(a) general and administrative costs that are not explicitly chargeable to the customer

(b) costs of wasted materials, labour, or other resources that were not reflected in the contract price

(c) costs that relate to satisfied performance obligations

(d) costs related to remaining performance obligations that cannot be distinguished from costs related to satisfied performance obligations.

Costs incurred in fulfilling a contract with a customer that are within the scope of another Standard, an entity shall account for those costs in accordance with those other Standards.

Illustration 73

Customer outsources its information technology data centre

Term = 5 years plus two 1-yr renewal options

Average customer relationship is 7 years

Entity spends ₹ 4,00,000 designing and building the technology platform needed to accommodate out-sourcing contract:

Design services	*₹ 50,000*
Hardware	*₹ 140,000*
Software	*₹ 100,000*
Migration and testing of data centre	*₹ 110,000*
TOTAL	***₹ 400,000***

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Solution

Design services	₹ 50,000	Assess under Ind AS 115. Any resulting asset would be amortised over 7 years (i.e. include renewals)
Hardware	₹ 140,000	Account for asset under Ind AS 16
Software	₹ 100,000	Account for asset under Ind AS 38
Migration and testing of data centre	₹ 110,000	Assess under Ind AS 115. Any resulting asset would be amortised over 7 years (i.e. include renewals)
TOTAL	**₹ 400,000**	

*****

10.3 Amortisation and impairment

Under Ind AS 115, an entity amortises capitalised contract costs on a systematic basis consistent with the pattern of transferring the goods or services related to those costs. If an entity identifies a significant change to the expected pattern of transfer, it updates its amortisation to reflect that change in estimate in accordance with Ind AS 8.

An entity recognizes an impairment loss in earnings if the carrying amount of an asset exceeds the remaining amount of consideration that the entity expects to receive in connection with the related goods or services less any directly related contract costs yet to be recognized. When determining the amount of consideration, it expects to receive, an entity ignores the constraint on variable consideration previously discussed, and adjusts for the effects of the customer's credit risk.

Before recognizing an impairment loss under the revenue recognition guidance, an entity recognizes impairment losses associated with assets related to the contract that are accounted in accordance with another Standard (for example, Ind AS 2, Ind AS 16 and Ind AS 38).

An entity would reverse a previously recognized impairment loss when the impairment conditions no longer exist or have improved. The increased carrying amount of the asset shall not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognized previously.

Illustration 74 : Amortisation

An entity enters into a service contract with a customer and incurs incremental costs to obtain the contract and costs to fulfil the contract. These costs are capitalised as assets in accordance with Ind AS 115. The initial term of the contract is five years but it can be renewed for

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subsequent one-year periods up to a maximum of 10 years. The average contract term for similar contracts entered into by entity is seven years.

Determine appropriate method of amortisation?

Solution

The most appropriate amortisation period is likely to be seven years (i.e. the initial term of five years plus two anticipated one year renewals) because that is the period over which the entity expects to provide services under the contract to which the capitalised costs relate.

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11. PRESENTATION & DISCLOSURE

11.1 Presentation

Under Ind AS 115, an entity presents a contract in its balance sheet as a contract liability, a contract asset, or a receivable, depending on the relationship between the entity's performance and the customer's payment at the reporting date. An entity shall present any unconditional rights to consideration separately as a receivable.

An entity presents a contract as a contract liability if the customer has paid consideration, or if payment is due as of the reporting date but the entity has not yet satisfied a performance obligation by transferring a goods or service. Conversely, if the entity has transferred goods or services as of the reporting date but the customer has not yet paid, the entity recognizes either a contract asset or a receivable. An entity recognizes a contract asset if it's right to consideration is conditioned on something other than the passage of time; otherwise, an entity recognizes a receivable.

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. An entity shall account for a receivable in accordance with Ind AS 109. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Ind AS 109 and the corresponding amount of revenue recognized shall be presented as an expense.

An entity shall also present separately the amount of excise duty included in the revenue recognized in the statement of profit and loss. This is an additional requirement inserted due to the Indian context in Ind AS 115.

11.2 Disclosure

Ind AS 115 requires many new disclosures about contracts with customers. The following table provides a summary:

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Disclosures	
Disclosure area	**Summary of requirements**
General	• revenue recognized from contracts with customers, separately from its other sources of revenue • impairment losses on receivables or contract assets
Disaggregation of revenue	• categories that depict the nature, amount, timing, and uncertainty of revenue and cash flows • sufficient information to enable users of financial statements to understand the relationship with revenue information disclosed for reportable segments under Ind AS 108 'Operating Segments'
Information about contract balances	• including opening and closing balances of contract assets, contract liabilities, and receivables (if not separately presented) • revenue recognized in the period that was included in contract liabilities at the beginning of the period and revenue from performance obligations (wholly or partly) satisfied in prior periods • explanation of relationship between timing of satisfying performance obligations and payment • explanation of significant changes in the balances of contract assets and liabilities
Information about performance obligations	• when the entity typically satisfies performance obligations • significant payment terms • nature of goods and services • obligations for returns, refunds and similar obligations • types of warranties and related obligations
Transaction price allocated to the remaining performance obligations	• transaction price allocated to the performance obligations that are unsatisfied and an explanation of when the entity expects to recognize such revenue.

Timing of satisfaction of performance obligations	• performance obligations that an entity satisfies over time:
	  ○ methods used to recognize revenue
	  ○ why the methods used provide a faithful depiction
	• performance obligations satisfied at a point in time:
	  ○ judgements made in evaluating when a customer obtains control

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Information about significant judgements	• judgements impacting the expected timing of satisfying performance obligations transaction price and amounts allocated to performance obligations (e.g. estimating variable consideration and assessing if constrained and allocating to performance obligations).
Transaction price and amount allocated to performance obligations	• determining transaction price, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring non-cash consideration • estimate of variable consideration is constrained • measuring obligations for returns, refunds and other similar obligations • allocating the transaction price, discounts and variable consideration to a specific part of the contract • reconcile the amount of revenue recognized in the statement of profit and loss with the contracted price
Assets recognized from the costs to obtain or fulfil a contract	• judgements made in determining costs amount of the costs incurred • to obtain or fulfil a contract with a customer • amortisation method used • closing balances by main category and amortisation expense
Practical expedients	• practical expedient elected by an entity in either paragraph 63 (about the existence of a significant financing component) or paragraph 94 (about the incremental costs of obtaining a contract)

12. SERVICE CONCESSION ARRANGEMENTS

12.1 About Arrangement

- Service Concession Arrangement involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes.
- Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer' or a 'public-to-private' service concession arrangement.

Infrastructure for public services—such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks—has

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traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

- A feature of these service arrangements is the public service nature of the obligation undertaken by the operator.
- Public policy is for the services related to the infrastructure to be provided to the public, irrespective of the identity of the party that operates the services. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:

  (a) the party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.

  (b) the operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.

  (c) the contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.

  (d) the operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

12.2 Accounting Principles

12.2.1 Treatment of the operator's rights over the infrastructure

- Infrastructure shall not be recognized as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator.
- The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

12.2.2 Recognition and measurement

- Since the operator acts as a service provider, he shall recognize and measure revenue in accordance with Ind AS 115 for the services it performs. The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.

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- If the operator performs more than one service (ie construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable shall be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable.
- The nature of the consideration i.e. whether financial asset or intangible asset determines its subsequent accounting treatment.
- The operator shall account for revenue and costs relating to construction or upgrade services.
- The operator shall account for revenue and costs relating to operation services in accordance with Ind AS 115.

12.2.3 Consideration given by the grantor to the operator

- If the operator provides construction or upgrade services, the consideration received or receivable by the operator shall be recognized at its fair value. The consideration may be rights to:

  (a) a financial asset, or

  (b) an intangible asset.

- The operator shall recognize a financial asset to the extent that
  - it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law.
  - it has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.
- The operator shall recognize an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.
- If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components shall be recognized initially at the fair value of the consideration received or receivable.

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12.2.4 Contractual obligations to restore the infrastructure to a specified level of serviceability

The operator may have contractual obligations it must fulfil as a condition of its licence, like to maintain or restore infrastructure, except for any upgrade element, which shall be recognized and measured in accordance with Ind AS 37, ie at the best estimate of the expenditure that would be required to settle the present obligation at the end of the reporting period.

12.2.5 Borrowing costs incurred by the operator

- Borrowing costs attributable to the arrangement shall be recognized as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service).
- If the operator does not have a contractual right to receive an intangible asset, borrowing costs attributable to the arrangement shall be capitalised during the construction phase of the arrangement.

12.2.6 Financial asset

- For recognition of financial asset, Ind AS 32, Ind AS 107 and Ind AS 109 shall be applied. The amount due from or at the direction of the grantor is accounted at:

  (a) amortised cost;

  (b) fair value through other comprehensive income; or

  (c) fair value through profit or loss.

- If the amount due from the grantor is measured at amortised cost or fair value through other comprehensive income, Ind AS 109 requires interest calculated using the effective interest method to be recognized in profit or loss.

12.2.7 Intangible asset

For recognition and measurement of intangible asset, one has to apply Ind AS 38 for guidance on measuring intangible assets acquired in exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets.

Comparison with AS 7 and AS 9

Service concession arrangements are specifically dealt with in detail unlike with AS 9 or AS 7. Also, there's a specific mention about recognition of financial asset or intangible asset as per Ind AS 115 which is not mentioned in either AS 7 or AS 9.

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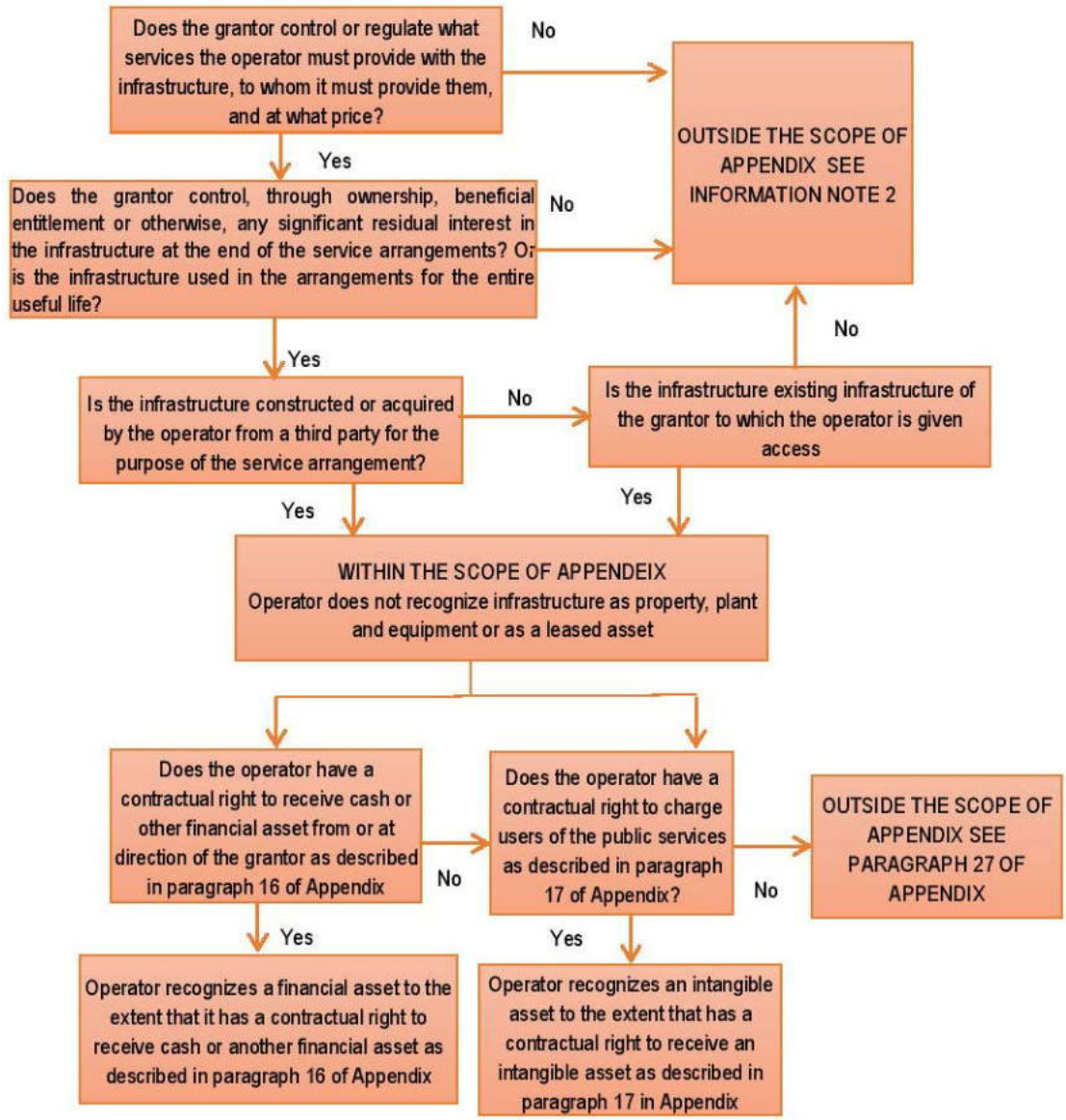
12.2.8 Items provided to the operator by the grantor

- Infrastructure items to which the operator is given access by the grantor for the purposes of the service arrangement are not recognized as property, plant and equipment of the operator.
- The grantor may also provide other items to the operator that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the services, they are not government grants as defined in Ind AS 20. They are recognized as assets of the operator, measured at fair value on initial recognition.
- The operator shall recognize a liability in respect of unfulfilled obligations it has assumed in exchange for the assets.

Information note 1

Accounting framework for public-to-private service arrangements

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12.3 Service Concession Arrangements: Disclosures

- All aspects of a service concession arrangement shall be considered in determining the appropriate disclosures in the notes. An operator and a grantor shall disclose the following in each period:

  (a) a description of the arrangement;

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(b) significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows (eg the period of the concession, re-pricing dates and the basis upon which re-pricing or re-negotiation is determined);

(c) the nature and extent (eg quantity, time period or amount as appropriate) of:

(i) rights to use specified assets;

(ii) obligations to provide or rights to expect provision of services;

(iii) obligations to acquire or build items of property, plant and equipment;

(iv) obligations to deliver or rights to receive specified assets at the end of the concession period;

(v) renewal and termination options; and

(vi) other rights and obligations (eg major overhauls);

(d) changes in the arrangement occurring during the period; and

(e) how the service arrangement has been classified.

- An operator shall disclose the amount of revenue and profits or losses recognized in the period on exchanging construction services for a financial asset or an intangible asset.
- The disclosures required in accordance with paragraph 6 of this Appendix shall be provided individually for each service concession arrangement or in aggregate for each class of service concession arrangements. A class is a grouping of service concession arrangements involving services of a similar nature (eg toll collections, telecommunications and water treatment services).

Illustration 75

A Ltd. is in the business of infrastructure and has two divisions; (I) Toll Roads and (II) Wind Power. The brief details of these business and underlying project details are as follows:

I. Bhilwara-Jabalpur Toll Project - The Company has commenced the construction of the project in the current year and has incurred total expenses aggregating to ₹ 50 crore as on 31st December, 20X1. Under IGAAP, the Company has 'recorded such expenses as Intangible Assets in the books of account. The brief details of the Concession Agreement are as follows:

- *Total Expenses estimated to be incurred on the project ₹ 100 crore;*
- *Fair Value of the construction services is ₹ 110 crore;*
- *Total Cash Flow guaranteed by the Government under the concession agreement is ₹ 200 crore;*

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- *Finance revenue over the period of operation phase is ₹ 15 crore:*
- *Other income relates to the services provided during the operation phase.*

II. *Kolhapur- Nagpur Expressway - The Company has also entered into another concession agreement with Government of Maharashtra in the current year. The construction cost for the said project will be ₹ 110 crore. The fair value of such construction cost is approximately ₹ 200 crore. The said concession agreement is Toll based project and the Company needs to collect the toll from the users of the expressway. Under IGAAP, A Ltd. has recorded the expenses incurred on the said project as an Intangible Asset.*

(i) *What would be the classification of Bhilwara-Jabalpur Toll Project as per applicable Ind AS? Give brief reasoning.*

(ii) *What would be the classification of Kolhapur-Nagpur Expressway Toll Project as per applicable Ind AS? Give brief reasoning.*

(iii) *Also, suggest suitable accounting entries for the preparation of financial statements as per Ind AS for the above 2 projects.*

Solution

(i) Here the operator has a contractual right to receive cash from the grantor. The grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator. Hence, the operator recognizes a financial asset to the extent it has a contractual right to receive cash.

(ii) Here the operator has a contractual right to charge users of the public services. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service. Therefore, the operator shall recognize an intangible asset to the extent it receives the right (a licence) to charge users of the public service.

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(iii) Accounting treatment for preparation of financial statements

Bhilwara-Jabalpur Toll Project

Journal Entries

	Particulars		Dr. (₹ in crore)	Cr. (₹ in crore)
	During construction:			
1	Financial asset A/c	Dr.	110	
	To Construction revenue			110
	[To recognize revenue relating to construction services, to be settled in case]			
2	Cost of construction (profit or loss)	Dr.	100	
	To Bank A/c (As and when incurred)			100
	[To recognize costs relating to construction services]			
	During the operation phase:			
3	Financial asset	Dr.	15	
	To Finance revenue (As and when received or due to receive)			15
	[To recognize interest income under the financial asset model]			
4	Financial asset	Dr.	75	
	To Revenue [(200-110) – 15]			75
	[To recognize revenue relating to the operation phase]			
5	Bank A/c	Dr.	200	
	To Financial asset			200
	[To recognize cash received from the grantor]			

Kolhapur-Nagpur Expressway -Intangible asset

Journal Entries

	Particulars		Dr. (₹ in crore)	Cr. (₹ in crore)
	During construction:			
1	Cost of construction (profit or loss)	Dr.	110	
	To Bank A/c (As and when incurred)			110
	[To recognize costs relating to construction services]			

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2	Intangible asset	Dr.	200	
	To Revenue			200
	[To recognize revenue relating to construction services provided for non-cash consideration]			
	During the operation phase:			
3	Amortisation expense	Dr.	200	
	To Intangible asset (accumulated amortisation)			200
	[To recognize amortisation expense relating to the operation phase over the period of operation]			
4	Bank A/c	Dr.	?	
	To Revenue			?
	[To recognize revenue relating to the operation phase]			

Note: Amount in entry 4 is kept blank as no information in this regard is given in the question.

*****

13. EXTRACTS OF FINANCIAL STATEMENTS FROM LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Hindustan Unilever Limited' for the financial year 2021-2022 with respect to 'Revenue from Contract with Customers' and its accounting policy thereon.

(All amounts in ₹ crores, unless otherwise stated)

Particulars	Note	Year ended 31st March, 2022	Year ended 31st March, 2021
INCOME			
Revenue from operations	25	52,446	47,028
Other income	26	258	410
TOTAL INCOME		52,704	47,438

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NOTE 25 REVENUE FROM OPERATIONS

Sale of products:

Revenue from sale of goods is recognised when control of the products being sold is transferred to our customer and when there are no longer any unfulfilled obligations. The performance obligations in our contracts are fulfilled at the time of dispatch, delivery or upon formal customer acceptance depending on customer terms.

Revenue is measured on the basis of contracted price, after deduction of any trade discounts, volume rebates and any taxes or duties collected on behalf of the Government such as goods and services tax, etc. Accumulated experience is used to estimate the provision for such discounts and rebates. Revenue is only recognised to the extent that it is highly probable a significant reversal will not occur.

Our customers have the contractual right to return goods only when authorised by the Group. An estimate is made of goods that will be returned and a liability is recognised for this amount using a best estimate based on accumulated experience.

Sale of services:

Income from Group owned salon is recognised when services are rendered.

Display income is recorded as per the term of the contract entered with the respective franchisee / parties.

Revenue from services are measured at fair value of the consideration received or receivable, after deduction of any sort of discounts and any taxes or duties collected on behalf of the government such as goods and services tax.

Income from services rendered:

Income from services rendered is recognised based on agreements/arrangements with the customers as the service is performed and there are no unfulfilled obligations.

Commission income on consignment sales:

Commission income on consignment sales (Consignment selling agency fees) is charged for rendering of services and for the use of the Group's sales and distribution network. Such revenue is recognised in the accounting period in which the services are rendered in accordance with the agreement with the parties.

Government grants:

The Group is entitled to 'Scheme of budgetary support' under Goods and Service Tax Regime in respect of eligible manufacturing units located in specified regions. Such grants are measured at amount receivable from the Government and are recognised as other operating revenue when there is a reasonable assurance that the Group will comply with all necessary conditions attached to that.

The Group has received approval under the Production Linked Incentive Scheme (PLI) of the Government of India for specific product categories. Incentive under the scheme is subject to meeting certain committed investments and defined incremental sales threshold. Such grants are recognised as other operating revenue when there is a reasonable assurance that the Group will comply with all necessary conditions attached to that.

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Income from such grants is recognised on a systematic basis over the periods to which they relate.

	Year ended 31st March, 2022	Year ended 31st March, 2021
Sale of products	51,472	46,269
Sale of services	76	52
Other operating revenue*		
Income from services rendered	294	222
Commission income on consignment sales	315	264
Government grants (GST budgetary support and Production linked incentives) #	140	108
Others (including scrap sales, rentals, etc)	149	113
Total	**52,446**	**47,028**

Previous period figures have been re-classified from Others for better presentation

Reconciliation of Revenue from sale of products & services with the contracted price

	Year ended 31st March, 2022	Year ended 31st March, 2021
Contracted Price	57,340	51,955
Less: Trade discounts, volume rebates, etc	(5,792)	(5,634)
Sale of products and Services	**51,548**	**46,321**

* There is no material adjustment made to contract price for revenue recognised as other operating revenue.

NOTE 26 OTHER INCOME

Interest income is recognised using the effective interest rate (EIR) method. Dividend income on investments is recognised when the right to receive dividend is established. Refer Note 38 on financial instruments for policy on measurement at fair value through profit or loss.

	Year ended 31st March, 2022	Year ended 31st March, 2021
Interest income on		
Bank deposits	102	216
Current investments	80	6
Others (including interest on Income tax refunds)	16	124
Dividend income from		
Non-current investments	1	1
Fair value gain/(loss)		
Investments measured at fair value through profit or loss*	59	63
Total	**258**	**410**

*Includes realised gain on sale of investment of ₹52 crores (31st March, 2021: ₹52 crores).

(Source: Annual Report 2021-2022 – Hindustan Unilever Limited)

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14. SIGNIFICANT DIFFERENCES IN IND AS 115 *VIS-À-VIS* AS 7 AND AS 9

S. No.	Particular	Ind AS 115	AS 7 and AS 9
1.	*Framework of Revenue Recognition*	Ind AS 115 gives a framework of revenue recognition within a standard. It specifies the core principle for revenue recognition which requires the 'revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services'.	AS 7 and AS 9 do not provide any such overarching principle to fall upon in case of doubt. There is no emphasis on performance obligation under the contract with customer.
2.	*Comprehensive Guidance on Recognition and Measurement of Multiple Elements within a Contract with Customer:*	Ind AS 115 gives comprehensive guidance on how to recognize and measure multiple elements within a contract with customer.	AS 7 and AS 9 do not provide comprehensive guidance on this aspect.
3.	*Coverage*	Ind AS 115 comprehensively deals with all types of performance obligation contracts with customers. However, it does not deal with revenue from 'interest' and 'dividend' which are covered in financial instruments standard.	AS 7 covers only revenue from construction contracts which is measured at consideration received / receivable. AS 9 deals only with recognition of revenue from sale of goods, rendering of services, interest, royalties and dividends.
4.	*Measurement of*	As per Ind AS 115, revenue is measured at transaction price, i.e.,	As per AS 9, Revenue is the gross inflow of cash,

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	Revenue	the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.	receivables or other considerations arising in the course of the ordinary activities. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. As per AS 7, revenue from construction contracts is measured at consideration received / receivable and to be recognized as revenue as construction progresses if certain conditions are met.
5.	*Recognition of Revenue*	As per Ind AS 115, revenue is recognized when the control is transferred to the customer. It introduces a 5-step model for revenue recognition.	As per AS 9, revenue is recognized when significant risks and rewards of ownership is transferred to the buyer. As per AS 7, revenue is recognized when the outcome of a construction contract can be estimated reliably, contract revenue should be recognized by reference to the stage of completion of the contract activity at the reporting date.
6.	*Multiple element or linked transactions*	Ind AS 115 gives comprehensive guidance on how to recognize and measure multiple elements / performance obligations within a contract with customer.	AS 7 and AS 9 provide no specific guidance for multiple element or linked transactions.

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7.	*Capitalisation of Costs*	Ind AS 115 provides guidance on recognition of costs to obtain and fulfil a contract, as asset.	AS 7 and AS 9 do not deal with such capitalisation of costs.
8.	*Guidance on combining contracts and variable and contingent consideration*	Ind AS 115 provides guidance on combining contracts entered into at or near the same time with the same customer (or related parties of the customer), guidance on treatment of variable and contingent consideration.	AS 7 and AS 9 do not deal with such aspects.
9.	Adjustment for time value of money	As per Ind AS 115, transaction price is adjusted for the effect of time value of money when a significant financing component exists.	As per AS 9, revenue is not adjusted for time value of money.
10.	*Guidance on Service Concession Arrangements*	Ind AS 115 gives guidance on service concession arrangements and disclosures thereof.	AS does not provide such guidance.
11.	*Disclosure Requirements*	Ind AS 115 contains detailed disclosure requirements.	Less disclosure requirements are prescribed in AS.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Q TV released an advertisement in Deshabandhu, a vernacular daily. Instead of paying for the same, Q TV allowed Deshabandhu a free advertisement spot, which was duly utilised by Deshabandu. How revenue for these non-monetary transactions in the area of advertising will be recognized and measured?

2. A Ltd. a telecommunication company, entered into an agreement with B Ltd. which is engaged in generation and supply of power. The agreement provided that A Ltd. will provide 1,00,000 minutes of talk time to employees of B Ltd. in exchange for getting power equivalent to 20,000 units. A Ltd. normally charges ₹ 0.50 per minute and B Ltd. charges ₹ 2.5 per unit. How should revenue be measured in this case?

3. Company X enters into an agreement on 1st January, 20X1 with a customer for renovation of hospital and install new air-conditioners for total consideration of ₹ 50,00,000. The promised renovation service, including the installation of new air-conditioners is a single performance obligation satisfied over time. Total expected costs are ₹ 40,00,000 including ₹ 10,00,000 for the air conditioners.

   Company X determines that it acts as a principal in accordance with paragraphs B34-B38 of Ind AS 115 because it obtains control of the air conditioners before they are transferred to the customer. The customer obtains control of the air conditioners when they are delivered to the hospital premises.

   Company X uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation.

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As at 31st March, 20X1, other costs incurred excluding the air conditioners are ₹ 6,00,000.

Whether Company X should include cost of the air conditioners in measure of its progress of performance obligation? How should revenue be recognized for the year ended March 20X1?

4. An entity G Ltd. enters into a contract with a customer P Ltd. for the sale of a machinery for ₹ 20,00,000. P Ltd. intends to use the said machinery to start a food processing unit. The food processing industry is highly competitive and P Ltd. has very little experience in the said industry.

   P Ltd. pays a non-refundable deposit of ₹ 1,00,000 at inception of the contract and enters into a long-term financing agreement with G Ltd. for the remaining 95 per cent of the agreed consideration which it intends to pay primarily from income derived from its food processing unit as it lacks any other major source of income. The financing arrangement is provided on a non-recourse basis, which means that if P Ltd. defaults then G Ltd. can repossess the machinery but cannot seek further compensation from P Ltd., even if the full value of the amount owed is not recovered from the machinery. The cost of the machinery for G Ltd. is ₹ 12,00,000. P Ltd. obtains control of the machinery at contract inception.

   When should G Ltd. recognize revenue from sale of machinery to P Ltd. in accordance with Ind AS 115?

5. Entity I sells a piece of machinery to the customer for ₹ 2 million, payable in 90 days. Entity I is aware at contract inception that the customer might not pay the full contract price. Entity I estimates that the customer will pay atleast ₹ 1.75 million, which is sufficient to cover entity I's cost of sales (₹ 1.5 million) and which entity I is willing to accept because it wants to grow its presence in this market. Entity I has granted similar price concessions in comparable contracts.

   Entity I concludes that it is highly probable that it will collect ₹ 1.75 million, and such amount is not constrained under the variable consideration guidance.

   What is the transaction price in this arrangement?

6. On 1st January 20X8, entity J enters into a one-year contract with a customer to deliver water treatment chemicals. The contract stipulates that the price per container will be adjusted retroactively once the customer reaches certain sales volume, defined, as follows:

Price per container	Cumulative sales volume
₹ 100	1 - 1,000,000 containers
₹ 90	1,000,001 - 3,000,000 containers
₹ 85	3,000,001 containers and above

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Volume is determined based on sales during the calendar year. There are no minimum purchase requirements. Entity J estimates that the total sales volume for the year will be 2.8 million containers, based on its experience with similar contracts and forecasted sales to the customer.

Entity J sells 700,000 containers to the customer during the first quarter ended 31st March 20X8 for a contract price of ₹ 100 per container.

How should entity J determine the transaction price?

7. Entity K sells electric razors to retailers for C 50 per unit. A rebate coupon is included inside the electric razor package that can be redeemed by the end consumers for C 10 per unit.

   Entity K estimates that 20% to 25% of eligible rebates will be redeemed, based on its experience with similar programmes and rebate redemption rates available in the market for similar programmes. Entity K concludes that the transaction price should incorporate an assumption of 25% rebate redemption, as this is the amount for which it is highly probable that a significant reversal of cumulative revenue will not occur if estimates of the rebates change.

   How should entity K determine the transaction price?

8. A manufacturer enters into a contract to sell goods to a retailer for ₹ 1,000. The manufacturer also offers price protection, whereby it will reimburse the retailer for any difference between the sale price and the lowest price offered to any customer during the following six months. This clause is consistent with other price protection clauses offered in the past, and the manufacturer believes that it has experience which is predictive for this contract.

   Management expects that it will offer a price decrease of 5% during the price protection period. Management concludes that it is highly probable that a significant reversal of cumulative revenue will not occur if estimates change.

   How should the manufacturer determine the transaction price?

9. Electronics Manufacturer M sells 1,000 televisions to Retailer R for ₹ 50,00,000 (₹ 5,000 per television). M provides price protection to R by agreeing to reimburse R for the difference between this price and the lowest price that it offers for that television during the following six months. Based on M's extensive experience with similar arrangements, it estimates the following outcomes.

Price reduction in next six months (₹)	Probability
0	70%

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₹ 500	20%
₹ 1,000	10%

Determine the transaction price.

10. Construction Company C enters into a contract with Customer E to build an asset. Depending on when the asset is completed, C will receive either ₹ 1,10,000 or ₹ 1,30,000.

Outcome	Consideration (₹)	Probability
Project completes on time	1,30,000	90%
Project is delayed	1,10,000	10%

Determine the transaction price.

11. Franchisor Y Ltd. licenses the right to operate a store in a specified location to Franchisee F. The store bears Y Ltd.'s trade name and F will have a right to sell Y Ltd.'s products for 10 years. F pays an up-front fixed fee. The franchise contract also requires Y Ltd. to maintain the brand through product improvements, marketing campaigns etc. Determine the nature of license.

Answers

1. Paragraph 5(d) of Ind AS 115 excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

In industries with homogenous products, it is common for entities in the same line of business to exchange products in order to sell them to customers or potential customers other than parties to exchange. The current scenario, on the contrary, will be covered under Ind AS 115 since the same is exchange of dissimilar goods or services because both of the entities deal in different mode of media, i.e., one is print media and another is electronic media and both parties are acting as customers and suppliers for each other.

Further, in the current scenario, it seems it is for consumption by the said parties and hence it does not fall under paragraph 5(d). It may also be noted that, even if it was to facilitate sales to customers or potential customers, it would not be scoped out since the parties are not in the same line of business.

As per paragraph 47 of Ind AS 115, "An entity shall consider the terms of the contract and

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its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both".

Paragraph 66 of Ind AS 115 provides that to determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of non-cash consideration) at fair value.

In accordance with the above, Q TV and Deshabandhu should measure the revenue promised in the form of non-cash consideration as per the above referred principles of Ind AS 115.

2. Paragraph 5(d) of Ind AS 115 excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

However, the current scenario will be covered under Ind AS 115 since the same is exchange of dissimilar goods or services.

As per paragraph 47 of Ind AS 115, "an entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both".

Paragraph 66 of Ind AS 115 provides that to determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of noncash consideration) at fair value.

On the basis of the above, revenue recognized by A Ltd. will be the consideration in the form of power units that it expects to be entitled for talktime sold, i.e. ₹ 50,000 (20,000 units x ₹ 2.5). The revenue recognized by B Ltd. will be the consideration in the form of talk time that it expects to be entitled for the power units sold, i.e., ₹ 50,000 (1,00,000 minutes x ₹ 0.50).

3. Paragraph B19 of Ind AS 115 inter alia, states that, "an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring

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progress in paragraph 39, do not depict the entity's performance in transferring control of goods or services to the customer".

In accordance with the above, Company X assesses whether the costs incurred to procure the air conditioners are proportionate to the entity's progress in satisfying the performance obligation. The costs incurred to procure the air conditioners (₹ 10,00,000) are significant relative to the total costs to completely satisfy the performance obligation (₹ 40,00,000). Also, Company X is not involved in manufacturing or designing the air conditioners.

Company X concludes that including the costs to procure the air conditioners in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph B19 of Ind AS 115, the entity adjusts its measure of progress to exclude the costs to procure the air conditioners from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the air conditioners at an amount equal to the costs to procure the air conditioners (i.e., at a zero margin).

Company X assesses that as at March, 20X1, the performance is 20 per cent complete (i.e., ₹ 6,00,000 / ₹ 30,00,000). Consequently, Company X recognizes the following-

As at 31st March, 20X1

	Amount in ₹
Revenue	18,00,000
Cost of goods sold	16,00,000
Profit	2,00,000

Revenue recognized is calculated as (20 per cent × ₹ 40,00,000) + ₹ 10,00,000.

(₹ 40,00,000 = ₹ 50,00,000 transaction price – ₹ 10,00,000 costs of air conditioners.)

Cost of goods sold is ₹ 6,00,000 of costs incurred + ₹ 10,00,000 costs of air conditioners.

4. As per paragraph 9 of Ind AS 115, "An entity shall account for a contract with a customer that is within the scope of this Standard only when all of the following criteria are met:

(a) the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;

(b) the entity can identify each party's rights regarding the goods or services to be transferred;

(c) the entity can identify the payment terms for the goods or services to be transferred;

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(d) the contract has commercial substance (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and

(e) it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession".

Paragraph 9(e) above, requires that for revenue to be recognized, it should be probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In the given case, it is not probable that G Ltd. will collect the consideration to which it is entitled in exchange for the transfer of the machinery. P Ltd.'s ability to pay may be uncertain due to the following reasons:

(a) P Ltd. intends to pay the remaining consideration (which has a significant balance) primarily from income derived from its food processing unit (which is a business involving significant risk because of high competition in the said industry and P Ltd.'s little experience);

(b) P Ltd. lacks sources of other income or assets that could be used to repay the balance consideration; and

(c) P Ltd.'s liability is limited because the financing arrangement is provided on a non-recourse basis.

In accordance with the above, the criteria in paragraph 9 of Ind AS 115 are not met.

Further, para 15 states that when a contract with a customer does not meet the criteria in paragraph 9 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when either of the following events has occurred:

(a) the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable; or

(b) the contract has been terminated and the consideration received from the customer is non-refundable.

Para 16 states that an entity shall recognize the consideration received from a customer as a liability until one of the events in paragraph 15 occurs or until the criteria in paragraph 9

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are subsequently met. Depending on the facts and circumstances relating to the contract, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

In accordance with the above, in the given case G Ltd. should account for the non-refundable deposit of ₹ 1,00,000 payment as a deposit liability as none of the events described in paragraph 15 have occurred—that is, neither the entity has received substantially all of the consideration, nor it has terminated the contract. Consequently, in accordance with paragraph 16, G Ltd. will continue to account for the initial deposit as well as any future payments of principal and interest as a deposit liability until the criteria in paragraph 9 are met (i.e. the entity is able to conclude that it is probable that the entity will collect the consideration) or one of the events in paragraph 15 has occurred. Further, G Ltd. will continue to assess the contract in accordance with paragraph 14 to determine whether the criteria in paragraph 9 are subsequently met or whether the events in paragraph 15 of Ind AS 115 have occurred.

5. Entity I is likely to provide a price concession and accept an amount less than ₹ 2 million in exchange for the machinery. The consideration is therefore variable. The transaction price in this arrangement is ₹ 1.75 million, as this is the amount which entity I expects to receive after providing the concession and it is not constrained under the variable consideration guidance. Entity I can also conclude that the collectability threshold is met for ₹ 1.75 million and therefore contract exists.

6. The transaction price is ₹ 90 per container based on entity J's estimate of total sales volume for the year, since the estimated cumulative sales volume of 2.8 million containers would result in a price per container of ₹ 90. Entity J concludes that based on a transaction price of ₹ 90 per container, it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. Revenue is therefore recognized at a selling price of ₹ 90 per container as each container is sold. Entity J will recognize a liability for cash received in excess of the transaction price for the first 1 million containers sold at ₹ 100 per container (that is, ₹ 10 per container) until the cumulative sales volume is reached for the next pricing tier and the price is retroactively reduced.

For the quarter ended 31st March, 20X8, entity J recognizes revenue of ₹ 63 million (700,000 containers x ₹ 90) and a liability of ₹ 7 million [700,000 containers x (₹ 100 - ₹ 90)].

Entity J will update its estimate of the total sales volume at each reporting date until the uncertainty is resolved.

7. Entity K records sales to the retailer at a transaction price of ₹ 47.50 (₹ 50 less 25% of ₹ 10). The difference between the per unit cash selling price to the retailers and the

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transaction price is recorded as a liability for cash consideration expected to be paid to the end customer. Entity K will update its estimate of the rebate and the transaction price at each reporting date if estimates of redemption rates change.

8. The transaction price is ₹ 950, because the expected reimbursement is ₹ 50. The expected payment to the retailer is reflected in the transaction price at contract inception, as that is the amount of consideration to which the manufacturer expects to be entitled after the price protection. The manufacturer will recognize a liability for the difference between the invoice price and the transaction price, as this represents the cash that it expects to refund to the retailer. The manufacturer will update its estimate of expected reimbursement at each reporting date until the uncertainty is resolved.

9. After considering all relevant facts and circumstances, M determines that the expected value method provides the best prediction of the amount of consideration to which it will be entitled. As a result, it estimates the transaction price to be ₹ 4,800 per television – i.e. (₹ 5,000 x 70%) + (₹ 4,500 x 20%) + (₹ 4,000 x 10%).

10. Because there are only two possible outcomes under the contract, C determines that using the most likely amount provides the best prediction of the amount of consideration to which it will be entitled. C estimates the transaction price to be ₹ 1,30,000, which is the single most likely amount.

11. The licence provides F access to the IP as it exists at any point in time in the licence period. This is because:

- Y Ltd. is required to maintain the brand, which will significantly affect the IP by affecting F's ability to obtain benefit from the brand;
- any action by Y Ltd. may have a direct positive or negative effect on F; and
- these activities do not transfer a goods or service to F.

Therefore, Y Ltd. recognizes the up-front fee over the 10-year franchise period.

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NOTES

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ANNEXURE

DIVISION II OF SCHEDULE III TO THE COMPANIES ACT, 2013



Division II

Financial Statements for a company whose financial statements are drawn up in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATMENT OF A COMPANY REQUIRED TO COMPLY WITH Ind AS

1. Every company to which Indian Accounting Standards apply, shall prepare its financial statements in accordance with this Schedule or with such modification as may be required under certain circumstances.

2. Where compliance with the requirements of the Act including Indian Accounting Standards (except the option of presenting assets and liabilities in the order of liquidity as provided by the relevant Ind AS) as applicable to the companies require any change in treatment or disclosure including addition, amendment substitution or deletion in the head or sub-head or any changes inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements under this Schedule shall stand modified accordingly.

3. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Indian Accounting Standards. Additional disclosures specified in the Indian Accounting Standards shall be made in the Notes or by way of additional statement or statements unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act, 2013 shall be made in the Notes in addition to the requirements set out in this Schedule.

4. (i) Notes shall contain information in addition to that presented in the Financial Statements and shall provide where required-

   (a) narrative description or disaggregation of items recognised in those statements; and

   (b) information about items that do not qualify for recognition in those statements.

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(ii) Each item on the face of the Balance Sheet, Statement of Changes in Equity and Statement of Profit and Loss shall be cross-referenced to any related information in the Notes. In preparing the Financial Statements including the Notes, a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation.

5. Depending upon the ***Total Income*** of the company, the figures appearing in the Financial Statements shall be rounded off as below:

Total Income	Rounding off
(i) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof
(Ii) one hundred crore rupees or more	To the nearest, lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

6. Financial Statements shall contain the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statement including Notes except in the case of first Financial Statements laid before the company after incorporation.

7. Financial Statements shall disclose all 'material' items, i,e, the items if they could. individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size or nature of the item or a combination of both, to be judged in the particular circumstances.

8. For the purpose of this Schedule, the terms used herein shall have the same meanings assigned to them in Indian Accounting Standards.

9. Where any Act or Regulation requires specific disclosure to be made in the standalone financial statement of a company, the said disclosure shall be made in addition to those required under this Schedule.

Note: This Schedule sets out the minimum requirements for disclosure on the face of the Financial Statements, i.e, Balance Sheet, Statement of Changes in Equity for the period, the Statement of profit and Loss for the period (The term 'Statement of Profit and Loss' has the same meaning as Profit and Loss Account) and Notes. Cash flow statement shall be prepared, where applicable, in accordance with the requirement of the relevant Indian Accounting Standard.

Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance to cater to industry or sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act, 2013 or under the Indian Accounting Standards.

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PART I -BALANCE SHEET

Name of the Company.....

Balance Sheet as at .....

(₹ in.....)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
(1)	ASSETS			
	Non-current assets			
	(a) Property, Plant and Equipment (b) Capital work-in-progress (c) Investment Property (d) Goodwill (e) Other Intangible assets (f) Intangible assets under development (g) Biological Assets other than bearer plants (h) Financial Assets (i) Investments (ii) Trade receivables (iii) Loans (i) Deferred tax assets (net) (j) Other non-current assets			
(2)	Current assets (a) Inventories (b) Financial Assets (i) Investments (ii) Trade receivables (iii) Cash and cash equivalents			

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	(iv) Bank balances other than (iii) above (v) Loans (vi) Others (to be specified) (c) Current Tax Assets (Net) (d) Other current assets			
	Total Assets			
	EQUITY AND LIABILITIES Equity (a) Equity Share capital (b) Other Equity			
(1)	LIABILITIES Non-current liabilities (a) Financial Liabilities (i) Borrowings (ia) ***Lease liabilities*** (ii) Trade Payables: (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises. (iii) Other financial liabilities (other than those specified in item (b), to be specified) (b) Provisions (c) Deferred tax liabilities (Net) (d) Other non-current liabilities			
(2)	Current liabilities (a) Financial Liabilities (i) Borrowings (ia) ***Lease liabilities*** (ii) Trade payables: (A) total outstanding dues of micro enterprises and small enterprises; and			

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	(B) total outstanding dues of creditors other than micro enterprises and small enterprises (iii) Other financial liabilities (other than those specified in item (c) (b) Other current liabilities (c) Provisions (d) Current Tax Liabilities (Net)			
	Total Equity and Liabilities			

see accompanying notes to the financial statements

STATEMENT OF CHANGES IN EQUITY

Name of the Company.....

A. Equity Share Capital

(1) ***Current reporting period***

Balance at the beginning of the *current* reporting period	*Changes in Equity Share Capital due to prior period errors*	*Restated balance at the beginning of the current reporting period*	Changes in equity share capital during the *current* year	Balance at the end of the *current* reporting period

(2) ***Previous reporting period***

Balance at the beginning of the previous reporting period	*Changes in Equity Share Capital due to prior period errors*	*Restated balance at the beginning of the previous reporting period*	*Changes in equity share capital during the previous year*	*Balance at the end of the previous reporting period*

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B. Other Equity

(1) Current Reporting Period

	Share application on money pending allotment	Equity component of compound financial instruments	Reserves and Surplus				Debt Instruments through other Comprehensive Income	Equity Instruments through Other Comprehensive Income	Effective portion of Cash Flow Hedges	Revaluation Surplus	Exchange differences on translating the financial statements of a foreign operation	Other items of Other Comprehensive Income (specify nature)	Money received against share capital	Total
			Capital Reserve	Securities Premium	Other Reserves (specify nature)	Retained Earnings								
Balance at the beginning of the ***current*** reporting period														
Changes in accounting policy or prior period errors														
Restated balance at the beginning of the ***current*** reporting period														
Total comprehensive Income for the ***current*** year														
Dividends														
Transfer to retained earnings														
Any other change (to be specified)														
Balance at the end of the ***current*** reporting period														

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(1) Previous Reporting Period

	Share application on money pending allotment	Equity component of compound financial instruments	Reserves and Surplus				Debt Instruments through other Comprehensive Income	Equity Instruments through Other Comprehensive Income	Effective portion of Cash Flow Hedges	Revaluation Surplus	Exchange differences on translating the financial statements of a foreign operation	Other items of Other Comprehensive Income (specify nature)	Money received against share capital	Total
			Capital Reserve	Securities Premium	Other Reserves (specify nature)	Retained Earnings								
Balance at the beginning of the previous reporting period														
Changes in accounting policy or prior period errors														
Restated balance at the beginning of the previous reporting period														
Total comprehensive Income for the previous year														
Dividends														
Transfer to retained earnings														
Any other change (to be specified)														
Balance at the end of the previous reporting period														

Note: Re-measurement of defined benefit plans and fair value changes relating to own credit risk of financial liabilities designated at fair value through profit or loss shall be recognised as a part of retained earnings with separate disclosure of such items alongwith the relevant amounts in the Notes or shall be shown as a separate column under Reserves and Surplus.

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GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An entity shall classify an asset as current when-

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

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

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

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

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

2. The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents, When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.

3. An entity shall classify a liability as current when-

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

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

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

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

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

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the Notes:

A Non-Current Assets

   I. Property, Plant and Equipment

      (i) Classification shall be given as:

         (a) Land

         (b) Buildings

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(c) Plant and Equipment

(d) Furniture and Fixtures

(e) Vehicles

(f) Office equipment

(g) Bearer Plants

(h) Others (specify nature)

(ii) Assets under lease shall be separately specified under each class of assets

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, ***amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property ,Plant and Equipment)*** and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

II. Investment Property

A reconciliation of the gross and net carrying amounts of each class of property at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

III. Goodwill

A reconciliation of the gross and net carrying amount of goodwill at the beginning and end of the reporting period showing additions, impairments, disposals and other adjustments.

IV. Other Intangible assets

(i) Classification shall be given as:

(a) Brands or trademarks

(b) Computer software

(c) Mastheads and publishing titles

(d) Mining rights

(e) Copyright, patents, other intellectual property rights, services and operating rights

(f) Recipes, formulae, models, designs and prototypes

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(g) Licenses and franchises

(h) Others (specify nature)

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, ***amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets)*** and other adjustments and the related amortization and impairment losses or reversals shall be disclosed separately.

V. Biological Assets other than bearer plants

A reconciliation of the carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments shall be disclosed separately.

VI. Investment

(i) Investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investments in Preference Shares;

(c) Investments in Government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms; or

(g) Other investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate that are-

(i) subsidiaries,

(ii) associates,

(iii) joint ventures, or

(iv) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). Investment in partnership firms along with names of the firms, their partners, total capital and the shares of each partner shall be disclosed separately.

(ii) The following shall also be disclosed:

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(a) Aggregate amount of quoted investment and market value thereof:

(b) Aggregate amount of unquoted investment: and

(c) Aggregate amount of impairment in value of investment.

VII. Trade Receivables

(i) Trade receivables shall be sub-classified as;

(a) Trade Receivables considered good - Secured;

(b) Trade Receivables considered good - Unsecured;

(c) Trade Receivables which have significant increase in Credit Risk; and

(d) Trade Receivables - credit impaired

(ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(iv) For trade receivables outstanding, following ageing schedule shall be given:

Trade Receivables ageing schedule ***(Amount in Rs.)***

Particulars	***Outstanding for following periods from due date of payment****					
	Less than 6 months	***6 months-1 year***	***1-2 years***	***2-3 years***	***More than 3 years***	***Total***
(i) Undisputed Trade receivables – considered good						
(ii) Undisputed Trade Receivables – which have significant increase in credit risk						
(iii) Undisputed Trade Receivables – credit impaired						

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(iv) Disputed Trade Receivables– considered good						
(v) Disputed Trade Receivables – which have significant increase in credit risk						
(vi) Disputed Trade Receivables – credit impaired						

** similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction.*

Unbilled dues shall be disclosed separately

VIII. Loans

(i) Loans shall be classified as-

(a) Loans to related parties (giving details thereof); and

(b) Other loans (specify nature).

(ii) Loans Receivables shall be sub-classified as:

(a) Loans Receivables considered good - Secured;

(b) Loans Receivables considered good - Unsecured;

(c) Loans Receivables which have significant increase in Credit Risk; and

(d) Loans Receivables - credit impaired;

The above shall also be separately sub-classified as-

(a) Secured, considered good;

(b) Unsecured, considered good; and

(c) Doubtful.

(iii) Allowance for bad and doubtful loans shall be disclosed under the relevant heads separately.

(iv) Loans due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

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IX. Other financial assets

(i) Security Deposits

(ii) Bank deposits with more than 12 months maturity

(iii) Others (to be specified)

X. Other non-current asset: Other non-current assets shall be classified as

(i) Capital Advances; and

(ii) Advances other than capital advances;

(1) Advances other than capital advances shall be classified as:

(a) Security deposits;

(b) Advances to related parties (giving details thereof; and

(c) Other advances (specify nature).

(2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private companies respectively in which any director is a partner or a director or a member should be separately stated, In case advances are of the nature of a financial asset as per relevant Ind AS, these are to be disclosed under other financial assets separately.

(iii) Others (specify nature).

B. Current Assets

I. Inventories

(i) Inventories shall be classified as-

(a) Raw materials;

(b) Work in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) stores and spares;

(f) Loose tools; and

(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

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II. Investment

(i) Investments shall be classified as-

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investment in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investment in partnership firms; and

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate that are-

(i) subsidiaries,

(ii) associates,

(iii) joint ventures, or

(iv) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid)

(ii) The following shall also be disclosed

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate amount of impairment in value of investments,

III. Trade Receivables

(i) Trade receivables shall be sub-classified as:

(a) Trade Receivables considered good - Secured;

(b) Trade Receivables considered good - Unsecured;

(c) Trade Receivables which have significant increase in Credit Risk; and

(d) Trade Receivables - credit impaired.

(ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or. private companies

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respectively in which any director is a partner or a director or a member should be separately stated.

(iv) For trade receivables outstanding, following ageing schedule shall be given:

Trade Receivables ageing schedule ***(Amount in Rs.)***

Particulars	***Outstanding for following periods from due date of payment****					
	Less than 6 months	***6 months-1 year***	***1-2 years***	***2-3 years***	***More than 3 years***	***Total***
(i) Undisputed Trade receivables – considered good						
(ii) Undisputed Trade Receivables – which have significant increase in credit risk						
(iii) Undisputed Trade Receivables – credit impaired						
(iv) Disputed Trade Receivables– considered good						
(v) Disputed Trade Receivables – which have significant increase in credit risk						
(vi) Disputed Trade Receivables – credit impaired						

** similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction.*

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Unbilled dues shall be disclosed separately

IV. Cash and cash equivalents

Cash and cash equivalents shall be classified as-

a. Balances with Banks (of the nature of cash and cash equivalents);

b. Cheques, drafts on hand;

c. Cash on hand; and

d. Others (specify nature).

V. Loans

(i) Loans shall be classified as:

(a) Loans to related parties (giving details thereof); and

(b) others (specify nature).

(ii) Loans Receivables shall be sub-classified as:

(a) Loans Receivables considered good - Secured;

(b) Loans Receivables considered good - Unsecured;

(c) Loans Receivables which have significant increase in Credit Risk; and

(d) Loans Receivables - credit impaired.

(iii) Allowance for bad and doubtful loans shall be disclosed under the relevant heads separately.

(iv) Loans due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

VA. Other Financial Assets: This is an all-inclusive heading, which incorporates financial assets that do not fit into any other financial asset categories, such as, Security Deposits.

VI. Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

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Other current assets shall be classified as-

(i) Advances other than capital advances

(1) Advances other than capital advances shall be classified as:

(a) Security Deposits;

(b) Advances to related parties (giving details thereof);

(c) Other advances (specify nature)

(2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(a) Earmarked balances with banks (for example for unpaid dividend) shall be separately stated.

(b) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(c) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

D. Equity

I. Equity Share Capital

For each class of equity share capital:

(a) the number and amount of shares authorised;

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

(c) par value per Share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;

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

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

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(g) shares in the company held by each shareholder holding more than five per cent. shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts or commitments for the sale of shares or disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date at which the Balance Sheet is prepared

- aggregate number and class of shares allotted as fully paid up pursuant to contract without payment being received in cash;
- aggregate number and class of shares allotted as fully paid up by way of bonus shares; and
- aggregate number and class of shares bought back;

(j) terms of any securities convertible into equity shares issued along with the earliest date of conversion in descending order starting from the farthest such date;

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers);

(l) forfeited shares (amount originally paid up).

(m) A company shall disclose Shareholding of Promoters* as under:

Shares held by promoters at the end of the year				% Change during the year***
S. No	Promoter name	No. of Shares**	% of total shares	
Total				

*Promoter here means promoter as defined in the Companies Act, 2013.

**Details shall be given separately for each class of shares

***Percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.

II. Other Equity

(i) 'Other Reserves' shall be classified in the notes as-

(a) Capital Redemption Reserve;

(b) Debenture Redemption Reserve;

(c) Share Options Outstanding Account; and

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(d) Others- (specify the nature and purpose of each reserve and the amount in respect thereof);

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) Retained Earnings represents surplus i.e. balance of the relevant column in the Statement of Changes in Equity;

(iii) A reserve specifically represented by earmarked investments shall disclose the fact that it is so represented;

(iv) Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'retained earnings'. Similarly, the balance of 'Other Equity', after adjusting negative balance of retained earnings, if any, shall be shown under the head 'Other Equity' even if the resulting figure is in the negative; and

(v) Under the sub-head 'Other Equity', disclosure shall be made for the nature and amount of each item.

E. Non-Current Liabilities

I. Borrowings

(i) borrowings shall be classified as-

(a) Bonds or debentures

(b) Term loans

(I) from banks

(II) from other Parties

(c) Deferred payment liabilities

(d) Deposits

(e) Loans from related parties

(f) Liability component of compound financial instruments

(g) Other loans (specify nature);

(ii) borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed;

(iv) bonds or debentures (along with the rate of interest, and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity

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or conversion, starting from farthest redemption or conversion date, as the case may be, where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due;

(v) particulars of any redeemed bonds or debentures which the company has power to reissue shall be disclosed;

(vi) terms of repayment of term loans and other loans shall be stated; and

(vii) period and amount of default as on the balance sheet date in repayment of borrowings and interest shall be specified separately in each case.

III. Provisions

The amounts shall be classified as-

(a) Provision for employee benefits; and

(b) Others (specify nature).

IV. Other non-current liabilities

(a) Advances; and

(b) Others (specify nature).

F. Current Liabilities

I. Borrowings

(i) Borrowings shall be classified as-

(a) Loans repayable on demand

(I) from banks

(II) from other parties

(b) Loans from related parties

(c) Deposits

(d) Other loans (specify nature);

(ii) borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case;

(iii) where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed;

(iv) period and amount of default as on the balance sheet date in repayment of borrowings and interest, shall be specified separately in each case;

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(v) Current maturities of long-term borrowings shall be disclosed separately.

II. Other Financial Liabilities

Other Financial liabilities shall be classified as-

(a) Interest accrued;

(b) Unpaid dividends;

(c) Application money received for allotment of securities to the extent refundable and interest accrued thereon;

(d) Unpaid matured deposits and interest accrued thereon;

(e) Unpaid matured debentures and interest accrued thereon; and

(f) Others (specify nature).

'Long term debt' is a borrowing having a period of more than twelve months at the time of origination.

III. Other current liabilities

The amounts shall be classified as-

(a) revenue received in advance;

(b) other advances (specify nature); and

(c) others (specify nature);

IV. Provisions

The amounts shall be classified as-

(i) provision for employee benefits; and

(ii) others (specify nature)

FA. Trade Payables

The following details relating to micro, small and medium enterprises shall be disclosed in the notes:

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006), along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) the amount of interest due and payable for the period of delay in making payment (which has been paid but beyond the appointed day during the year) but without adding the

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interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and

(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.- The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning as assigned to them under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

FB. For trade payables due for payment, following ageing schedule shall be given:

Trade Payables aging schedule ***(Amount in ₹)***

Particulars	***Outstanding for following periods from due date of payment****				
	Less than 1 year	***1-2 years***	***2-3 years***	***More than 3 years***	***Total***
(i) MSME					
(ii) Others					
(iii) Disputed dues – MSME					
(iv) Disputed dues - Others					

*Similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

G. The presentation of liabilities associated with group of assets classified as held for sale and non-current assets classified as held for sale shall be in accordance with the relevant Indian Accounting Standards (Ind ASs)

H. **Contingent Liabilities and Commitments (to the extent not provided for)**

(i) Contingent Liabilities shall be classified as-

(a) claims against the company not acknowledged as debt;

(b) guarantees excluding financial guarantees; and

(c) other money for which the company is contingently liable.

(ii) Commitments shall be classified as-

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(a) estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) uncalled liability on shares and other investments partly paid; and

(c) other commitments (specify nature).

I. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and title related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on irredeemable preference shares shall also be disclosed separately.

J. Where in respect of an issue of securities made for a specific purpose the whole or part of amount has not been used for the specific purpose at the Balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

JA. Where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the balance sheet date, the company shall disclose the details of where they have been used.

L. Additional Regulatory Information

(i) Title deeds of Immovable Properties not held in name of the Company

The company shall provide the details of all the immovable properties (other than properties where the Company is the lessee and the lease agreements are duly executed in favour of the lessee) whose title deeds are not held in the name of the company in following format and where such immovable property is jointly held with others, details are required to be given to the extent of the company's share.

Relevant line item in the Balance sheet	Description of item of property	Gross carrying value	Title deeds held in the name of	Whether title deed holder is a promoter, director or relative# of promoter*/ director or employee of promoter/director	Property held since which date	Reason for not being held in the name of the company**
PPE -	Land Building	-	-	-	-	**also indicate if in dispute

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Investment property -	Land Building					
PPE retired from active use and held for disposal	Land Building					
Others						

#Relative here means relative as defined in the Companies Act, 2013.

*Promoter here means promoter as defined in the Companies Act, 2013.

(ii) The Company shall disclose as to whether the fair value of investment property (as measured for disclosure purposes in the financial statements) is based on the valuation by a registered valuer as defined under rule 2 of Companies (Registered Valuers and Valuation) Rules, 2017.

(iii) Where the Company has revalued its Property, Plant and Equipment (including Right-of-Use Assets), the company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of Companies (Registered Valuers and Valuation) Rules, 2017.

(iv) Where the company has revalued its intangible assets, the company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of Companies (Registered Valuers and Valuation) Rules, 2017.

(v) The following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, directors, KMPs and the related parties (as defined under Companies Act, 2013), either severally or jointly with any other person, that are:

(a) repayable on demand; or

(b) without specifying any terms or period of repayment,

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

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(vi) Capital-Work-in Progress (CWIP)

(a) For Capital-work-in progress, following ageing schedule shall be given:

CWIP aging schedule

(Amount in Rs.)

CWIP	***Amount in CWIP for a period of***				***Total****
	Less than 1 year	***1-2 years***	***2-3 years***	***More than 3 years***	
Project in progress					
Projects temporarily suspended					

**Total shall tally with CWIP amount in the balance sheet.*

(b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given**:

(Amount in ₹)

CWIP	***To be completed in***			
	Less than 1 year	***1-2 years***	***2-3 years***	***More than 3 years***
Project 1				
Project 2				

***Details of projects where activity has been suspended shall be given separately.*

(vii) Intangible assets under development:

(a) For Intangible assets under development, following ageing schedule shall be given:

Intangible assets under development aging schedule

(Amount in ₹)

Intangible assets under development	***Amount in CWIP for a period of***				***Total****
	Less than 1 year	***1-2 years***	***2-3 years***	***More than 3 years***	
Project in progress					
Projects temporarily suspended					

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** Total shall tally with the amount of Intangible assets under development in the balance sheet.*

(b) For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, the following Intangible assets under development completion schedule shall be given**:

(Amount in ₹)

CWIP	To be completed in			
	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

*****Details of projects where activity has been suspended shall be given separately.***

(viii) Details of Benami Property held

Where any proceeding has been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, the company shall disclose the following:

(a) Details of such property,

(b) Amount thereof,

(c) Details of Beneficiaries,

(d) If property is in the books, then reference to the item in the Balance Sheet,

(e) If property is not in the books, then the fact shall be stated with reasons,

(f) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor then the details shall be provided,

(g) Nature of proceedings, status of same and company's view on same.

(ix) where the Company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following:

(a) whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts;

(b) if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

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(x) Wilful Defaulter*

Where a company is a declared wilful defaulter by any bank or financial Institution or other lender, following details shall be given:

(a) Date of declaration as wilful defaulter,

(b) Details of defaults (amount and nature of defaults)

** wilful defaulter" here means a person or an issuer who or which is categorized as a wilful defaulter by any bank or financial institution (as defined under the Companies Act, 2013) or consortium thereof, in accordance with the guidelines on wilful defaulters issued by the Reserve Bank of India.*

(xi) Relationship with Struck off Companies

***Where the company has any transactions with companies struck off under section** 248 of the Companies Act, 2013 or section 560 of Companies Act, 1956, the Company shall disclose the following details, namely:*

Name of struck off Company	***Nature of transactions with struck off Company***	***Balance Outstanding***	***Relationship with the Struck off company, if any, to be disclosed***
	Investments in securities		
	Receivables		
	Payables		
	Shares held by stuck off company		
	Other outstanding balances (to be specified)		

(xii) Registration of charges or satisfaction with Registrar of Companies (ROC)

Where any charges or satisfaction yet to be registered with ROC beyond the statutory period, details and reasons thereof shall be disclosed.

(xiii) Compliance with number of layers of companies

Where the company has not complied with the number of layers prescribed under clause (87) of section 2 of the Act read with the Companies (Restriction on number of Layers) Rules, 2017, the name and CIN of the companies beyond the specified layers and the relationship or extent of holding of the company in such downstream companies shall be disclosed.

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(xiv) Following Ratios to be disclosed:

(a) Current Ratio,

(b) Debt-Equity Ratio,

(c) Debt Service Coverage Ratio,

(d) Return on Equity Ratio,

(e) Inventory turnover ratio,

(f) Trade Receivables turnover ratio,

(g) Trade payables turnover ratio,

(h) Net capital turnover ratio,

(i) Net profit ratio,

(j) Return on Capital employed,

(k) Return on investment.

The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

(xv) Compliance with approved Scheme(s) of Arrangements

Where the Scheme of Arrangements has been approved by the Competent Authority in terms of sections 230 to 237 of the Companies Act, 2013, the company shall disclose that the effect of such Scheme of Arrangements have been accounted for in the books of account of the Company in accordance with the Scheme and in accordance with accounting standards' and any deviation in this regard shall be explained.

(xvi) Utilisation of Borrowed funds and share premium:

(A) Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall

(i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or

(ii) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries; the company shall disclose the following:

(I) date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.

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(II) date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries alongwith complete details of the ultimate beneficiaries.

(III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).

(B) Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall

(i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or

(ii) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:

(I) date and amount of fund received from Funding parties with complete details of each Funding party.

(II) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries alongwith complete details of the other intermediaries or ultimate beneficiaries.

(III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).]

7. When a company applies an accounting policy retrospectively or makes a restatement of items in the financial statements or when it reclassifies items in its financial statements, the company shall attach to the Balance Sheet, a "Balance Sheet" as at the beginning of the earliest comparative period presented.

8. Share application money pending allotment shall be classified into equity or liability in accordance with relevant Indian Accounting Standards. share application money to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable shall be separately shown under 'Other financial liabilities'.

9. Preference shares including premium received on issue, shall be classified and presented as 'Equity' or 'Liability' in accordance with the requirements of the relevant Indian Accounting Standards. Accordingly, the disclosure and presentation requirements in that regard applicable

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to the relevant class of equity or liability shall be applicable mutatis mutandis to the preference shares. For instance, plain vanilla redeemable preference shares shall be classified and presented under 'non-current liabilities' as 'borrowings' and the disclosure requirements in this regard applicable to such borrowings shall be applicable mutatis mutandis to redeemable preference shares.

10. Compound financial instruments such as convertible debentures, where split into equity and liability components, as per the requirements of the relevant Indian Accounting Standards, shall be classified and presented under the relevant heads in 'Equity' and 'Liabilities'

11. Regulatory Deferral Account Balances shall be presented in the Balance Sheet in accordance with the relevant Indian Accounting Standards.

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PART II - STATEMENT OF PROFIT AND LOSS

Name of the Company.....

Statement of Profit and Loss for the period ended.....

	Particulars	Note No.	Figures as at the end of current reporting period	Figures for the previous reporting period
I	Revenue from operations			
II	Other Income			
III	Total Income (I + II)			
IV	EXPENSES Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress			
	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expenses			
	Other expenses			
	Total expenses (IV)			
V	Profit/(loss) before exceptional items and tax (I-IV)			
VI	Exceptional Items			
VII	Profit/ (loss) before exceptions items and tax(V-VI)			
VIII	Tax expense: (1) Current tax (2) Deferred tax			
IX	Profit (Loss) for the period from continuing operations (VII - VIII)			
X	Profit/(loss) from discontinued operations			

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XI	Tax expenses of discontinued operations			
XII	Profit/(loss) from Discontinued operations (after tax) (X-XI)			
XIII	Profit/(loss) for the period (IX+XII)			
XIV	Other Comprehensive Income A. (i) Items that will not be reclassified to profit or loss (ii) Income tax relating to items that will not be reclassified to profit or loss B. (i) Items that will be reclassified to profit or loss (ii) Income tax relating to items that will be reclassified to profit or loss			
XV	Total Comprehensive Income for the period (XIII+XIV) Comprising Profit (Loss) and Other comprehensive Income for the period)			
XVI	Earnings per equity share (for continuing operation): (1) Basic (2) Diluted			
XVII	Earnings per equity share (for discontinued operation): (1) Basic (2) Diluted			
XVIII	Earning per equity share (for discontinued & continuing operation) (1) Basic (2) Diluted			

see accompanying notes to the financial statements

GENERAL INSTRUCTIONS FOR PREPARING OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account, in like manner as they apply to a Statement of Profit and Loss,

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2. The Statement of Profit and Loss shall include:

   (1) Profit of loss for the Period;

   (2) Other Comprehensive Income for the period

   The sum of (1) and (2) above is “Total Comprehensive Income"

3. Revenue from operations shall disclose separately in the notes

   (a) sale of products (including Excise Duty);

   (b) sale of services;

   (ba) Grants or donations received (relevant in case of section 8 companies only); and

   (c) other operating revenues.

4. Finance Costs: Finance costs shall be classified as-

   (a) interest;

   (b) dividend on redeemable preference shares;

   (c) exchange differences regarded as an adjustment to borrowing costs; and

   (d) other borrowing costs (specify nature).

5. Other income: other income shall be classified as-

   (a) interest Income;

   (b) dividend Income; and

   (c) other non-operating income (net of expenses directly attributable to such income)

6. Other Comprehensive Income shall be classified into-

   (A) Items that will not be reclassified to profit or loss

      (i) Changes in revaluation surplus;

      (ii) Re-measurements of the defined benefit plans;

      (iii) Equity Instruments through Other Comprehensive Income;

      (iv) Fair value changes relating to own credit risk of financial liabilities designated at fair value through profit or loss;

      (v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and

      (v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and

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(vi) Others (specify nature).

(B) Items that will be reclassified to profit or loss;

(i) Exchange differences in translating the financial statements of a foreign operation;

(ii) Debt instruments through Other Comprehensive Income;

(iii) The effective portion of gains and loss on hedging instruments in a cash flow hedge;

(iv) Share of other comprehensive income in Associates and Joint Ventures, to the extent to be classified into profit or loss; and

(v) Others (specify nature)

7. Additional Information: A Company shall disclose by way of notes, additional information regarding aggregate expenditure and income on the following items:

(a) employee Benefits expense (showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) share based payments to employees, (iv) staff welfare expenses).

(b) depreciation and amortisation expense;

(c) any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 10,00,000, whichever is higher, in addition to the consideration of 'materiality 'as specified in clause 7 of the General Instructions for Preparation of Financial Statements of a Company;

(d) interest Income;

(e) interest Expense

(f) dividend income;

(g) net gain or loss on sale of investments;

(h) net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(i) payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for other services, (e) for reimbursement of expenses;

(j) in case of companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities; and

(k) details of items of exceptional nature;

(l) Undisclosed income

The Company shall give details of any transaction not recorded in the books of accounts that has been surrendered or disclosed as income during the year in the tax assessments under

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the Income Tax Act, 1961 (such as, search or survey or any other relevant provisions of the Income Tax Act, 1961), unless there is immunity for disclosure under any scheme and shall also state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

(m) Corporate Social Responsibility (CSR)

Where the company covered under section 135 of the Companies Act, the following shall be disclosed with regard to CSR activities:-

(i) amount required to be spent by the company during the year,

(ii) amount of expenditure incurred,

(iii) shortfall at the end of the year,

(iv) total of previous years shortfall,

(v) reason for shortfall,

(vi) nature of CSR activities,

(vii) details of related party transactions, e.g.,contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,

(viii) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year shall be shown separately.

(n) Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:-

(i) profit or loss on transactions involving Crypto currency or Virtual Currency,

(ii) amount of currency held as at the reporting date,

(iii) deposits or advances from any person for the purpose of trading or investing in Crypto Currency or virtual currency.

8. Changes in Regulatory Deferral Account Balances shall be presented in the Statement of Profit and Loss in accordance with the relevant Indian Accounting Standards

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PART III - GENERAL INSRUCTIONS FOR THE PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

1. Where a company is required to prepare Consolidated Financial Statements, i.e,, consolidated balance sheet, consolidated statement of changes in equity and consolidated statement of profit and loss, the company shall mutatis mutandis follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet, statement of changes in equity and statement of profit and loss .In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules 2015, including the following, namely:

   (i) Profit or loss attributable to 'non-controlling interest 'and to 'owners of the parent' in the statement of profit and loss shall be presented as allocation for the period Further, 'total comprehensive income for the period attributable to 'non-controlling interest' and to 'owners of the parent shall be presented in the statement of profit and loss as allocation for the period. The aforesaid disclosures for 'total comprehensive income shall also be made in the statement of changes in equity. In addition to the disclosure requirements in the Indian Accounting Standards, the aforesaid disclosures shall also be made in respect of 'other comprehensive Income

   (ii) 'Non-controlling interests' in the Balance Sheet and in the Statement of Changes in Equity, within equity, shall be presented separately from the equity of the 'owners of the parent'.

   (iii) Investments accounted for using the equity method.

2. In Consolidated Financial Statement, the following shall be disclosed by the way of additional information

Name of the entity in the Group	Net Asset i.e. total assets minus total liabilities		Share in profit or loss		Share in other comprehensive income		Share in total comprehensive income	
	As % of consolidated net assets	Amount	As % of consolidated profit or loss	Amount	As % of consolidated other comprehensive income	Amount	As % of total comprehensive income	Amount
Parent Subsidiaries In dian 1. 2. 3. Foreign								

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1. 2. 3. Non-Controlling Interest in all subsidiaries Associates (Investment as per the equity method) Indian 1. 2. 3. Foreign 1. 2. 3. Joint Venture (Investment as per the equity method) Indian 1. 2. 3. Foreign 1. 2. 3.								
Total								

3. All subsidiaries, associates and joint venture (whether Indian or Foreign) will be covered under consolidated financial statement.

4. An entity shall disclose the list of subsidiaries or associates or joint venture which have been consolidated in the consolidated financial statement along with the reason of not consolidating.

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NOTES

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CHAPTER 6

IND AS ON ASSETS OF THE FINANCIAL STATEMENTS



UNIT 1:
INDIAN ACCOUNTING STANDARD 2: INVENTORIES

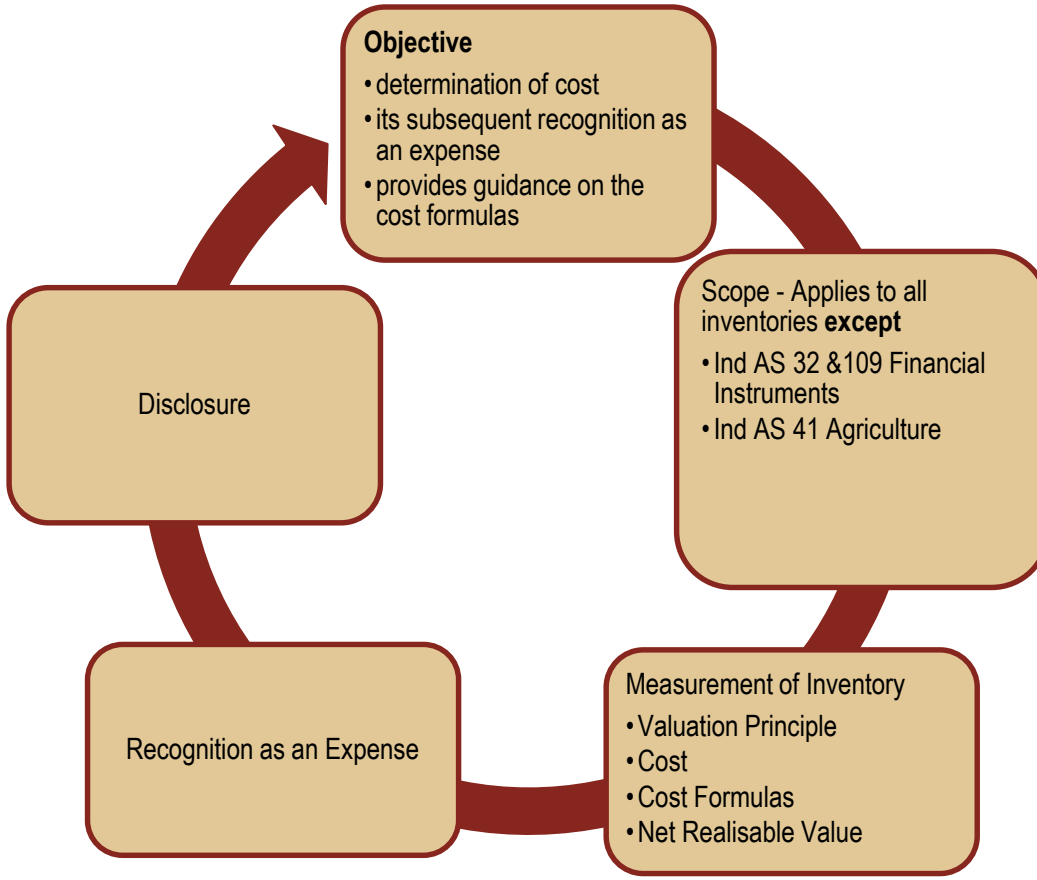
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Describe the objective and scope of the standard
- Define the terms inventories, net realisable value and fair value
- Determine the inventory cost
- Apply the cost formula for valuation of inventory
- Evaluate as to how and when to perform write-downs to net realisable value
- Recognize the write downs as an expense

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UNIT OVERVIEW



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1.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for inventories. This Standard provides guidance for determining the cost of inventories and for subsequent recognition as an expense, including any write-down to net realisable value.

It provides guidance on the techniques for the measurement of cost, such as the standard cost method or retail method. It also outlines acceptable methods of determining cost, including specific identification, first-in-first-out and weighted average cost method.

1.2 SCOPE

This Standard is applicable to all inventories, except:

a) financial instruments (to be accounted under Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments).

b) biological assets (i.e. living animals or plants) related to agricultural activity and agricultural produce at the point of harvest (to be accounted under Ind AS 41, Agriculture).

Note: In accordance with Ind AS 41 "Agriculture", inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less costs to sell at the point of harvest. This fair value less costs to sell as determined in accordance with Ind AS 41 will become the cost of the inventories at that date for application of Ind AS 2 "Inventories".

- **This Standard does not apply to the measurement of inventories held by:**

a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries.

When such inventories are measured at net realisable value, changes in that value are recognized in profit or loss in the period of the change.

b) commodity broker-traders who measure their inventories at fair value less costs to sell.

When such inventories are measured at net realisable value / fair value less costs to sell, changes in those values are to be recognized in profit or loss in the period of the change.

Broker-traders are those who buy or sell commodities for others or on their own account. They acquire inventories principally with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. When these inventories are measured at fair value less costs to sell, they are excluded from only **the measurement requirements** of this Standard.

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1.3 RELEVANT DEFINITIONS

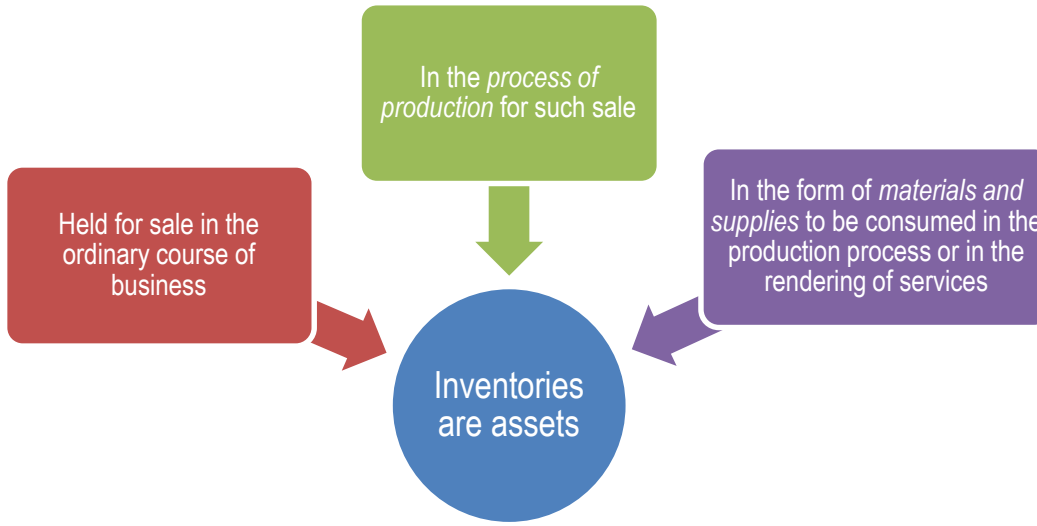
The following are the key terms used in this standard:

1) **Inventories** are assets:

   a) held for sale in the ordinary course of business; (Finished Goods)

   b) in the process of production for such sale; or (Work in progress)

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



2) **Inventories encompass of:**

   a) goods purchased and held for resale (e.g. merchandise purchased by a retailer and held for resale, or land and other property held for resale);

   b) finished goods produced, or work in progress being produced, by the entity; and includes

   c) materials and supplies awaiting use in the production process.

Costs incurred to fulfill a contract with a customer that do not give rise to inventories are accounted as per Ind AS 115.

Illustration 1

As per Ind AS 2, inventories include 'materials and supplies awaiting use in the production process'. Examine whether the packing material and publicity material are covered by the term 'materials and supplies awaiting use in the production process'.

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Solution

While the primary packing material may be included within the scope of the term 'materials and supplies awaiting use in the production process' but the secondary packing material and publicity material cannot be so included, as these are selling costs which are required to be excluded as per Ind AS 2. For this purpose, the primary packing material is one which is essential to bring an item of inventory to its saleable condition, for example, bottles, cans etc., in case of food and beverages industry. Other packing material required for transporting and forwarding the material will normally be in the nature of secondary packing material.

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3) **Net realisable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.

4) **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Ind AS 113, *Fair Value Measurement*.)

Note: Net realisable value for inventories may not equal fair value less costs to sell.

Example 1

An entity holds inventories of 10,000 units and it could sell the same in the market @ ₹ 10 each. The entity has an order in hand to sell the inventories @ ₹ 11. The incremental selling cost per unit is ₹ 0.50 per unit. In this situation, fair value is ₹ 10 each, but net realisable value is ₹ 10.5 each.

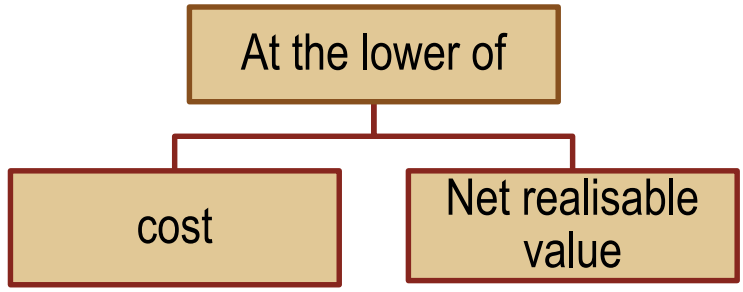
Difference between Net Realisable Value (NRV) and Fair Value (FV)

Basis	NRV	FV
Meaning	NRV refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business.	FV reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date
Measurement base	Entity-specific value i.e. the amount that the entity actually expects to make from selling the particular inventory	Market based measurement

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1.4 MEASUREMENT OF INVENTORIES

Inventories shall be measured at the lower of cost and net realisable value.



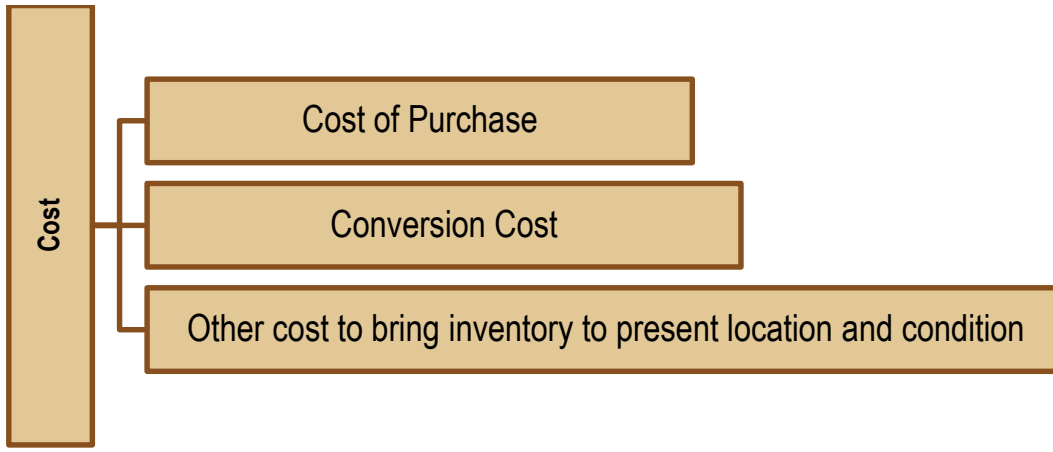
1) Cost of Inventories

Cost of Inventories comprises:

a) all costs of purchase;

b) costs of conversion; and

c) other costs incurred in bringing the inventories to their present location and condition.



2) Cost of purchase

The costs of purchase of inventories include:

a) the purchase price,

b) import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities),

c) transport, handling and

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d) other costs directly attributable to the acquisition of finished goods, materials and services.

Any trade discounts, rebates and other similar items are deducted in determining the costs of purchase of inventory.

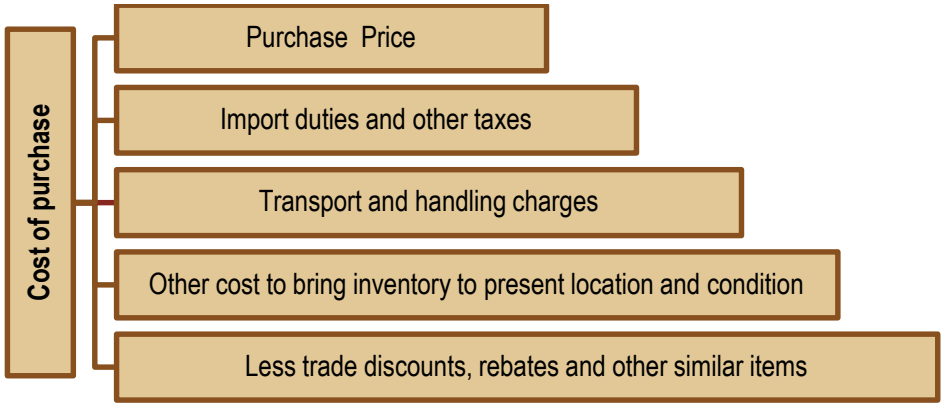


Illustration 2

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

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

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

Calculate the cost of inventory.

Solution

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

Note: The intention to take settlement discount is irrelevant.

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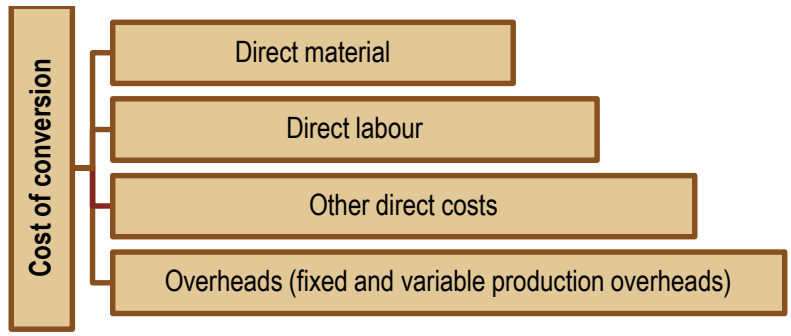
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3) Cost of conversion

- The costs of conversion of inventories include costs directly related to the units of production, such as:

  a) direct material, direct labour and other direct costs; and

  b) a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.



- Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings, equipment and right-of-use assets used in the production process, and equipment, and the cost of factory management and administration.
- Allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity.
- When production levels are abnormally low, unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost.
- Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

  Note: Production overheads must be absorbed based on normal production capacity even if this is not achieved in a period. If production capacity is unusual in a particular period the overheads might be under or over absorbed. Interruptions in production may occur while costs still are being incurred.

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Note: The process of allocating costs to units of production is usually called absorption. This is usually done by linking the total production overheads to some production variable, for example, time, wages, materials or simply the number of units expected to be manufactured.

Example 2

Pluto Ltd. has a plant with the normal capacity to produce 5,00,000 unit of a product per annum and the expected fixed overheads is ₹ 15,00,000. Fixed overheads on the basis of normal capacity is ₹ 3 per unit (15,00,000/5,00,000).

Case 1:

Actual production is 5,00,000 units. Fixed overhead on the basis of normal capacity and actual overheads will lead to same figure of ₹ 15,00,000. Therefore, it is advisable to include this on normal capacity.

Case 2:

Actual production is 3,75,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 15,00,000, therefore, overheads on actual basis is ₹ 4 p/u (15,00,000 / 3,75,000).

Hence by valuing inventory at ₹ 4 each for fixed overheads purpose, it will be overvalued and the losses of ₹ 3,75,000 will also be included in closing inventory leading to a higher gross profit than actually earned.

Therefore, it is advisable to include fixed overheads per unit on normal capacity to actual production (3,75,000 x 3) ₹ 11,25,000 and balance ₹ 3,75,000 (3,75,000 x 1) shall be transferred to Profit & Loss Account as an expense.

Case 3:

Actual production is 7,50,000 units. Fixed overheads is not going to change with the change in output and will remain constant at ₹ 15,00,000, therefore, overheads on actual basis is ₹ 2 (15,00,000/ 7,50,000).

Hence by valuing inventory at ₹ 3 each for fixed overheads purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 3 per unit, total fixed overhead comes to ₹ 22,50,000 whereas, actual fixed overhead expense is only ₹ 15,00,000. Therefore, it is advisable to include fixed overhead on actual basis (7,50,000 x 2) ₹ 15,00,000.

Illustration 3: Normal production capacity

A business plans for production overheads of ₹ 10,00,000 per annum.

The normal level of production is 1,00,000 units per annum.

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

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

Solution

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

Overhead to be expensed:	**₹**
Total production overhead	10,00,000
The amount absorbed into inventory is (75,000 x 10)	(7,50,000)
The amount not absorbed into inventory	2,50,000

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

*****

Illustration 4: Conversion costs

ABC Ltd. manufactures control units for air conditioning systems.

Each control unit requires the following:

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

1 component Y at a cost of ₹ 800 each

Sundry raw materials at a cost of ₹ 150 each

The company incurs the following monthly expenses:

Factory rent ₹ 16,500

Energy cost ₹ 7,500

Selling and administrative costs ₹ 10,000

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

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

Calculate the cost of inventory.

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Solution

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

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

*****

4) Other costs

- Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.
- Cost to be **excluded** from the cost of inventories and recognized as expenses in the period in which they are incurred are:

  a) abnormal amounts of wasted materials, labour or other production costs;

  b) storage costs, unless those costs are necessary in the production process before a further production stage;

  Example 3

  The production of whiskey involves the distilling of aged whiskey in a cask prior to bottling should be capitalised, as aging is integral to making the finished product saleable.

  c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

  d) selling costs.

- The extent to which borrowing cost is included in the cost of inventories is determined on the basis of the requirement of Ind AS 23 Borrowing Costs.

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Ind AS 23 "requires that the borrowing costs shall be capitalised on qualifying assets but scopes out inventories that are manufactured in large quantities on a repetitive basis. It also clarifies that inventories manufactured over a short period of time are not qualifying assets. However, any manufacturer that is producing small quantities over a long period of time has to capitalise borrowing costs into cost of inventories.

- An entity may acquire inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase prices for normal credit terms and the amount paid, is recognized as interest expense over the period of the financing.

Illustration 5: Conversion costs

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

At year end 31 March 20X1, twenty cars are in stock. Compute the cost of inventory, finance cost and cost of goods sold.

Solution

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

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

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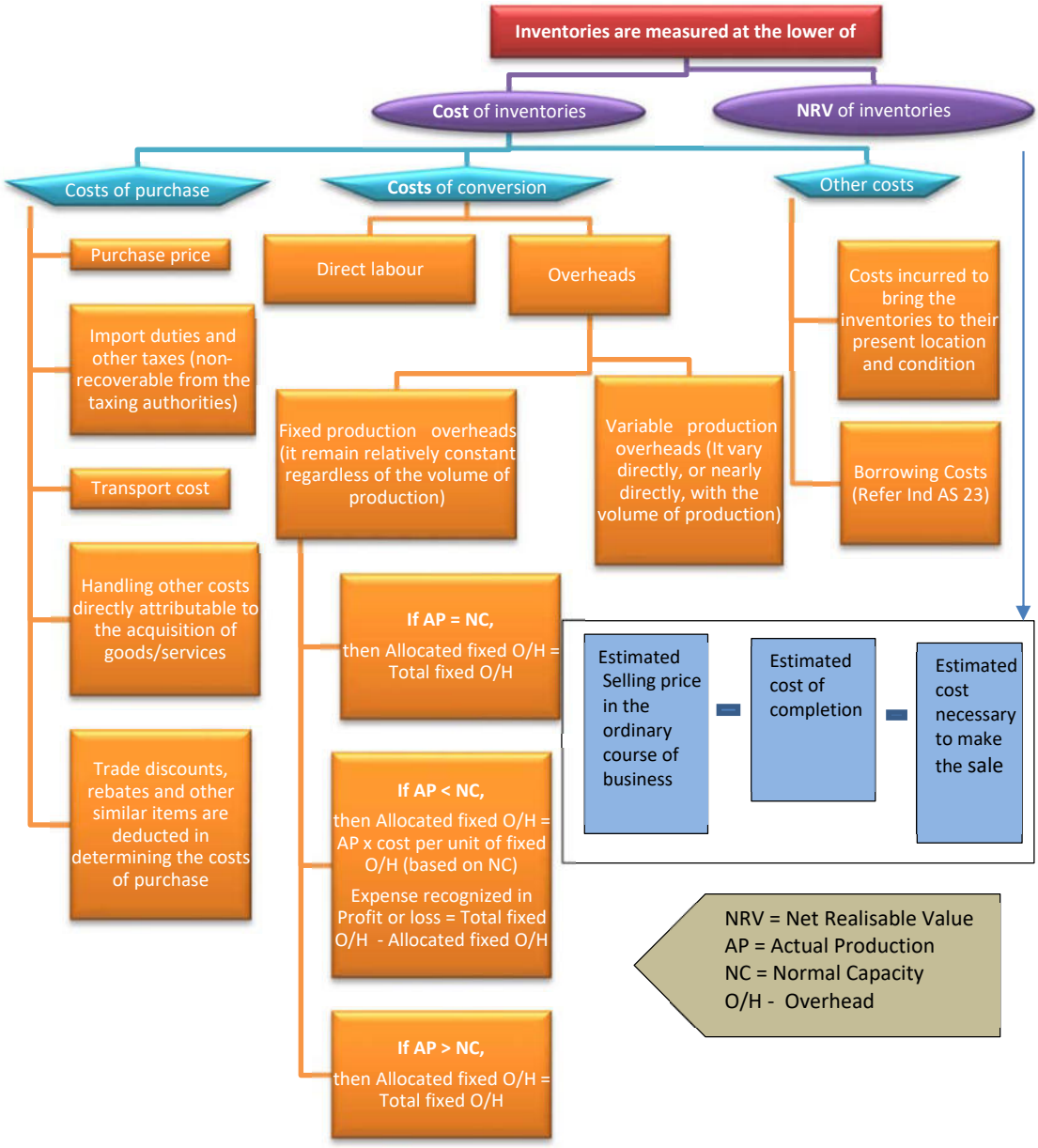


Illustration 6: Cost of Inventory

Venus Trading Company purchases cars from several countries and sells them to Asian countries. During the current year, this company has incurred following expenses:

1. *Trade discounts on purchase*

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2. *Handling costs relating to imports*
3. *Salaries of accounting department*
4. *Sales commission paid to sales agents*
5. *After sales warranty costs*
6. *Import duties*
7. *Costs of purchases (based on supplier's invoices)*
8. *Freight expense*
9. *Insurance of purchases*
10. *Brokerage commission paid to indenting agents*

Evaluate which costs are allowed by Ind AS 2 for inclusion in the cost of inventory in the books of Venus.

Solution

Items number 1, 2, 6, 7, 8, 9, 10 are allowed by Ind AS 2 for the calculation of cost of inventories. Salaries of accounts department, sales commission, and after sale warranty costs are not considered to be the cost of inventory. Therefore, they are not allowed by Ind AS 2 for inclusion in cost of inventory and are expensed off in the profit and loss account.

*****

Illustration 7

As per Ind AS 2, selling costs are excluded from the cost of inventories and are required to be recognized as an expense in the period in which these are incurred. Advise whether the distribution costs would now be included in the cost of inventories under Ind AS 2.

Solution

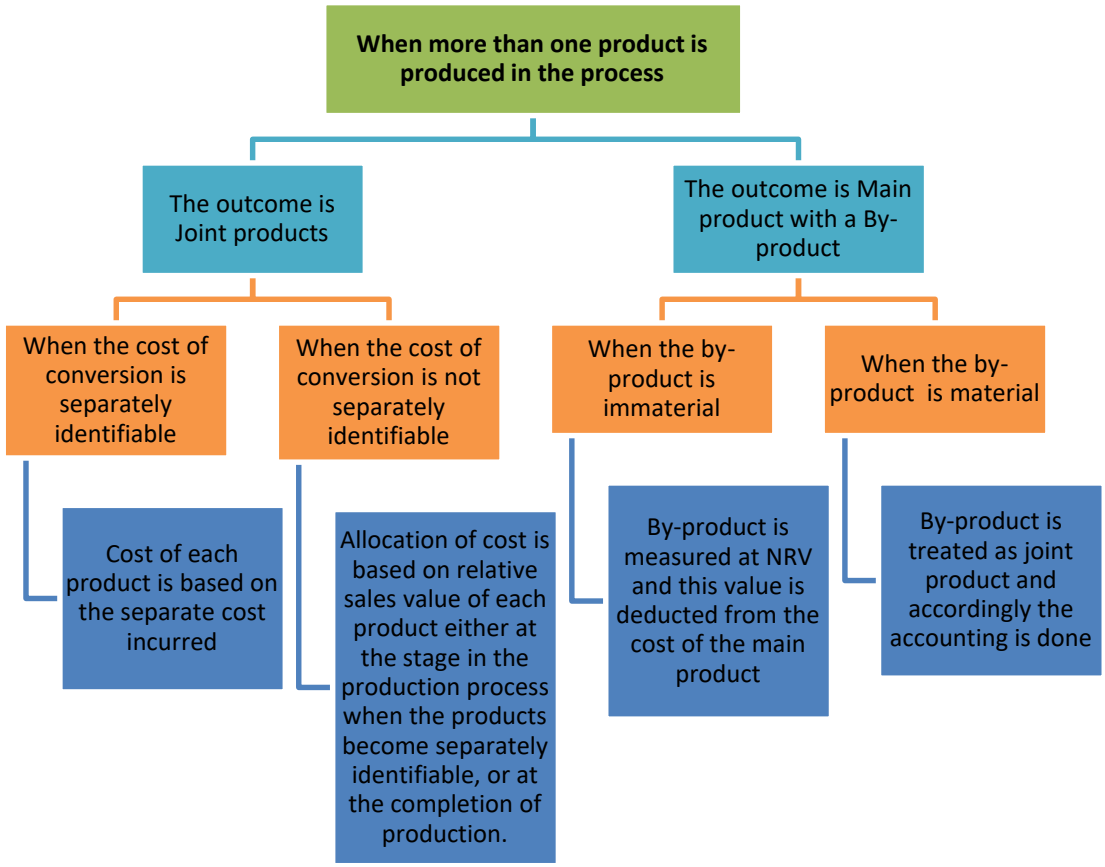
Selling and distribution costs are generally used as single term because both are related, as selling costs are incurred to effect the sale and the distribution costs are incurred by the seller to complete a sale transaction by making the goods available to the buyer from the point of sale to the point at which the buyer takes possession. Since these costs are not related to bringing the goods to their present location and condition, the same are not included in the cost of inventories. Accordingly, though the word 'distribution costs' is not specifically mentioned in Ind AS 2, these costs would continue to be excluded from the cost of inventories.

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5) Allocation of cost to joint products and by-products

- A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product.
- When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production.
- Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.



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Illustration 8

In a manufacturing process of Mars Ltd, one by-product BP emerges besides two main products MP1 and MP2 apart from scrap. Details of cost of production process are here under:

Item	Unit	Amount	Output	Closing Stock 31.3.20X1
Raw material	14,500	1,50,000	MP1 - 5,000 units	250
Wages	-	90,000	MP2 - 4,000 units	100
Fixed overhead	-	65,000	BP- 2,000 units	
Variable overhead	-	50,000		

Average market price of MP1 and MP2 is ₹ 60 per unit and ₹ 50 per unit respectively, by-product is sold @ ₹ 20 per unit. There is a profit of ₹ 5,000 on sale of by-product after incurring separate processing charges of ₹ 8,000 and packing charges of ₹ 2,000, ₹ 5,000 was realised from sale of scrap.

Calculate the value of closing stock of MP1 and MP2 as on 31.3.20X1.

Solution

As per Ind AS 2 'Inventories', most by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realisable value and this value is deducted from the cost of the main product.

1) Calculation of NRV of By-product BP

Selling price of by-product	2,000 units x 20 per unit	40,000
Less: Separate processing charges of by- product BP		(8,000)
Packing charges		(2,000)
Net realisable value of by-product BP		30,000

2) Calculation of cost of conversion for allocation between joint products MP1 and MP2

Raw material		1,50,000
Wages		90,000
Fixed overhead		65,000
Variable overhead		50,000
Less: NRV of by-product BP (See calculation 1)	30,000	
Sale value of scrap	5,000	(35,000)
Joint cost to be allocated between MP1 and MP2		3,20,000

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3) Determination of "basis for allocation" and allocation of joint cost to MP1 and MP2

	MP I	MP 2
Output in units (a)	5,000	4,000
Sales price per unit (b)	60	50
Sales value (a x b)	3,00,000	2,00,000
Ratio of allocation	3	2
Joint cost of ₹ 3,20,000 allocated in the ratio of 3:2 (c)	1,92,000	1,28,000
Cost per unit [c/a]	**38.4**	**32**

4) Determination of value of closing stock of MP1 and MP2

Particulars	MP I	MP 2
Closing stock in units	250 units	100 units
Cost per unit	38.4	32
Value of closing stock	9,600	3,200

*****

6) Cost of agricultural produce harvested from biological assets

In accordance with Ind AS 41, *Agriculture*, inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less costs to sell at the point of harvest. This is the cost of the inventories at that date for application of this Standard.

7) Techniques for the measurement of cost

- Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate to actual cost.
- Standard Cost Method: Cost is based on normal levels of materials and supplies, labour efficiency and capacity utilisation. They are regularly reviewed and revised where necessary.



- Retail Method: Cost is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. This method is

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often used in the retail industry for measuring inventories of rapidly changing items that have similar margins.

- The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.
- The percentage has to be carefully determined to ensure that it takes into consideration the circumstances in which inventory has been marked down to below its original selling price. Adjustments have to be made to eliminate the effect of these markdowns so as to prevent any item of inventory being valued at less than both its cost and its net realisable value. An average percentage for each retail department is often used. Judgement is applied in the retail method in determining the margin to be removed from the selling price of inventory in order to convert it back to cost.

Illustration 9: Measurement techniques of Cost

Mars Fashions is a new luxury retail company located in Lajpat Nagar, New Delhi. Kindly advise the accountant of the company on the necessary accounting treatment for the following items:

(a) One of Company's product lines is beauty products, particularly cosmetics such as lipsticks, moisturizers and compact make-up kits. The company sells hundreds of different brands of these products. Each product is quite similar, is purchased at similar prices and has a short lifecycle before a new similar product is introduced. The point of sale and inventory system is not yet fully functioning in this department. The sales manager of the cosmetic department is unsure of the cost of each product but is confident of the selling price and has reliably informed you that the Company, on average, make a gross margin of 65% on each line.

(b) Mars Fashions also sells handbags. The Company manufactures their own handbags as they wish to be assured of the quality and craftsmanship which goes into each handbag. The handbags are manufactured in India in the factory which has made handbags for the last fifty years. Normally, Mars manufactures 100,000 handbags a year in their handbag division which uses 15% of the space and overheads of the head office factory. The division employs ten people and is seen as being an efficient division within the overall company.

In accordance with Ind AS 2, explain how the items referred to in a) and b) should be measured.

Solution

(a) The retail method can be used for measuring inventories of the beauty products. The cost of the inventory is determined by taking the selling price of the cosmetics and reducing it by the gross margin of 65% to arrive at the cost.

(b) The handbags can be measured using standard cost especially if the results approximate cost. Given that the company has the information reliably on hand in

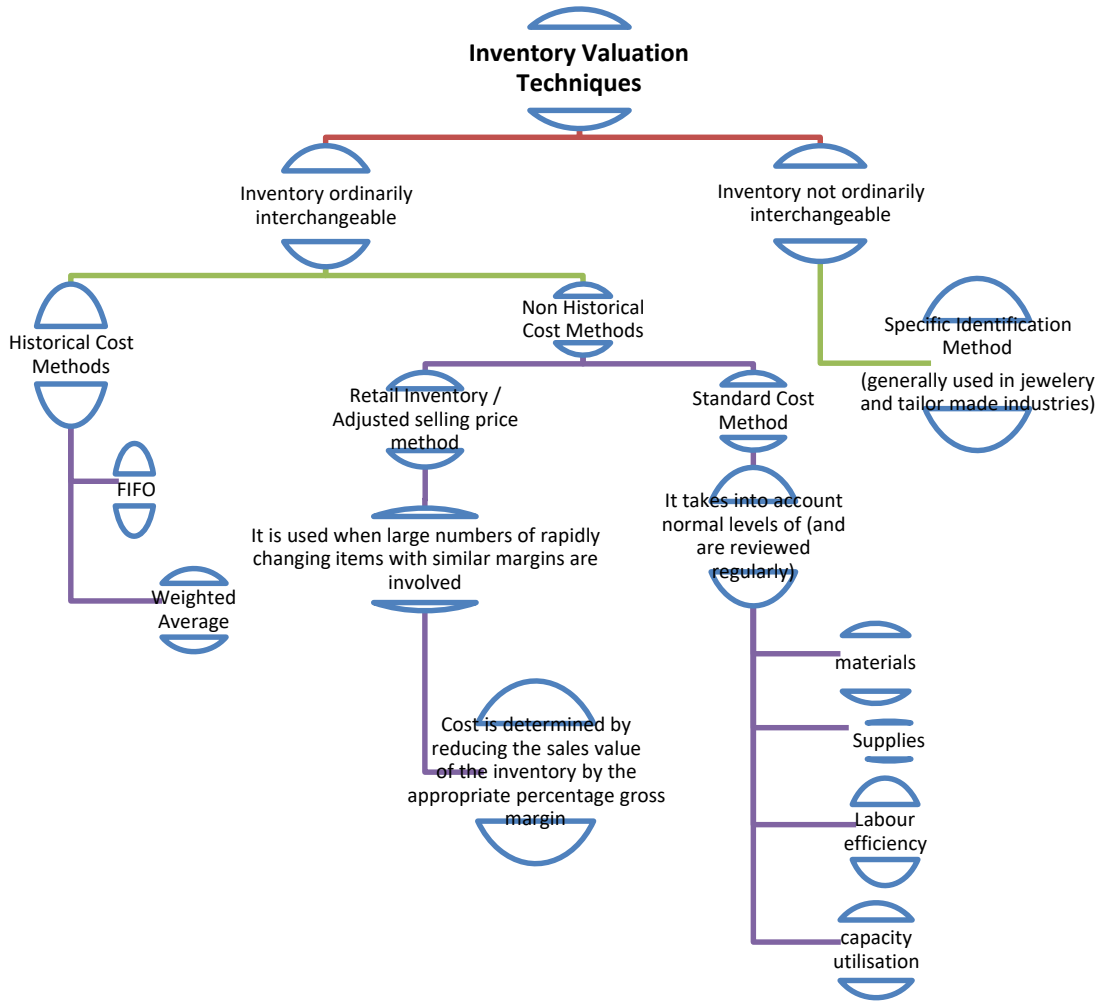
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relation to direct materials, direct labour, direct expenses and overheads, it would be the best method to use to arrive at the cost of inventories.

*****

8) Cost Formulas

An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified. For example, inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.



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9) Inventory not ordinarily interchangeable

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs. Specific identification of cost means that specific costs are attributed to identified items of inventory.

10) Inventory ordinarily interchangeable

- The costs of inventories, other than that are not ordinarily interchangeable and goods or services produced and segregated for specific projects, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula.

  First-in, First-out Cost Formula (FIFO) assumes that the items of inventory that were purchased or produced first are sold first. Hence in such a case, the items remaining in inventory at the end of the period are those which were most recently purchased or produced.

  For example, in case of a perishable goods business ie food retailers will first sell the goods he had purchased at the earliest.

  The FIFO method, by allocating the earliest costs incurred against revenue, matches actual cost flows with the physical flow of goods reasonably accurately. In case of other businesses as well which do not deal in perishable goods, this would reflect what would probably be a sound management policy. In practice, the FIFO method is generally used where it is not possible to value inventory on an actual cost basis.

  Weighted Average Cost Formula is suitable where inventory units are identical or nearly identical. It involves the computation of an average unit cost by dividing the total cost of units by the number of units. The average unit cost then has to be revised with every receipt of inventory, or alternatively at the end of predetermined periods. In practice, weighted average systems are widely used in packaged inventory systems that are computer controlled, although its results are not very different from FIFO in times of relatively low inflation, or where inventory turnover is relatively fast.

  Formula: Calculation of new weighted average after each purchase

  $$\text{New weighted average} = \frac{\text{Cost of inventory currently in store + Cost of new items received}}{\text{Number of units currently in store + Number of new units received}}$$

  LIFO (last-in, first-out), as its name suggests, is the opposite of FIFO and assumes that the most recent purchases or production are used first. In certain cases, this could represent the physical flow of inventory (e.g. if a store is filled and emptied from the top). **However, it is not an acceptable cost formula under Ind AS 2.**

  LIFO is an attempt to match current costs with current revenues so that profit or loss excludes the effects of holding gains or losses. Therefore, LIFO is an attempt to achieve something closer to replacement cost accounting for the statement of profit or loss,

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whilst disregarding the statement of financial position. The period-end balance of inventory on hand represents the earliest purchases of the item, resulting in inventories being stated in the statement of financial position at amounts which may bear little relationship to recent cost levels.

Example 4: FIFO and Weighted Average method

Particulars	Units available	Units sold	Actual Cost/unit (₹)	Actual Total Cost (₹)
Opening inventory	100	-	2.10	210
Sale	-	75	-	-
Purchases	150	-	2.80	420
Sale	-	100	-	-
Purchase	50	-	3.00	150
Total	300	175	-	780

Solution:

FIFO Method:

Cost of Goods Sold: 100 units x ₹ 2.10 + 75 units x ₹ 2.80 = ₹ 420

Closing Inventory: 50 units x ₹ 3.00 + 75 units x ₹ 2.80 = ₹ 360

Weighted Average Method:

Weighted average cost / units: `780 / 300 units = ₹ 2.60

Cost of Goods Sold: 175 units x ₹ 2.60 = ₹ 455

Closing Inventory: 125 units x ₹ 2.60 = ₹ 325

Note: Weighted average method in practice is a moving average so computed after each purchase made and so sales are cost at most recent averages.

Cost of Goods Sold:

75 units @ ₹ 2.10 and 100 units @ ₹ 2.70 i.e. total cost = ₹ 427.50

Closing Inventory: 125 units x ₹ 2.82 = ₹ 352.50

- An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Illustration 10

State whether an entity can use different cost formulae for inventories held at different geographical locations having similar nature and use to it.

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Solution

Paragraph 25 of Ind AS 2 prescribes that the cost of inventories, other than the items of inventories which are not ordinarily interchangeable as dealt with in paragraph 23, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having similar nature and use to it. In this case, since the inventories held at different geographical location are of similar nature and use to the entity, different cost formula cannot be used for inventory valuation purposes.

*****

- **FIFO formula** assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.
- Under the **weighted average** cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

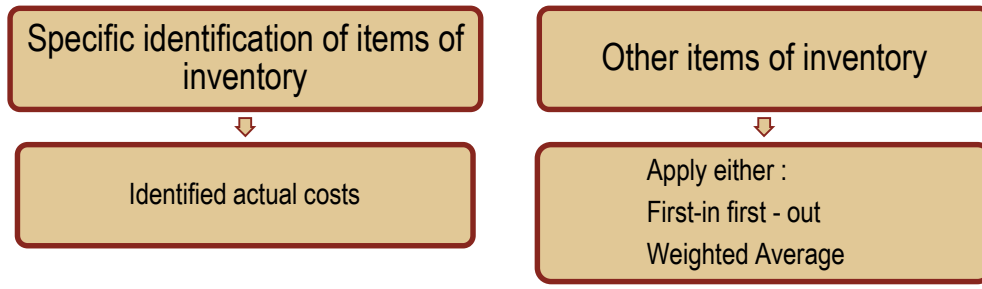


Illustration 11

Mercury Ltd. uses a periodic inventory system. The following information relates to 20X1-20X2.

Date	*Particular*	*Unit*	*Cost p.u.*	*Total Cost*
April	*Inventory*	*200*	*10*	*2,000*
May	*Purchases*	*50*	*11*	*550*
September	*Purchases*	*400*	*12*	*4,800*
February	*Purchases*	*350*	*14*	*4,900*
	Total	*1,000*		*12,250*

Physical inventory at 31.3.20X2 400 units.

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Calculate ending inventory value and cost of sales using:

(a) FIFO

(b) Weighted Average

Solution

FIFO inventory 31.3.20X2	350 @14 = 50 @ 12 =	4,900 600 5,500
Cost of Sales	12,250-5,500 =	6,750
Weighted average cost per item	12,250/1000 =	12.25
Weighted average inventory at 31.3.20X2	400 x 12.25 =	4,900
Cost of sales 20X1-20X2	12,250-4,900 =	7,350

*****

11) Net realisable value

Measurement of net realisable value

- Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined.

Illustration 12

Recommend whether the following costs should be considered while determining the Net Realisable Value (NRV) of the inventories?

(a) Costs of completion of work-in-progress;

(b) Trade discounts expected to be allowed on sale; and

(c) Cash discounts expected to be allowed for prompt payment

Solution

Ind AS 2 defines Net Realisable Value as the "estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale."

Costs of completion of work-in-progress are incurred to convert the work-in progress into finished goods. Since these costs are in the nature of completion costs, in accordance with the above definition, the same should be deducted from the estimated selling price to determine the NRV of work-in- progress.

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Trade discount is a reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

Trade discount is allowed either expressly through an agreement or through prevalent commercial practices in the terms of the trade and the same is adjusted in arriving at the selling price. Accordingly, the trade discount expected to be allowed should be deducted to determine the estimated selling price.

Cash discount is a reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

These types of costs are incurred to recover the sale proceeds immediately or before the end of the specified period or credit period allowed to the customer. In other words, these costs are not incurred to make the sale, therefore, the same should not be considered while determining NRV.

*****

- Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise. **These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.**

Example 5

A loss realised on a sale of a product after the end of the period may well provide evidence of the net realisable value of that product at the end of the period. However, if this product is, for example, an exchange traded commodity, and the loss realised can be attributed to a fall in prices on the exchange after the period end date, then this loss would not, in itself, provide evidence of the net realisable value at the period end date.

Illustration 13

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

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

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Solution

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

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

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

*****

- Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess quantity is based on general selling prices. If there is a firm contract to sell quantities in excess of inventory quantities that the entity holds or is able to obtain under a firm purchase contract, this may give rise to an onerous contract liability that should be provided for in accordance with Ind AS 37 "Provisions, Contingent Liabilities and Contingent Assets".

Illustration 14

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

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

Solution

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

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

Therefore, Company P will write down those remaining 40 units by ₹ 120 (i.e. 40 x 3).

Total cost of inventory would be

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

*****

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- Inventories are usually written down to net realisable value item by item. It is not appropriate to write inventories down on the basis of a classification of inventory, for example, finished goods, or all the inventories in a particular operating segment. The cost and net realisable value should be compared for each separately identifiable item of inventory, or group of similar inventories, rather than for inventory in total.

Illustration 15

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

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

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

Solution

The value of closing inventory in the financial statements:

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

*****

Writing inventories down to net realisable value

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be used are expected to be sold at or above cost. This is the case even if these materials in their present condition have a net realisable value that is below cost and would therefore otherwise require write down.

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Example 6

A whisky distiller would not write down an inventory of grain because of a fall in the grain price, so long as it expects to sell the whisky at a price which is sufficient to recover cost.

However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. In other words, if an entity writes down any of its finished goods, the carrying value of any related raw materials should also be reviewed to see if they too need to be written down.

Often raw materials are used to make a number of different products. In these cases, it is normally not possible to arrive at a particular net realisable value for each item of raw material based on the selling price of any one type of finished item. If the current replacement cost of those raw materials is less than their historical cost, a provision is only required to be made if the finished goods into which they will be made are expected to be sold at a loss. **No provision should be made just because the anticipated profit will be less than normal.**

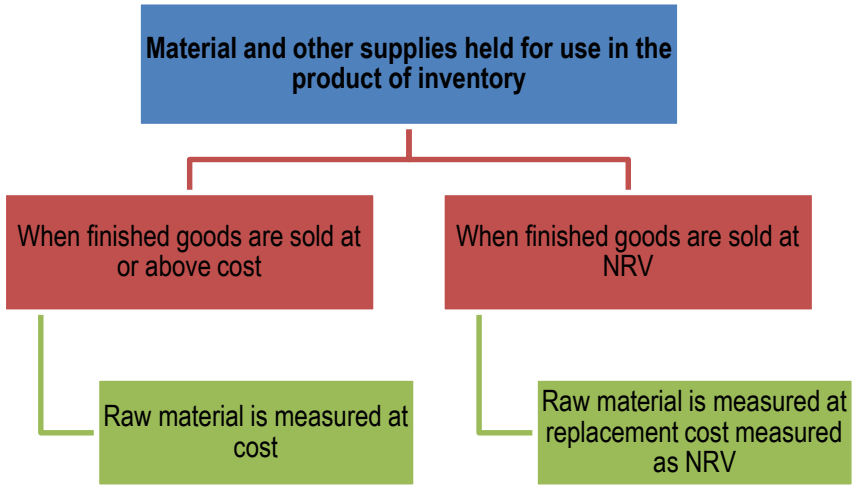


Illustration 16

Particulars		***Kg.***	`
Opening Inventory:	*Finished Goods*	*1,000*	*25,000*
	Raw Materials	*1,100*	*11,000*
Purchases		*10,000*	*1,00,000*
Labour			*76,500*
Overheads (Fixed)			*75,000*

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Sales		*10,000*	*2,80,000*
Closing Inventory:	*Raw Materials*	*900*	
	Finished Goods	*1200*	

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

Solution

Calculation of cost for closing inventory

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

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

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

Therefore, value of closing inventory: Finished Goods (1,200 x 20)	₹ 24,000
Raw Materials (900 x 9.50)	₹ 8,550
	₹ 32,550

*****

Reversals of write-downs

- A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realisable value.

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- This occurs, for example, when an item of inventory that is carried at net realisable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

Illustration 17

Sun Pharma Limited, a renowned company in the field of pharmaceuticals has the following four items in inventory: The cost and net realisable value is given as follows:

Item	*Cost*	*Net Realisable Value*
A	*2,000*	*1,900*
B	*5,000*	*5,100*
C	*4,400*	*4,550*
D	*3,200*	*2,990*
Total	***14,600***	***14,540***

Calculate the value of Inventories:

a. On an item by item basis

b. On a group basis

Solution

Inventories shall be measured at the lower of cost and net realisable value.

Item by item basis:	
A	1,900
B	5,000
C	4,400
D	2,990
	14,290
Group basis	**14,540**

*****

1.5 RECOGNITION AS AN EXPENSE

1) The amount of inventories recognized as an expense in the period will generally be:

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a) carrying amount of the inventories sold in the period in which related revenue is recognized; and

b) the amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognized as an expense in the period the write-down or loss occurs;

reduced by

the amount of any reversal in the period of any write-down of inventories, arising from an increase in net realisable value shall be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

2) Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognized as an expense during the useful life of that asset through charging of depreciation on that asset.

Example 7

An item of inventory costing ₹ 20,000 as covered under Ind AS 2 is consumed in the construction of self-constructed property to be accounted as Property, plant and equipment under Ind AS 16. The cost of such property, plant and equipment other than inventories is ₹ 80,000. Such Inventory needs to be capitalised in the cost of Property, plant and equipment. The useful life of the property is 5 years. The depreciation on such property charged to profit and loss account is ₹ 20,000 per annum (i.e. 1,00,000 / 5)

1.6 DISCLOSURE

The financial statements shall disclose:

1) Accounting policies

The accounting policies adopted in measuring inventories, including the cost formula used.

2) Analysis of carrying amount

The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity.

Common classifications of inventories are as follows:

a) Merchandise;

b) Production supplies;

c) Materials;

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d) Work in progress; and

e) Finished goods.

The inventories of a service provider may be described as work in progress

3) Inventories carried at fair value less costs to sell

The carrying amount of inventories carried at fair value less costs to sell.

4) Amounts recognized in profit or loss

a) the amount of inventories recognized as an expense during the period;

b) the amount of any write-down of inventories recognized as an expense in the period; and

c) the amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the period.

In addition, disclosure is required of the circumstances or events that led to the reversal of a write-down of inventories.

5) Inventories pledged as security

The carrying amount of inventories pledged as security for liabilities.

An entity adopts a format for profit or loss that results in amounts being disclosed other than the cost of inventories recognized as an expense during the period. Under this format, the entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognized as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.

1.7 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following are the extracts from the financial statements of the listed entity 'Titan Company Limited' for the financial year 2021-2022 with respect to 'Inventories' and its accounting policy thereon.

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Standalone Balance Sheet

as at 31st March 2022

₹ in crore

Particulars	Note	As at 31st March 2022	As at 31st March 2021
ASSETS			
(1) Non-current assets			
(2) Current assets			
(a) Inventories		12,787	7,984
(b) Financial assets			
(i) Investments	11.1	15	2,753
(ii) Trade receivables	11.2	495	291
(iii) Cash and cash equivalents	11.3	117	147

10 Inventories

₹ in crore

Particulars	As at 31st March 2022	As at 31st March 2021
Raw materials	2,105	1,770
Work-in-progress {refer (a) below}	311	330
Finished goods	8,123	4,433
Stock-in-trade	2,227	1,430
Stores and spares	16	16
Loose tools	5	5
	12,787	**7,984**
Included above, goods-in-transit		
Raw materials	14	5
Stock-in-trade	9	1
	23	**6**
a) Details of inventory of work-in-progress		
Watches	154	134
Jewellery	153	194
Others	4	2
	311	**330**

(i) The cost of inventories recognised as an expense during the year is ₹ 20,658 crore (Previous year: ₹ 15,769 crore).

(ii) The cost of inventories recognised as an expense includes ₹ 1 crore (Previous year: ₹ 0.38 crore) in respect of write down of inventory to net-realisable value.

(iii) The inventory includes Gold purchased on loan from banks amounting to ₹ 5,212 crore (Previous year: ₹ 4,094 crore).

(iv) Refer note (xvii) under significant accounting policies for mode of valuation.

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Standalone Statement of Profit and Loss

for the year ended 31st March 2022

₹ in crore

Particulars	Note	For the year ended 31st March 2022	For the year ended 31st March 2021
I. Revenue from operations	19	27,210	20,602
II. Other income	20	246	181
III. Total income (I +II)		**27,456**	**20,783**
IV. Expenses:			
Cost of raw materials and components consumed		20,939	13,143
Purchase of stock-in-trade		4,187	2,462
Changes in inventories of finished goods, stock-in-trade and work-in-progress	21	(4,468)	164

21 Changes in inventories of finished goods, stock-in-trade and work-in-progress

₹ in crore

Particulars	For the year ended 31st March 2022	For the year ended 31st March 2021
Closing stock		
Finished goods	8,123	4,433
Work-in-progress	311	330
Stock-in-trade	2,227	1,430
	10,661	**6,193**
Opening stock		
Finished goods	4,433	4,514
Work-in-progress	330	308
Stock-in-trade	1,430	1,535
	6,193	**6,357**
(Increase)/decrease in inventory	**(4,468)**	**164**

ACCOUNTING POLICY

Inventories

Inventories [other than quantities of gold for which the price is yet to be determined with the suppliers (Unfixed gold) or where hedge contracts have been entered into for quantities of gold and accounted for as fair value hedge] are stated at the lower of cost and net realisable value determined on an item-by-item basis. Cost is determined as follows:

a) Gold is valued on first-in-first-out basis.

b) Stores and spares, loose tools and raw materials are valued on a moving weighted average rate.

c) Work-in-progress and finished goods (other than gold) are valued on full absorption cost method based on the moving average cost of production.

d) Traded goods are valued on a moving weighted average rate/cost of purchases.

Cost comprises all costs of purchase including duties and taxes (other than those subsequently recoverable by the Company), freight inwards and other expenditure

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directly attributable to acquisition. Work-in-progress and finished goods include appropriate proportion of overheads and, where applicable, other taxes.

Unfixed gold and quantities of gold covered under fair value hedge have been entered into is valued at gold prices prevailing on the period closing date.

Net realisable value represents the estimated selling price for inventories less estimated costs of completion and costs necessary to make the sale.

(Source: Annual Report 2021-2022 – Titan Company Limited)

1.8 SIGNIFICANT DIFFERENCES IN IND AS 2 *VIS-À-VIS* AS 2

S. No.	Particular	Ind AS 2	AS 2
1.	*Subsequent Recognition*	Ind AS 2 deals with the subsequent recognition of cost / carrying amount of inventories as an expense.	AS 2 does not provide the same.
2.	*Inventory held by Commodity Broker-traders*	Ind AS 2 does not apply to measurement of inventories held by commodity broker-traders, who measure their inventories at fair value less costs to sell.	This aspect is not there in the AS 2.
3.	*Definition of Fair Value and Distinction Between NRV and Fair Value*	Ind AS 2 defines fair value and provides an explanation in respect of distinction between 'net realisable value' and 'fair value'.	AS 2 does not contain the definition of fair value and such explanation.
4.	*Subsequent Assessment of NRV*	Ind AS 2 provides detailed guidance in case of subsequent assessment of net realisable value. It also deals with the reversal of the write-down of inventories to net realisable value to the extent of the amount of original write-down, and the recognition and	AS 2 does not deal with such reversal.

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		disclosure thereof in the financial statements.	
5.	*Exclusion from its Scope but Guidance given*	Ind AS 2 excludes from its scope only the measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products though it provides guidance on measurement of such inventories.	AS 2 excludes from its scope such types of inventories.
6.	*Cost Formulae*	Ind AS 2 requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity.	AS 2 specifically provides that the formula used in determining the cost of an item of inventory should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. UA Ltd. purchased raw material @ ₹ 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in inventory. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realisable value of the raw material for valuation of inventories at the end of the year. However, replacement cost of raw material is ₹ 300 per kg. Compute the value of inventory of raw material?

2. Sun Ltd. has fabricated special equipment (solar power panel) during 20X1-20X2 as per drawing and design supplied by the customer. However, due to a liquidity crunch, the customer has requested the company for postponement in delivery schedule and requested the company to withhold the delivery of finished goods products and discontinue the production of balance items.

   As a result of the above, the details of customer balance and the goods held by the company as work-in-progress and finished goods as on 31.3.20X3 are as follows:

Solar power panel (WIP)	₹ 85 lakhs
Solar power panel (finished products)	₹ 55 lakhs
Sundry Debtor (solar power panel)	₹ 65 lakhs

   The petition for winding up against the customer has been filed during 20X2-20X3 by Sun Ltd. Advise on provision to be made of ₹ 205 lakh included in Sundry Debtors, Finished goods and work-in-progress in the financial statement of 20X2-20X3.

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

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

   Determine the value inventory at the following dates:

   (a) 31st March 20X1

   (b) 31st March 20X2

4. The following information is gathered from an entity:

   - Full capacity is 10,000 labour hours in a year.
   - Normal capacity is 7,500 labour hours in a year.
   - Actual labour hours for current period are 6,500 hours.
   - Total fixed production overhead is ₹ 1,500.
   - Total variable production overhead is ₹ 2,600.
   - Total opening inventory is 2,500 units.
   - Total units produced in a year are 6,500 units.
   - Total units sold in a year are 6,700 units.
   - The cost of inventories is assigned by using FIFO cost formula.

   Determine the overhead costs to be allocated to cost of goods sold and closing inventory?

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

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

   (b) Trade discounts on purchases ₹ 10,000

   (c) Import duties ₹ 200

   (d) Freight and insurance on purchases ₹ 250

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(e) Other handling costs relating to imports ₹ 100

(f) Salaries of accounting department ₹ 15,000

(g) Brokerage commission payable to indenting agents for arranging imports ₹ 300

(h) Sales commission payable to sales agents ₹ 150

(i) After-sales warranty costs ₹ 600

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

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

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

During January 20X1 the entity designed the corporate gifts for the customer.

Design costs included:

- cost of external designer = ₹ 7,000; and
- labour = ₹ 3,000.

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

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

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

- consumable stores =₹ 55,000
- labour = ₹ 65,000
- depreciation of plant used to manufacture the customised corporate gifts =₹ 15,000

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

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

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Answers

1. As per Ind AS 2 "Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. Therefore, in this case, UA Ltd. will value the inventory of raw material at ₹ 30,00,000 (10,000 kg. @ ₹ 300 per kg.).

2. From the facts given in the question it is obvious that Sun Ltd. is a manufacturer of solar power panel. As per Ind AS 2 'Inventories', inventories are assets (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. Therefore, solar power panel held in its stock will be considered as its inventory. Further, as per the standard, inventory at the end of the year is to be valued at lower of cost or NRV.

   As the customer has postponed the delivery schedule due to liquidity crunch the entire cost incurred for solar power panel which were to be supplied has been shown in Inventory. The solar power panel are in the possession of the Company which can be sold in the market. Hence, the company should value such inventory as per principle laid down in Ind AS 2 i.e. lower of Cost or NRV. Though, the goods were produced as per specifications of buyer the Company should determine the NRV of these goods in the market and value the goods accordingly. Change in value of such solar power panel should be provided for in the books. In the absence of the NRV of WIP and Finished product given in the question, assuming that cost is lower, the company shall value its inventory as per Ind AS 2 for ₹ 140 lakhs [i.e solar power panel (WIP) ₹ 85 lakhs + solar power panel (finished products) ₹ 55 lakhs].

   Alternatively, if it is assumed that there is no buyer for such fabricated solar power panel, then the NRV will be Nil. In such a case, full value of finished goods and WIP will be provided for in the books.

   As regards Sundry Debtors balance, since the Company has filed a petition for winding up against the customer in 20X2-20X3, it is probable that amount is not recoverable from the party. Hence, the provision for doubtful debts for ₹ 65 lakhs shall be made in the books against the debtor's amount.

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

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(a) In the given case, for valuation of inventory as on 31 March 20X1, cost of inventory would be ₹ 10 million and net realisable value would be ₹ 7.5 million (i.e. Expected selling price ₹ 8 million - estimated selling expenses ₹ 0.5 million). Accordingly, inventory shall be measured at ₹ 7.5 million i.e. lower of cost and net realisable value. Therefore, inventory write down of ₹ 2.5 million would be recorded in income statement of that year.

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

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

Fixed production overhead absorption rate:

= Fixed production overhead / labour hours for normal capacity

= ₹ 1,500 / 7,500

= ₹ 0.2 per hour

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

Therefore, fixed production overhead allocated to 6,500 units produced during the year (one unit per hour) = 6,500 units x1 hour x ₹ 0.2 = ₹ 1,300.

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

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

Variable production overhead absorption rate:

= Variable production overhead/actual hours for current period

= ₹ 2,600 / 6,500 hours

= ₹ 0.4 per hour

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

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

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

= 2,500 + 6,500 – 6,700 = 2,300 units

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

= Number of units of closing inventory x Number of hours to produce each unit x (Fixed production overhead absorption rate + Variable production overhead absorption rate)

= 2,300 units x 1 hour x (₹ 0.2 + ₹ 0.4)

= ₹ 1,380

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

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

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

Statement showing cost of inventory

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

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

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6. Statement showing computation of inventory cost

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

Working Note:

Costs of testing product designed for specific customer:

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

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UNIT 2 :
INDIAN ACCOUNTING STANDARD 16 : PROPERTY, PLANT AND EQUIPMENT

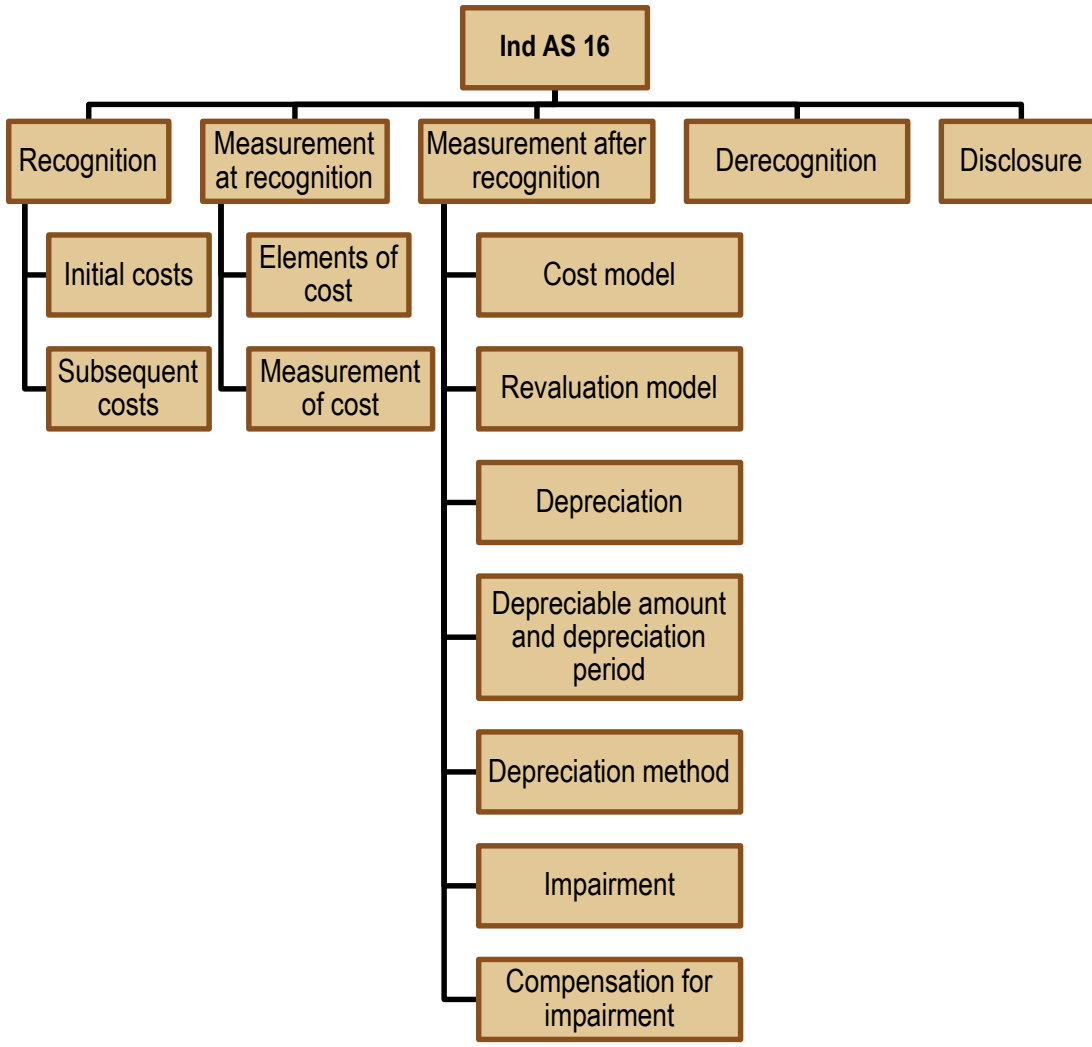
LEARNING OUTCOMES

After studying this unit, you will be able to

- State the objective and scope of this standard
- Define various terms used in the standard
- Apply the revaluation and cost models of accounting for property, plant and equipment
- Interpret the differences between repairs and maintenance, replacement and major inspection
- Account for the changes in depreciation method, useful life and residual value
- Integrate the accounting for changes in existing, decommissioning, restoration and similar assets

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UNIT OVERVIEW



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2.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognized in relation to them.

2.2 SCOPE

- This Standard shall be applied in accounting for property, plant and equipment except when another Standard requires or permits a different accounting treatment.
- This Standard does not apply to:

(a) PPE classified as held for sale (as per Ind AS 105)	(b) Biological assets related to agricultural activity other than bearer plants (Ind AS 41)
(c) Recognition and measurement of exploration and evaluation assets (Ind AS 106)	(d) Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b)–(d).

- An entity accounting for investment property in accordance with Ind AS 40, *Investment Property,* shall use the cost model in this Standard for owned investment property.

2.3 RELEVANT DEFINITIONS

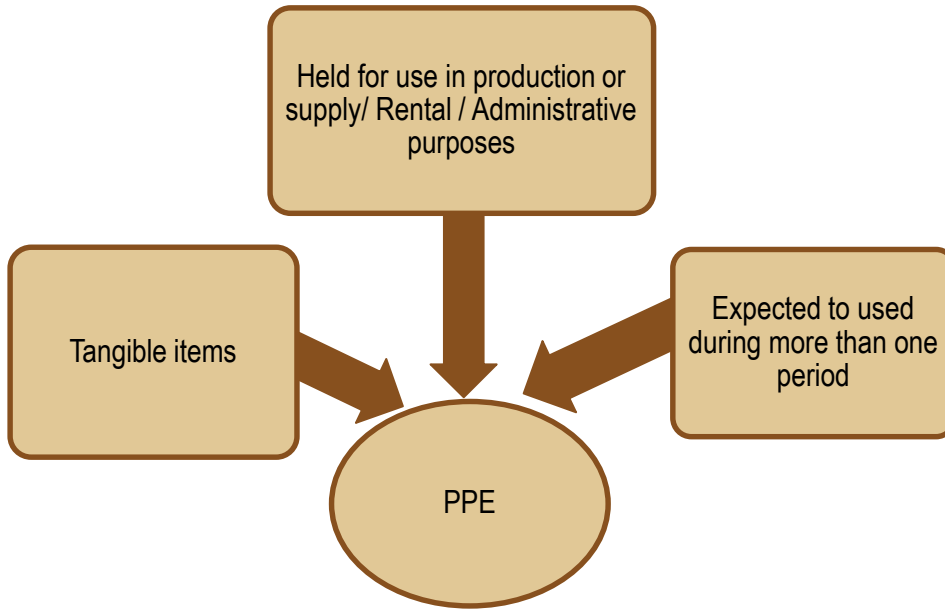
The following are the key terms used in this standard:

- **Property, plant and equipment** are tangible items that:

  a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

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b) are expected to be used during more than one period.



- A **bearer plant** is a living plant that:

  (a) is used in the production or supply of agricultural produce;

  (b) is expected to bear produce for more than one period; and

  (c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

- **Carrying amount** is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.

- **Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other Indian Accounting Standards, e.g. Ind AS 102, *Share-based Payment*.

- **Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.

- **Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life.

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- **Entity-specific value** is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Ind AS 113, *Fair Value Measurement*.)
- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- **Recoverable amount** is the higher of an asset's fair value less costs of disposal and its value in use.
- The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
- **Useful life** is:

  a) the period over which an asset is expected to be available for use by an entity; or

  b) the number of production or similar units expected to be obtained from the asset by an entity.



2.4 RECOGNITION

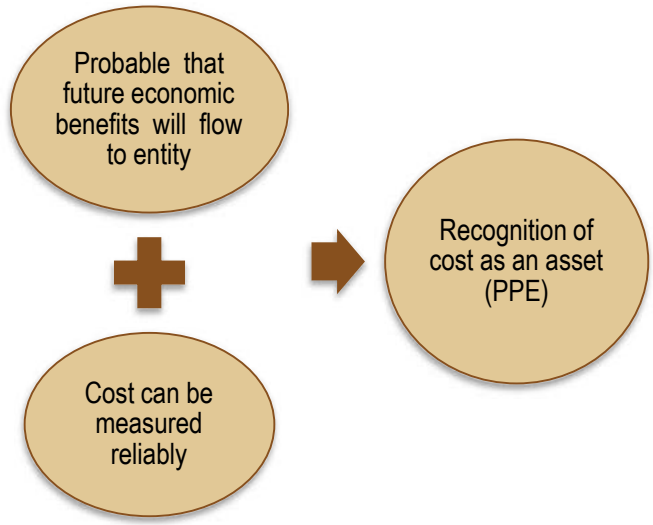
2.4.1 General recognition criteria

The cost of an item of property, plant and equipment shall be recognized as an asset if, and only if:

a) it is probable that future economic benefits associated with the item will flow to the entity; and

b) the cost of the item can be measured reliably.

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2.4.2 Recognition of Spare parts, stand-by equipment and servicing equipment

Items such as spare parts, stand-by equipment and servicing equipment are recognized in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

2.4.3 Unit of measurement for recognition of PPE and Aggregation of individually insignificant items

This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.

2.4.4 Initial Cost

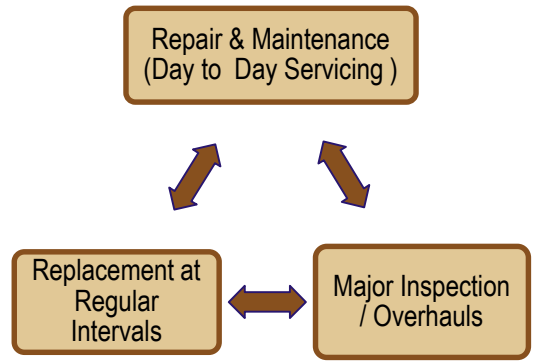
Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets.

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Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

For example: A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognized as an asset because without them the entity is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with Ind AS 36 Impairment of Assets.

2.4.5 Subsequent costs



2.4.5.1 Repair and maintenance

An entity does not recognize in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognized in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables and may include the cost of small parts.

2.4.5.2 Replacement of parts of a property, plant and equipment

- Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.
- Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement.
- Under the recognition principle, an entity recognizes in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is

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incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognized in accordance with the derecognition provisions of this Standard.

2.4.5.3 Major inspections or overhauls

- A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced.
- When each major inspection is performed, its cost is recognized in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied.
- Any remaining carrying amount of the cost of the previous inspection is derecognized. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

Example - Inspection Cost

A shipping company is required by law to bring all ships into dry dock every five years for a major inspection and overhaul. Overhaul expenditure might at first sight seem to be a repair to ships but it is actually a cost incurred in getting the ship back into a seaworthy condition. As such the costs must be capitalised.

A ship which cost ₹ 20 million with a 20 year life must have major overhaul every five years. The estimated cost of the overhaul at the five-year point is ₹ 5 million.

The depreciation charge for the first five years of the assets life will be as follows:

	Overhaul component (million)	Ship (other than overhaul component) (million)
Cost	5	15
Years	5	20
Depreciation per year	1	0.75

Total accumulated depreciation for the first five years will be ₹ 8.75 million (₹ (1 + 0.75) x 5), and the carrying amount of the ship at the end of year 5 will be ₹ 11.25 million (₹ 20 less 8.75).

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Assume that the actual overhaul costs incurred at the end of year 5 are ₹ 6 million. This amount will now be capitalised into the costs of the ship, to give a carrying amount of ₹ 17.25 million (being ₹ 11.25 million plus 6 million).

The depreciation charge for years 6 to 10 will be as follows:

	Overhaul component (₹ in million)	Ship (other than overhaul component) (₹ in million)
Cost	6	11.25
Years	5	15
Depreciation per year	1.2	0.75

Annual depreciation for years 6 to 10 will now be ₹ 1.95 million [₹ (1.2 + 0.75)]. This process will be continued for years 11 to 15 and years 16 to 20. By the end of year 20, the capital cost of ₹ 20 million will have been depreciated plus the actual overhaul costs incurred at years 5, 10 and 15.

2.5 MEASUREMENT AT RECOGNITION

2.5.1 Measurement at cost

An item of property, plant and equipment that qualifies for recognition as an asset should be initially measured at its cost.

2.5.2 Element of cost

2.5.2.1 Cost of an acquired asset

2.5.2.1.1 Component of cost

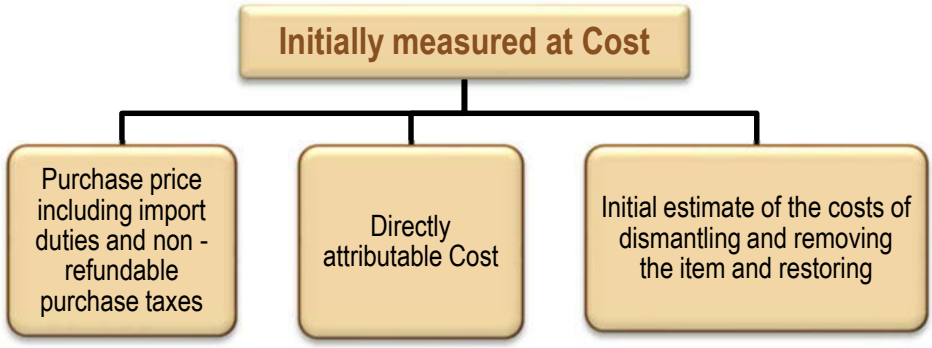
- The cost of an item of property, plant and equipment comprises:

  a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;

  b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and

  c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

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- **Examples of directly attributable costs are:**

Employee benefits cost arising directly from construction or acquisition of PPE

Cost of Site Preparation

Initial delivery and handling costs

Installation and assembly costs

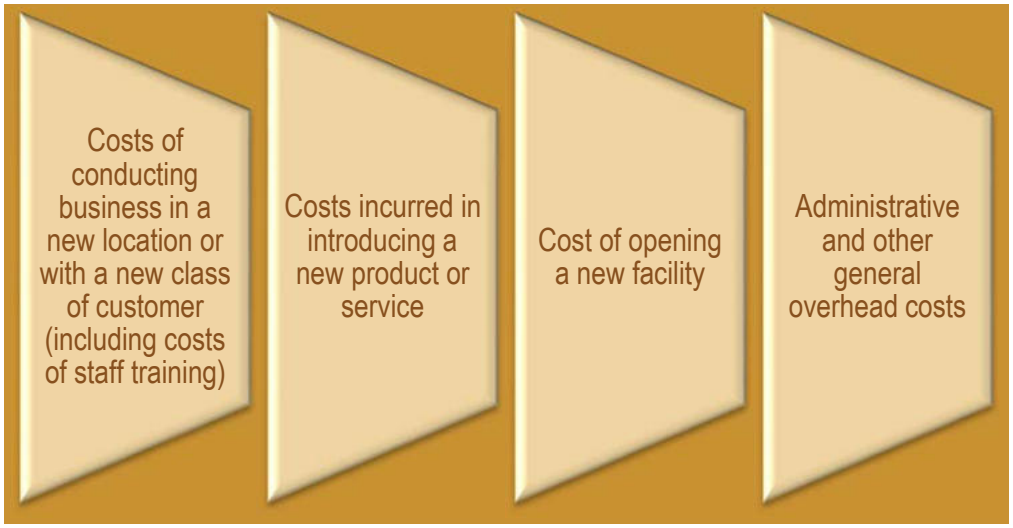
Professional Fees

Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment).

Note: Excess of net sale proceeds of items produced over the cost of testing, if any, shall not be recognized in the profit or loss but deducted from the directly attributable costs considered as part of cost of an item of property, plant, and equipment

- **Examples of costs that are not costs of an item of property, plant and equipment are:**

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2.5.2.2 Cost of self-constructed asset and Bearer Plants

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale. Therefore, any internal profits are eliminated in arriving at such costs.

Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.

Ind AS 23 'Borrowing Costs', establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management. Consequently, references to 'construction' in this Standard should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

2.5.2.3 Cost of dismantling, removal and site restoration

Cost incurred by an entity in respect of obligation for dismantling, removing and restoring the site on which an item of property, plant and equipment is located are recognized and measured in accordance with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

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If the obligations are incurred when the asset is acquired, or during a period when the item is used other than to produce inventories, they are included in the cost of the item property, plant and equipment.

An entity applies Ind AS 2, Inventories, to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.

2.5.2.4 Incidental operations

Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management.

These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts.

Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognized in profit or loss and included in their respective classifications of income and expense.

2.5.2.5 Cessation of capitalisation

Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item.

- **For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:**

  a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

  b) initial operating losses, such as those incurred while demand for the item's output builds up; and

  c) costs of relocating or reorganizing part or all of an entity's operations.

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Example

Moon Ltd incurs the following costs in relation to the construction of a new factory and the introduction of its products to the local market. The below table illustrates which of the items of cost can be capitalised as per Ind AS 16.

Particulars	₹ 000 (Cost incurred)	₹ 000 (As per Ind AS 16)
Site preparation costs	150	150
Direct Material	2,000	2,000
Direct Labour cost, including ₹ 10,000 incurred during an industrial strike	1,160	1,150
Testing of various processes in factory	200	200
Consultancy fees for installation of equipment	300	300
Relocation of staff to new factory	450	-
General overheads	550	-
Estimated Costs to dismantle (at present value)	200	200
Total Cost to be Capitalised as per Ind AS 16		**4,000**

2.5.3 Measurement of cost

2.5.3.1 Payment deferred beyond normal credit terms

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognized as interest over the period of credit unless such interest is capitalised in accordance with Ind AS 23.

Illustration 1 - Deferred Payment Credit

On 1st April, 20X1, an item of property is offered for sale at ₹ 10 million, with payment terms being three equal installments of ₹ 33,33,333 over a two-year period (payments are made on 1st April, 20X1, 31st March, 20X2 and 31st March, 20X3). Implicit interest rate of 5.36 percent p.a.

Pass necessary journal entries for recording the property in accordance with Ind AS 16.

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Solution

Ind AS 16 requires that the cost of an item of PPE is the cash price equivalent at the recognition date. Hence, the purchaser that takes up the deferred payment terms will recognize the acquisition of the asset as follows:

		(₹)	(₹)
On 1st April, 20X1			
Property, Plant and Equipment (W.N. 1)	Dr.	95,00,000	
To Bank A/c			33,33,333
To Accounts Payable (W.N. 2)			61,66,667
(Initial recognition of property)			
On 31st March, 20X2			
Interest Expense (W.N. 2)	Dr.	3,30,533	
Accounts payable (W.N. 2)	Dr.	30,02,800	
To Bank A/c			33,33,333
(Recognition of interest expense and payment of second installment)			
On 31st March, 20X3			
Interest Expense (W.N. 2)	Dr.	1,69,467	
Accounts payable (W.N. 2)	Dr.	31,63,867	
To Bank A/c			33,33,334
(Recognition of interest expense and payment of final installment)			

Working Notes:

1. Calculation of cash price equivalent at initial recognition

Year	Payment	Discounting factor @ 5.36%	Present value
1.4.20X1	33,33,333	1.000	33,33,333
31.3.20X2	33,33,333	0.949	31,63,333
31.3.20X3	33,33,334	0.901	30,03,334
Initial date cash price equivalent	1,00,00,000		95,00,000

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2. Calculation of interest expenses

Year	Opening balance (a)	Interest @ 5.36% (b) = (a) x 5.36%	Total payment at year beginning (c)	Principal amount in the instalment (d) = (c) – (b)	Closing balance (e) = (a) - (d)
1.4.20X1	95,00,000	-	33,33,333	33,33,333	61,66,667
31.3.20X2	61,66,667	3,30,533	33,33,333	30,02,800	31,63,867
31.3.20X3	31,63,867	1,69,467*	33,33,334	31,63,867	Nil

*Difference of ₹ 116 [(31,63,867 x 5.36%) – (33,33,334 - 31,63,867)] is due to approximation.

*****

2.5.3.2 Measurement of PPE acquired in Exchange

- One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an item of property, plant and equipment is measured at fair value (even if an entity cannot immediately derecognize the asset given up) unless:

  a) the exchange transaction lacks commercial substance; or

  b) the fair value of neither the asset received nor the asset given up is reliably measurable.

- If the acquired item is not measured at fair value [because of considerations mentioned in a) and b) above], its cost is measured at the carrying amount of the asset given up.

- An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

  a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

  b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

  c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

- For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows.

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- The fair value of an asset is reliably measurable if:
  a) the variability in the range of reasonable fair value measurements is not significant for that asset or
  b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.
- If an entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.
- The carrying amount of an item of property, plant and equipment may be reduced by Government grants in accordance with Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance.

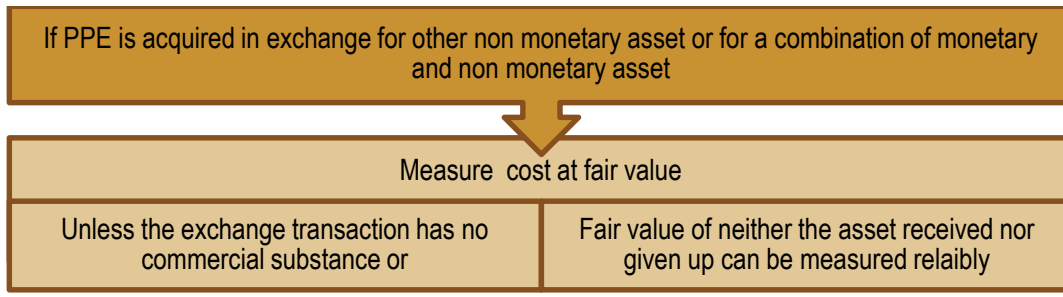


Illustration 2 – Exchange of Assets

Pluto Ltd owns land and building which are carried in its balance sheet at an aggregate carrying amount of ₹ 10 million. The fair value of such asset is ₹ 15 million. It exchanges the land and building for a private jet, which has a fair value of ₹ 20 million, and pays additional ₹ 3 million in cash.

Apply necessary provisions of Ind AS 16 for the above transactions and pass journal entry for the same.

Solution

Provided that the transaction has commercial substance, the entity should recognize the private jet at a cost of ₹ 18 million (being ₹ 15 million plus 3 million cash) and should recognize a profit on disposal of the land and building of ₹ 5 million, calculated as follow:

	(₹ 000)
Recognition of fair value of asset acquired (15,000 + 3,000)	18,000
Less: Carrying amount of land and building disposed	(10,000)

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Cash Paid	(3,000)
Profit on exchange of assets	5,000

The required journal entry is therefore as follow:

Property, Plant and Equipment (Private Jet)	Dr.	18,000	
To Property, Plant and Equipment (Land and Building)			10,000
To Cash			3,000
To Profit on exchange of assets			5,000

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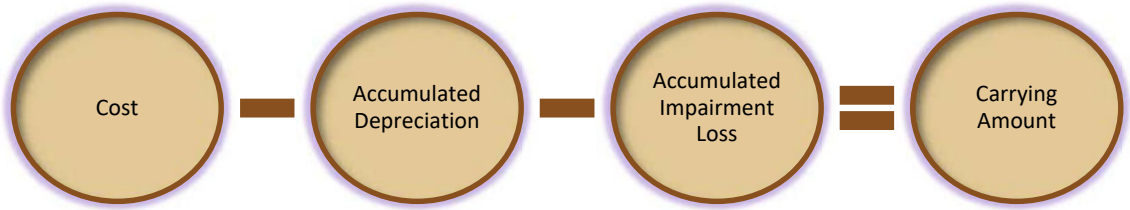
2.6 MEASUREMENT AFTER RECOGNITION

2.6.1 Alternative bases available for measurement after recognition

An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

2.6.2 Cost model

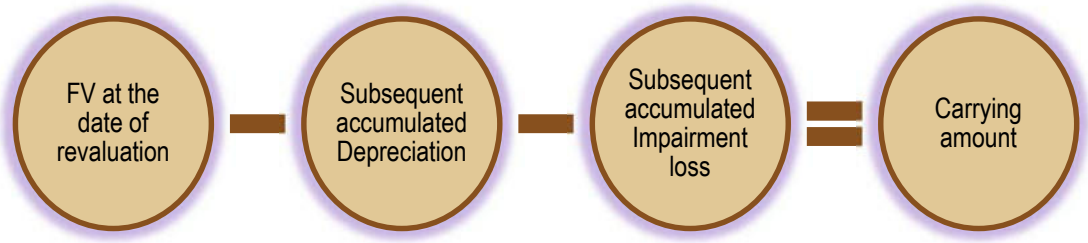
After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.



2.6.3 Revaluation model

After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations are required to be carried out with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

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2.6.3.1 Frequency of revaluations

- The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation.
- Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

2.6.3.2 Accumulated depreciation at the date of revaluation

- When an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

  a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

  b) the accumulated depreciation is eliminated against the gross carrying amount of the asset.

Illustration 3: Accumulated depreciation at the date of revaluation

Jupiter Ltd. has an item of property, plant and equipment with an initial cost of ₹ 100,000. At the date of revaluation accumulated depreciation amounted to ₹ 55,000. The fair value of asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.

Prepare the necessary journal entries.

Solution

Method – I: Depreciation Elimination Approach

Accumulated depreciation	Dr.	55,000	
To Asset Cost			55,000

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Asset Cost	Dr.	20,000	
To Revaluation reserve			20,000

The net result is that the asset has a carrying amount of ₹ 65,000 (100,000 – 55,000 + 20,000).

Method – II: Restatement Approach

Carrying amount (100,000 – 55,000) =	45,000
Fair value (revalued amount)	65,000
Surplus	20,000
% of surplus to the carrying amount (20,000 / 45,000)	44.44%

Entries to be Made:

Asset (1,00,000 x 44.44%)	Dr.	44,444	
To Accumulated Depreciation (55,000 x 44.44%)			24,444
To Revaluation Reserve			20,000

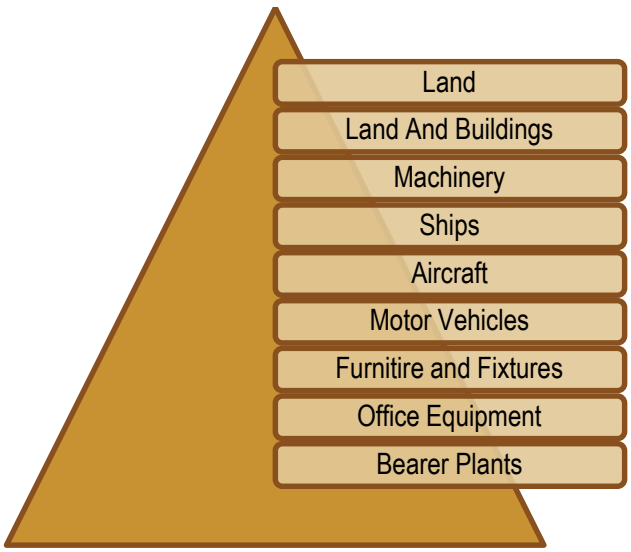
(Being the entry to increase both the original cost and the accumulated depreciation by 44.44%)

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2.6.3.3 Revaluation to be made for entire class of assets

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:



The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates.

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However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

Illustration 4: Revaluation model for entire class

Venus Ltd. is a large manufacturing group. It owns a considerable number of industrial buildings, such as factories and warehouses, and office buildings in several capital cities. The industrial buildings are located in industrial zones whereas the office buildings are in central business districts of the cities. Venus's Ltd. management wants to apply the Ind AS 16 revaluation model to subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings.

Analyse the accounting treatment to be applied by the management in the light of Ind AS 16.

Solution

Venus's Ltd. management can apply the revaluation model only to the office buildings.

The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location.

Ind AS 16 permits assets to be revalued on a class-by-class basis.

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can therefore be applied to these classes for subsequent measurement. All properties within the class of office buildings must therefore be carried at revalued amount. Separate disclosure of the two classes must be given in accordance with para 73 of Ind AS 16.

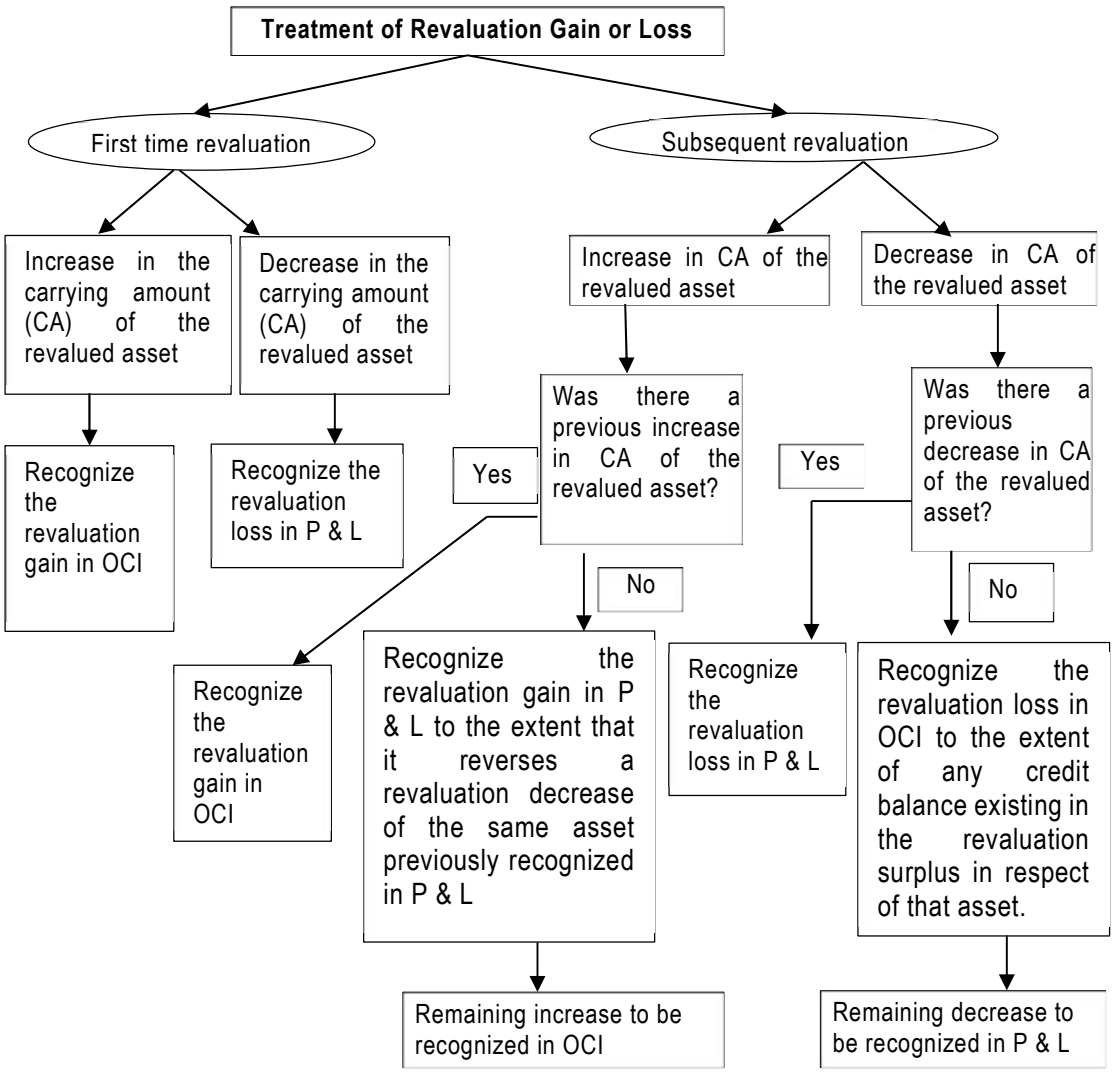
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2.6.3.4 Treatment of surplus or deficit arising on revaluation

- If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit or loss.
- If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in profit or loss. However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

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Treatment of revaluation gain and loss is summarized in the below diagram:



The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognized. This may involve transferring the whole of the surplus when the asset is retired or disposed of.

However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

The effects of taxes on income, if any, resulting from the revaluation of property, plant and equipment are recognized and disclosed in accordance with Ind AS 12, *Income Taxes*.

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Illustration 5: Utilisation of Revaluation Surplus

An item of PPE was purchased for ₹ 9,00,000 on 1st April, 20X1. It is estimated to have a useful life of 10 years and is depreciated on a straight-line basis. On 1st April, 20X3, the asset is revalued to ₹ 9,60,000. The useful life remains unchanged as ten years. Ignore impact of deferred taxes.

Calculate depreciation and revaluation surplus for 20X3-20X4 as per Ind AS 16.

Solution

Calculation of Additional Depreciation:	**(₹)**
Actual depreciation for 20X3-20X4 based on revalued amount (9,60,000/8)	1,20,000
Depreciation for 20X3-20X4 based on historical cost (9,00,000/10)	(90,000)
Additional Depreciation	30,000

In the profit or loss for 20X3-20X4, a depreciation expense of ₹ 1,20,000 will be charged. A reserve transfer, which will be shown in the statement of changes in equity, may be undertaken as follows:

Revaluation surplus	Dr.	30,000	
To Retained earnings			30,000

The closing balance on the revaluation surplus on 31st March, 20X4 will therefore be as follows:

Balance arising on revaluation (9,60,000 – 7,20,000)		2,40,000
Transfer to retained earnings		(30,000)
		2,10,000

2.6.4 Depreciation

- The depreciable amount of an asset should be allocated on a systematic basis over its useful life. The depreciation charge for each period should be recognized in profit or loss unless it is included in the carrying amount of another asset.
- Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.
- An entity allocates the amount initially recognized in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft.
- A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of

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another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

- To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.
- Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.
- If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.
- In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

2.6.4.1 Residual Value

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Illustration 6: Revision of Useful Life

An asset which cost ₹ 10,000 was estimated to have a useful life of 10 years and residual value ₹ 2000. After two years, useful life was revised to 4 remaining years.

Calculate the depreciation charge for the years 1,2,3.

Solution: ₹

	Year-1	Year-2	Year-3
Cost	10,000	10,000	10,000
Less: Accumulated Depreciation	(800)	(1,600)	(3,200)

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Carrying Amount	9,200	8,400	6,800
Charges for year	$\frac{10,000-2,000}{10}$ = 800	$\frac{10,000-2,000}{10}$ = 800	$\frac{8,400-2,000}{4}$ = 1,600

*****

- The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.
- Depreciation is recognized even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

2.6.4.2 Commencement of depreciation

Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

2.6.4.3 Cessation of depreciation

- Depreciation of an asset ceases at the earlier of:
  a) the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105.
  b) and the date that the asset is derecognized.
- Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

2.6.4.4 Factors affecting the useful life of an asset

The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output;

b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle;

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c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset; and

d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

2.6.4.5 Impact of an entity's asset management policy

The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset.

Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

2.6.4.6 Depreciation method

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The depreciation method applied to an asset is reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change is accounted for as a change in an accounting estimate in accordance with Ind AS 8.

Illustration 7: Change in Depreciation Method

An entity acquired an asset 3 years ago at a cost of ₹ 5 million. The depreciation method adopted for the asset was 10 percent reducing balance method.

At the end of Year 3, the entity estimates that the remaining useful life of the asset is 8 years and determines to adopt straight –line method from that date so as to reflect the revised estimated pattern of recovery of economic benefits.

Calculate the depreciation charge for respective years in accordance with Ind AS 16.

Solution

Change in depreciation method shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8 and hence will have a prospective effect.

Depreciation charges for year 1 to 11 will be as follows:

Year 1	₹ 5,00,000

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Year 2	₹ 4,50,000
Year 3	₹ 4,05,000
Year 4 to Year 11 (refer W.N.)	₹ 4,55,625 p.a.

Working Note:

Year	Opening balance of asset (a)	Depreciation @ 10% on (a)	Closing balance of asset (c) = (a)- (b)
1	50,00,000	5,00,000	45,00,000
2	45,00,000	4,50,000	40,50,000
3	40,50,000	4,05,000	36,45,000

Year 3 onwards method of depreciation has been changed from reducing balance method to straight line method for which it is assessed that the remaining useful life is 8 years. Hence revised depreciation would be calculated as follows:

Revised depreciation as per straight line method = (Carrying amount as at the end of the 3rd year – Residual value) / Remaining useful life

= 36,45,000 / 8 years = ₹ 4,55,625 per annum (for year 4 to year 11)

*****

A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include:

a) Straight-line depreciation method results in a constant charge over the useful life if the asset's residual value does not change.

b) Diminishing balance method results in a decreasing charge over the useful life.

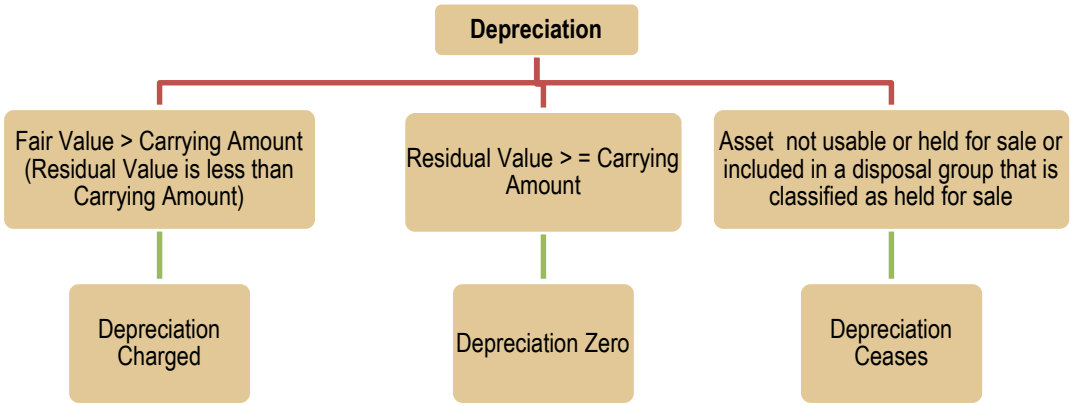
c) Units of production method results in a charge based on the expected use or output.

The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset (e.g. revenue is affected by other inputs and processes, selling activities and changes in

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sales volumes and prices). The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.



2.6.5 Impairment

2.6.5.1 Identification of an impairment loss

To determine whether an item of property, plant and equipment is impaired, an entity applies Ind AS 36, *Impairment of Assets*. Ind AS 36 explains how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognizes, or reverses the recognition of, an impairment loss.

2.6.5.2 Compensation for impairment

- Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.
- Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

  a) impairments of items of property, plant and equipment are recognized in accordance with Ind AS 36;

  b) derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;

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c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and

d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.

2.7 DERECOGNITION

2.7.1 Derecognition- general

- The carrying amount of an item of property, plant and equipment should be derecognized:

  a) on disposal; or

  b) when no future economic benefits are expected from its use or disposal.

- The gain or loss arising from the derecognition of an item of property, plant and equipment is included in profit or loss when the item is derecognized (unless Ind AS 116 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

- However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets shall be recognized as revenue in accordance with Ind AS 115, Revenue from Contracts with Customers.

- The date of disposal of an item of property, plant and equipment is the date the recipient obtains control of that item in accordance with Ind AS 115. Ind AS 116 applies to disposal by a sale and leaseback.

- If, under the recognition principle, an entity recognizes in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognizes the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

- The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

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- The date of disposal of an item of property, plant and equipment is the date the recipient obtains control of that item in accordance with the requirements for determining when a performance obligation is satisfied in Ind AS 115. Ind AS 116 applies to disposal by a sale and leaseback.
- The amount of consideration to be included in the gain or loss arising from the derecognition of an item of property, plant and equipment is determined in accordance with the requirements for determining the transaction price in Ind AS 115.
- Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.

2.8 DISCLOSURE

2.8.1 Disclosure- general

- The financial statements shall disclose, for each class of property, plant and equipment:
  a) the measurement bases used for determining the gross carrying amount;
  b) the depreciation methods used;
  c) the useful lives or the depreciation rates used; and
  d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period.
- Entity is also required to provide a reconciliation of the carrying amount at the beginning and end of the period showing:
  a) additions;
  b) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;
  c) acquisitions through business combinations;
  d) increases or decreases resulting from revaluations and from impairment losses recognized or reversed in other comprehensive income in accordance with Ind AS 36;
  e) impairment losses recognized in profit or loss in accordance with Ind AS 36;
  f) impairment losses reversed in profit or loss in accordance with Ind AS 36;
  g) depreciation;

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h) the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and

i) other changes.

- The financial statements shall also disclose:

  a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

  b) the amount of expenditures recognized in the carrying amount of an item of property, plant and equipment in the course of its construction;

  c) the amount of contractual commitments for the acquisition of property, plant and equipment; and

  d) if it is not disclosed separately in the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.

- Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information that allows them to review the policies selected by management and enables comparisons to be made with other entities. For similar reasons, it is necessary to disclose:

  (a) depreciation, whether recognized in profit or loss or as a part of the cost of other assets, during a period; and

  (b) accumulated depreciation at the end of the period.

- In accordance with Ind AS 8 an entity discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:

  (a) residual values;

  (b) the estimated costs of dismantling, removing or restoring items of property, plant and equipment;

  (c) useful lives; and

  (d) depreciation methods

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2.8.2 Items stated at revalued amounts

- If items of property, plant and equipment are stated at revalued amounts, the following should be disclose:

  a) the effective date of the revaluation;

  b) whether an independent valuer was involved;

  c) for each revalued class of property, plant and equipment, the carrying amount that would have been recognized had the assets been carried under the cost model; and

  d) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

2.8.3 Additional recommended disclosure

- Entities are encouraged but not required, to disclose the following amounts:

  a) the carrying amount of temporarily idle property, plant and equipment;

  b) the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

  c) the carrying amount of property, plant and equipment retired from active use and not classified as held for sale in accordance with Ind AS 105; and

  d) when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount.

Illustration 8

MS Ltd. has acquired a heavy machinery at a cost of ₹ 1,00,00,000 (with no breakdown of the component parts). The estimated useful life is 10 years. At the end of the sixth year, one of the major components, the turbine requires replacement, as further maintenance is uneconomical. The remainder of the machine is perfect and is expected to last for the next four years. The cost of a new turbine is ₹ 45,00,000. The discount rate assumed is 5%.

Analyse whether the cost of the new turbine can be recognized as an asset, and, if yes, then apply the accounting treatment relevant to it.

Solution

The new turbine will produce economic benefits to MS Ltd., and the cost is measurable. Hence, the item should be recognized as an asset. The original invoice for the machine did not specify the cost of the turbine; however, the cost of the replacement ₹ 45,00,000 can be used as an indication (usually by discounting) of the likely cost, six years previously.

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If an appropriate discount rate is 5% per annum, ₹ 45,00,000 discounted back six years amounts to ₹ 33,57,900 [₹ 45,00,000/$(1.05)^6$], i.e., the approximate cost of turbine before 6 years.

The current carrying amount of the turbine which is required to be replaced of ₹ 13,43,160 would be derecognized from the books of account, (i.e., Original Cost ₹ 33,57,900 as reduced by accumulated depreciation for past 6 years ₹ 20,14,740, assuming depreciation is charged on straight-line basis.)

The cost of the new turbine, ₹ 45,00,000 would be added to the cost of machine, resulting in a revision of carrying amount of machine to ₹ 71,56,840. (i.e., ₹ 40,00,000* – ₹ 13,43,160 + ₹ 45,00,000).

*Original cost of machine ₹ 1,00,00,000 reduced by accumulated depreciation (till the end of 6 years) ₹ 60,00,000.

*****

Illustration 9

On 1st April, 20X1, XYZ Ltd. acquired a machine under the following terms:

	₹
List price of machine	*80,00,000*
Import duty	*5,00,000*
Delivery fees	*1,00,000*
Electrical installation costs	*10,00,000*
Pre-production testing	*4,00,000*
Purchase of a five-year maintenance contract with vendor	*7,00,000*

In addition to the above information XYZ Ltd. was granted a trade discount of 10% on the initial list price of the asset and a settlement discount of 5%, if payment for the machine was received within one month of purchase. XYZ Ltd. paid for the plant on 20th April, 20X1.

Compute the cost of the asset to be recognized.

Solution

In accordance with Ind AS 16, all costs required to bring an asset to its present location and condition for its intended use should be capitalized. Therefore, the initial purchase price of the asset should be

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	₹
List price	80,00,000
Less: Trade discount (10%)	(8,00,000)
	72,00,000
Import duty	5,00,000
Delivery fees	1,00,000
Electrical installation costs	10,00,000
Pre-production testing	4,00,000
Total amount to be capitalized at 1st April, 20X1	**92,00,000**

Maintenance contract is a separate contract to get service, therefore, the maintenance contract cost of ₹ 7,00,000 should be taken as a prepaid expense and charged to the profit or loss over a period of 5 years.

In addition, the settlement discount received of ₹ 3,60,000 (₹ 72,00,000 x 5%) is to be shown as other income in the profit or loss.

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Illustration 10

X Limited started construction on a building for its own use on 1st April, 20X0. The following costs are incurred:

	₹
Purchase price of land	*30,00,000*
Stamp duty & legal fee	*2,00,000*
Architect fee	*2,00,000*
Site preparation	*50,000*
Materials	*10,00,000*
Direct labour cost	*4,00,000*
General overheads	*1,00,000*

Other relevant information: Material costing ₹ 1,00,000 had been spoiled and therefore wasted and a further ₹ 1,50,000 was spent on account of faulty design work. As a result of these problems, work on the building was stopped for two weeks during November, 20X0 and it is estimated that ₹ 22,000 of the labour cost relate to that period. The building was completed on

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1st January, 20X1 and brought in use 1st April, 20X1. X Limited had taken a loan of ₹ 40,00,000 on 1st April, 20X0 for construction of the building. The loan carried an interest rate of 8% per annum and is repayable on 1st April, 20X2. Assume that the entity did not considered the construction period as substantial period of time as per Ind AS 23.

Calculate the cost of the building that will be included in tangible non-current asset as an addition?

Solution

Only those costs which are directly attributable to bringing the asset into working condition for its intended use should be included. Administration and general costs cannot be included. Cost of abnormal amount of wasted material/ labor or other resources is not included as per para 22 of Ind AS 16. Here, the cost of spoilt materials and faulty designs are assumed to be abnormal costs. Also, it is assumed that the wastages and labor charges incurred are abnormal in nature. Hence, same are also not included in the cost of PPE.

Amount to be included in Property, Plant and Equipment (PPE):

	₹
Purchase price of land	30,00,000
Stamp duty & legal fee	2,00,000
Architect fee	2,00,000
Site preparation	50,000
Material (10,00,000 – 2,50,000)	7,50,000
Direct labour cost (4,00,000 – 22,000)	3,78,000
General overheads	Nil
Interest*	Nil
Total to be capitalized	45,78,000

*****

Illustration 11

XYZ Ltd. purchased an asset on 1st January, 20X0, for ₹ 1,00,000 and the asset had an estimated useful life of ten years and a residual value of nil. The company has charged depreciation using the straight-line method at ₹ 10,000 per annum. On 1st January, 20X4, the management of XYZ Ltd. reviews the estimated life and decides that the asset will probably be useful for a further four years and, therefore, the total life is revised to eight years.

Account for the asset for the remaining years.

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Solution

Change in useful economic life of an asset is change in accounting estimate, which is to be applied prospectively, i.e., the depreciation charge will need to be recalculated. On 1st January, 20X4, when the asset's net book value is ₹ 60,000. The company should amend the annual provision for depreciation to charge the unamortised cost (namely, ₹ 60,000) over the revised remaining life of four years. Consequently, it should charge depreciation for the next four years at ₹ 15,000 per annum.

*****

Illustration 12

On 1st April, 20X1, Sun Ltd. purchased some land for ₹ 10 million (including legal costs of ₹ 1 million) in order to construct a new factory. Construction work commenced on 1st May, 20X1. Sun Ltd incurred the following costs in relation with its construction:

- *Preparation and levelling of the land – ₹ 3,00,000.*
- *Purchase of materials for the construction – ₹ 6.08 million in total.*
- *Employment costs of the construction workers – ₹ 2,00,000 per month.*
- *Overhead costs incurred directly on the construction of the factory – ₹ 1,00,000 per month.*
- *Ongoing overhead costs allocated to the construction project using the company's normal overhead allocation model – ₹ 50,000 per month.*
- *Income received during the temporary use of the factory premises as a car park during the construction period – ₹ 50,000.*
- *Costs of relocating employees to work at the new factory – ₹ 3,00,000.*
- *Costs of the opening ceremony on 31st January, 20X2 – ₹ 1,50,000.*

The factory was completed on 30th November, 20X1 (which is considered as substantial period of time as per Ind AS 23) and production began on 1st February, 20X2. The overall useful life of the factory building was estimated at 40 years from the date of completion. However, it is estimated that the f will need to be replaced 20 years after the date of completion and that the cost of replacing the roof at current prices would be 30% of the total cost of the building.

At the end of the 40-year period, Sun Ltd has a legally enforceable obligation to demolish the factory and restore the site to its original condition. The directors estimate that the cost of demolition in 40 years' time (based on prices prevailing at that time) will be ₹ 20 million. An annual risk adjusted discount rate which is appropriate to this project is 8%. The present value of ₹ 1 payable in 40 years' time at an annual discount rate of 8% is ₹ 0.046.

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The construction of the factory was partly financed by a loan of ₹ 17·5 million taken out on 1st April, 20X1. The loan was at an annual rate of interest of 6%. Sun Ltd received investment income of ₹ 100,000 on the temporary investment of the proceeds.

Compute the carrying amount of the factory on the Balance Sheet of Sun Ltd at 31st March, 20X2. Explain the treatment of all the amounts referred to in this part of the answer.

Solution

Computation of the cost of the factory

Description	Included in P.P.E. ₹ '000	Explanation
Purchase of land	10,000	Both the purchase of the land and the associated legal costs are direct costs of constructing the factory.
Preparation and levelling	300	A direct cost of constructing the factory
Materials	6,080	A direct cost of constructing the factory
Employment costs of construction workers	1,400	A direct cost of constructing the factory for a seven-month period
Direct overhead costs	700	A direct cost of constructing the factory for a seven-month period
Allocated overhead costs	Nil	Not a direct cost of construction
Income from use as a car park	Nil	Not essential to the construction so recognized directly in profit or loss
Relocation costs	Nil	Not a direct cost of construction
Opening ceremony	Nil	Not a direct cost of construction
Finance costs	612.50	Capitalize the interest cost incurred in a seven-month period (purchase of land would not trigger off capitalization since land is not a qualifying asset. Infact, the construction started from 1st May, 20X1)
Investment income on temporary investment of the loan proceeds	(100)	offset against the amount capitalized
Demolition cost recognized as a provision	920	Where an obligation must recognize as part of the initial cost
Total	19,912.50	

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Computation of accumulated depreciation		
Total depreciable amount	9,912.50	All of the net finance cost of 512.50 (612.50 – 100) has been allocated to the depreciable amount. Also, acceptable to reduce by allocating a portion to the non-depreciable land element principle
Depreciation must be in two parts:		
Depreciation of roof component	49.56	9,912.50 x 30% x 1/20 x 4/12
Depreciation of remainder	57.82	9,912.50 x 70% x 1/40 x 4/12
Total depreciation	107.38	
Computation of carrying amount	19,805.12	19,912.50 – 107.38

*****

2.9 CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND SIMILAR LIABILITIES (APPENDIX A)

Many entities have obligations to dismantle, remove and restore items of property, plant and equipment after the end of particular period. The initial estimate of such costs is included in the cost of an item of property, plant and equipment. For instance, a lessee who has taken an office building on lease may do some leasehold improvements and may have an obligation under the lease agreement to dismantle the leasehold improvements at the end of the lease. Such obligations are referred to as 'decommissioning, restoration and similar liabilities'.

Ind AS 37 contains requirements on how to measure decommissioning, restoration and similar liabilities. **Appendix A to Ind AS 16 provides guidance on how to account for** the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.

2.9.1 When to apply guidance in Appendix A to Ind AS 16

The guidance in Appendix A to Ind AS 16 applies to changes in the measurement of any existing de-commissioning, restoration or similar liability that is both:

- recognized as part of the cost of an item of property, plant and equipment in accordance with Ind AS 16 or as part of the cost of a right-of-use asset in accordance with Ind AS 116; and
- recognized as a liability in accordance with Ind AS 37.

2.9.2 Issues addressed by Appendix A to Ind AS 16

This Appendix addresses how the **effect of the following events that change the measurement** of an existing decommissioning, restoration or similar liability should be accounted for:

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a) a change in the estimated outflow of resources embodying economic benefits (e.g. cash flows) required to settle the obligation;

b) a change in the current market-based discount rate as defined in paragraph 47 of Ind AS 37 (this includes changes in the time value of money and the risks specific to the liability); and

c) an increase that reflects the passage of time (also referred to as the unwinding of the discount).

2.9.3 Accounting guidance in Appendix A to Ind AS 16

- Appendix A to Ind AS 16 offers two different approaches to account for changes in decommissioning **liability depending upon whether the entity follows cost model or revaluation model**.
- If the related asset is measured using the **cost model**:

  (a) subject to point (b) below, changes in the decommissioning, restoration and similar liability shall be **added to, or deducted from,** the cost of the asset in the current period and related provision for decommissioning and site restoration is accordingly adjusted.

  (b) **any such decrease** in the decommissioning, restoration and similar liability **cannot exceed** the carrying amount of the asset. In case, the said decrease in the decommissioning liability is more than the carrying amount of the asset, **the excess is recognized immediately as income** in statement of profit and loss.

  (c) if the changes in the decommissioning liability and the resultant **adjustment results in an addition to the cost** of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, **the entity shall test the asset for impairment** by estimating its recoverable amount, and shall account for any impairment loss, in accordance with Ind AS 36.

- If the asset is measured using the **revaluation model**:

  (a) **Any increase in liability** arising out of changes in decommissioning liabilities is **adjusted against revaluation surplus to the extent credit balance is available relating to that particular asset through 'other comprehensive income'**. Any excess is, however, recognized in the statement of profit and loss.

  (b) **Any decrease in liability** arising out of changes in decommissioning liabilities, is **recognized in the revaluation reserve ie equity through 'other comprehensive income'**. However, if there was any revaluation deficit previously charged to profit or loss, to that extent it can be recognized as income in the statement of profit and loss.

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(c) If there is **decrease** in decommissioning liability **in excess of the carrying amount** of the asset, such excess is treated as 'deemed revaluation' and is **recognized immediately in the statement of profit and loss**.

(d) Any change in liability would require the asset to be tested for impairment to ascertain if there is any change in fair value.

(e) **Change in the revaluation surplus** arising from a change in the decommissioning liability **shall be presented as a separate line item** in the Statement of Other Comprehensive Income, as required under Ind AS 1.

- The ***adjusted depreciable amount*** of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognized in profit or loss as they occur. This applies under both the cost model and the revaluation model.
- The ***periodic unwinding of the discount*** shall be recognized in profit or loss as a finance cost, as it occurs. Capitalisation under Ind AS 23 is not permitted.

Illustration 13

H Limited purchased an item of PPE costing ₹ 100 million which has useful life of 10 years. The entity has a contractual decommissioning and site restoration obligation, estimated at ₹ 5 million to be incurred at the end of 10th year. The current market-based discount rate is 8%.

The company follows SLM method of depreciation. H Limited follows the Cost Model for accounting of PPE.

Determine the carrying value of an item of PPE and decommissioning liability at each year end when

(a) There is no change in the expected decommissioning expenses, expected timing of incurring the decommissioning expense and / or the discount rate

(b) At the end of Year 4, the entity expects that the estimated cash outflow on account of decommissioning and site restoration to be incurred at the end of the useful life of the asset will be ₹ 8 million (in place of ₹ 5 million, estimated in the past).

Determine in case (b), how H Limited need to account for the changes in the decommissioning liability?

Solution

The present value of such decommissioning and site restoration obligation at the end of 10th year is ₹ **2.32 million** [being 5 / $(1.08)^{10}$]. H Limited will recognize the present value of decommissioning liability of ₹ 2.32 million as an **addition to cost of PPE and** will also recognize

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a corresponding decommissioning liability. Further, the entity will recognize the unwinding of discount as finance charge.

(a) The following table shows the relevant computations, if there is **no change** in the expected decommissioning expenses, expected timing of incurring the decommissioning expense and / or the discount rate: (₹ in million)

Year	Opening Amount of PPE	Depreciation Charge (on SLM) for 10 Years	Carrying Amount of PPE at the end of the year	Opening Decommissioning Liability	Unwinding of Interest @ 8%	Closing Decommissioning Liability
1	102.32	10.23	92.08	2.32	0.19	2.50
2	92.08	10.23	81.85	2.50	0.20	2.70
3	81.85	10.23	71.62	2.70	0.22	2.92
4	71.62	10.23	61.39	2.92	0.23	3.15
5	61.39	10.23	51.16	3.15	0.25	3.40
6	51.16	10.23	40.93	3.40	0.27	3.68
7	40.93	10.23	30.69	3.68	0.29	3.97
8	30.69	10.23	20.46	3.97	0.32	4.29
9	20.46	10.23	10.23	4.29	0.34	4.63
10	10.23	10.23	-	4.63	0.37	5.00
Total		**102.32**			**2.68**	

(b) The changes to the estimate of expected decommissioning obligation:

- The present value of the decommissioning liability at the end of Year 4 works out to be **₹ 5.04 million** [being 8 / $(1.08)^6$].
- As against this, the carrying amount of decommissioning liability at the end of Year 4 is **₹ 3.15 million** (as computed above).
- The changes in the decommissioning liability of **₹ 1.89 million** *(being ₹ 5.04 million less ₹ 3.15 million)* shall be ***added to*** the cost of the asset in the current period and the related provision for decommissioning liability is also adjusted.

  The journal entry will be:

  PPE Dr. ₹ 1.89 million

  To Provision for decommissioning liability ₹ 1.89 million

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- The following table shows the calculations for years 5 - 10:

Year	Opening Amount of PPE	Depreciation Charge SLM – 10 Years	Carrying Amount of PPE at end of the year	Opening Decommissioning Liability	Unwinding of Interest @8%	Closing Decommissioning Liability
5	63.28	10.55	52.73	5.04	0.40	5.44
6	52.73	10.55	42.19	5.44	0.44	5.88
7	42.19	10.55	31.64	5.88	0.47	6.35
8	31.64	10.55	21.09	6.35	0.51	6.86
9	21.09	10.55	10.55	6.86	0.55	7.41
10	10.55	10.55	-	7.41	0.59	8.00
Total		**63.28**			**2.96**	

Note that in the above table:

- Opening amount of PPE at the beginning of Year 5 is computed as ₹ 63.28 million (being carrying amount of ₹ 61.39 million at the end of Year 4 *plus* increase of ₹ 1.89 million arising due to increase in the present value of the decommissioning liability at the end of Year 4).
- The revised carrying amount of PPE (at ₹ 63.28 million) at the beginning of Year 5 will be depreciated over the balance 6 years of the useful life).
- Opening decommissioning liability at the beginning of Year 5 is computed as ₹ 5.04 million (being carrying amount of ₹ 3.15 million at the end of Year 4 *plus* increase of ₹ 1.89 million).

  Since the entity has adjusted the increase in the decommissioning liability against the carrying amount of PPE, it needs to evaluate whether the new carrying amount (in this case, ₹ 63.28 million) is recoverable. If not, it will give rise to impairment loss, to be accounted for under Ind AS 36.

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2.10 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Cummins India Limited' for the financial year 2021-2022 with respect to 'Property, Plant and Equipment' and its accounting policy thereon.

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BALANCE SHEET AS AT MARCH 31, 2022

Particulars	Notes No.	As at March 31, 2022
ASSETS		
Non-current assets		
Property, plant and equipment	2.1	115,362

2.1 Property, plant and equipment (PPE)

₹ Lacs

Particulars	Gross block					Depreciation and Amortisation					Net block
	As at April 1, 2021	Additions	Adjustment ***	Deductions / Write-off	As at March 31, 2022	As at April 1, 2021	For the year	Adjustment ***	Deductions / Write-off	As at March 31, 2022	As at March 31, 2022
Freehold land @	3,612	-	-	-	3,612	-	-	-	-	-	3,612
Leasehold Improvements	607	-	-	-	607	55	6	-	-	61	546
Roads	2,993	67	-	-	3,060	2,022	126	(0)	(0)	2,148	912
Buildings #	83,989	910	13	47	84,865	14,230	1,901	13	43	16,101	68,764
Plant and machinery #	100,984	9,548	4,456	8,852	106,136	64,860	5,421	1,995	5,565	66,711	39,425
Furniture and fittings #	5,158	11	5	78	5,096	2,730	452	5	49	3,138	1,958
Vehicles	458	19	(14)	-	463	286	46	(14)	-	318	145
	197,801	10,555	4,460	8,977	203,839	84,183	7,952	1,999	5,657	88,477	115,362

ACCOUNTING POLICY

Property, plant and equipment and investment properties

Property plant and equipment, capital work in progress and investment properties are stated at cost of acquisition or construction net of accumulated depreciation and impairment loss (if any).

All significant costs relating to the acquisition and installation of property plant and equipment/ investment properties are capitalised. Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. All other repairs and maintenance are charged to the Statement of Profit and Loss during the financial period in which they are incurred.

When significant parts of plant and equipment are required to be replaced at intervals, the Company depreciate them separately based on their specific useful lives.

Depreciation is computed on straight line method based on useful lives, determined based on internal technical evaluation, as follows:

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Assets	*Useful life*
Roads	*10 years*
Office building and investment properties	*Upto 60 years*
Factory building	*30 years*
Plant and machinery	*3 to 15 years*
Furniture and fittings	*5 to 10 years*
Vehicles	*8 to 9 years*

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period.

Freehold land is carried at cost. Losses arising from the retirement of, and gains and losses arising from disposal of property, plant and equipment which are carried at cost are recognized in the Statement of Profit and Loss.

Leasehold improvements are amortised on straight line basis over the period of lease.

Transfers are made to investment properties only when there is a change in use. Transfers between investment property and owner-occupied property do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

(Source: Annual Report 2021-2022 - Cummins India Limited)

2.11 SIGNIFICANT DIFFERENCES IN IND AS 16 *VIS-À-VIS* AS 10

S. No.	Particular	Ind AS 16	AS 10
1.	*Fixed Assets retired from Active Use and Held for Sale*	Ind AS 16 does not deal with the assets 'held for sale' because the treatment of such assets is covered in Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations.	AS 10 deals with accounting for items of fixed assets retired from active use and held for sale.
2.	*Stripping Costs in the Production Phase of a Surface Mine*	Ind AS 16 provides guidance on measuring 'Stripping Costs in the Production Phase of a Surface Mine'.	AS 10 does not contain this guidance.

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2.12 CARVE OUT IN IND AS 16 *VIS-À-VIS* IAS 16

Para 17(e) of Ind AS 16 has been amended (through a notification by MCA on 23rd March, 2022) by adding a clarification that the excess of net proceeds from sale of items produced during testing will not be credited to Profit or loss i.e. it will be deducted from the cost of an item of property, plant and equipment.

However, an amendment made in IAS 16 by IASB prohibited deduction of proceeds of items produced during testing from cost of an item of property, plant and equipment.

This differential treatment in IAS 16 and Ind AS 16 has led to a carve out, which will have consequential impact on depreciation, impairment, and deferred tax.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

1.	Cost of the plant (cost per supplier's invoice plus taxes)	₹ 25,00,000
2.	Initial delivery and handling costs	₹ 2,00,000
3.	Cost of site preparation	₹ 6,00,000
4.	Consultants used for advice on the acquisition of the plant	₹ 7,00,000
5.	Interest charges paid to supplier of plant for deferred credit	₹ 2,00,000
6.	Net present value of estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
7.	Operating losses before commercial production	₹ 4,00,000

Advise ABC Ltd. on the costs that can be capitalized in accordance with Ind AS 16.

2. A Ltd. has an item of property, plant and equipment with an initial cost of ₹ 1,00,000. At the date of revaluation, accumulated depreciation amounted to ₹ 55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.

Pass journal entries with regard to revaluation.

3. B Ltd. owns an asset with an original cost of ₹ 2,00,000. On acquisition, management determined that the useful life was 10 years and the residual value would be ₹ 20,000. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value.

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At the end of year 8, management has reviewed the useful life and residual value and has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by the company. As a result, the residual value will reduce to ₹ 10,000.

Analyze how would the above changes in estimates be accounted by B Ltd.

4. X Ltd. has a machine which got damaged due to fire as on 31st January, 20X1. The carrying amount of machine was ₹ 1,00,000 on that date. X Ltd. sold the damaged asset as scrap for ₹ 10,000. X Ltd. has insured the same asset against damage. As on 31st March, 20X1, the compensation proceedings were still in process but the insurance company has confirmed the claim. Compensation of ₹ 50,000 is receivable from the insurance company.

   Determine the accounting for the above transaction for X Ltd.

5. An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1st April, 2XX1. The plant has a useful life of 40 years. Its initial cost was ₹ 1,20,000 which included an amount for decommissioning costs of ₹ 10,000, which represented ₹ 70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on 31st March. After 10 years, the net present value of the decommissioning liability has decreased by ₹ 8,000. The discount rate has not yet changed.

   Examine how the entity will account for the above changes in decommissioning liability in the 11th year, if it adopts cost model.

6. An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1st April, 20X1. The plant has a useful life of 40 years. Its initial cost was ₹ 1,20,000. This included an amount for decommissioning costs of ₹ 10,000, which represented ₹ 70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on 31st March. Assume that a market-based discounted cash flow valuation of ₹ 1,15,000 is obtained at 31st March, 20X4. This valuation is after deduction of an allowance of ₹ 11,600 for decommissioning costs, which represents no change to the original estimate, after the unwinding of three years' discount. On 31st March, 20X5, the entity estimates that, as a result of technological advances, the present value of the decommissioning liability has decreased by ₹ 5,000. The entity decides that a full valuation of the asset is needed at 31st March, 20X5, in order to ensure that the carrying amount does not differ materially from fair value. The asset is now valued at ₹ 1,07,000, which is net of an allowance for the reduced decommissioning obligation.

   Examine how will the entity account for the above changes in decommissioning liability if it adopts revaluation model.

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7. A Ltd. purchased some Property, Plant and Equipment on 1st April, 20X1, and estimated their useful lives for the purpose of financial statements prepared on the basis of Ind AS. Following were the original cost, and useful life of the various components of property, plant, and equipment assessed on 1st April, 20X1:

Property, Plant and Equipment	Original Cost	Estimated useful life
Buildings	₹ 15,000,000	15 years
Plant and machinery	₹ 10,000,000	10 years
Furniture and fixtures	₹ 3,500,000	7 years

A Ltd. uses the straight-line method of depreciation. On 1st April, 20X4, the entity reviewed the following useful lives of the property, plant, and equipment through an external valuation expert:

Buildings	10 years
Plant and machinery	7 years
Furniture and fixtures	5 years

There were no salvage values for the three components of the property, plant, and equipment either initially or at the time the useful lives were revised.

Examine the impact of revaluation of useful life on the Statement of Profit and Loss for the year ending 31st March, 20X5.

8. Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31st March, 20X1 to the managing director Mr. Y for approval. Mr. Y, who is not an accountant, had raised following query from Mr. X after going through the draft financial statements:

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

Advise the finance controller for resolving the query of the managing director?

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9. Company X performed a revaluation of all of its plant and machinery at the beginning of 20X1. The following information relates to one of the machinery:

	Amount ('000)
Gross carrying amount	₹ 200
Accumulated depreciation (straight-line method)	(₹ 80)
Net carrying amount	₹ 120
Fair value	₹ 150

The useful life of the machinery is 10 years and the company uses Straight line method of depreciation. The revaluation was performed at the end of 4 years.

Advise how should the company account for revaluation of plant and machinery and depreciation subsequent to revaluation. Support your answer with journal entries.

10. An entity has the following items of property, plant and equipment:

- Property A — a vacant plot of land on which it intends to construct its new administration headquarters;
- Property B — a plot of land that it operates as a landfill site;
- Property C — a plot of land on which its existing administration headquarters are built;
- Property D — a plot of land on which its direct sales office is built;
- Properties E1–E10 — ten separate retail outlets and the land on which they are built;
- Equipment A — computer systems at its headquarters and direct sales office that are integrated with the point of sale computer systems in the retail outlets;
- Equipment B — point of sale computer systems in each of its retail outlets;
- Furniture and fittings in its administrative headquarters and its sales office;
- Shop fixtures and fittings in its retail outlets.

Determine the classes of property, plant and equipment for disclosure by the entity?

11. Heaven Ltd. had purchased a machinery on 1.4.2X01 for ₹ 30,00,000, which is reflected in its books at written down value of ₹ 17,50,000 on 1.4.2X06. The company has estimated an upward revaluation of 10% on 1.4.2X06 to arrive at the fair value of the asset. Heaven Ltd. availed the option given by Ind AS of transferring some of the surplus as the asset is used by an enterprise.

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On 1.4.2X08, the machinery was revalued downward by 15% and the company also re-estimated the machinery's remaining life to be 8 years. On 31.3.2X10 the machinery was sold for ₹ 9,35,000. The company charges depreciation on straight line method.

Prepare machinery account in the books of Heaven Ltd. over its useful life to record the above transactions.

Answers

1. According to Ind AS 16, these costs can be capitalized:

1.	Cost of the plant	₹ 25,00,000
2.	Initial delivery and handling costs	₹ 2,00,000
3.	Cost of site preparation	₹ 6,00,000
4.	Consultants' fees	₹ 7,00,000
5.	Net present value of estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
		₹ 43,00,000

Note: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of ₹ 2,00,000 and operating losses before commercial production amounting to ₹ 4,00,000 are not regarded as directly attributable costs and thus cannot be capitalized. They should be written off to the Statement of Profit and Loss in the period they are incurred.

2. The entries to be passed would be:

		₹	₹
Accumulated depreciation	Dr.	55,000	
To Asset A/c			55,000
(Being elimination of accumulated depreciation against the cost of the asset)			
Asset A/c	Dr	20,000	
To Revaluation Surplus			20,000
(Being increase of net asset value to Fair value)			

Note: The net result is that the asset has a carrying amount of ₹ 65,000 [1,00,000 – 55,000 + 20,000.]

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3. Calculation of accumulated depreciation till 8th year

Depreciable amount {Cost less residual value} = ₹ 2,00,000 – ₹ 20,000 = ₹ 1,80,000.

Annual depreciation = Depreciable amount / Useful life = 1,80,000 / 10 = ₹ 18,000.

Accumulated depreciation = 18,000 x No. of years (8) = ₹ 1,44,000.

Calculation of carrying amount at the end of the 8th year

The asset has a carrying amount of ₹ 56,000 at the end of year 8 [ie. ₹ 2,00,000 – ₹ 1,44,000]

Accounting of the changes in estimates

Revision of the useful life to 12 years results in a remaining useful life of 4 years (ie 12 years – 8 years).

The revised depreciable amount is ₹ 46,000 (₹ 56,000 – ₹ 10,000)

Thus, depreciation should be charged in future ie from 9th year onwards at ₹ 11,500 per annum (₹ 46,000 / 4 years).

4. As per para 66 of Ind AS 16, impairment or losses of items of property, plant and equipment and related claims for or payments of compensation from third parties are separate economic events and should be accounted for separately.

X Ltd. should account for the above transaction as given below:

At the time of sale of scrap machine, X Ltd. should write off the carrying amount of asset from books of account and provide a loss of ₹ 90,000. (i.e., carrying amount of ₹ 1,00,000 – realised amount of ₹ 10,000)

As on 31st March, 20X1, X Ltd. should recognize income of ₹ 50,000 against the compensation receivable in its profit or loss.

5. On 31st March, 2X11, the plant is 10 years old. Accumulated depreciation is ₹ 30,000 (₹ 120,000 x 10 / 40 years). Due to unwinding of discount @ 5% over the 10 years, the amount of decommissioning liability has increased from ₹ 10,000 to ₹ 16,300 (approx.).

On 31st March, 2X11, the discount rate has not changed. However, the entity estimates that, as a result of technological advances, the net present value of the decommissioning liability has decreased by ₹ 8,000. Accordingly, the entity adjusts the decommissioning liability from ₹ 16,300 to ₹ 8,300. On this date, the entity passes the following journal entry to reflect the change:

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		₹	₹
Provision for decommissioning liability	Dr.	8,000	
To Asset			8,000

Following this adjustment, the carrying amount of the asset is ₹ 82,000 (₹ 1,20,000 – ₹ 8,000 – ₹ 30,000), which will be depreciated over the remaining 30 years of the asset's life giving a depreciation expense for the next year of ₹ 2,733 (₹ 82,000 / 30). The next year's finance cost for unwinding of discount will be ₹ 415 (₹ 8,300 × 5 per cent).

6.

At 31st March, 20X4:	₹
Asset at valuation (1)	1,26,600
Accumulated depreciation	Nil
Decommissioning liability	(11,600)
Net assets	1,15,000
Retained earnings (2)	(10,600)
Revaluation surplus (3)	15,600

Notes:

(1) When accounting for revalued assets to which decommissioning liabilities attach, it is important to understand the basis of the valuation obtained. For example:

(a) if an asset is valued on a discounted cash flow basis, some valuers may value the asset without deducting any allowance for decommissioning costs (a 'gross' valuation), whereas others may value the asset after deducting an allowance for decommissioning costs (a 'net' valuation), because an entity acquiring the asset will generally also assume the decommissioning obligation. For financial reporting purposes, the decommissioning obligation is recognized as a separate liability, and is not deducted from the asset. Accordingly, if the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability, so that the liability is not counted twice.

(b) if an asset is valued on a depreciated replacement cost basis, the valuation obtained may not include an amount for the decommissioning component of the asset. If it does not, an appropriate amount will need to be added to the valuation to reflect the depreciated replacement cost of that component.

Since, the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability. Valuation obtained of

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₹ 1,15,000 plus decommissioning costs of ₹ 11,600, allowed for in the valuation but recognized as a separate liability = ₹ 1,26,600.

(2) Three years' depreciation on original cost ₹ 1,20,000 × 3/40 = ₹ 9,000 plus cumulative discount on ₹ 10,000 at 5 per cent compound = ₹ 1,600; total ₹ 10,600.

(3) Revalued amount ₹ 1,26,600 less previous net book value of ₹ 1,11,000 (cost ₹ 120,000 less accumulated depreciation ₹ 9,000).

The depreciation expense for 20X4-20X5 is therefore ₹ 3,420 (₹ 1,26,600 x 1 / 37) and the discount expense for 20X5 is ₹ 600 (11,600 x 5% = 580 or 600 (to the nearest 100). On 31st March, 20X5, the decommissioning liability (before any adjustment) is ₹ 12,200. However, as per the estimate of the entity, the present value of the decommissioning liability has decreased by ₹ 5,000. Accordingly, the entity adjusts the decommissioning liability from ₹ 12,200 to ₹ 7,200.

The whole of this adjustment is taken to revaluation surplus, because it does not exceed the carrying amount that would have been recognized had the asset been carried under the cost model. If it had done, the excess would have been taken to profit or loss. The entity makes the following journal entry to reflect the change:

		₹	₹
Provision for decommissioning liability	Dr.	5,000	
To Revaluation surplus			5,000

As at 31st March, 20X5, the entity revalued its asset at ₹ 1,07,000, which is net of an allowance of ₹ 7,200 for the reduced decommissioning obligation that should be recognized as a separate liability. The valuation of the asset for financial reporting purposes, before deducting this allowance, is therefore ₹ 1,14,200. The following additional journal entry is needed:

Notes:

		₹	₹
Accumulated depreciation (1)	Dr.	3,420	
To Asset at valuation			3,420
Revaluation surplus (2)	Dr.	8,980	
To Asset at valuation (3)			8,980

(1) Eliminating accumulated depreciation of ₹ 3,420 in accordance with the entity's accounting policy.

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(2) The debit is to revaluation surplus because the deficit arising on the revaluation does not exceed the credit balance existing in the revaluation surplus in respect of the asset.

(3) Previous valuation (before allowance for decommissioning costs) ₹ 1,26,600, less cumulative depreciation ₹ 3,420, less new valuation (before allowance for decommissioning costs) ₹ 1,14,200.

Following this valuation, the amounts included in the balance sheet are:

Asset at valuation	1,14,200
Accumulated depreciation	Nil
Decommissioning liability	(7,200)
Net assets	1,07,000
Retained earnings (1)	(14,620)
Revaluation surplus (2)	11,620

Notes:

(1) ₹ 10,600 at 31st March, 20X4, plus depreciation expense of ₹ 3,420 and discount expense of ₹ 600 = ₹ 14,620.

(2) ₹ 15,600 at 31st March, 20X4, plus ₹ 5,000 arising on the decrease in the liability, less ₹ 8,980 deficit on revaluation = ₹ 11,620.

7. The annual depreciation charges prior to the change in useful life were

Buildings	₹ 1,50,00,000/15 =	₹ 10,00,000
Plant and machinery	₹ 1,00,00,000/10 =	₹ 10,00,000
Furniture and fixtures	₹ 35,00,000/7 =	₹ 5,00,000
Total =		₹ 25,00,000 (A)

The revised annual depreciation for the year ending 31st March, 20X5, would be

Buildings	[₹1,50,00,000 – (₹ 10,00,000 × 3)] / 10	₹ 12,00,000
Plant and machinery	[₹ 1,00,00,000 – (₹ 10,00,000 × 3)] / 7	₹ 10,00,000
Furniture and fixtures	[₹ 35,00,000 – (₹ 5,00,000 × 3)] / 5	₹ 4,00,000
Total		₹ 26,00,000 (B)

The impact on Statement of Profit and Loss for the year ending 31st March, 20X5

= ₹ 26,00,000 – ₹ 25,00,000 = ₹ 1,00,000

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This is a change in accounting estimate which is adjusted prospectively in the period in which the estimate is amended and, if relevant, to future periods if they are also affected. Accordingly, from 20X4-20X5 onward, excess of ₹ 1,00,000 will be charged in the Statement of Profit and Loss every year till the time there is any further revision.

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

The accounting treatment of most tangible non-current assets is governed by Ind AS 16 'Property, Plant and Equipment'. Ind AS 16 states that the accounting treatment of PPE is determined on a class by class basis. For this purpose, property and plant would be regarded as separate classes. Ind AS 16 requires that PPE is measured using either the cost model or the revaluation model. This model is applied on a class by class basis and must be applied consistently within a class. Ind AS 16 states that when the revaluation model applies, surpluses are recorded in other comprehensive income, unless they are cancelling out a deficit which has previously been reported in profit or loss, in which case it is reported in profit or loss. Where the revaluation results in a deficit, then such deficits are reported in profit or loss, unless they are cancelling out a surplus which has previously been reported in other comprehensive income, in which case they are reported in other comprehensive income.

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

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

9. According to paragraph 35 of Ind AS 16, when an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

(a) The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and

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the carrying amount of the asset after taking into account accumulated impairment losses.

In such a situation, the revised carrying amount of the machinery will be as follows:

Gross carrying amount	₹ 250	[(200/120) x 150]
Net carrying amount	₹ 150	
Accumulated depreciation	₹ 100	(₹ 250 – ₹ 150)

Journal entry

Plant and Machinery (Gross Block)	Dr.	₹ 50	
To Accumulated Depreciation			₹ 20
To Revaluation Reserve			₹ 30

Depreciation subsequent to revaluation

Since the Gross Block has been restated, the depreciation charge will be ₹ 25 per annum (₹ 250/10 years).

Journal entry

Accumulated Depreciation	Dr.	₹ 25 p.a.	
To Plant and Machinery (Gross Block)			₹ 25 p.a.

(b) The accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with the paragraphs 39 and 40 of Ind AS 16.

In this case, the gross carrying amount is restated to ₹ 150 to reflect the fair value and accumulated depreciation is set at zero.

Journal entry

Accumulated Depreciation	Dr.	₹ 80	
To Plant and Machinery (Gross Block)			₹ 80
Plant and Machinery (Gross Block)	Dr.	₹ 30	
To Revaluation Reserve			₹ 30

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Depreciation subsequent to revaluation

Since the revalued amount is the revised gross block, the useful life to be considered is the remaining useful life of the asset which results in the same depreciation charge of ₹ 25 per annum as per Option A (₹ 150 / 6 years).

Journal entry

Accumulated Depreciation	Dr.	₹ 25 p.a.	
To Plant and Machinery (Gross Block)			₹ 25 p.a.

10. To answer this question one must make a materiality judgement.

A class of assets is defined as a grouping of assets of a similar nature and use in an entity's operations.

The nature of land without a building is different to the nature of land with a building.

Consequently, land without a building is a separate class of asset from land and buildings. Furthermore, the nature and use of land operated as a landfill site is different from vacant land. Hence, the entity should disclose Property A separately. The entity must apply judgement to determine whether the entity's retail outlets are sufficiently different in nature and use from its office buildings, and thus constitute a separate class of land and buildings.

The computer equipment is integrated across the organization and would probably be classified as a single separate class of asset.

Furniture and fittings used for administrative purposes could be sufficiently different to shop fixtures and fittings in retail outlets to be classified in two separate classes of assets.

11. **In the books of Heaven Ltd.**

Machinery A/c

Date	Particulars	Amount	Date	Particulars	Amount
1.4.2X01	To Bank/ Vendor	30,00,000	31.3.2X02	By Depreciation (W.N.1)	2,50,000
			31.3.2X02	By Balance c/d	27,50,000
		30,00,000			30,00,000
1.4.2X02	To Balance b/d	27,50,000	31.3.2X03	By Depreciation	2,50,000
			31.3.2X03	By Balance c/d	25,00,000
		27,50,000			27,50,000
1.4.2X03	To Balance b/d	25,00,000	31.3. 2X04	By Depreciation	2,50,000

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			31.3.2X04	By Balance c/d	22,50,000
		25,00,000			25,00,000
1.4.2X04	To Balance b/d	22,50,000	31.3.2X05	By Depreciation	2,50,000
			31.3.2X05	By Balance c/d	20,00,000
		22,50,000			22,50,000
1.4.2X05	To Balance b/d	20,00,000	31.3.2X06	By Depreciation	2,50,000
			31.3.2X06	By Balance c/d	17,50,000
		20,00,000			20,00,000
1.4.2X06	To Balance b/d	17,50,000	31.3.2X07	By Depreciation (W.N.2)	2,75,000
1.4.2X06	To Revaluation Reserve @ 10%	1,75,000	31.3.2X07	By Balance c/d	16,50,000
		19,25,000			19,25,000
1.4.2X07	To Balance b/d	16,50,000	31.3.2X08	By Depreciation	2,75,000
			31.3.2X08	By Balance c/d	13,75,000
		16,50,000			16,50,000
1.4.2X08	To Balance b/d	13,75,000	1.4.2X08	By Revaluation Reserve (W.N.4)	1,25,000
			31.3.2X09	By Profit and Loss A/c (W.N.5)	81,250
			31.3.2X09	By Depreciation (W.N.3)	1,46,094
			31.3.2X09	By Balance c/d	10,22,656
		13,75,000			13,75,000
1.4.2X09	To Balance b/d	10,22,656	31.3.2X10	By Depreciation	1,46,094
31.3.2X10	To Profit and Loss A/c (balancing figure)	58,438*	31.3.2X10	By Bank A/c	9,35,000
		10,81,094			10,81,094

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Working Notes:

1. Calculation of useful life of machinery on 1.4.2X01

Depreciation charge in 5 years = (30,00,000 – 17,50,000) = ₹ 12,50,000

Depreciation per year as per Straight Line method = 12,50,000 / 5 years

= ₹ 2,50,000

Remaining useful life = ₹ 17,50,000 / ₹ 2,50,000 = 7 years

Total useful life = 5 years + 7 years = 12 years

2. Depreciation after upward revaluation as on 1.4.2X06

	₹
Book value as on 1.4.2X06	17,50,000
Add: 10% upward revaluation	1,75,000
Revalued amount	19,25,000

Remaining useful life 7 years (Refer W.N.1)

Depreciation on revalued amount = 19,25,000 / 7 years = ₹ 2,75,000 lakh

3. Depreciation after downward revaluation as on 1.4.2X08

	₹
Book value as on 1.4.2X08	13,75,000
Less: 15% Downward revaluation	(2,06,250)
Revalued amount	11,68,750

Revised useful life 8 years

Depreciation on revalued amount = 11,68,750 / 8 years = ₹ 1,46,094

4. Amount transferred from revaluation reserve

Revaluation reserve on 1.4.2X06 (A)	₹ 1,75,000
Remaining useful life	7 years
Amount transferred every year (1,75,000 / 7)	₹ 25,000
Amount transferred in 2 years (25,000 x 2) (B)	₹ 50,000
Balance of revaluation reserve on 1.4.2X08 (A-B)	₹ 1,25,000

5. Amount of downward revaluation to be charged to Profit and Loss Account

Downward revaluation as on 1.4.2X08 (W.N.3)	₹ 2,06,250
Less: Adjusted from Revaluation reserve (W.N.4)	(₹ 1,25,000)
Amount transferred to Profit and Loss Account	₹ 81,250

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UNIT 3 :
INDIAN ACCOUNTING STANDARD 23 : BORROWING COSTS

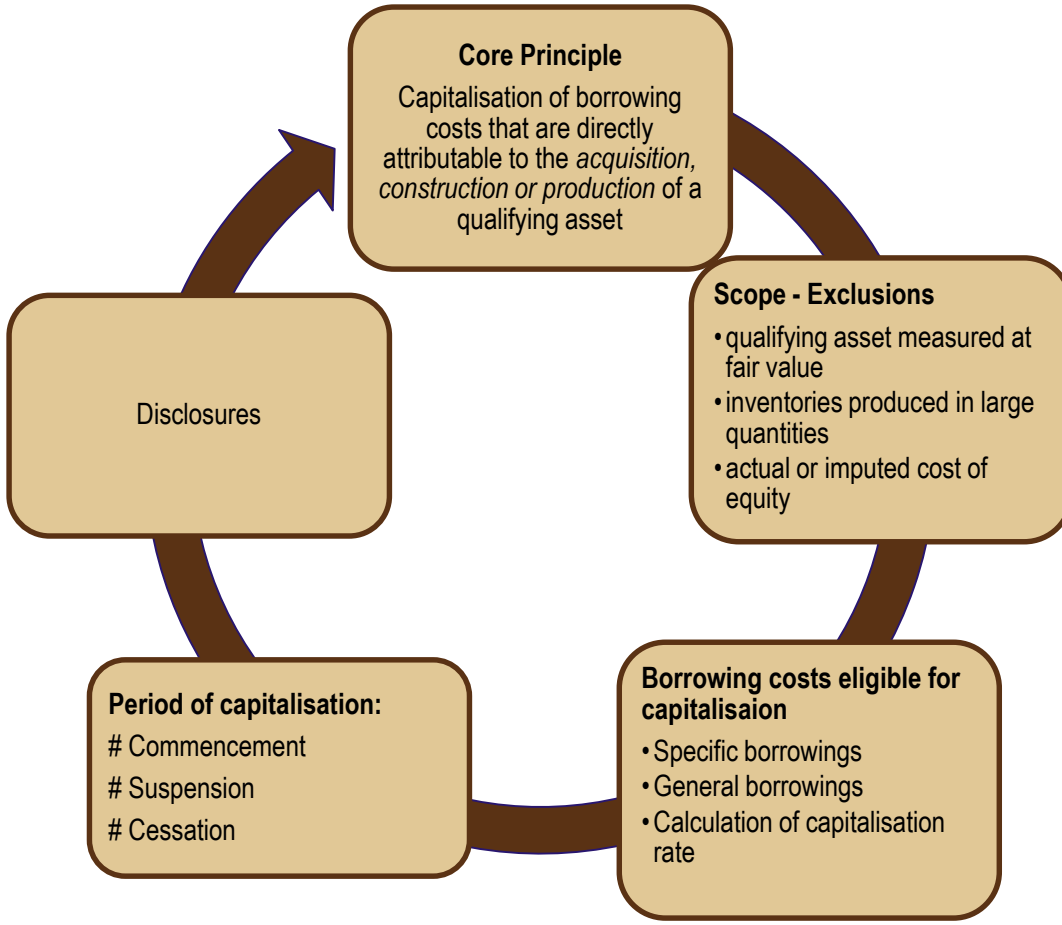
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Identify the core principle and scope of the standard
- Define borrowing cost, qualifying asset and other related terms
- Examine various conditions and pre-conditions for capitalisation of borrowing costs
- Recognize suspension and cessation of capitalization of borrowing cost
- Comply with the disclosure requirements of the standard
- Differentiate between Ind AS 23 and AS 16.

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UNIT OVERVIEW



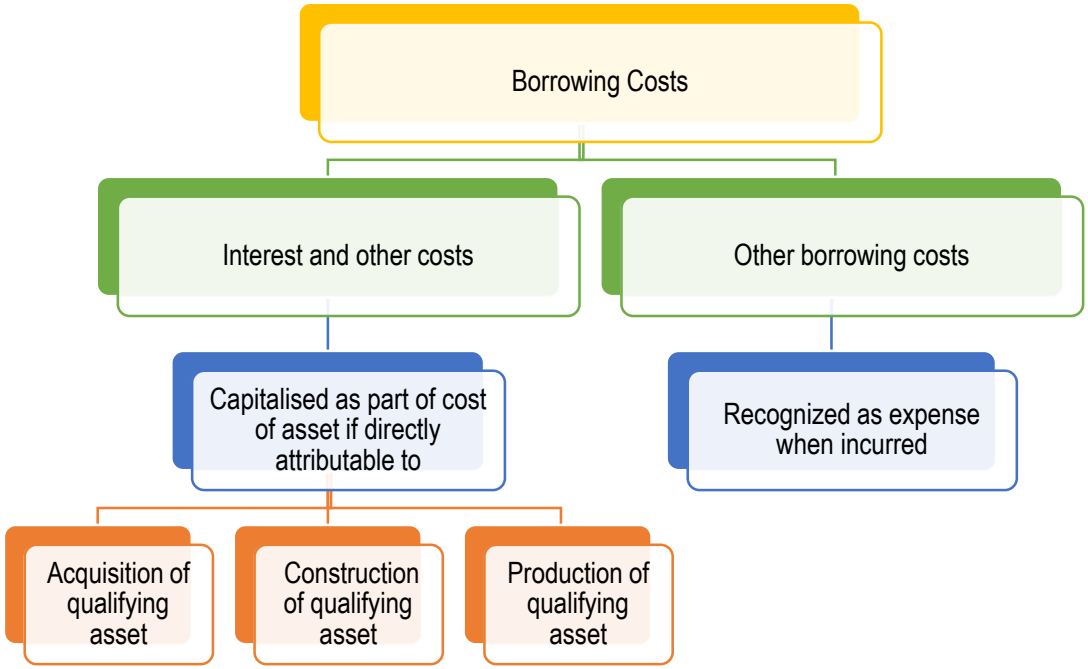
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3.1 CORE PRINCIPLE

The core principle of Ind AS 23 states that:

a. Borrowing costs that are directly attributable to the *acquisition, construction or production* of a qualifying asset are included in the cost of that asset i.e. must be capitalised.

b. Other borrowing costs are recognized as an expense in the period in which they are incurred.



3.2 SCOPE OF THE STANDARD

- An entity shall apply this standard in accounting for borrowing costs.
- The Standard does not apply to actual or imputed cost of equity, including preferred capital not classified as a liability.

Example 1

Dividend paid on equity shares, cost of issuance of equity shares, cost of preference share capital (not classified as liability as per Ind AS 32) will not be included as borrowing cost within the purview of this standard.

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- The general requirement of this standard (to capitalise directly attributable borrowings cost) is not required to be applied to:

  (a) qualifying assets that are measured at fair value, for example, a biological asset accounted for under Ind AS 41 - If the assets are held under fair value model with all changes going to statement of profit or loss, then capitalisation would not affect measurement in the balance sheet and would involve only reallocation between finance cost and fair value movement in the Statement of profit and loss.

  (b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis – This exemption acknowledges the difficulty both in allocating borrowing costs to such inventories and monitoring those borrowing costs until the inventories are sold.

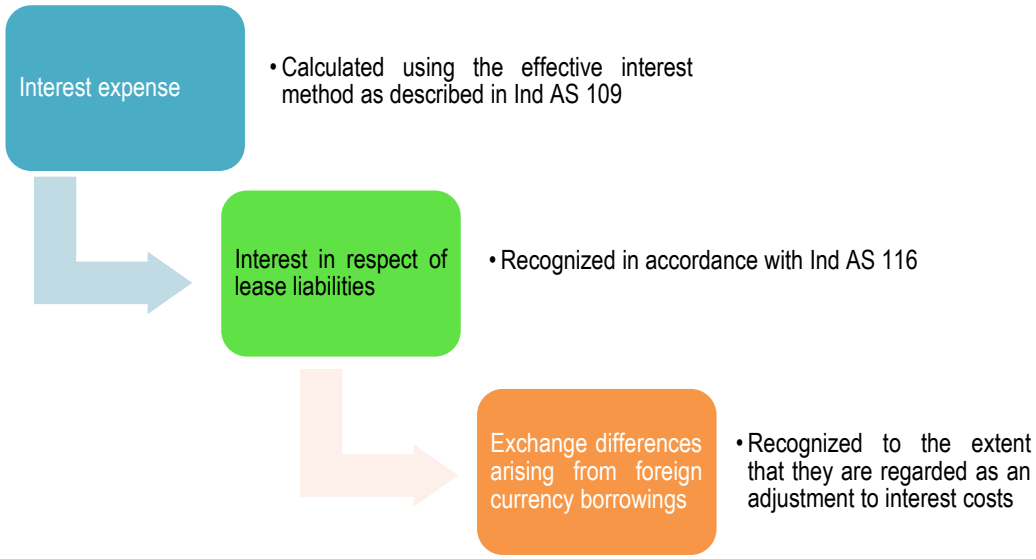
3.3 KEY DEFINITIONS

Following are the terms defined in the standard:

1. **Borrowing costs:** These are interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs may include:

   - interest expense calculated using the effective interest rate method as described in Ind AS 109 *Financial Instruments;*
   - interest in respect of lease liabilities recognized in accordance with Ind AS 116, Leases; and
   - exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs

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2. **Qualifying asset:** Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Examples of qualifying assets are manufacturing plants, real estate and infrastructure assets such as bridges and railways etc.

Ind AS 23 does not provide any guidance on what constitutes a 'substantial period of time'. The specific facts and circumstances should be considered in each case. For example, it is likely that a period of twelve months or more might be considered 'substantial'.

Depending on the circumstances, any of the following may be qualifying assets:

(a) inventories

(b) manufacturing plants

(c) power generation facilities

(d) intangible assets

(e) investment properties

(f) bearer plants.

Financial assets and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets.

Assets that are ready for their intended use or sale when acquired are not qualifying assets.

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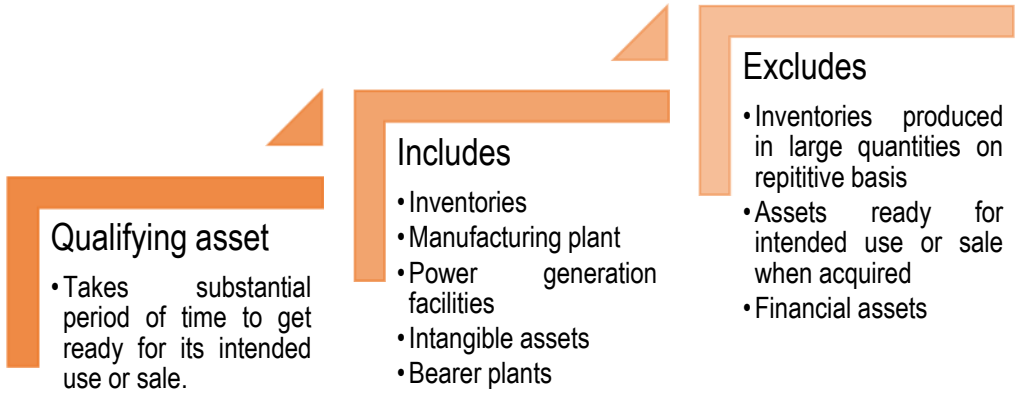


Illustration 1

A company deals in production of dairy products. It prepares and sells various milk products like ghee, butter and cheese. The company borrowed funds from bank for manufacturing operation. The cheese takes substantial longer period to get ready for sale.

State whether borrowing costs incurred to finance the production of inventories (cheese) that have a long production period, be capitalised?

Solution

Ind AS 23 does not require the capitalisation of borrowing costs for inventories that are manufactured in large quantities on a repetitive basis. However, interest capitalisation is permitted as long as the production cycle takes a 'substantial period of time', as with cheese.

*****

Illustration 2

A company is in the process of developing computer software. The asset has been qualified for recognition purposes. However, the development of computer software will take substantial period of time to complete.

(i) Evaluate whether computer software can be termed as a 'qualifying asset' under Ind AS 23?

(ii) Analyse whether management intention should be considered for assessment of the asset as a qualifying asset?

Solution

(i) Yes. An intangible asset that takes a substantial period of time to get ready for its intended use or sale is a 'qualifying asset'. This would be the case for an internally generated

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computer software in the development phase when it takes a 'substantial period of time' to complete.

(ii) Yes. Management should assess whether an asset, at the date of acquisition, is 'ready for its intended use or sale'. The asset might be a qualifying asset, depending on how management intends to use it. For example, when an acquired asset can only be used in combination with a larger group of fixed assets or was acquired specifically for the construction of one specific qualifying asset, the assessment of whether the acquired asset is a qualifying asset is made on a combined basis.

*****

Illustration 3

A telecom company has acquired a 3G license. The licence could be sold or licensed to a third party. However, management intends to use it to operate a wireless network. Development of the network starts when the license is acquired.

Identify whether the borrowing costs on the acquisition of the 3G license be capitalised until the network is ready for its intended use.

Solution

Yes. The license has been exclusively acquired to operate the wireless network. The fact that the license can be used or licensed to a third party is irrelevant. The acquisition of the license is the first step in a wider investment project (developing the network). It is part of the network investment, which meets the definition of a qualifying asset under Ind AS 23.

*****

Illustration 4

A real estate company has incurred expenses for the acquisition of a permit allowing the construction of a building. It has also acquired equipment that will be used for the construction of various buildings.

Examine whether the borrowing costs on the acquisition of the permit and the equipment be capitalised until the construction of the building is complete.

Solution

With respect to Permit

Yes, since permit is specific to one building. It is the first step in a wider investment project. It is part of the construction cost of the building, which meets the definition of a qualifying asset.

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With respect to Equipment

No, since the equipment will be used for other construction projects. It is ready for its 'intended use' at the acquisition date. Hence, it does not meet the definition of a qualifying asset.

*****

Illustration 5

Is interest on a finance lease of a qualifying asset capitalised as borrowing costs?

Solution

Yes, interest incurred for a finance lease is specific to an asset. Interest is capitalised if the asset is a qualifying asset or is used solely for the construction of a qualifying asset. For example, a crane or a dockyard is leased for the purpose of constructing a ship. The ship is a qualifying asset. The interest on the finance lease of the crane or dockyard is capitalised as borrowing costs. Borrowing costs on the finance lease can only be capitalised up to the point when the construction of the qualifying asset is complete.

*****

3.4 EXCHANGE DIFFERENCE TO BE INCLUDED IN BORROWING COSTS

The extent to which exchange differences can be considered as borrowing cost depends on the terms and conditions of the foreign currency borrowing.

The gains and losses that are an adjustment to interest costs include the interest rate differential between borrowing costs that would be incurred if the entity borrowed funds in its functional currency and borrowing costs actually incurred on foreign currency borrowings. An entity may borrow funds in a currency that is not its functional currency e.g. A Company with INR functional currency may take US dollar loan for financing asset development project in a company.

This may have been done on the basis that, over the period of the development of asset, the borrowing costs, even after allowing for exchange differences, were expected to be less than the interest cost of an equivalent INR loan.

Following approach is to be followed for determining the extent to which the exchange difference should be treated as borrowing costs:

(i) the adjustment should be of an amount which is equivalent to the extent to which the exchange loss does not exceed the difference between the cost of borrowing in functional currency when compared to the cost of borrowing in a foreign currency.

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Example 2

An entity can borrow funds in its functional currency (₹) @ 12%. It borrows $ 1,000 @ 4% on 1st April, 20X1 when $ 1 = ₹ 40. The equivalent amount in functional currency is ₹ 40,000. Interest is payable on 31st March, 20X2. On 31st March, 20X2, exchange rate is $ 1 = ₹ 50. The loan is not due for repayment. The exchange loss in this case is ₹ 10,000 [$ 1,000 x (₹ 50- ₹ 40)]. The borrowing cost is ₹ 2,000 ($ 1,000 x 4% x ₹ 50).

Had the entity borrowed funds in functional currency the borrowing cost would have been ₹ 4,800 (₹ 40,000 x 12%).

The entity will treat exchange difference upto ₹ 2,800 (₹ 4,800 – ₹ 2,000) as a borrowing cost that may be eligible for capitalisation under this Standard.

Thus, the total eligible borrowing cost is ₹ 4,800 (₹ 2,000 + ₹ 2,800) equivalent to the borrowing cost in functional currency.

If the exchange rate on 31st March, 20X2, is $ 1 = ₹ 41. The exchange loss is ₹ 1,000 [$ 1,000 – (₹ 41 – ₹ 40)]. The entity will treat the entire exchange loss as an eligible borrowing cost as total cost of the borrowing ₹ 2,640 [(₹ 1,000 x 4% x 41) + ₹ 1,000] in foreign currency does not exceed the cost of borrowings in functional currency, i.e., ₹ 4,800.

(ii) where there is an unrealised exchange loss which is treated as an adjustment to interest and subsequently there is a realised or unrealised gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognized as an adjustment should also be recognized as an adjustment to interest.

Example 3: Continuing with the aforesaid example 2:

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 48; the exchange rate on 31st March, 20X2, being $ 1= ₹ 50, the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 1,920 ($ 1,000 x 4% x ₹ 48). There is an exchange gain of ₹ 2,000 ($ 1,000 x (₹ 50 – ₹48)). This will be adjusted in the borrowing cost as there is unrealized exchange loss and the adjustment is less than the exchange loss of ₹ 2,800 recognized in earlier year.

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 44; the exchange rate on 31st March, 20X2, being $ 1 = ₹ 50, the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 1,760 ($ 1,000 x 4% x ₹ 44). There is an exchange gain of ₹ 6,000 [$ 1,000 x (₹ 50 – ₹ 44)]. This will be adjusted in the borrowing cost upto ₹ 2,800 as there is unrealized exchange loss and the adjustment of the exchange loss recognized in earlier years is of ₹ 2,800.

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If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 44 and part of loan is repaid; the exchange rate on 31st March, 20X2, being $ 1 = ₹ 50; $ 600 of the borrowings was paid on 31st March, 20X2, $ 400 of the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 704 ($ 400 x 4% x ₹ 44). There is an exchange gain of ₹ 2,400 [$ 400 x (₹ 50 – ₹ 44)]. The unrealised exchange loss of earlier year is ₹ 4,000 [$ 400 x (₹ 50 – ₹ 40)] out of which ₹ 1,120 (₹ 2,800 x $ 400 / $ 1000) was charged in 31st March, 20X2, as borrowing cost. Thus, there will be an adjustment in the borrowing cost upto ₹ 1,120 as this is unrealised exchange loss.

Illustration 6

ABC Ltd. has taken a loan of USD 20,000 on 1st April, 20X1 for constructing a plant at an interest rate of 5% per annum payable on annual basis.

On 1st April, 20X1, the exchange rate between the currencies i.e. USD vs Rupees was ₹ 45 per USD. The exchange rate on the reporting date i.e. 31st March, 20X2 is ₹ 48 per USD.

The corresponding amount could have been borrowed by ABC Ltd. from State Bank of India in local currency at an interest rate of 11% per annum as on 1st April, 20X1.

Compute the borrowing cost to be capitalized for the construction of plant by ABC Ltd. for the period ending 31st March, 20X2.

Solution

In the above situation, the borrowing cost needs to determine for interest cost on such foreign currency loan and eligible exchange loss difference if any.

(a) Interest on foreign currency loan for the period:

USD 20,000 x 5% = USD 1,000

Converted in ₹: USD 1,000 x ₹ 48/USD = ₹ 48,000

(b) Interest that would have resulted if the loan was taken in Indian Currency:

USD 20,000 x ₹ 45/USD x 11% = ₹ 99,000

(c) Difference between interest on foreign currency borrowing and local currency borrowing:

₹ 99,000 - 48,000 = ₹ 51,000

Increase in liability due to change in exchange difference: USD 20,000 x (48 - 45) = ₹ 60,000

Hence, out of exchange loss of ₹ 60,000 on principal amount of foreign currency loan, only exchange loss to the extent of ₹ 51,000 is considered as borrowing costs.

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Total borrowing cost to be capitalized is as under:

(a)	Interest cost on borrowing	₹ 48,000
(b)	Exchange difference to the extent considered to be an adjustment to Interest cost	₹ 51,000
		₹ 99,000

The exchange difference of ₹ 51,000 has been capitalized as borrowing cost and the remaining ₹ 9,000 will be expensed off in the Statement of Profit and Loss.

*****

3.5 RECOGNITION

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset.
- Such borrowing cost are capitalised when below two conditions are satisfied:
  - it is probable that it will result in future economic benefits to the entity; and
  - the costs can be measured reliably.
- Other borrowing costs are recognized as an expense in the period in which they are incurred.
- When an entity applies Ind AS 29 *Financial Reporting in Hyperinflationary Economies*, it recognizes as an expense the part of borrowing costs that compensates for inflation during the same period.

3.5.1 Borrowing costs eligible for capitalisation

The borrowing costs that are eligible for capitalisation are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

Since it may not always be easy to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided, the standard includes separate requirements for specific borrowings and general borrowings.

3.5.1.1 Specific borrowing costs

- If an entity borrows funds specifically to obtain a qualifying asset, the borrowing costs that are directly related to that qualifying asset can be readily identified.
- The borrowings cost eligible for capitalisation would be the **actual** borrowing costs incurred during the period less any investment income on the temporary investment of those borrowings.

Note: *A 'notional' borrowing cost cannot be capitalised.* Ind AS 23 limits the amount that can be capitalised to the actual borrowing costs incurred. The standard does not address actual or imputed cost of equity. Where an entity has no borrowings and uses its own cash

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resources to finance the construction of property, plant and equipment, the entity cannot assume that interest that could have been earned on that cash represents forgone benefit and could be capitalised.

- An entity may obtain borrowed funds specifically and incur associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

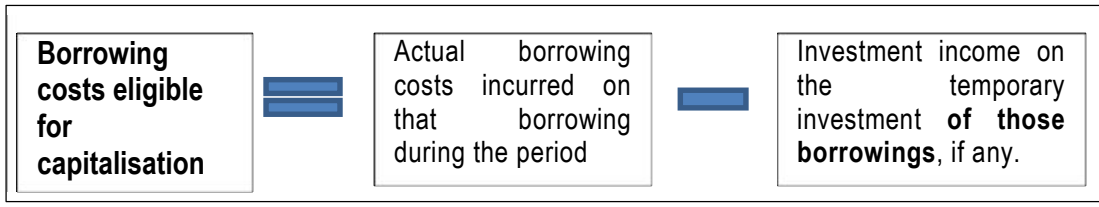


Illustration 7

Alpha Ltd. on 1st April, 20X1, borrowed ₹ 30,00,000 @ 9% to finance the construction of two qualifying assets. Construction started on 1st April, 20X1. The loan facility was availed on 1st April, 20X1 and was utilized as follows with remaining funds invested temporarily at 7%:

	Factory Building	Office Building
1st April, 20X1	5,00,000	10,00,000
1st October, 20X1	5,00,000	10,00,000

Calculate the cost of the asset and the borrowing cost to be capitalized.

Solution:

Particulars	Factory Building	Office Building
Borrowing Costs	(10,00,000 x 9%) 90,000	(20,00,000 x 9%) 1,80,000
Less: Investment Income	(5,00,000 x 7% x 6/12) (17,500)	(10,00,000x7% x 6/12) (35,000)
	72,500	1,45,000
Cost of the asset:		
Expenditure incurred	10,00,000	20,00,000
Borrowing Costs	72,500	1,45,000
Total	**10,72,500**	**21,45,000**

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3.5.1.2 General borrowing costs

- All borrowings that are not specific represents general borrowings.
- When funds are borrowed specifically for a qualifying asset, costs in relation to that borrowing are accounted for as specific borrowing costs until the asset is ready for its intended use or sale; if the borrowing remains outstanding after the related asset is ready for its intended use or sale, it becomes part of 'general borrowings'.

Illustration 8

On 1st April, 20X1, A Ltd. took 8% loan of ₹ 50,00,000 for construction of building A which is repayable after 6 years ie on 31st March, 20X7. The construction of building was completed on 31st March, 20X3. A Ltd. started constructing a new building B in the year 20X3-20X4, for which he used his existing borrowings. He has outstanding general-purpose loan of ₹ 25,00,000, interest on which is payable @ 9% and ₹ 15,00,000, interest on which is payable @ 7%.

Recommend whether the specific borrowing should be transferred to the general borrowings pool once the respective qualifying asset is completed.

Solution

Yes. If specific borrowings were not repaid once the relevant qualifying asset was completed, they become general borrowings for as long as they are outstanding.

The borrowing costs that are directly attributable to obtaining qualifying assets are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. If cash was not spent on other qualifying assets, it could be directed to repay this specific loan. Thus, borrowing costs could be avoided (that is, they are directly attributable to other qualifying assets).

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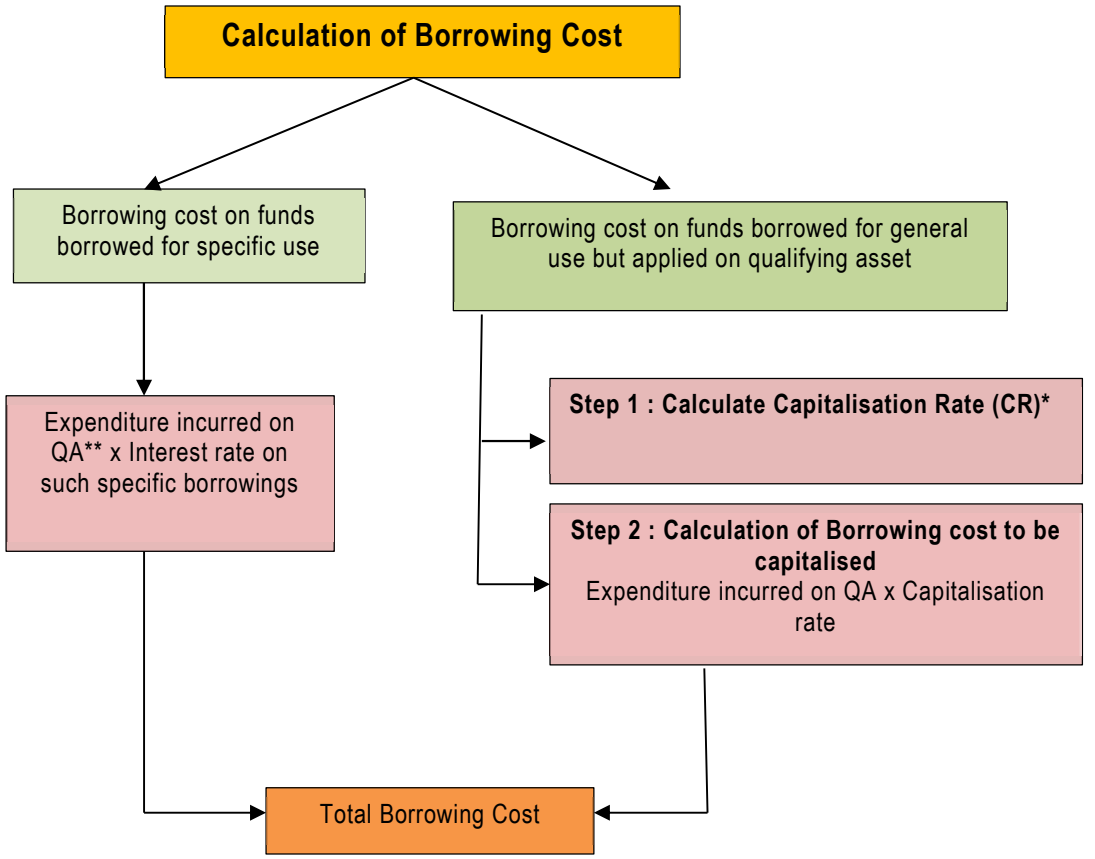
- When general borrowings are used for qualifying assets, Ind AS 23 requires that, borrowing costs eligible for capitalisation is calculated by applying a capitalisation rate to the expenditures on qualifying assets.
- The amount of borrowing costs eligible for capitalisation is always limited to the amount of actual borrowing costs incurred during the period.

3.5.2 Calculation of capitalisation rate

- When the funds are borrowed generally for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that qualifying asset.

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- The capitalisation rate is the weighted average of the borrowing costs applicable to all the general borrowings of the entity that are outstanding during the period.
- Borrowing costs in respect of specific funds borrowed for the purpose of obtaining a qualifying asset shall be excluded from calculation of capitalisation rate until substantially all the activities necessary to prepare that qualifying asset for its intended use or sale are complete.
- The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.



$$*CR = \frac{\text{Weighted average borrowing costs on outstanding borrowings of the entity (excluding specific borrowings cost)}}{\text{Total outstanding borrowings of the entity during the period (excluding specific borrowings)}}$$

**QA = Qualifying Asset

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Illustration 9

Beta Ltd. had the following loans in place at the end of 31st March, 20X2:

(Amounts in ₹ 000s)

Loan	*1st April, 20X1*	*31st March, 20X2*
18% Bank Loan	*1,000*	*1,000*
16% Term Loan	*3,000*	*3,000*
14% Debentures	*-*	*2,000*

14% Debentures were issued to fund the construction of office building on 1st July, 20X1 but the development activities has yet to be started.

On 1st April, 20X1, Beta Ltd. began the construction of a Plant being a qualifying asset using the existing borrowings. Expenditure drawn down for the construction was: ₹ 5,00,000 on 1st April, 20X1 and ₹ 25,00,000 on 1st January, 20X2.

Calculate the borrowing cost that can be capitalised for the plant.

Solution

Capitalisation rate	$\frac{(18\% \times 1{,}000)}{1{,}000+3{,}000} + \frac{(16\% \times 3{,}000)}{1{,}000+3{,}000}$	16.5%
Borrowing Costs	(5,00,000 x 16.5%) + (25,00,000 x16.5% x 3/12)	₹ 1,85,625

Capitalisation rate for above illustration could also be calculated with the following approach by assigning weights to the borrowings:

Particulars	Loan	Weighted average (a)	Interest rate (b)	Capitalisation rate (a*b)
18% Bank Loan	1,000	25%	18%	4.5%
16% Term Loan	3,000	75%	16%	12%
Total	**4,000**	**100%**		**16.5%**

Answer in both the approaches would be same as can be seen from the above two solutions.

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3.5.3 Expenditure to which capitalisation rate is applied

- In determining the borrowing costs to be capitalised, the amount of expenditure on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities.
- Expenditures are reduced by any progress payments received and grants received in connection with the asset (see Ind AS 20 *Accounting for Government Grants and Disclosure of Government Assistance*).
- The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

3.5.4 Excess of the carrying amount over recoverable amount

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Standards.

3.6 PERIOD OF CAPITALISATION

3.6.1 Commencement of capitalisation

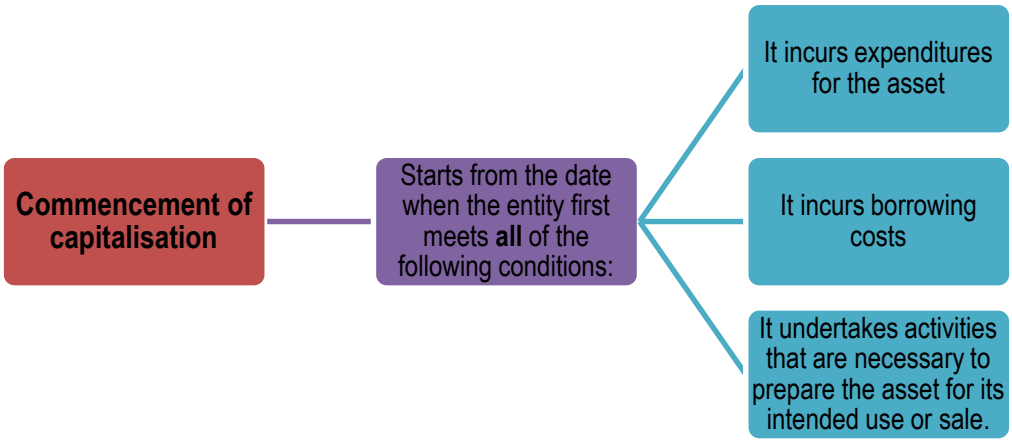
- An entity is required to begin the capitalisation of borrowing costs as part of the cost of a qualifying asset on the commencement date.
- The commencement date is the date when the entity first meets all of the following conditions cumulatively on a particular date:

  (a) it incurs expenditures for the asset;

  (b) it incurs borrowing costs; and

  (c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

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Explanation to the three conditions for commencement date

- **Expenditures on a qualifying asset include:**
  - Those expenditures that have resulted in payments of cash
  - transfers of other assets
  - assumption of interest-bearing liabilities

  Expenditures are reduced by any progress payments received and grants received in connection with the asset.
- **Activities necessary to prepare asset for its intended use or sale:**
  - Includes technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction.
  - excludes the holding of an asset when no production or development that changes the asset's condition is taking place.

  For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Illustration 10 : Commencement Date

X Ltd. is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:

(i) 15th May, 20X1: Loan interest relating to the project started incurring

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(ii) 2nd June, 20X1 : Technical site planning commenced

(iii) 19th June, 20X1 : Expenditure on the project started incurring

(iv) 18th July, 20X1 : Construction work commenced

Identify the commencement date for capitalisation of borrowing cost.

Solution

In the above case, the three conditions to be tested for commencement date would be:

Borrowing cost has been incurred on : 15th May, 20X1

Expenditure has been incurred for the asset on : 19th June, 20X1

Activities necessary to prepare asset for its intended use or sale: 2nd June, 20X1

Commencement date would be the date when the above three conditions would be satisfied in all i.e. 19th June, 20X1

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3.6.2 Suspension of capitalisation

- Capitalisation of borrowing costs shall be suspended during the extended periods in which the active development of a qualifying asset is suspended. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, the standard distinguishes between extended periods of interruption (when capitalisation would be suspended) and periods of temporary delay that are a necessary part of preparing the asset for its intended purpose (when capitalisation is not normally suspended).
- Capitalisation of borrowing cost is not suspended when temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period when high water levels delay construction of a bridge, if such high-water levels are common during the construction period in the geographical region involved. Similarly, capitalisation continues during periods when inventory is undergoing slow transformation – the example is given of inventories taking an extended time to mature (presumably such products as Scotch whisky or Cognac, although the relevance of this may be limited as these products are likely to meet the optional exemption for 'routinely manufactured' products.

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Example 4: Suspension of Capitalisation

(a) Construction suspended between October, 20X1 to January, 20X2 during which period certain heavy construction equipment under use was shifted to another site.

In this case, capitalization of borrowing costs needs to be suspended since active development is interrupted.

(b) When Qualifying Asset construction is about to complete, there was temporary delay of 20 days on account of some technical reasons.

In this case, capitalization of borrowing costs shall be continued.

3.6.3 Cessation of capitalisation

- Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
- An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.
- When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

  For e.g. A business park comprising several buildings, each of which can be used individually, is a qualifying asset for which each part is capable of being usable while construction continues on other parts.

  For a qualifying asset that needs to be complete in its entirety before any part can be used as intended, it would be appropriate to capitalise related borrowing costs until all the activities necessary to prepare the entire asset for its intended use or sale are substantially complete. An example of this is an industrial plant, such as a steel mill, involving several processes which are carried out in sequence at different parts of the plant within the same site.

Example 5

H Limited, a real estate company, gives immovable property on rent. It has completed on 31st May, 20X1, a commercial complex consisting of various offices that could be rented out. It expects that the commercial complex will be completely rented out by 30th June, 20X1. However, due to adverse market conditions, only 10% of the commercial complex could be

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rented out by its reporting date of 31st March, 20X2. H Limited wants to capitalise the eligible borrowing costs incurred up to 31st March, 20X2.

H Limited should capitalise borrowing costs only up to 31st May, 20X1. The borrowing cost incurred thereafter cannot be capitalised as the asset was ready for its intended use on 31st May, 20X1. The fact that only a small portion could be rented out by 31st March, 20X2, is not relevant.

3.7 DISCLOSURE

Entities are required to disclose:

(a) the amount of borrowing costs capitalised during the period; and

(b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation

3.8 OTHER RELEVANT CONCEPTS

3.8.1 Dividends payable on shares classified as financial liabilities

- An entity might finance its operations in whole or in part by the issue of **preference shares** and in some circumstances these will be **classified as financial liabilities** (as per Ind AS 32). **Dividends payable** on these instruments would **meet the definition of borrowing costs**, subject to the fulfillment of certain conditions.

Example 6

An entity might have funded the development of a qualifying asset by issuing redeemable preference shares that are redeemable at the option of the holder and so are classified as financial liabilities under Ind AS 32. In this case, dividend would be treated as interest and meet the definition of borrowing costs and so should be capitalised following the principles on specific borrowings as discussed in a separate section 4.5.1.1 above.

3.8.2 Capitalising borrowing cost in group financial statements

- There may be a situation when the borrowings are taken by one company and qualifying asset is developed by another company within a group.

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- It may be **appropriate to capitalise interest in the group financial statements** on borrowings that appear in the financial statements of a different group entity from that carrying out the development.
- Based on the underlying principle of Ind AS 23, capitalisation in such circumstances would only be appropriate if the amount capitalised fairly reflected the interest cost of the group on borrowings **from third parties** that could have been avoided if the expenditure on the qualifying asset were not made.
- However, **the entity carrying out the development should not capitalise any interest in its own financial statements** as it has no borrowings.
- If, however, the entity has **intra-group borrowings** then interest on such borrowings may be **capitalised in its own financial statements**.

Illustration 11

A subsidiary (or jointly controlled entity or associate) finances the construction of a qualifying asset with an inter-company loan. Are borrowing costs incurred on the inter-company loan capitalised in the separate financial statements of the subsidiary (or jointly controlled entity or associate)?

Solution

Yes. Borrowing costs are capitalised to the extent of the actual costs incurred by the subsidiary (or jointly controlled entity or associate).

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3.8.3 Cessation of capitalisation for maturing inventories

- For maturing inventories, it is sometimes difficult to determine when the 'period of production' ends, i.e. when inventories are being held for sale as opposed to being held to mature.

Example 7

Whisky is 'mature' after three years but goes on improving with age for many more years. Provided that it is consistent with the entity's business model to hold such items so that they mature further, it would seem acceptable to continue to add borrowing costs to the value of such maturing inventories for as long as it can be demonstrated that the particular item of

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inventory continues to increase in value solely on account of increasing age, rather than because of market fluctuations or inflation.

- If this cannot be demonstrated, then the inventories should be regarded as held for sale and no further borrowing costs should be capitalised.

3.9 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Larsen & Toubro Limited' for the financial year 2021-2022 with respect to 'Borrowing Costs'.

Notes:

(1) Borrowing cost capitalised in accordance with Ind AS 23 "Borrowing Costs" is as follows:

₹ crore

Class of Assets	2021-22	2020-21
Capital work-in-progress		
Property, plant and equipment - building	8.83	27.75
Investment property - building	12.63	13.11
Total	21.46	40.86

(2) The average borrowing cost used for capitalisation is 7.29% (previous year: 6.56%).

Note in Property, Plant and Equipment & Capital work-in-progress

- *Additions during the year and capital work-in-progress of buildings include ` 8.83 crore (previous year: ` 27.75 crore) being borrowing cost capitalised in accordance with Accounting Standard (Ind AS) 23 "Borrowing Costs".*
- *The rate used to determine the amount of borrowing costs eligible for capitalisation is 6.23% (previous year: 5.71%).*

ACCOUNTING POLICY

Borrowing Costs

Borrowing costs include finance costs calculated using the effective interest method, finance charges in respect of assets acquired on lease and exchange differences arising on foreign currency borrowings, to the extent they are regarded as an adjustment to finance costs. In cases where hedging instruments are acquired for protection against exchange rate risk related to borrowings and are accounted as hedging a time-period related hedge item, the borrowing costs also include the amortisation of premium element of the forward contract and foreign currency basis spread as applicable, over the period of the hedging instrument.

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Borrowing costs net of any investment income from the temporary investment of related borrowings that are attributable to the acquisition, construction or production of a qualifying asset are capitalised / inventoried as part of cost of such asset till such time the asset is ready for its intended use or sale. A qualifying asset is an asset that necessarily requires a substantial period of time to get ready for its intended use or sale. All other borrowing costs are recognized in profit or loss in the period in which they are incurred..

(Source: Annual Report 2021-2022 - 'Larsen & Toubro Limited')

3.10 SIGNIFICANT DIFFERENCES IN IND AS 23 *VIS-À-VIS* AS 16

S. No.	Particular	Ind AS 23	AS 16
1.	*Qualifying Asset measured at Fair Value*	Ind AS 23 does not require an entity to apply this standard to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value, for example, a biological asset	AS 16 does not provide for such scope exclusion
2.	*Applicability to Inventories*	Ind AS 23 does not require the application of this Standard to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis	AS 16 does not provide for such scope exclusion and is applicable to borrowing costs related to all inventories that require substantial period of time to bring them in saleable condition
3.	*Inclusion as Borrowing Costs*	Ind AS 23 requires calculation of interest expense using the effective interest rate method as described in Ind AS 109. Items (b) and (c) are not mentioned as some of those components of borrowing costs are	AS 16, *Borrowing Costs*, *inter alia,* include the following: (a) interest and commitment charges on bank borrowings and

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		considered as the components of interest expense calculated using the effective interest rate method.	other short-term and long-term borrowings; (b) amortisation of discounts or premiums relating to borrowings; (c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings
4.	*Interest on leases*	Ind AS 23 includes interest in respect of lease liabilities (recognized as per Ind AS 116)	AS 16 includes finance charges in respect of assets acquired under finance lease as part of borrowing costs
5.	*Unrealized exchange loss*	Ind AS 23 provides that where there is an unrealized exchange loss which is treated as an adjustment to interest and subsequently there is a realized or unrealized gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognized as an adjustment should also be recognized as an adjustment to interest.	AS 16 does not explicitly deal with such scenario.
6.	*Explanation of Substantial Period of Time*	This explanation is not included in Ind AS 23.	AS 16 gives explanation for meaning of 'substantial period of time' appearing in the definition of the term 'qualifying asset' as twelve months

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7.	*Reporting in Hyperinflationary Economies*	Ind AS 23 provides that when Ind AS 29, '*Financial Reporting in Hyperinflationary Economies',* is applied, part of the borrowing costs that compensates for inflation should be expensed as required by that Standard (and not capitalized in respect of qualifying assets).	AS 16 does not contain a similar clarification because at present, in India, there is no Standard on '*Financial Reporting in Hyperinflationary Economies'.*
8.	*Borrowings of the Parent and its Subsidiaries for Computing Weighted Average*	Ind AS 23 specifically provides that in some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs while in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.	This specific provision is not there in AS 16.
9.	*Disclosure of capitalisation rate*	Ind AS 23 requires disclosure of capitalization rate used to determine the amount of borrowing costs eligible for capitalization.	AS 16 does not have this disclosure requirement.
10.	*Borrowing cost in regard to foreign currency borrowing*	For the purpose of computing borrowing cost under Ind AS 23 in regard to foreign currency borrowing, the difference is to be computed with reference to functional currency	Under AS 16 read with AS 11, the difference is between the local currency and foreign currency.

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Questions

1. Marine Transport Limited ordered 3 ships for its fleet on 1st April, 20X0. It pays a down payment of 25% of the contract value of each of the ship out of long-term borrowings from a scheduled bank. The delivery has to commence from the financial year 20X7. On 1st March, 20X2, the ship builder informs that it has commenced production of one ship. There is no progress on other 2 ships. Marine Transport Limited prepares its financial statements on financial year basis.

   Advise whether it is permissible for Marine Transport Limited to capitalise any borrowing costs for the financial year ended 31st March, 20X1 or 31st March, 20X2.

2. X Limited has a treasury department that arranges funds for all the requirements of the Company including funds for working capital and expansion programs. During the year ended 31st March, 20X2, the Company commenced the construction of a qualifying asset and incurred the following expenses:

Date	Amount (₹)
1st July, 20X1	2,50,000
1st December, 20X1	3,00,000

The details of borrowings and interest thereon are as under:

Particulars	Average Balance (₹)	Interest (₹)
Long term loan @ 10%	10,00,000	1,00,000
Working capital loan	5,00,000	65,000
	15,00,000	1,65,000

Compute the borrowing costs that need to be capitalised.

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3. An entity constructs a new head office building commencing on 1st September 20X1, which continues till 31st December 20X1. Directly attributable expenditure at the beginning of the month on this asset are ₹ 1,00,000 in September 20X1 and ₹ 2,50,000 in each of the months of October to December 20X1.

   The entity has not taken any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. During the year, the entity had issued 10% debentures with a face value of ₹ 20 lacs and had an overdraft of ₹ 5,00,000, which increased to ₹ 7,50,000 in December 20X1. Interest was paid on the overdraft at 15% until 1 October 20X1, then the rate was increased to 16%.

   Calculate the capitalization rate for computation of borrowing cost in accordance with Ind AS 23 'Borrowing Costs'.

4. K Ltd. began construction of a new building at an estimated cost of ₹ 7 lakh on 1st April, 20X1. To finance construction of the building it obtained a specific loan of ₹ 2 lakh from a financial institution at an interest rate of 9% per annum.

   The company's other outstanding loans were:

Amount	Rate of Interest per annum
₹ 7,00,000	12%
₹ 9,00,000	11%

   The expenditure incurred on the construction was:

April, 20X1	₹ 1,50,000
August, 20X1	₹ 2,00,000
October, 20X1	₹ 3,50,000
January, 20X2	₹ 1,00,000

   The construction of building was completed by 31st January, 20X2.

   Following the provisions of Ind AS 23 'Borrowing Costs', calculate the amount of interest to be capitalized and pass necessary journal entry for capitalizing the cost and borrowing cost in respect of the building as on 31st January, 20X2.

5. On 1st April, 20X1, entity A contracted for the construction of a building for ₹ 22,00,000. The land under the building is regarded as a separate asset and is not part of the qualifying assets. The building was completed at the end of March, 20X2, and during the period the following payments were made to the contractor:

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Payment date	Amount (₹ '000)
1st April, 20X1	200
30th June, 20X1	600
31st December, 20X1	1,200
31st March, 20X2	200
Total	2,200

Entity A's borrowings at its year end of 31st March, 20X2 were as follows:

a. 10%, 4-year note with simple interest payable annually, which relates specifically to the project; debt outstanding on 31st March, 20X2 amounted to ₹ 7,00,000. Interest of ₹ 65,000 was incurred on these borrowings during the year, and interest income of ₹ 20,000 was earned on these funds while they were held in anticipation of payments.

b. 12.5% 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,000,000 and remained unchanged during the year; and

c. 10% 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,500,000 and remained unchanged during the year.

Determine the amount of the borrowing costs which can be capitalized at the year end as per relevant Ind AS.

6. In a group with Parent Company "P" there are 3 subsidiaries with following business:

"A" – Real Estate Company

"B" – Construction Company

"C" – Finance Company

- Parent Company has no operating activities of its own but performs management functions for its subsidiaries.
- Financing activities and cash management in the group are coordinated centrally.
- Finance Company is a vehicle used by the group solely for raising finance.
- All entities in the group prepare Ind AS financial statements.

The following information is relevant for the current reporting period 20X1-20X2:

Real Estate Company

- Borrowings of ₹ 10,00,000 with an interest rate of 7% p.a.

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- Expenditures on qualifying assets during the period amounted to ₹ 15,40,000.
- All construction works were performed by Construction Company. Amounts invoiced to Real Estate Company included 10% profit margin.

Construction Company

- No borrowings during the period.
- Financed ₹ 10,00,000 of expenditures on qualifying assets using its own cash resources.

Finance Company

- Raised ₹ 20,00,000 at 7% p.a. externally and issued a loan to Parent Company for general corporate purposes at the rate of 8%.

Parent Company

- Used loan from Finance Company to acquire a new subsidiary.
- No qualifying assets apart from those in Real Estate Company and Construction Company.
- Parent Company did not issue any loans to other entities during the period.

Compute the amount of borrowing costs eligible for capitalisation in the financial statements of each of the four entities for the current reporting period 20X1-20X2.

7. Examine how will you capitalise the interest, when qualifying assets are funded by borrowings in the nature of bonds that are issued at discount.

   Y Ltd. issued at the start of year 1, 10% (interest paid annually and having maturity period of 4 years) bonds with a face value of ₹ 2,00,000 at a discount of 10% to finance a qualifying asset which is ready for intended use at the end of year 2.

   Compute the amount of borrowing costs to be capitalized if the company amortizes discount using Effective Interest Rate method by applying 13.39% p.a. of EIR.

8. Nikka Limited has obtained a term loan of ₹ 620 lacs for a complete renovation and modernisation of its Factory on 1st April, 20X1. Plant and Machinery was acquired under the modernisation scheme and installation was completed on 30th April, 20X2. An expenditure of ₹ 510 lacs was incurred on installation of Plant and Machinery, ₹ 54 lacs has been advanced to suppliers for additional assets (acquired on 25th April, 20X1) which were also installed on 30th April, 20X2 and the balance loan of ₹ 56 lacs has been used for working capital purposes. Management of Nikka Limited considers the 12 months period as substantial period of time to get the asset ready for its intended use.

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The company has paid total interest of ₹ 68.20 lacs during financial year 20X1-20X2 on the above loan. The accountant seeks your advice how to account for the interest paid in the books of accounts. Will your answer be different, if the whole process of renovation and modernization gets completed by 28th February, 20X2?

Answers

1. As per paragraph 5 of Ind AS 23, a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

As per paragraph 17 of Ind AS 23, an entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) It incurs expenditures for the asset.

(b) It incurs borrowing costs.

(c) It undertakes activities that are necessary to prepare the asset for its intended use or sale.

The ship is a qualifying asset as it takes substantial period of time for its construction. Thus, the related borrowing costs should be capitalised.

Marine Transport Limited borrows funds and incurs expenditures in the form of down payment on 1st April, 20X0. Thus, condition (a) and (b) are met. However, condition (c) is met only on 1st March, 20X2, and that too only with respect to one ship. Thus, there is no capitalisation of borrowing costs during the financial year ended 31st March, 20X1. Even during the financial year ended 31st March, 20X2, borrowing costs relating to the 'one' ship whose construction had commenced from 1st March, 20X2 will be capitalised from 1st March, 20X2 to 31st March, 20X2. All other borrowing costs are expensed.

2. The capitalisation rate is calculated as below:

Total borrowing costs / Weighted average total borrowings: 1,65,000/15,00,000 = 11%.

Interest to be capitalised is calculated as under:

— On ₹ 2,50,000 @ 11% p.a. for 9 months = ₹ 20,625

— On ₹ 3,00,000 @ 11% p.a. for 4 months = ₹ 11,000

Total interest capitalised for the year ended 31st March 20X2 is ₹ 31,625

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3. Since the entity has only general borrowing hence first step will be to compute the capitalisation rate. The capitalisation rate of the general borrowings of the entity during the period of construction is calculated as follows:

Finance cost on ₹ 20 lacs 10% debentures during September – December 20X1	₹ 66,667
Interest @ 15% on overdraft of ₹ 5,00,000 in September 20X1	₹ 6,250
Interest @ 16% on overdraft of ₹ 5,00,000 in October and November 20X1	₹ 13,333
Interest @ 16% on overdraft of ₹ 7,50,000 in December 20X1	₹ 10,000
Total finance costs in September – December 20X1	₹ 96,250

Weighted average borrowings during period

$$= \frac{(20,00,000 \times 4) + (500,000 \times 3) + (750,000 \times 1)}{4} = ₹\ 25,62,500$$

Capitalisation rate = Total finance costs during the construction period / Weighted average borrowings during the construction period

= 96,250 / 25,62,500 = 3.756%

4. (i) Calculation of capitalization rate on borrowings other than specific borrowings

Amount of loan (₹)	*Rate of interest*		*Amount of interest (₹)*
7,00,000	12%	=	84,000
9,00,000	11%	=	99,000
16,00,000			1,83,000
Weighted average rate of interest (1,83,000/16,00,000) x 100		=	11.4375%

(ii) Computation of borrowing cost to be capitalized for specific borrowings and general borrowings based on weighted average accumulated expenses

Date of incurrence of expenditure	*Amount spent*	*Financed through*	*Calculation*	*₹*
1st April, 20X1	1,50,000	Specific borrowing	1,50,000 x 9% x 10/12	11,250

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1st August, 20X1	2,00,000	Specific borrowing	50,000 x 9% x 10/12	3,750
		General borrowing	1,50,000x11.4375% x 6/12	8,578.125
1st October, 20X1	3,50,000	General borrowing	3,50,000x11.4375% x 4/12	13,343.75
1st January, 20X2	1,00,000	General borrowing	1,00,000x11.4375% x 1/12	953.125
				37,875

Note: Since construction of building started on 1st April, 20X1, it is presumed that all the later expenditures on construction of building had been incurred at the beginning of the respective month.

(iii) Total expenses to be capitalized for building

	₹
Cost of building ₹ (1,50,000 + 2,00,000 + 3,50,000 + 1,00,000)	8,00,000
Add: Amount of interest to be capitalized	37,875
	8,37,875

(iv) Journal Entry

Date	*Particulars*		*₹*	*₹*
31.1.20X2	Building account	Dr.	8,37,875	
	To Bank account			8,00,0000
	To Interest payable (borrowing cost)			37,875
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)			

Note: In the above journal entry, it is assumed that interest amount will be paid at the year end. Hence, entry for interest payable has been passed on 31.1.20X2.

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Alternatively, following journal entry may be passed if interest is paid on the date of capitalization:

Date	*Particulars*		*₹*	*₹*
31.1.20X2	Building account	Dr.	8,37,875	
	To Bank account			8,37,875
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)			

5. As per Ind AS 23, when an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity should determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

The amount of borrowing costs eligible for capitalization, in cases where the funds are borrowed generally, should be determined based on the capitalisation rate and expenditure incurred in obtaining a qualifying asset. The costs incurred should first be allocated to the specific borrowings.

Analysis of expenditure:

Date	Expenditure (₹ '000)	Amount allocated in general borrowings (₹ '000)	Weighted for period outstanding (₹ '000)
1st April 20X1	200	0	0
30th June 20X1	600	100*	100 × 9/12 = 75
31st Dec 20X1	1,200	1,200	1,200 × 3/12 = 300
31st March 20X2	200	200	200 × 0/12 = 0
Total	2,200		375

*Specific borrowings of ₹ 7,00,000 fully utilized on 1st April & on 30th June to the extent of ₹ 5,00,000 hence remaining expenditure of ₹ 1,00,000 allocated to general borrowings.

The capitalisation rate relating to general borrowings should be the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

$$\text{Capitalisation rate} = \frac{(10,00,000 \times 12.5\%) + (15,00,000 \times 10\%)}{10,00,000 + 15,00,000} = 11\%$$

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Borrowing cost to be capitalized:	Amount (₹)
On specific loan	65,000
On General borrowing (3,75,000 × 11%)	41,250
Total	1,06,250
Less: interest income on specific borrowings	(20,000)
Amount eligible for capitalization	86,250
Therefore, the borrowing costs to be capitalized are ₹ 86,250.	

6. Following is the treatment as per Ind AS 23:

Finance Company

No expenditure on qualifying assets have been incurred, so Finance Company cannot capitalise anything.

Real Estate Company

Total interest costs in the financial statements of Real Estate Company is ₹ 70,000. Expenditures on qualifying assets exceed total borrowings, so the total amount of interest can be capitalised.

Construction Company

No interest expense has been incurred, so Construction Company cannot capitalise anything.

Consolidated financial statements of Parent Company:

Total general borrowings of the group: ₹ 10,00,000 + ₹ 20,00,000 = ₹ 30,00,000

Although Parent Company used proceeds from loan to acquire a subsidiary, this loan cannot be excluded from the pool of general borrowings.

Total interest expenditures for the group = ₹ 30,00,000 x 7% = ₹ 2,10,000

Total expenditures on qualifying assets for the group are added up. Profit margin charged by Construction Company to Real Estate Company is eliminated:

Real Estate Company – ₹ 15,40,000/1.1 = ₹ 14,00,000

Construction Co – ₹ 10,00,000

Total consolidated expenditures on qualifying assets:

₹ (14,00,000 + 10,00,000) = ₹ 24,00,000

Capitalisation rate = 7%

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Borrowing costs eligible for capitalisation = ₹ 24,00,000 x 7% = ₹ 1,68,000

Total interest expenditures of the group are higher than borrowing costs eligible for capitalisation calculated based on the actual expenditures incurred on the qualifying assets. Therefore, only ₹ 1,68,000 can be capitalised.

7. Capitalisation Method

As per the Standard, borrowing costs may include interest expense calculated using the effective interest method. Further, capitalisation of borrowing cost should cease where substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Thus, only that portion of the amortized discount should be capitalised as part of the cost of a qualifying asset which relates to the period during which acquisition, construction or production of the asset takes place.

Capitalisation of Interest

Hence, based on the above explanation the amount of borrowing cost of year 1 & 2 are to be capitalised and the borrowing cost relating to year 3 & 4 should be expensed.

Quantum of Borrowing

The value of the bond to Y Ltd. is the transaction price ie ₹ 1,80,000 (2,00,000 – 20,000)

Therefore, Y Ltd will recognize the borrowing at ₹ 1,80,000.

Computation of the amount of Borrowing Cost to be Capitalised

Y Ltd will capitalise the interest (borrowing cost) using the effective interest rate of 13.39% for two years as the qualifying asset is ready for intended use at the end of the year 2, the details of which are as follows:

Year	*Opening Borrowing*	*Interest expense @ 13.39% to be capitalised*	*Total*	*Interest paid*	*Closing Borrowing*
	(1)	*(2)*	*(3)*	*(4)*	*(5) = (3) – (4)*
1	1,80,000	24,102	2,04,102	20,000	1,84,102
2	1,84,102	24,651	2,08,753	20,000	1,88,753
		48,753			

Accordingly, borrowing cost of ₹ 48,753 will be capitalized to the cost of qualifying asset.

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8. As per Ind AS 23, Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognized as an expense.

Where, a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Accordingly, the treatment of Interest of ₹ 68.20 lakh occurred during the year 20X1-20X2 would be as follows:

(i) When construction of asset completed on 30th April, 20X2

The treatment for total borrowing cost of ₹ 68.20 lakh will be as follows:

Purpose	Nature	Interest to be capitalised	Interest to be charged to profit and loss account
		₹ in lakh	₹ in lakh
Modernisation and renovation of plant and machinery	Qualifying asset	[68.20 x (510/620)] = 56.10	**Nil**
Advance to suppliers for additional assets	Qualifying asset	[68.20 x (54/620)] = 5.94	**Nil**
Working Capital	Not a qualifying asset		[68.20 x (56/620)] = 6.16
		62.04	6.16

(ii) When construction of assets is completed by 28th February, 20X2

When the process of renovation gets completed in less than 12 months, the plant and machinery and the additional assets will not be considered as qualifying assets (until and unless the entity specifically considers that the assets took substantial period for completing their construction). Accordingly, the whole of interest will be charged off / expensed off to Profit and Loss account.

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UNIT 4 :
INDIAN ACCOUNTING STANDARD 36 : IMPAIRMENT OF ASSETS

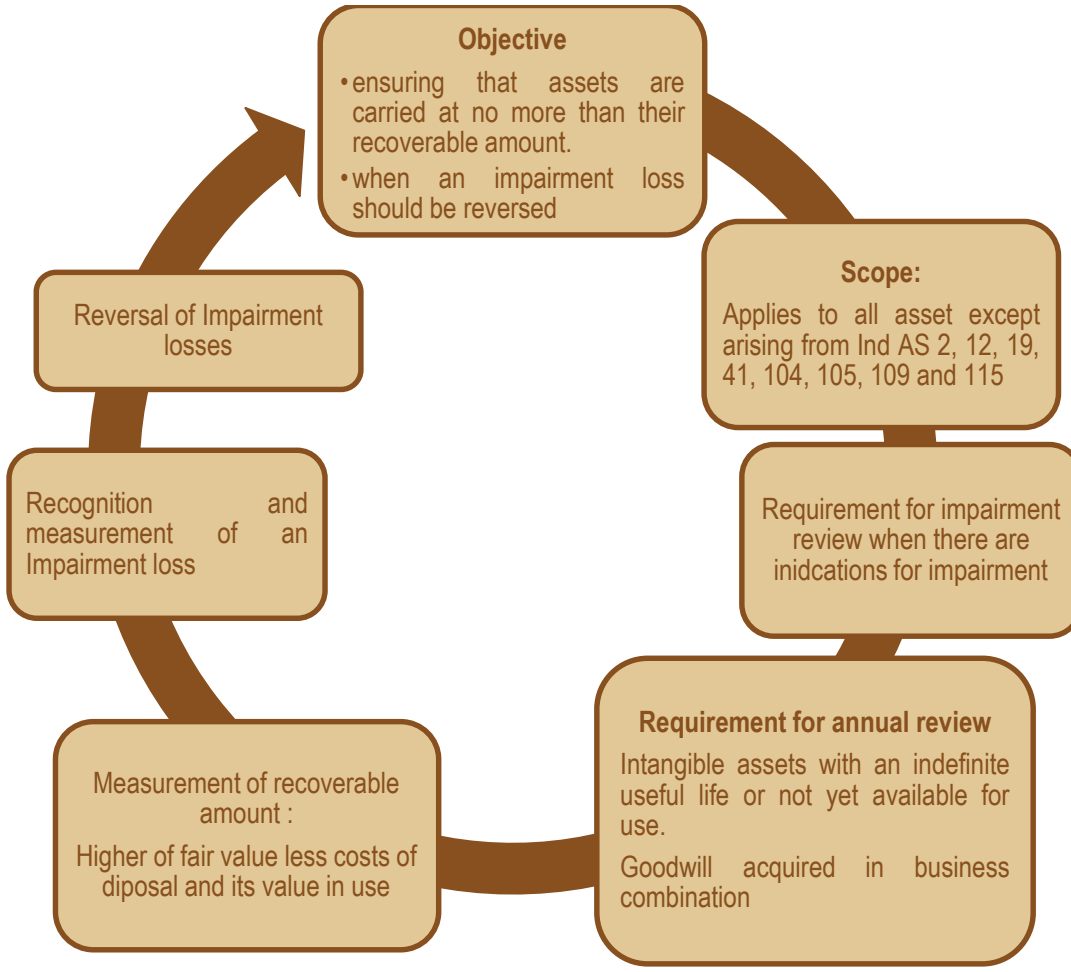
LEARNING OUTCOMES

After studying this unit, you will be able to

- Comprehend the objective and scope of this standard
- Define the terms impairment loss, cash-generating unit, corporate assets, recoverable amount etc.
- Examine the criteria for identifying an asset that may be impaired
- Measure the Recoverable Amount
- Recognise and Measure the Impairment loss
- Identify and examine the Cash Generating Unit of the entity and impair the Goodwill
- Allocate and Reverse the Impairment loss
- Disclose the facts as per the requirement of the standard
- Differentiate between Ind AS 36 and AS 28.

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UNIT OVERVIEW



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4.1 OBJECTIVE

The objective of this Standard is to prescribes the methodology that an entity applies to ensure that its assets are not carried at more than their recoverable amount (i.e. the higher of fair value less costs of disposal and value in use). With the exception of goodwill and certain intangible assets for which an annual impairment test is required.

An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. In such case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss.

The Standard also specifies when an entity shall reverse an impairment loss and prescribes disclosures.

4.2 SCOPE

- This Standard shall be applied in accounting for the impairment of all assets, other than:

Inventories (as covered in Ind AS 2)
Contract assets and assets arising from costs to obtain or fulfill a contract (Ind AS 115)
Deferred tax assets (Ind AS 12)
Assets arising from employees benefits (Ind AS 19)

Biological Assets measured at fair value less cost to sell (Ind AS 41)
Deferred acquisition costs and intangible assets arising from insurance contracts (Ind AS 104)
Non-current assets (or disposal groups) classified as held for sale (as covered in Ind AS 105)
Financial Assets (within the scope of Ind AS 109)

All of the items excluded from the scope of Ind AS 36 are covered by other Ind AS which contain requirements that are equivalent to impairment assessments in some form. For

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example, Ind AS 2 requires inventories to be measured after initial recognition 'at the lower of cost and net realisable value'. It is therefore unnecessary to test inventories for further impairment in accordance with Ind AS 36 as the recoverability of these assets has already been determined through the subsequent measurement requirements of Ind AS 2.

- This Standard applies to financial assets classified as:



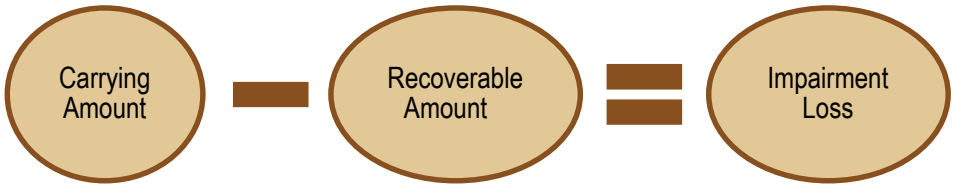
Impairment of other financial assets shall be accounted as per Ind AS 109, Financial Instruments.

4.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

1. ***Carrying amount*** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.
2. A ***cash-generating unit*** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
3. ***Corporate assets*** are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.
4. ***Costs of disposal*** are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.
5. ***Depreciable amount*** is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.
6. ***Depreciation (Amortisation)*** is the systematic allocation of the depreciable amount of an asset over its useful life.
7. ***Fair value*** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (refer Ind AS 113 Fair Value Measurement).
8. An ***impairment loss*** is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.

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9. The ***recoverable amount*** of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use.

10. ***Useful life*** is either:

a) the period of time over which an asset is expected to be used by the entity; or

b) the number of production or similar units expected to be obtained from the asset by the entity.

11. ***Value in use*** is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

4.4 IDENTIFYING AN ASSET THAT MAY BE IMPAIRED

4.4.1 Identifying an asset that may be impaired - General

- An asset is impaired when its carrying amount exceeds its recoverable amount.



- An entity shall **assess** at the end of each reporting period whether there is any **indication** that an asset may be impaired. If any such indication exists, the entity is required to estimate the **recoverable amount** of the asset.
- Irrespective of whether there is any indication of impairment, an entity is required to test following items for impairment at least annually:



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For above three assets, the entity should not have wait for Impairment indicators, rather there is mandate of impairment testing. We will discuss this aspect in detail in the next section.

4.4.2 Indications of impairment

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

4.4.2.1 External source of Information

The following are external source of information which may indicate that an asset is impaired:

a) during the period, an asset's **market value** has **declined significantly** more than would be expected as a result of the passage of time or normal use;

b) significant changes with an **adverse effect** on the entity have taken place during the period, or will take place in the near future, in the **technological, market, economic or legal environment** in which the entity operates or in the market to which an asset is dedicated;

c) market **interest rates** or other market rates of return on investments have **increased** during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially; and

d) the carrying amount of the net assets of the entity is more than its market capitalisation.

4.4.2.2 Internal source of Information

The following are internal source of information which may indicate that an asset is impaired:

a) evidence is available of **obsolescence or physical damage** of an asset;

b) significant changes with an **adverse effect** on the entity have taken place during the period or are expected to take place in the near future, in the extent to which, or manner in which, **an asset is used or is expected to be used**. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite;

c) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. Such evidence may include:

   (i) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;

   (ii) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;

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(iii) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or

(iv) operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future.

4.4.2.3 Dividend from a subsidiary, jointly controlled entity or associate

For an investment in a subsidiary, jointly controlled entity or associate, the investor recognises a dividend from the investment and evidence is available that:

(i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or

(ii) the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared.

The above list is not exhaustive. An entity may identify other indications that an asset may be impaired and these would also require the entity to determine the asset's recoverable amount or, in the case of goodwill, perform an impairment test.

If market interest rates or other market rates of return on investments have increased during the period, an entity is not required to make a formal estimate of an asset's recoverable amount in the following cases:

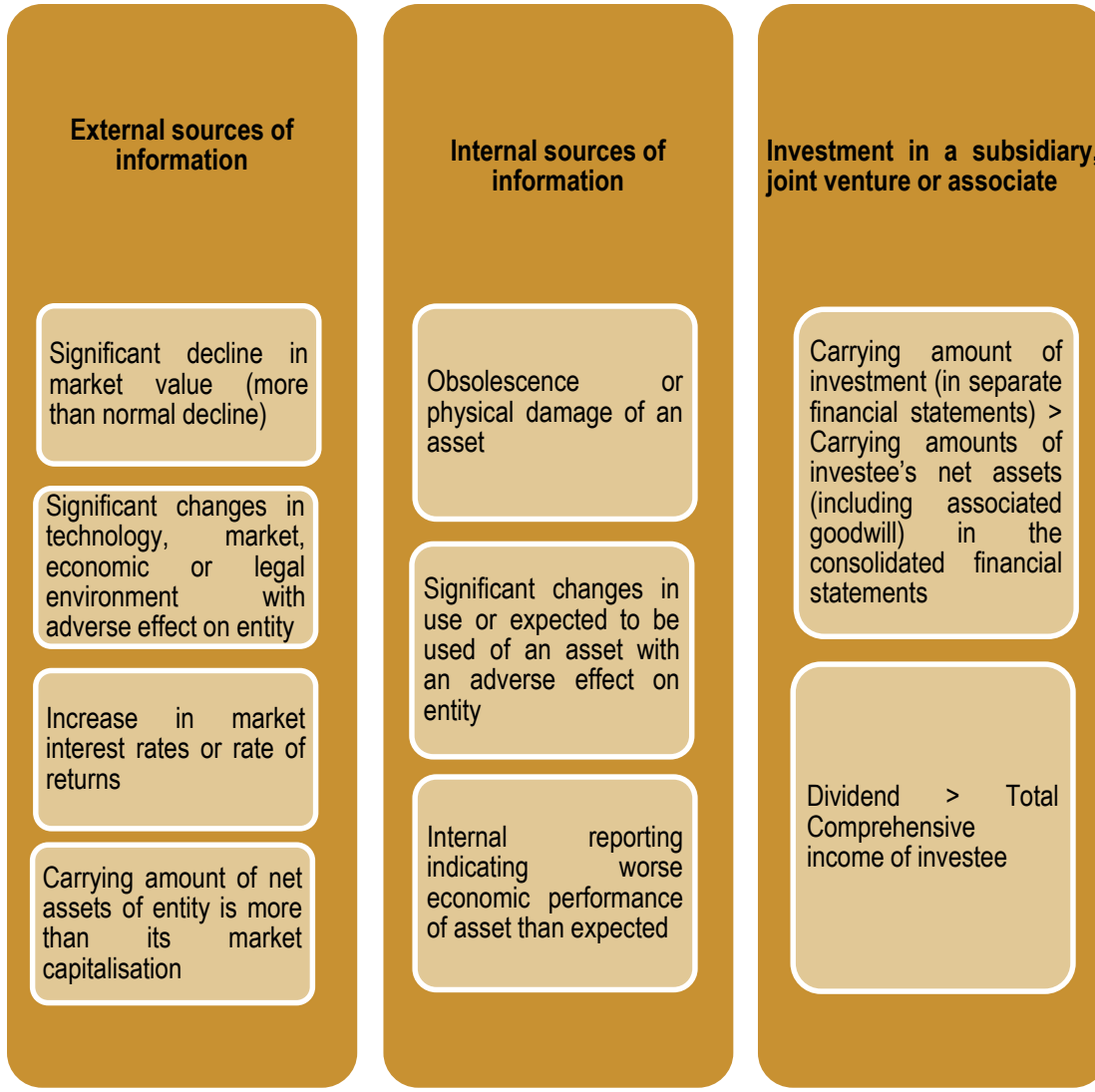
a) if the discount rate used in calculating the asset's value in use is unlikely to be affected by the increase in these market rates. For example, increases in short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life; or

b) if the discount rate used in calculating the asset's value in use is likely to be affected by the increase in these market rates but previous sensitivity analysis of recoverable amount shows that:

(i) it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase (e.g. in some cases, an entity may be able to demonstrate that it adjusts its revenues to compensate for any increase in market rates); or

(ii) the decrease in recoverable amount is unlikely to result in a material impairment loss.

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4.5 REQUIREMENT FOR ANNUAL REVIEW

4.5.1 Items required to be tested for impairment at least annually

Irrespective of whether there is any indication of impairment, an entity is required to test following items for impairment at least annually:

a) intangible asset with an indefinite useful life;

b) intangible asset not yet available for use; and

c) goodwill acquired in a business combination.

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4.5.2 Intangible assets required to be tested for impairment at least annually

Intangible asset with an indefinite useful life and intangible assets not yet available for use to be tested for impairment

a) annually; and

b) and whenever there is an indication, at the end of a reporting period, that the asset may be impaired

by comparing its carrying amount with its recoverable amount, irrespective of whether there is any indication that it may be impaired.

- This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year and whenever there is an indication, at the end of a reporting period, that the asset may be impaired.

Example 1

Intellectual Property rights (IPR) having Indefinite useful life has been tested for Impairment in the first quarter of FY 20X1-20X2. Impairment testing on such assets needs to be mandatory done in the same time frame i.e first quarter of FY 20X2-20X3. Suppose there is an indication of impairment in third quarter of FY 20X2-20X3, in such case, the company needs to do impairment testing in third quarter apart from mandatory annual review.

- Different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period.
- However, the most recent detailed calculation of such an asset's recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period, provided all of the following criteria are met:

  a) if the intangible asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets and is therefore tested for impairment as part of the cash-generating unit to which it belongs, the assets and liabilities making up that unit have not changed significantly since the most recent recoverable amount calculation;

  b) the most recent recoverable amount calculation resulted in an amount that exceeded the asset's carrying amount by a substantial margin; and

  c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the asset's carrying amount is remote.

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4.5.3 Goodwill

4.5.3.1 CGUs to which goodwill has been allocated

A cash-generating unit to which goodwill has been allocated is tested for impairment both:

a) annually, and

b) whenever there is an indication that the unit may be impaired,

by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity recognises an impairment loss in accordance with the requirement of this standard.

4.5.3.2 Timing of impairment tests

- The annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units may be tested for impairment at different times.
- However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period.

4.5.3.3 Individual assets to be tested before CGU to which goodwill has been allocated

- If the assets constituting the CGU to which goodwill has been allocated are tested for impairment at the same time as the unit containing the goodwill, they shall be tested for impairment before the unit containing the goodwill.
- Similarly, if the CGUs constituting a group of CGUs to which goodwill has been allocated are tested for impairment at the same time as the group of units containing the goodwill, the individual units shall be tested for impairment before the group of units containing the goodwill.
- At the time of impairment testing a CGU to which goodwill has been allocated, there may be an indication of an impairment of an asset within the unit containing the goodwill. In such circumstances, the entity tests the asset for impairment first, and recognises any impairment loss for that asset before testing for impairment the cash-generating unit containing the goodwill.
- Similarly, there may be an indication of an impairment of a cash-generating unit within a group of units containing the goodwill. In such circumstances, the entity tests the cash-generating unit for impairment first, and recognises any impairment loss for that unit, before testing for impairment the group of units to which the goodwill is allocated.

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4.5.3.4 Rolling forward detailed calculations from a preceding period

The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all the following criteria are met:

a) the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;

b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and

c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.

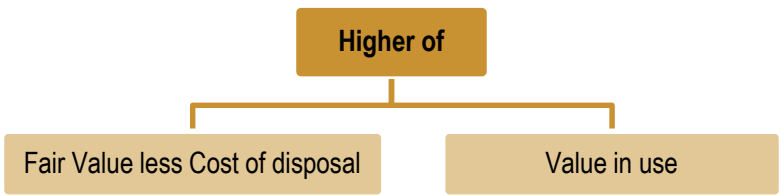
4.5.3.5 CGUs to which it has not been possible to allocate goodwill

- When goodwill relates to a CGU but has not been allocated to that unit, the unit shall be tested for impairment, whenever there is an indication that the unit may be impaired, by comparing the unit's carrying amount, excluding any goodwill, with its recoverable amount. Any impairment loss is recognised in accordance with the requirement of this standard.
- If a CGU as described above includes in its carrying amount an intangible asset that has an indefinite useful life or is not yet available for use and that asset can be tested for impairment only as part of the CGU, the unit also to be tested for impairment annually.

4.6 MEASUREMENT OF RECOVERABLE AMOUNT

4.6.1 Recoverable amount

The ***recoverable amount*** of an asset or a CGU is the higher of its fair value less costs of disposal and its value in use.



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Illustration 1

The carrying value of a building in the books of Sun Ltd. as at 31st March, 20X1 is ₹ 300 lakh. As on that date the value in use is ₹ 250 lakh and fair value less cost of disposal is ₹ 238 lakh.

Calculate the Recoverable Amount.

Solution

Recoverable Amount : Higher of Fair Value less Costs of disposal and Value in Use

Fair Value less costs of disposal : ₹ 250 lakh

Value in Use : ₹ 238 lakh

Therefore, Recoverable value will be ₹ 250 lakh

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4.6.2 Circumstances in which it is not necessary to calculate both an asset's fair value less costs of disposal and its value in use

- If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.
- If there is no basis for making a reliable estimate of fair value less costs of disposal, recoverable amount is measured by reference to value in use alone.
- In some cases, estimates, averages and computational short cuts may provide reasonable approximations of the detailed computations (illustrated in this Standard) for determining fair value less costs of disposal or value in use.

4.6.3 Circumstances in which recoverable amount is determined in the context of CGU

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (refer paragraphs 65–103), unless either:

a) the asset's fair value less costs of disposal is higher than its carrying amount; or

b) the asset's value in use can be estimated to be close to its fair value less costs of disposal and fair value less costs of disposal can be determined.

Some of the indicators are aimed at individual assets rather than the CGU of which they are a part of. For example, a decline in the value of an asset or evidence that it is obsolete or damaged. Such indicators may also imply that a wider review of the business or CGU is required. However, this is not always the case. For example, if there is a slump in property prices and the market

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value of the entity's new head office falls below its carrying value this would constitute an indicator of impairment and trigger a review. At the level of the individual asset, as fair value less cost of disposal is below carrying amount, this might indicate that a write-down is necessary. However, building's recoverable amount may have to be considered in the context of a CGU of which it is a part of. This is an example of a situation where it may not be necessary to re-estimate an asset's recoverable amount because it may be obvious that the CGU has suffered no impairment. In short, it may be irrelevant to the recoverable amount of the CGU that it contains a head office whose market value has fallen.



4.7 FAIR VALUE LESS COSTS OF DISPOSAL

4.7.1 Fair value and costs of disposal – definition

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (Ind AS 113 Fair Value Measurement).

Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

4.7.2 Cost of disposal to be deducted

Costs of disposal, other than those that have been recognised as liabilities, are deducted in determining fair value less costs of disposal. Examples of such costs are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

However, termination benefits (as defined in Ind AS 19) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

4.7.3 Contrasting fair value and value in use

Fair value differs from value in use. Fair value reflects the assumptions market participants would use when pricing the asset. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to market participants:

a) additional value derived from the grouping of assets (such as the creation of a portfolio of investment properties in different locations);

b) synergies between the asset being measured and other assets;

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c) legal rights or legal restrictions that are specific only to the current owner of the asset; and

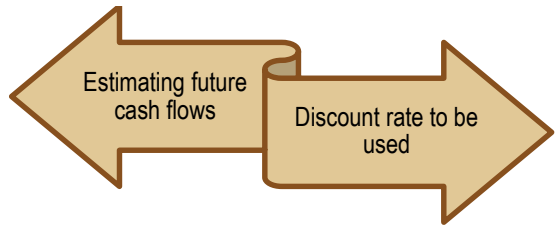
d) tax benefits or tax burdens that are specific to the current owner of the asset.

4.8 VALUE IN USE

4.8.1 Value in use – general

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

Primarily two key decisions are involved in determining value in use:



4.8.2 Estimation of expected future cash flows

The following elements shall be reflected in the calculation of an asset's value in use:

a) an estimate of the future cash flows the entity expects to derive from the asset;

b) expectations about possible variations in the amount or timing of those future cash flows;

c) the time value of money, represented by the current market risk-free rate of interest;

d) the price for bearing the uncertainty inherent in the asset; and

e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

- **Estimating the value in use of an asset involves the following steps:**

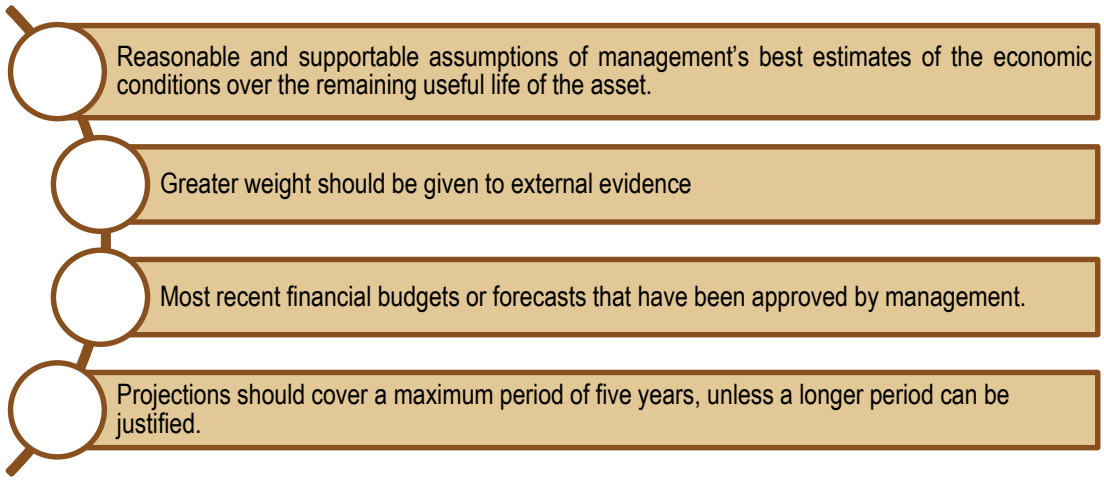
  a) estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and

  b) applying the appropriate discount rate to those future cash flows.

- The elements identified above in point (b), (d) and (e) can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate. Whichever approach an entity adopts to reflect expectations about possible variations in the amount or timing of future cash flows, the result shall be to reflect the expected present value of the future cash flows, i.e. the weighted average of all possible outcomes.

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- **When estimating expected future cash flows, the following rules apply:**



a) Projections of cash flows shall be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.

Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows. Management shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

b) Base cash flow projections on the most recent financial budgets/forecasts approved by management but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.

c) Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

d) Estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate

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for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

e) Period beyond the budgets / forecasts period will be the terminal period. The terminal value is an estimate of the present value all the cash flows in the terminal period (as at the end of the forecast period) based on the final cash flow in the forecast period. For example, assume that an entity has a 5 year forecast period, the formula to determine the terminal value as at the end of year 5 is:

Terminal value at the end of year 5 = (Cash flows of 5th year x (1+growth rate)) / (weighted average cost of capital minus growth rate).

f) Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining, unless an increase in the rate matches objective information about patterns over a product or industry lifecycle. If appropriate, the growth rate is zero or negative.

g) Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases attributable to general inflation. Therefore, if the discount rate includes the effect of price increases attributable to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases attributable to general inflation, future cash flows are estimated in real terms (but include future specific price increases or decreases).

4.8.2.1 Estimates of future cash flows shall include:

a) projections of cash inflows from the continuing use of the asset;

b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset;

c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life shall be the amount that an entity expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's fair value less costs of disposal, except that, in estimating those net cash flows:

(i) an entity uses prices prevailing at the date of the estimate for similar assets that have reached the end of their useful life and have operated under conditions similar to those in which the asset will be used; and

(ii) the entity adjusts those prices for the effect of both future price increases due to general inflation and specific future price increases or decreases. However, if estimates of

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future cash flows from the asset's continuing use and the discount rate exclude the effect of general inflation, the entity also excludes this effect from the estimate of net cash flows on disposal;

d) projections of cash outflows include those for the day-to-day servicing of the asset as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset and

e) in the same way that corporate assets can be allocated to a CGU's carrying value, the CGU's cash flows shall also include an appropriate apportionment of corporate overheads when calculating value in use. However, care should be taken around internal charges for using the asset.

4.8.2.2 Estimates of future cash flows shall exclude:

- Estimates of future cash flows do not include:

(a) cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables);

(b) cash outflows that relate to obligations that have been recognised as liabilities (for example, payables, pensions or provisions);

(c) future cash outflows or related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future restructuring to which an entity is not yet committed.

Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets,* contains guidance clarifying when an entity is committed to a restructuring.

When an entity becomes committed to a restructuring, some assets are likely to be affected by this restructuring. Once the entity is committed to the restructuring its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts approved by management) and its estimates of future cash outflows for the restructuring are included in a restructuring provision in accordance with Ind AS 37;

(d) estimated future cash flows that are expected to arise from improving or enhancing the asset's performance, i.e. the general rule is that future cash flows should be forecasted for CGUs or assets in their current condition.

Estimates of future cash flows do include future cash flows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition.

When a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when

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estimating the future cash flows associated with the unit. Similarly, when a single asset consists of components with different estimated useful lives, the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset when estimating the future cash flows generated by the asset;

(e) cash inflows or outflows from financing activities. Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined. Otherwise, the effect of some assumptions will be counted twice or ignored.

Because the time value of money is considered by discounting the estimated future cash flows, these cash flows exclude cash inflows or outflows from financing activities;

(f) income tax receipts or payments. Because the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis; and

(g) when corporate assets have been allocated to a CGU's carrying amount, any internal charges incurred by the CGU for using such assets shall not be included in the CGU's expected future cash flows. To do so would be to double-count the impact of the corporate assets and could result in an impairment loss being recognised incorrectly.

Illustration 2

Saturn India Ltd is reviewing one of its business segments for impairment. The carrying value of its net assets is 40 million. Management has produced two computations for the value-in-use of the business segment. The first value of ₹ 36 million excludes the benefit to be derived from a future reorganization, but the second value of ₹ 44 million includes the benefits to be derived from the future reorganization. There is not an active market for the sale of the business segments.

Advise whether the business segment needs to be impaired.

Solution

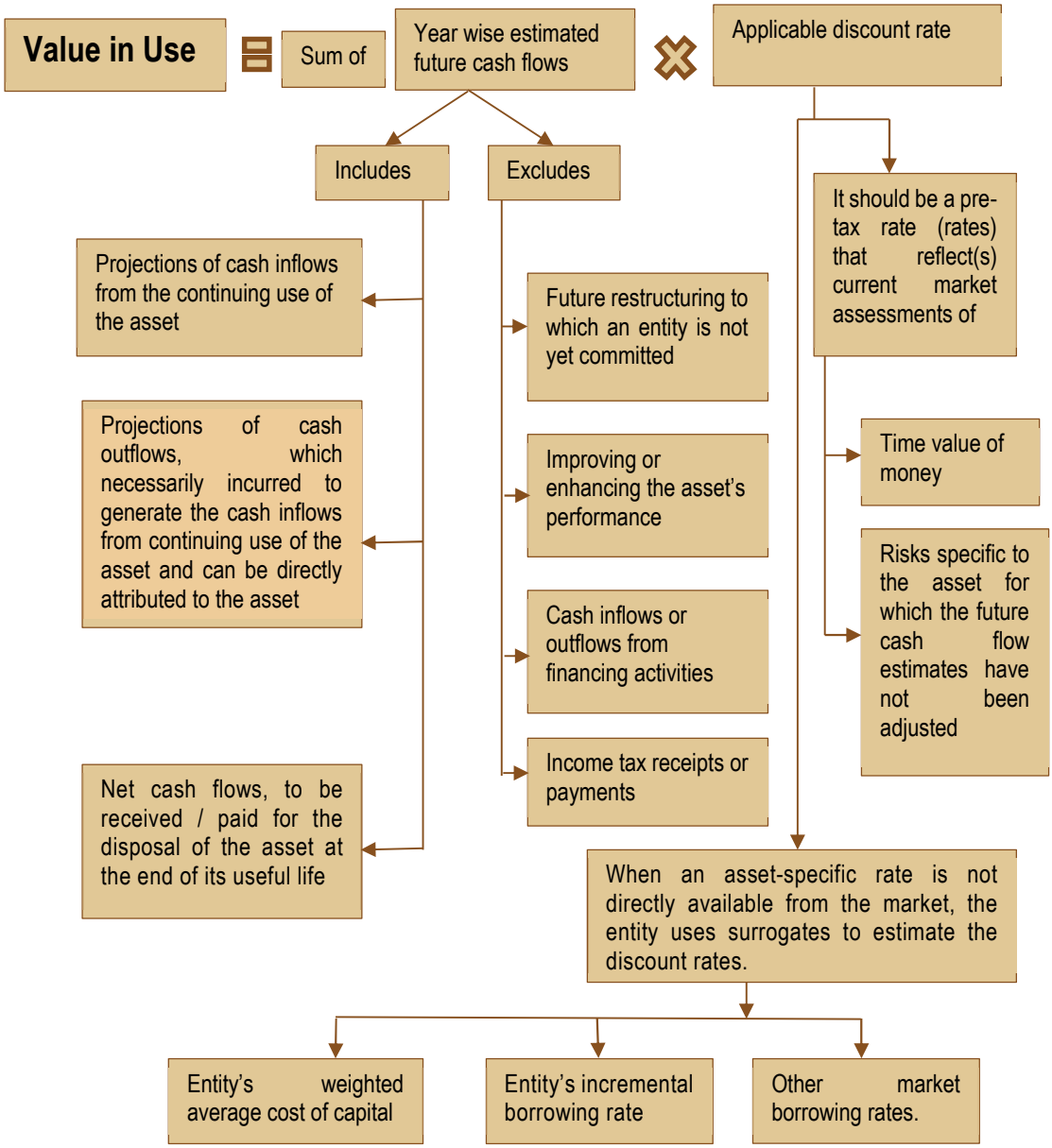
The benefit of the future reorganization should not be taken into account in calculating value-in-use. Therefore, the net assets of the business segment will be impaired by ₹ 4 million because the value-in-use of ₹ 36 million is lower than the carrying value of ₹ 40 million. The value-in-use can be used as the recoverable amount as there is no active market for the sale of the business segment.

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4.8.2.3 Foreign currency future cash flows

Future cash flows are first estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. After that, an entity translates the present value using the spot exchange rate at the date of the value in use calculation. This is to avoid the problems inherent in using forward exchange rates, which are based on differential interest rates. Using such a rate would result in double-counting the time value of money, first in the discount rate and then in the forward rate.

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4.8.3 Discount rate

- The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of:
  a) the time value of money; and
  b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.

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- This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review. However, the discount rate(s) used to measure an asset's value in use shall not reflect risks for which the future cash flow estimates have been adjusted. Otherwise, the effect of some assumptions will be double counted.
- When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate.

Appendix A also gives the following guidelines for selecting the appropriate discount rate:

- it should be adjusted to reflect the specific risks associated with the projected cash flows (such as country, currency, price and cash flow risks) and to exclude risks that are not relevant;
- to avoid double counting, the discount rate does not reflect risks for which future cash flow estimates have been adjusted;
- the discount rate is independent of the entity's capital structure and the way it financed the purchase of the asset;
- if the basis for the rate is post-tax (such as a weighted average cost of capital), it is adjusted for the Value in Use (VIU) calculation to reflect a pre-tax rate; and
- normally, the entity uses a single discount rate but it should use separate discount rates for different future periods if the VIU is sensitive to different risks for different periods or to the term structure of interest rates.
- The discount rate specific for the asset or CGU will take account of the period over which the asset or CGU is expected to generate cash inflows and it may not be sensitive to changes in short-term rates.

Illustration 3

Mars Ltd. gives the following estimates of cash flows relating to property, plant and equipment on 31st March, 20X4. The discount rate is 15%

Year	*Cash Flow (₹ in lakh)*
20X4-20X5	*2,000*
20X5-20X6	*3,000*
20X6-20X7	*3,000*
20X7-20X8	*4,000*
20X8-20X9	*2,000*
Residual Value at 31st March, 20X9	*500*

Property, plant & equipment was purchased on 1st April, 20X1 for ₹ *20,000 lakh*

Useful Life was *8 Years*

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Residual Value estimated at the end of 8 years *₹ 500 lakh*

Fair value less cost to disposal *₹ 10,000 lakh*

Calculate impairment loss, if any on the property, plant and equipment. Also calculate the revised carrying amount and revised depreciation of property, plant and equipment.

Solution

(a) Calculation of Carrying Amount on 31st March, 20X4 *(₹ in lakh)*

Particular	Amount
Original Cost on 1st April, 20X1	20,000
Less: Depreciation $\frac{(20{,}000-500)}{8}\times 3$	(7,313)
Carrying Amount	12,687

(b) Calculation of Value in Use

Year	Cash Flows	*P.V.*	Amount
20X4-20X5	2,000	.870	1,740
20X5-20X6	3,000	.756	2,268
20X6-20X7	3,000	.658	1,974
20X7-20X8	4,000	.572	2,288
20X8-20X9 (including residual value)	2,500	.497	1,243
Total			**9,513**

(c) Calculation of Recoverable Amount

Particular	Amount
Value in Use	9,513
Fair value less costs of disposal	10,000
Recoverable Amount	10,000

(d) Calculation of Impairment Loss

Carrying Amount – Recoverable Amount

12,687 – 10,000 = 2,687

(e) Calculation of Revised Carrying Amount

Particular	Amount
Carrying Amount	12,687
Less: Impairment Loss	(2,687)
Revised Carrying Amount	10,000

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(f) **Calculation of Revised Depreciation**

$$\frac{\text{Revised Carrying Amount} - \text{Residual Value}}{\text{Remaining Life}}$$

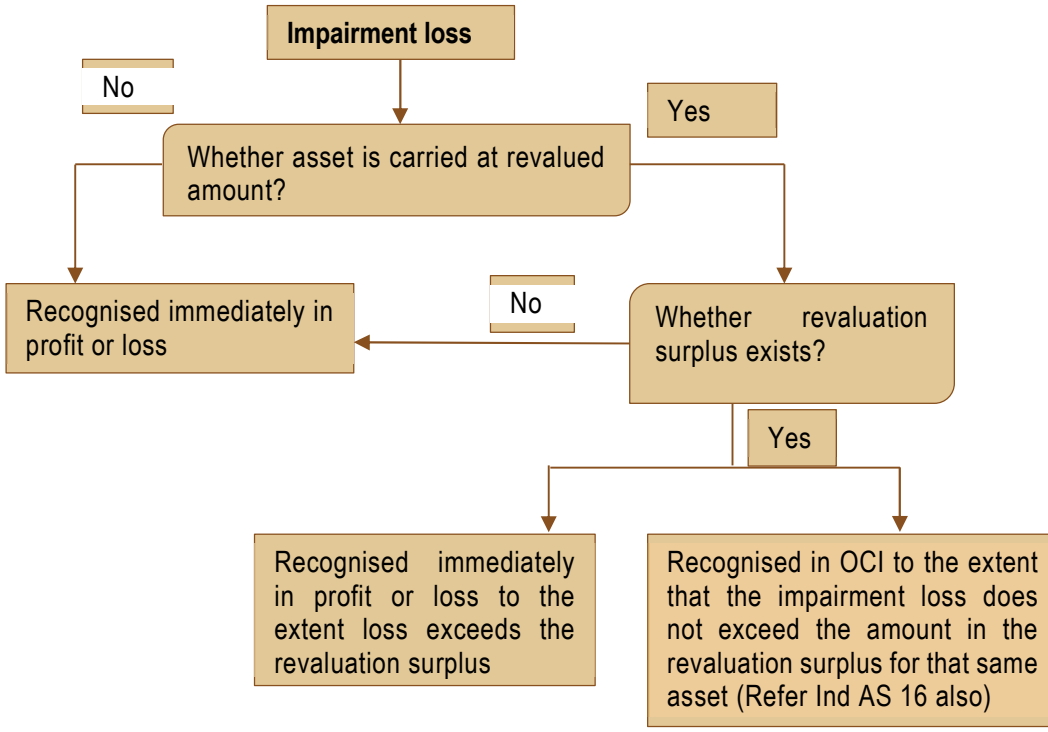
$$\frac{10{,}000 - 500}{5} = 1{,}900$$

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4.9 RECOGNISING AND MEASURING AN IMPAIRMENT LOSS

4.9.1 Recognition and measurement of an impairment loss - Individual Asset

If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.



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Note:

1. Any impairment loss of a revalued asset shall be treated as a revaluation decrease as per other standard.
2. When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability, if required.
3. After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.
4. If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with Ind AS 12 by comparing the revised carrying amount of the asset with its tax base.

Illustration 4 : Impairment Loss

Jupiter Ltd, a leading manufacturer of steel is having a furnace, which is carried in the balance sheet on 31st March, 20X1 at ₹ 250 lakh. As at that date the value in use and fair value is ₹ 200 lakh. The cost of disposal is ₹ 13 lakh.

Calculate the impairment loss to be recognised in the books of the company?

Solution

Calculation of Impairment Loss:

Calculation of Impairment Loss	***₹ in lakh***
Recoverable Amount =	200
Higher of ,	
Fair Value less Cost of Disposal (200 -13)	187
Or	
Value in Use	200
Impairment Loss = Carrying Amount – Recoverable Amount	
= 250 – 200	50

- An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in Ind AS 16).
- Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard. Impairment loss on a revalued asset is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Such an impairment loss on a revalued asset reduces the revaluation surplus for that asset.

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- When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another Standard.
- After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset is adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.
- If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with Ind AS 12 by comparing the revised carrying amount of the asset with its tax base.

Illustration 5

Mercury Ltd. has an identifiable asset with a carrying amount of ₹ 1,000. Its recoverable amount is ₹ 650. The tax rate is 30% and the tax base of the asset is ₹ 800. Impairment losses are not deductible for tax purposes. Identify the impact of impairment loss on related deferred tax asset / liability against the revised carrying amount of asset.

Solution

The effect of impairment loss is as follows:

	Identifiable assets before impairment loss	***Impairment loss***	***Identifiable assets after impairment loss***
	₹	₹	₹
Carrying amount	1,000	(350)	650
Tax Base	800	-	800
Taxable (deductible) temporary difference	200	(350)	(150)
Deferred tax liability (asset) at 30%	60	(105)	(45)

In accordance with Ind AS 12, the entity recognises the deferred tax asset to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

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4.9.2 Recognition and measurement of an impairment loss for a cash-generating unit and goodwill

4.9.2.1 Identification of cash generating units

- A ***cash-generating unit*** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

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- If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity is required to determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).
- The recoverable amount of an individual asset cannot be determined if:
  a) the asset's value in use cannot be estimated to be close to its fair value less costs of disposal (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and
  b) the asset does not generate cash inflows that are largely independent of those from other assets.
- In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.
- If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.
- In Practice, CGUs could represent:
  a) An entire entity
  b) Departments or business units within an entity
  c) Production line within a department, or within an entity
  d) Groups of items of property, plant and equipment within a production line, or within a department, or within an entity

Examples 2 & 3

2. A mining entity owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine.

   It is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, ie the mine as a whole.

3. A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

   Since the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets

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or groups of assets is the cash inflows generated by the five routes together. The cash-generating unit for each route is the bus company as a whole.

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4.9.2.2 Relevance of internal management reporting to the identification of CGUs

Cash inflows are inflows of cash and cash equivalents received from parties external to the entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including how management monitors the entity's operations or how management makes decisions about continuing or disposing of the entity's assets and operations.

4.9.2.3 Active market exists for the output produced by an asset or group of assets

- If an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit, even if some or all of the output is used internally.
- Even if part or all of the output produced by an asset or a group of assets is used by other units of the entity, this asset or group of assets forms a separate cash-generating unit if the entity could sell the output on an active market. This is because the asset or group of assets could generate cash inflows that would be largely independent of the cash inflows from other assets or groups of assets.
- If the cash inflows generated by any asset or cash-generating unit are affected by internal transfer pricing, an entity shall use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:

  a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and

  b) the future cash outflows used to determine the value in use of any other assets or cash-generating units that are affected by the internal transfer pricing.

4.9.2.4 Cash-generating units to be identified consistently from period to period

- Cash-generating units shall be identified consistently from period to period for the same asset or types of assets, unless a change is justified.
- If an entity determines that an asset belongs to a cash-generating unit different from that in previous periods, or that the types of assets aggregated for the asset's cash-generating unit have changed, disclosures are required about the cash-generating unit, if an impairment loss is recognised or reversed for the cash-generating unit.

4.9.2.5 Allocation of assets and liabilities to CGUs

- The **recoverable amount** of a cash-generating unit is the higher of the cash-generating unit's fair value less costs of disposal and its value in use.

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- ***Carrying amount*** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon. The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.
- The carrying amount of a cash-generating unit:

  a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and

  b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

  This is because fair value less costs of disposal and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised.
- In some cases, although some assets contribute to the estimated future cash flows of a cash-generating unit, they cannot be allocated to the cash-generating unit on a reasonable and consistent basis. This might be the case for goodwill or corporate assets such as head office assets.
- It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs of disposal (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

Illustration 6

A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is ₹ 500, which is equal to the present value of the restoration costs.

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The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around ₹ 800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately ₹ 1,200, excluding restoration costs. The carrying amount of the mine is ₹ 1,000.

Recommend the impairment loss is to be accounted for.

Solution

The cash-generating unit's fair value less costs of disposal is ₹ 800. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be ₹ 700 (₹ 1,200 less ₹ 500). The carrying amount of the cash-generating unit is ₹ 500, which is the carrying amount of the mine (₹ 1,000) less the carrying amount of the provision for restoration costs (₹ 500). Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount. Thus, there is no impairment loss.

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- For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit (for example, receivables or other financial assets) or liabilities that have been recognised (for example, payables, pensions and other provisions). In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

4.9.2.6 Allocating goodwill to cash-generating units

- Goodwill can only generate cash inflows in combination with other assets which means that an impairment test cannot be carried out on goodwill alone. For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.

  Operating synergies fall into two broad groups, those that improve margin (e.g. through cost savings and economies of scale) and those that give an opportunity for future growth (e.g. through the benefits of the combined talent and technology). In all of the following cases, the acquiring entity can identify the synergies and the CGU or CGU group that benefits from them. Goodwill will be allocated to the relevant CGU or CGU group.

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Examples 4 - 6

4. An airline is subject to cost pressures common in the sector. It acquires another operation with similar international operations on the basis that it can reduce its workforce and asset base. It will combine its operational management, including its sales, reporting and human resources functions, into one head office and consolidate all aircraft maintenance in a single site that currently has capacity. These cost savings are the synergies of the business combination and goodwill would therefore be allocated to the CGU or group of CGUs that benefit from these cost savings.

5. A mining entity (group) extracts a metal ore that does not have an active market until it has been through a smelting and refining process. The entity considers the CGU to comprise the smelter together with the individual mines. When the entity acquires a mine, the synergies relate to cost savings as the mine's fixed costs are already covered by the existing refining operations. Goodwill is therefore allocated to the CGU comprising the smelter, the existing mines and the newly acquired mine.

6. A global consumer products company, which allocates goodwill at the operating segment level, purchases a company best-known for razors and razor blades. It has not previously manufactured razors although its 'grooming products' operating segment does manufacture other shaving products. The acquirer expects that it will be able to increase sales of its shaving products through association with the target company's razors and through branding. No assets of the acquired business are allocated to the grooming products operating segment but this segment will benefit from the synergies of the business combination and therefore goodwill from the acquisition will be allocated to it.

- Goodwill sometimes cannot be allocated on a non-arbitrary basis to individual cash-generating units, but only to groups of cash-generating units. Each unit or group of units to which the goodwill is so allocated:

  a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

  b) not be larger than an operating segment as defined by paragraph 5 of Ind AS 108 'Operating Segments' before aggregation.

- Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. Goodwill does not generate cash flows independently of other assets or groups of assets and, therefore, it will always be tested for impairment as part of a CGU or a group of CGUs.

- If the initial allocation of goodwill acquired in a business combination cannot be completed before the end of the annual period in which the business combination is effected, that initial

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allocation shall be completed before the end of the first annual period beginning after the acquisition date.

- In accordance with Ind AS 103 'Business Combinations', if the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected, the acquirer:

  a) accounts for the combination using those provisional values; and

  b) recognises any adjustments to those provisional values as a result of completing the initial accounting within the measurement period, which will not exceed twelve months from the acquisition date.

  In such circumstances, it might also not be possible to complete the initial allocation of the goodwill recognised in the combination before the end of the annual period in which the combination is affected. When this is the case, the entity discloses the information required by this standard.

- If goodwill has been allocated to a cash-generating unit and the entity disposes of an operation within that unit, the goodwill associated with the operation disposed of shall be:

  a) included in the carrying amount of the operation when determining the gain or loss on disposal; and

  b) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

Example 7

An entity sells for ₹ 100 an operation that was part of a cash-generating unit to which goodwill has been allocated. The goodwill allocated to the unit cannot be identified or associated with an asset group at a level lower than that unit, except arbitrarily. The recoverable amount of the portion of the cash-generating unit retained is ₹ 300.

Since the goodwill allocated to the cash-generating unit cannot be non-arbitrarily identified or associated with an asset group at a level lower than that unit, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the unit retained. Therefore, 25 per cent of the goodwill allocated to the cash-generating unit is included in the carrying amount of the operation that is sold.

If an entity reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated, the goodwill shall be reallocated to the units affected. This reallocation is performed by using a relative value approach similar to that used when an entity disposes of an operation within a cash-

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generating unit, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units.

Example 8

Goodwill had previously been allocated to cash-generating unit A. The goodwill allocated to A cannot be identified or associated with an asset group at a level lower than A, except arbitrarily. A is to be divided and integrated into three other cash-generating units, B, C and D.

Since the goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to units B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D.

Illustration 7

Entity A acquires Entity B for ₹ 50 million, of which ₹ 35 million is the fair value of the identifiable assets acquired and liabilities assumed. The acquisition of B Ltd. is to be integrated into two of Entity A's CGUs with the net assets being allocated as follows:

₹ in million

	CGU 1	*CGU 2*	*Total*
Fair value of acquired identifiable tangible and intangible assets	*25*	*10*	*35*

In addition to the net assets acquired that are assigned to CGU 2, the acquiring entity expects CGU 2 to benefit from certain synergies related to the acquisition (e.g. CGU 2 is expected to realise higher sales of its products because of access to the acquired entity's distribution channels). There is no synergistic goodwill attributable to other CGUs.

Entity A allocated the purchase consideration of the acquired business to CGU 1 and CGU 2 as ₹ 33 million and ₹ 17 million respectively.

Determine the allocation of goodwill to each CGU?

Solution:

If goodwill is allocated to the CGUs based on the difference between the purchase consideration and the fair value of net assets acquired ie direct method, the allocation would be as follows: (All figures are ₹ in million, unless otherwise specified)

	CGU 1	CGU 2	Total
Allocation of Purchase consideration	33	17	50
Less: Acquired identifiable tangible and intangible assets	(25)	(10)	(35)
Goodwill assigned to CGUs	8	7	15

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4.9.2.7 Allocating corporate assets to cash-generating units

- ***Corporate assets*** are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units. Corporate assets include group or divisional assets such as the building of a headquarters or a division of the entity, EDP equipment or a research centre. The structure of an entity determines whether an asset meets this Standard's definition of corporate assets for a particular cash-generating unit.
- The distinctive characteristics of corporate assets are that:

  a) they do not generate cash inflows independently of other assets or groups of assets; and

  b) their carrying amount cannot be fully attributed to the cash-generating unit under review.
- Because corporate assets do not generate separate cash inflows, they are tested for impairment in the context of the CGU or group of CGUs to which the asset belongs. In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:

  a) can be allocated on a reasonable and consistent basis to that unit, the entity compares the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount. Any impairment loss is recognised in accordance with the requirement of this standard.

  b) cannot be allocated on a reasonable and consistent basis to that unit, the entity:

     (i) compares the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognise any impairment loss in accordance with the requirement of this standard;

     (ii) identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and

     (iii) compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised in accordance with the requirement of this standard.

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Illustration 8

Earth Infra Ltd has two cash-generating units, A and B. There is no goodwill within the units' carrying values. The carrying values of the CGUs are CGU A for ₹ 20 million and CGU B for ₹ 30 million. The company has an office building which it is using as an office headquarter and has not been included in the above values and can be allocated to the units on the basis of their carrying values. The office building has a carrying value of ₹ 10 million. The recoverable amounts are based on value-in-use of ₹ 18 million for CGU A and ₹ 38 million for CGU B.

Determine whether the carrying values of CGU A and B are impaired.

Solution

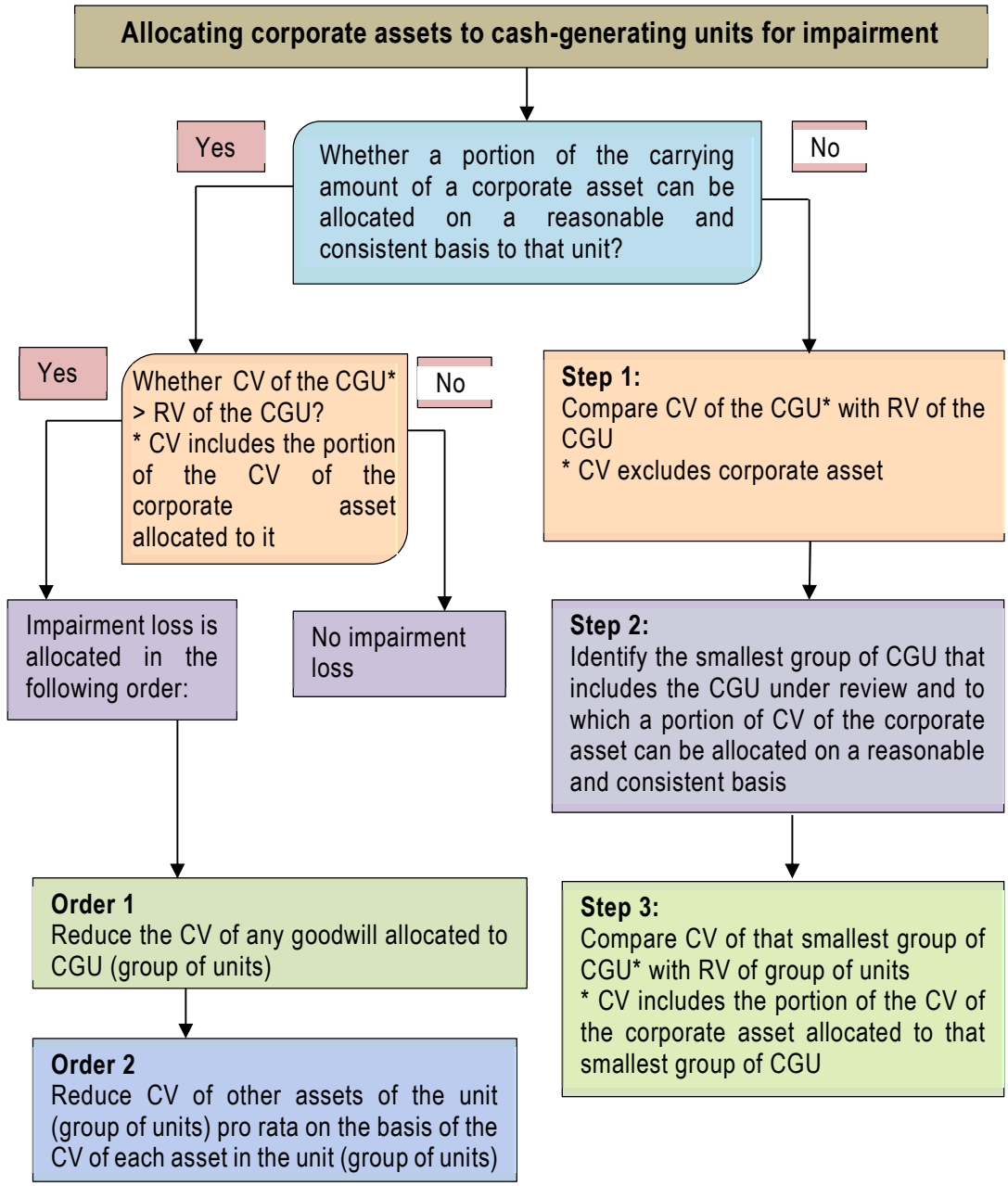
The office building is a corporate asset which needs to be allocated to CGU A and B on a reasonable and consistent basis:

	A	B	Total
Carrying value of CGUs	20	30	50
Allocation of office building	4	6	10
(office building is allocated in the ratio of Carrying value of CGU's)			
Carrying value of CGU after Allocation of corporate asset	24	36	60
Recoverable Amount	18	38	56
Impairment Loss	6	-	

The impairment loss will be allocated on the basis of 4/24 against the building (₹ 1 million) and 20/24 against the other assets (₹ 5 million).

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4.9.2.8 Recognition and measurement of an impairment loss for a cash-generating unit

- An impairment loss is recognised for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss is allocated to reduce the carrying amount of the

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assets of the unit (group of units) in the following order:

a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and

b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

- In allocating an impairment loss to individual assets within a CGU, the carrying amount of an individual shall not be reduce below the highest of:



- The amount of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit (group of units).
- If the recoverable amount of an individual asset cannot be determined:

a) an impairment loss is recognised for the asset if its carrying amount is greater than the higher of its fair value less costs of disposal and the results of the allocation procedures described; and

b) no impairment loss is recognised for the asset if the related cash-generating unit is not impaired. This applies even if the asset's fair value less costs of disposal is less than its carrying amount.

Illustration 9

A machine has suffered physical damage but is still working, although not as well as before it was damaged. The machine's fair value less costs of disposal is less than its carrying amount. The machine does not generate independent cash inflows. The smallest identifiable group of assets that includes the machine and generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: budgets/forecasts approved by management reflect no commitment of management to replace the machine.

Assumption 2: budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

Advise the accounting for the impairment loss of machine in above scenarios.

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Solution

1. The recoverable amount of the machine alone cannot be estimated because the machine's value in use:

   a) may differ from its fair value less costs of disposal; and

   b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

   The production line is not impaired. Therefore, no impairment loss is recognised for the machine. Nevertheless, the entity may need to reassess the depreciation period or the depreciation method for the machine. Perhaps a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are expected to be consumed by the entity.

2. The machine's value in use can be estimated to be close to its fair value less costs of disposal. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (i.e. the production line). Because the machine's fair value less costs of disposal is less than its carrying amount, an impairment loss is recognised for the machine.

After the allocation procedures have been applied, a liability is recognised for any remaining amount of an impairment loss for a cash-generating unit if, and only if, that is required by another Indian Accounting Standard.

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4.9.3 Two-step approach for goodwill allocated to a group of CGUs

When goodwill is allocated to a group of CGUs for the purpose of impairment testing but cannot be allocated on a non-arbitrary basis to individual CGUs, the individual CGUs must be tested for impairment before the group of CGUs containing the associated goodwill.

4.10 REVERSING AN IMPAIRMENT LOSS

4.10.1 Reversals of impairment losses – general

- An entity is required to assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.
- An impairment loss recognised for goodwill shall not be reversed in a subsequent period.
- An impairment loss recognised in prior periods for an asset other than goodwill shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the

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case, the carrying amount of the asset is, except as described in paragraph 117, increased to its recoverable amount.

- A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or from sale, since the date when an entity last recognised an impairment loss for that asset. Examples of changes in estimates include:

  a) a change in the basis for recoverable amount (ie whether recoverable amount is based on fair value less costs of disposal or value in use);

  b) if recoverable amount was based on value in use, a change in the amount or timing of estimated future cash flows or in the discount rate; or

  c) if recoverable amount was based on fair value less costs of disposal, a change in estimate of the components of fair value less costs of disposal.

- An asset's value in use may become greater than the asset's carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. Therefore, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

4.10.2 Indications of reversals of impairment loss

In assessing whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased, an entity shall consider, as a minimum, the following indications:

4.10.2.1 External sources of information

a) there are observable indication that the asset's value has increased significantly during the period;

b) significant changes with a favorable effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated; and

c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

4.10.2.2 Internal sources of information

a) significant changes with a favourable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs; and

b) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

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- If there is an indication that an impairment loss recognised for an asset other than goodwill may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with the Indian Accounting Standard applicable to the asset, even if no impairment loss is reversed for the asset.

4.10.3 Reversing an impairment loss for an individual asset

- The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years. Any increase in excess of this amount would be a revaluation and would be accounted for under the appropriate Standard (e.g. Ind AS 16 Property, Plant and Equipment).
- A reversal of an impairment loss for an asset other than goodwill is recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Indian Accounting Standard. Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with that other Indian Accounting Standard.
- A reversal of an impairment loss on a revalued asset is recognised in other comprehensive income and increases the revaluation surplus for that asset. However, to the extent that an impairment loss on the same revalued asset was previously recognised in profit or loss, a reversal of that impairment loss is also recognised in profit or loss.
- After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset is adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

4.10.4 Reversing an impairment loss for a cash-generating unit

- A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised as discussed above.
- In allocating a reversal of an impairment loss for a cash-generating unit, the carrying amount of an asset shall not be increased above the lower of:
  a) its recoverable amount (if determinable); and
  b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.
- The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset is allocated pro rata to the other assets of the unit, except for goodwill.

4.10.5 Reversing an impairment loss for goodwill not permitted

- An impairment loss recognised for goodwill shall not be reversed in a subsequent period.

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- Ind AS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill. Any increase in the recoverable amount of goodwill in the periods following the recognition of an impairment loss for that goodwill is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill.

Illustration 10: Reversal of Impairment Loss

On 1st April 20X1, Venus Ltd acquired 100% of Saturn Ltd for ₹ 4,00,000. The fair value of the net identifiable assets of Saturn Ltd was ₹ 3,20,000 and goodwill was ₹ 80,000. Saturn Ltd is in coal mining business. On 31st March, 20X3, the government cancelled licenses given to it in few states.

As a result Saturn's Ltd revenue is estimated to get reduce by 30%. The adverse change in market place and regulatory conditions is an indicator of impairment. As a result, Venus Ltd has to estimate the recoverable amount of goodwill and net assets of Saturn Ltd on 31st March, 20X3.

Venus Ltd uses straight line depreciation. The useful life of Saturn's Ltd assets is estimated to be 20 years with no residual value. No independent cash inflows can be identified to any individual assets. So, the entire operation of Saturn Ltd is to be treated as a CGU. Due to the regulatory entangle it is not possible to determine the selling price of Saturn Ltd as a CGU. Its value in use is estimated by the management at ₹ 2,12,000.

Suppose by 31st March, 20X5 the government reinstates the licenses of Saturn Ltd. The management expects a favourable change in net cashflows. This is an indicator that an impairment loss may have reversed. The recoverable amount of Saturn's Ltd net asset is re-estimated. The value in use is expected to be ₹ 3,04,000 and fair value less cost to disposal is expected to be ₹ 2,90,000.

Calculate the impairment loss, if any. Also advise the accounting treatment for reversal of impairment loss and the subsequent depreciation thereon.

Solution

Since the fair value less costs of disposal is not determinable the recoverable amount of the CGU is its value in use. The carrying amount of the assets of the CGU on 31st March, 20X3 is as follows:

Calculation of Impairment loss

			₹
	Goodwill	**Other assets**	**Total**
Historical Cost	80,000	3,20,000	4,00,000
Accumulated Depreciation (3,20,000/20) x 2	-	(32,000)	(32,000)
Carrying Amount	80,000	2,88,000	3,68,000
Impairment Loss	(80,000)	(76,000)	(1,56,000)

Revised Carrying Amount

- Impairment Loss = Carrying Amount – Recoverable Amount (₹ 3,68,000 - ₹ 2,12,000)

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= ₹ 1,56,000 is charged in statement of profit and loss for the period ending 31st March, 20X3 as impairment loss.

- Impairment loss is allocated first to goodwill ₹ 80,000 and remaining loss of ₹ 76,000 (₹ 1,56,000 – ₹ 80,000) is allocated to the other assets.

Reversal of Impairment loss

Reversal of impairment loss is recognised subject to:-

- The impairment loss on goodwill cannot be reversed.
- The increased carrying amount of an asset after reversal of an impairment loss not to exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

Calculation of carrying amount of identifiable assets had no impairment loss is recognised

	₹
Historical Cost	3,20,000
Accumulated Depreciation for 4 years (3,20,000/20) x 4	(64,000)
Carrying amount had no impairment loss is recognised on 31st March, 20X5	2,56,000

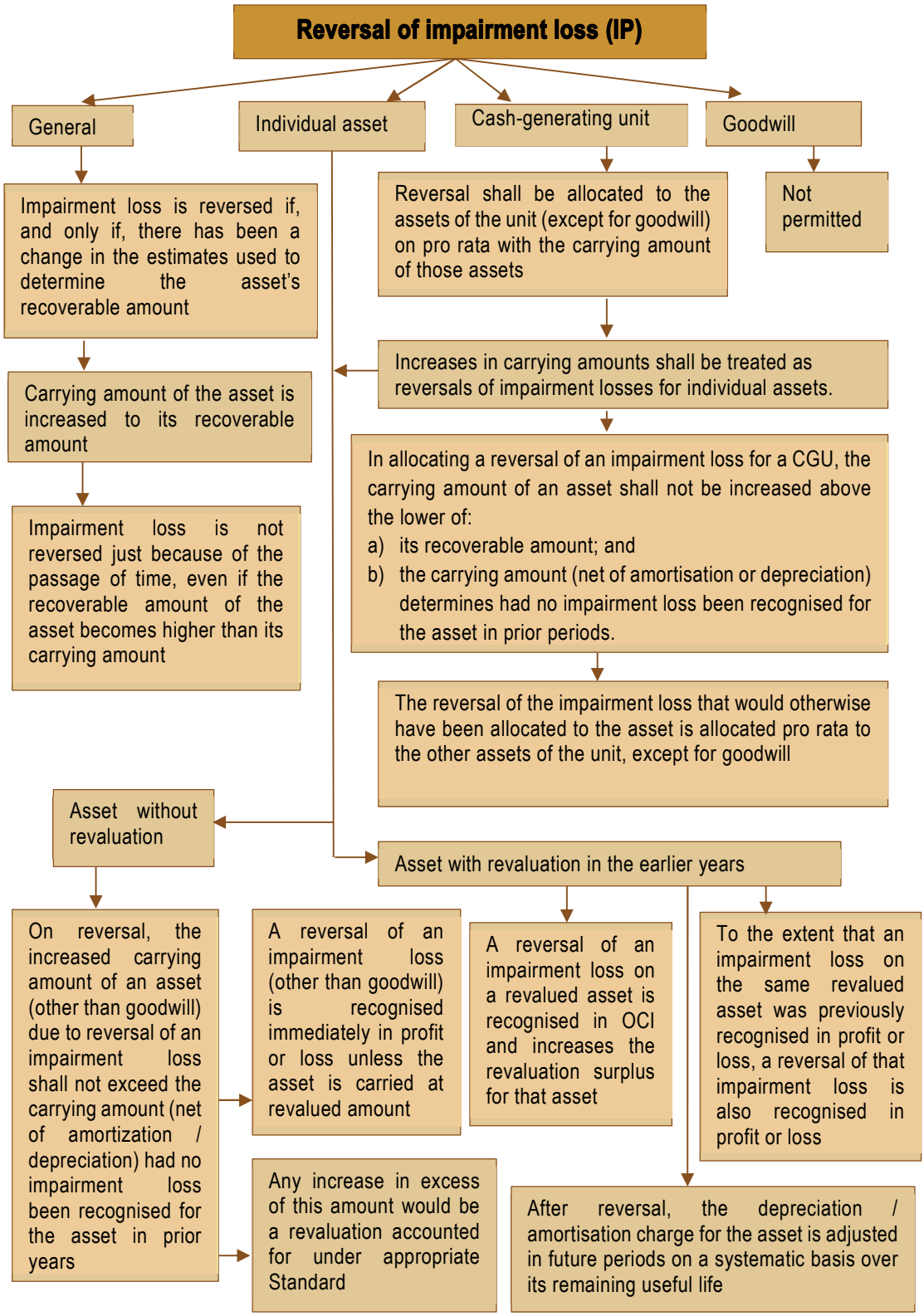
Carrying amount of other assets after recognition of impairment loss

	₹
Carrying amount on 31st March, 20X3	2,12,000
Accumulated Depreciation for 2 years (2,12,000/18) x 2 [rounded off to nearest thousand for ease of calculation]	(24,000)
Carrying amount on 31st March, 20X5	1,88,000

- The impairment loss recognised previously can be reversed only to the extent of lower of re-estimated recoverable amount is ₹ 2,56,000 (higher of fair value less costs of disposal ₹ 2,90,000 and value in use ₹ 3,04,000)
- Impairment loss reversal will be ₹ 68,000 i.e. (₹ 2,56,000 – ₹ 1,88,000). This amount is recognised as income in the statement of profit and loss for the year ended 31st March, 20X5.
- The carrying amount of other assets at 31st March, 20X5 after reversal of impairment loss will be ₹ 2,56,000.
- From 1st April, 20X5 the depreciation charge will be ₹ 16,000 i.e. (₹ 2,56,000/16)

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4.10.6 Non-controlling interests – the impact on goodwill impairment testing

The amount of goodwill recorded by an entity when it acquires a controlling stake in a subsidiary that is less than 100% of its equity depends on which of the two following methods have been used to calculate it. Under Ind AS 103 'Business Combinations' an entity has a choice between two methods:

i. Goodwill attributable to the non-controlling interests (NCI) is **not recognised** in the parent's consolidated financial statements **as the non-controlling interest is stated at its proportion of the net fair value of the net identifiable assets** of the acquiree.

ii. The NCI is measured at its acquisition-date fair value, which means that its share of **goodwill will also be recognised**.

Under method (i) above the carrying amount of that CGU comprises:

a) both the parent's interest and the non-controlling interest in the identifiable net assets of the CGU; and

b) the parent's interest in goodwill.

But part of the recoverable amount of the CGU determined in accordance with Ind AS 36 is attributable to the non-controlling interest in goodwill.

Ind AS 103 allows both measurement methods. The choice of method is to be made for each business combination, rather than being a policy choice, and could have a significant effect on the amount recognized for goodwill.

The Standard states that not all of the goodwill arising will necessarily be allocated to a CGU or group of CGUs which includes the subsidiary with NCI.

If an entity measures NCI as its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, goodwill attributable to NCI is included in the recoverable amount of the related cash-generating unit but is not recognised in the parent's consolidated financial statements. As a consequence, an entity shall gross up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to NCI. This adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash generating unit is impaired.

Below is the guidance given on the allocation of impairment losses:

a) If a subsidiary, or part of a subsidiary, with NCI is itself a CGU, the impairment loss is allocated between the parent and NCI on the same basis as that on which profit or loss is allocated.

b) If it is part of a larger CGU, goodwill impairment losses are allocated to the parts of the CGU that have a NCI and the parts that do not on the following basis:

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(i) to the extent that the impairment relates to goodwill in the CGU, the relative carrying values of the goodwill of the parts before the impairment; and

(ii) to the extent that the impairment relates to identifiable assets in the CGU, the relative carrying values of these assets before the impairment. Any such impairment is allocated to the assets of the parts of each unit pro-rata on the basis of the carrying amount of each asset in the part.

In those parts that have NCI, the impairment loss is allocated between the parent and NCI on the same basis as that on which profit or loss is allocated.

If an impairment loss attributable to NCI relates to goodwill that is not recognised in the parent's consolidated financial statements, that impairment is not recognised as a goodwill impairment loss. In such cases, only the impairment loss relating to the goodwill that is allocated to the parent is recognised as a goodwill impairment loss.

Illustration 11 - NCI measurement and Goodwill impairment

A Ltd acquires 80% shares of a subsidiary B Ltd. for ₹ 3,200 thousand. At the date of acquisition, B Ltd.'s identifiable net assets is ₹ 3,000 thousand. A elects to measure NCI at proportionate share of net identifiable assets. It recognises

	₹ in thousand
Purchase Consideration	*3,200*
NCI (3,000 x 20%)	*600*
	3,800
Less: Net Assets	*(3,000)*
Goodwill	*800*

At the end of next financial year, B Ltd.'s carrying amount is reduced to ₹ 2,700 thousand (excluding goodwill).

Recoverable amount of B Ltd.'s assets is

Case (i) ₹ 2,000 thousand,

Case (ii) ₹ 2,800 thousand

Calculate impairment loss allocable to Parent and NCI in both the cases.

Solution

Case (i) ₹ in thousand

Particulars	**Goodwill**	**Other Asset**	**Total**
Carrying amount	800	2,700	**3,500**
Unrecognised NCI (notional) [(800 / 80%) x 20%]	200	-	**200**
Notional Total	**1,000**	**2,700**	**3,700**

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Recoverable amount	-	-	2,000
Total Impairment loss	-	-	**(1,700)**
Impairment loss recognised in CFS	(800)	(700)	**(1,500)**
Carrying amount after impairment	-	2,000	**2,000**

Impairment loss on:	**Parent**	**NCI**
Goodwill	(800)	-
Other assets	(560)	(140)
Total	**(1,360)**	**(140)**

Case (ii)

Particulars	**Goodwill**	**Other Asset**	**Total**
Carrying amount	800	2,700	**3,500**
Unrecognised NCI (notional) (800 / 80% x 20%)	200	-	**200**
Notional Total	**1,000**	**2,700**	**3,700**
Recoverable amount	-	-	**2,800**
Total Impairment loss	-	-	**(900)**
Impairment loss recognised in CFS (900 x 80%)	(720)	-	**(720)**
Carrying amount after impairment (800 – 720)	80	2,700	**2,780**

Impairment loss on:	**Parent**	**NCI**
Goodwill	(720)	-
Other assets	-	-
Total	**(720)**	**-**

It is to be noted that since an entity measures NCI at its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, goodwill attributable to NCI is not recognised in the parent's consolidated financial statements and so the impairment loss on such goodwill not recognised.

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4.11 DISCLOSURE

4.11.1 Disclosure – general

- An entity is required to disclose the following for each class of assets:
  a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;
  b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;
  c) the amount of impairment losses on revalued assets recognised in other comprehensive income during the period; and
  d) the amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.
- The information required as above may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of property, plant and equipment, at the beginning and end of the period, as required by Ind AS 16.

4.11.2 Entities reporting segment information

- An entity that reports segment information in accordance with Ind AS 108 shall disclose the following for each reportable segment:
  a) the amount of impairment losses recognised in profit or loss and in other comprehensive income during the period; and
  b) the amount of reversals of impairment losses recognised in profit or loss and in other comprehensive income during the period.

4.11.3 Impairment losses recognised or reversed in the period

- An entity is required to disclose the following for each material impairment loss recognised or reversed during the period for an individual asset, including goodwill, or a cash-generating unit:
  a) the events and circumstances that led to the recognition or reversal of the impairment loss;
  b) the amount of the impairment loss recognised or reversed;
  c) for an individual asset:

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(i) the nature of the asset; and

(ii) if the entity reports segment information in accordance with Ind AS 108, the reportable segment to which the asset belongs;

d) for a cash-generating unit:

(i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment as defined in Ind AS 108);

(ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance Ind AS 108, by reportable segment; and

(iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;

e) the recoverable amount of the asset or CGU, and whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs of disposal or its value in use;

f) if recoverable amount is fair value less costs of disposal, the entity shall disclose the following information:

(i) the level of the fair value hierarchy (refer Ind AS 113) within which the fair value measurement of the asset (cash-generating unit) is categorised in its entirety (without taking into account whether the 'costs of disposal' are observable);

(ii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) used to measure fair value less costs of disposal. If there has been a change in valuation technique, the entity shall disclose that change and the reason(s) for making it; and

(iii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the asset's (cash-generating unit's) recoverable amount is most sensitive. The entity shall also disclose the discount rate(s) used in the current measurement and previous measurement if fair value less costs of disposal is measured using a present value technique.

g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

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4.11.4 Other impairment losses/reversals material in aggregate to the financial statements

An entity shall disclose the following information for the aggregate impairment losses and the aggregate reversals of impairment losses recognised during the period for which no information is disclosed in above paragraph:

a) the main classes of assets affected by impairment losses and the main classes of assets affected by reversals of impairment losses; and

b) the main events and circumstances that led to the recognition of these impairment losses and reversals of impairment losses.

4.11.5 Unallocated goodwill

If any portion of the goodwill acquired in a business combination during the period has not been allocated to a cash-generating unit (group of units) at the end of the reporting period, the amount of the unallocated goodwill shall be disclosed together with the reasons why that amount remains unallocated.

4.11.6 Information to be disclosed for CGUs to which significant goodwill or indefinite – life intangible assets have been allocated

An entity is required to disclose the following information for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:

a) the carrying amount of goodwill allocated to the unit (group of units);

b) the carrying amount of intangible assets with indefinite useful lives allocated to the unit (group of units);

c) the basis on which the unit's (group of units') recoverable amount has been determined (ie value in use or fair value less costs of disposal);

d) if the unit's (group of units') recoverable amount is based on value in use:

   (i) each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.

   (ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

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(iii) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.

(iv) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.

(v) the discount rate(s) applied to the cash flow projections.

e) if the unit's (group of units') recoverable amount is based on fair value less costs of disposal, the valuation technique(s) used to measure fair value less costs of disposal. An entity is not required to provide the disclosures required by Ind AS 113. If fair value less costs of disposal is not measured using a quoted price for an identical unit (group of units), an entity shall disclose the following information:

(i) each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive;

(ii) a description of management's approach to determining the value (or values) assigned to each key assumption, whether those values reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information;

(iii) the level of the fair value hierarchy (see Ind AS 113 within which the fair value measurement is categorised in its entirety (without giving regard to the observability of 'costs of disposal'); and

(iv) if there has been a change in valuation technique, the change and the reason(s) for making it. If fair value less costs of disposal is measured using discounted cash flow projections, an entity shall disclose the following information:

(v) the period over which management has projected cash flows;

(vi) the growth rate used to extrapolate cash flow projections; and

(vii) the discount rate(s) applied to the cash flow projections.

f) if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:

(i) the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount;

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(ii) the value assigned to the key assumption; and

(iii) the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.

4.11.7 Information to be disclosed for CGUs to which insignificant goodwill or indefinite-life intangible assets have been allocated

- If some or all of the carrying amount of goodwill or intangible assets with indefinite useful lives is allocated across multiple cash-generating units (groups of units), and the amount so allocated to each unit (group of units) is not significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, that fact shall be disclosed, together with the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to those units (groups of units).
- In addition, if the recoverable amounts of any of those units (groups of units) are based on the same key assumption(s) and the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to them is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, an entity shall disclose that fact, together with:

  a) the aggregate carrying amount of goodwill allocated to those units (groups of units);

  b) the aggregate carrying amount of intangible assets with indefinite useful lives allocated to those units (groups of units);

  c) a description of the key assumption(s);

  d) a description of management's approach to determining the value(s) assigned to the key assumption(s), whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information; and

  e) if a reasonably possible change in the key assumption(s) would cause the aggregate of the units' (groups of units') carrying amounts to exceed the aggregate of their recoverable amounts:

    (i) the amount by which the aggregate of the units' (groups of units') recoverable amounts exceeds the aggregate of their carrying amounts;

    (ii) the value(s) assigned to the key assumption(s); and

    (iii) the amount by which the value(s) assigned to the key assumption(s) must change, after incorporating any consequential effects of the change on the other variables used to measure recoverable amount, in order for the aggregate of the units' (groups of units') recoverable amounts to be equal to the aggregate of their carrying amounts.

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- The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit (group of units) may, in accordance with paragraph 24 or 99, be carried forward and used in the impairment test for that unit (group of units) in the current period provided specified criteria are met. When this is the case, the information for that unit (group of units) that is incorporated into the disclosures required by paragraphs 134 and 135 relate to the carried forward calculation of recoverable amount.

Illustration 12

From the following details of an asset, compute:

(a) Impairment loss and its treatment.

(b) Current year depreciation for the year end.

Particulars of assets:

Cost of asset	*₹ 56 lakh*
Useful life	*10 years*
Salvage value	*Nil*
Carrying value at the beginning of the year	*₹ 27.30 lakh*
Remaining useful life	*3 years*
Recoverable amount at the beginning of the year	*₹ 12 lakh*
Upward revaluation done in last year (at the year end)	*₹ 14 lakh*

Solution

Impairment loss

Impairment loss = Carrying amount of the asset – Recoverable amount

= ₹ 27.30 lakh – ₹ 12 lakh = ₹ 15.30 lakh

Treatment of impairment loss

As per Ind AS 36, impairment loss (whether of an individual asset of a CGU) is recognised in the following manner:

(a) *Impairment loss of a revalued asset*: It is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. The balance, if any, is recognised as an expense in the statement of profit and loss.

(b) *Impairment loss of other assets*: Impairment loss of any other asset should be recognised as an expense in the statement of profit and loss.

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Since, the asset in question has been revalued upwards, the impairment loss will be adjusted first against the revaluation surplus of ₹ 14 lakh. The balance amount of ₹ 1.30 lakh will be recognised as an expense in the profit and loss account.

Current year depreciation

Revised carrying amount (after recognising impairment loss)	₹ 12 lakh
Remaining useful life	3 years
Salvage value	Nil
Annual depreciation (12/3)	₹ 4 lakh

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Illustration 13

Venus Ltd. has an asset, which is carried in the Balance Sheet on 31st March, 20X1 at ₹ 500 lakh. As at that date the value in use is ₹ 400 lakh and the fair value less costs to sells is ₹ 375 lakh.

From the above data:

(a) Calculate impairment loss.

(b) Prepare journal entries for adjustment of impairment loss.

Solution

According to Ind AS 36, *Impairment of Assets*, impairment loss is the excess of 'Carrying amount of the asset' over 'Recoverable Amount'.

In the present case, the impairment loss can be computed in the following manner: Step 1: Fair value *less* costs to sell: ₹ 375 lakh

Step 2: Value in use: ₹ 400 lakh

Step 3: Recoverable amount, i.e., higher of 'fair value *less* costs to sell' & 'value in use'.

Thus, recoverable amount is ₹ 400 lakh

Step 4: Carrying amount of the asset ₹ 500 lakh

Step 5: Impairment loss, i.e., excess of amount computed in step 4 over amount computed in Step 3.

₹ 100 lakh (being the difference between ₹ 500 lakh and ₹ 400 lakh).

According to Ind AS 36, an impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard. Assuming, that the asset is not carried at revalued amount, the impairment loss of ₹ 100 lakh will be charged to Profit & Loss Account.

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Journal Entries

Date	Particulars		Dr.	Cr.
				₹ in lakh
31.3.20X1	Impairment Loss A/c	Dr.	100	
	To Assets A/c			100
	(Being impairment loss on an asset recognised)			
31.3.20X1	Statement of Profit & Loss	Dr.	100	
	To Impairment Loss A/c			100
	(Being impairment loss transferred to statement of profit and loss)			

*****

Illustration 14

A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

Identify the cash-generating unit for an individual magazine title.

Solution

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis. Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent of each other, and that each magazine title is a separate cash-generating unit.

*****

Illustration 15

A mining entity owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine.

Recommend whether the entity should determine the recoverable amount for the private railway or for the mining business as a whole.

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Solution

It is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, i.e., the mine as a whole.

*****

Illustration 16

A bus company provides services under contract with a municipality that requires minimum service on each of seven separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Examine whether the company should determine the recoverable amount for an individual asset or for a cash generating unit.

Solution

Because the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the seven routes together. The cash- generating unit for each route is the bus company as a whole.

*****

Illustration 17

A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same entity. X's products are sold to Y at a transfer price that passes all margins to X. 80% of Y's final production is sold to customers outside of the entity.

60% of X's final production is sold to Y and the remaining 40% is sold to customers outside of the entity. For each of the following cases, evaluate the cash-generating units for X and Y?

(a) If X could sell the products it sells to Y in an active market and internal transfer prices are higher than market prices, what are the cash-generating units for X and Y?

(b) If there is no active market for the products X sells to Y, what are the cash-generating units for X and Y?

Solution

(a) Cash-generating unit for X: X could sell its products in an active market and, so, generate cash inflows that would be largely independent of the cash inflows from Y. Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y.

Cash-generating unit for Y: It is likely that Y is also a separate cash-generating unit. Y sells 80% of its products to customers outside of the entity. Therefore, its cash inflows can be regarded as largely independent.

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Effect of internal transfer pricing: Internal transfer prices do not reflect market prices for X's output. Therefore, in determining value in use of both X and Y, the entity adjusts financial budgets/forecasts to reflect management's best estimate of future prices that could be achieved in arm's length transactions for those of X's products that are used internally.

(b) **Cash-generating units for X and Y:** It is likely that the recoverable amount of each plant cannot be assessed independently of the recoverable amount of the other plant because:

(i) the majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y.

(ii) the two plants are managed together.

As a consequence, it is likely that X and Y together are the smallest group of assets that generates cash inflows that are largely independent.

*****

Illustration 18

XYZ Limited produces a single product and owns plants 1, 2 and 3. Each plant is located in a different country. Plant 1 produces a component that is assembled in either Plant 2 or Plant 3. The combined capacity of Plant 2 and Plant 3 is not fully utilised. XYZ Limited's products are sold worldwide from either Plant 2 or Plant 3, e.g., Plant 2's production can be sold in Plant 3's country if the products can be delivered faster from Plant 2 than from Plant 3. Utilisation levels of Plant 2 and Plant 3 depend on the allocation of sales between the two sites.

If there is no active market for Plant 1's products, evaluate what are the cash-generating units for Plant 1, Plant 2 and Plant 3?

Solution

It is likely that the recoverable amount of each plant cannot be assessed independently because:

(a) There is no active market for Plant 1's products. Therefore, Plant 1's cash inflows depend on sales of the final product by Plant 2 and Plant 3.

(b) Although there is an active market for the products assembled by Plant 2 and Plant 3, cash inflows for Plant 2 and Plant 3 depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for Plant 2 and Plant 3 can be determined individually.

As a consequence, it is likely that Plant 1, Plant 2 and Plant 3 together (i.e., XYZ Limited as a whole) are the smallest identifiable group of assets that generates cash inflows that are largely independent.

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Illustration 19

Goodwill had previously been allocated to cash-generating unit A. The goodwill allocated to A cannot be identified or associated with an asset group at a level lower than A, except arbitrarily. A is to be divided and integrated into three other cash-generating units, B, C and D.

Recommend how the goodwill should be reallocated to B, C and D.

Solution

Since goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to units B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D.

*****

Illustration 20

XYZ Limited has a cash-generating unit 'Plant A' as on 1st April, 20X1 having a carrying amount of ₹ 1,000 crore. Plant A was acquired under a business combination and goodwill of ₹ 200 crore was allocated to it. It is depreciated on straight line basis. Plant A has a useful life of 10 years with no residual value. On 31st March, 20X2, Plant A has a recoverable amount of ₹ 600 crore.

Calculate the impairment loss on Plant A. Also, determine its allocation as per Ind AS 36.

Solution

Particulars	Goodwill (₹ in crore)	Identifiable assets (₹ in crore)	Total (₹ in crore)
Historical cost	200	1,000	1,200
Depreciation (20X1-20X2)	-	(100)	(100)
Carrying amount	200	900	1,100

Since, the recoverable amount is ₹ 600 crore, there is an impairment loss of ₹ 500 crore. The impairment loss of ₹ 500 crore should be allocated to goodwill first, and then to the other identifiable assets, i.e., ₹ 200 crore to goodwill and ₹ 300 crore to identifiable assets of Plant A.

			(₹ in crore)
Particulars	**Goodwill**	**Identifiable assets**	**Total**
Impairment loss	(200)	(300)	(500)
Carrying amount after impairment loss	-	600	600

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Illustration 21

Sun Ltd is an entity with various subsidiaries. The entity closes its books of account at every year ended on 31st March. On 1st July, 20X1, Sun Ltd acquired an 80% interest in Pluto Ltd. Details of the acquisition were as follows:

- *Sun Ltd acquired 800,000 shares in Pluto Ltd by issuing two equity shares for every five acquired. The fair value of Sun Ltd's share on 1st July, 20X1 was ₹ 4 per share and the fair value of a Pluto's share was ₹ 1.40 per share. The costs of issue were 5% per share.*
- *Sun Ltd incurred further legal and professional costs of ₹ 100,000 that directly related to the acquisition.*
- *The fair values of the identifiable net assets of Pluto Ltd at 1st July, 20X1 were measured at ₹ 1.3 million. Sun Ltd initially measured the non-controlling interest in Pluto Ltd at fair value. They used the market value of a Pluto Ltd share for this purpose. No impairment of goodwill arising on the acquisition of Pluto Ltd was required at 31st March, 20X2 or 20X3.*

Pluto Ltd comprises three cash generating units A, B and C. When Pluto Ltd was acquired the directors of Sun Ltd estimated that the goodwill arising on acquisition could reasonably be allocated to units A:B:C on a 2:2:1 basis. The carrying values of the assets in these cash generating units and their recoverable amounts are as follows:

Unit	Carrying value (before goodwill allocation)	Recoverable amount
	₹ '000	₹ '000
A	600	740
B	550	650
C	450	400

Required:

(i) *Compute the carrying value of the goodwill arising on acquisition of Pluto Ltd in the consolidated Balance Sheet of Sun Ltd at 31st March, 20X4 following the impairment review.*

(ii) *Compute the total impairment loss arising as a result of the impairment review, identifying how much of this loss would be allocated to the non-controlling interests in Pluto Ltd.*

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Solution

1. Computation of goodwill on acquisition

Particular	Amount (₹ '000)
Cost of investment (8,00,000 x 2/5 x ₹ 4)	1,280
Fair value of non-controlling interest (2,00,000 x ₹ 1·4)	280
Fair value of identifiable net assets at date of acquisition	(1,300)
So goodwill equals	260

Acquisition costs are not included as part of the fair value of the consideration given under Ind AS 103, Business Combination.

2. Calculation of impairment loss

Unit	Carrying value			Recoverable Amount	Impairment Loss
	Before Allocation	Allocation of goodwill (2:2:1)	After Allocation		
A	600	104	704	740	Nil
B	550	104	654	650	4
C	400*	52	452	400	52

* After writing down assets in the individual CGU to recoverable amount.

3. Calculation of closing goodwill

Goodwill arising on acquisition (W1)	260
Impairment loss (W2)	(56)
So closing goodwill equals	204

4. Calculation of overall impairment loss

on goodwill (W3)	56
on assets in unit C (450 – 400)	50
So total loss equals	106

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₹ 21.2 (20%) of the above is allocated to the NCI with the balance allocated to the shareholders of Sun Ltd.

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4.12 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Hindustan Unilever Limited' for the financial year 2021-2022 with respect to impairment and the accounting policy thereon.

Impairment

Assessment for impairment is done at each Balance Sheet date as to whether there is any indication that a non-financial asset may be impaired. Indefinite life intangible assets are subject to a review for impairment annually or more frequently if events or circumstances indicate that it is necessary. For the purpose of assessing impairment, the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets is considered as a cash generating unit. Goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Groups's cash-generating units that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

If any indication of impairment exists, an estimate of the recoverable amount of the individual asset/cash generating unit is made. Asset/cash generating unit whose carrying value exceeds their recoverable amount are written down to the recoverable amount by recognising the impairment loss as an expense in the Consolidated Statement of Profit and Loss.

The impairment loss is allocated first to reduce the carrying amount of goodwill (if any) allocated to the cash generating unit and then to the other assets of the unit, pro rata based on the carrying amount of each asset in the unit. Recoverable amount is higher of an asset's or cash generating unit's value in use and its fair value less cost of disposal. Value in use is estimated future cash flows expected to arise from the continuing use of an asset or cash generating unit and from its disposal at the end of its useful life discounted to their present value using a post-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In determining fair value less costs of disposal, recent market transactions are considered. If no such transactions can be identified, an appropriate valuation model is used.

Assessment is also done at each Balance Sheet date as to whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. Basis the assessment a reversal of an impairment loss for an asset other than goodwill is recognised in the consolidated statement of profit and loss.

No impairment was identified in FY 2021-22 (FY 2020-21: Nil).

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Significant Cash Generating Units (CGUs)

The Group has identified its reportable segments, i.e. Home Care, Beauty & Personal Care, Foods & Refreshment and Others as the CGUs. The goodwill and indefinite-life intangible assets acquired through business combinations have been allocated to CGU 'Beauty & Personal Care' and "Foods & Refreshment". The carrying amount of goodwill and indefinite-life intangible assets is as under:

	As at 31st March, 2022		As at 31st March, 2021	
	Beauty & Personal Care	Foods and Refreshment	Beauty & Personal Care	Foods & Refreshment
Goodwill	15	17,301	15	17,301
Indefinite life intangible assets	572	27,210	572	27,210
Total	**587**	**44,511**	**587**	**44,511**

The recoverable amount of each CGU has been calculated based on its value in use, estimated as the present value of projected future cash flows.

Following key assumptions were considered while performing Impairment testing:

	As at 31st March, 2022		As at 31st March, 2021	
	Beauty & Personal Care	Foods & Refreshment	Beauty & Personal Care	Foods & Refreshment
Average Annual Growth rate for 5 years	8.0%	9.5%	8.0%	11.0%
Terminal Growth Rate	5.0%	5.0%	3.5%	3.5%
Weighted Average Cost of Capital % (WACC) post tax (Discount rate)	9.1%	9.1%	8.9%	8.9%
Segmental margins	27.5%	18.6%	28.5%	16.6%

The projections cover a period of five years, as the Group believes this to be the most appropriate timescale over which to review and consider annual performances before applying a fixed terminal value multiple to the final year cash flows. The growth rates and segmental margins used to estimate cash flows for the first five years are based on past performance, and on the Group's five-year strategic plan.

Weighted Average Cost of Capital % (WACC) for the Group = Risk free return + (Market risk premium x Beta for the Holding Company).

The Group has performed sensitivity analysis around the base assumptions and has concluded that there are no reasonably possible changes to key assumptions that would cause the carrying amount of a CGU to exceed its recoverable amount.

(Source: Annual Report 2021-2022 - 'Hindustan Unilever Limited)

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4.13 SIGNIFICANT DIFFERENCES IN IND AS 36 *VIS-À-VIS* AS 28

S. No.	Particular	Ind AS 36	AS 28
1.	*Financial Assets*	Ind AS 36 applies to financial assets classified as: (a) subsidiaries, as defined in Ind AS 110,	AS 28 does not apply to such assets

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		(b) associates as defined in Ind AS 28, (c) joint ventures as defined in Ind AS 111.	
2.	*Assets*	Ind AS 36 specifically excludes biological assets related to agricultural activity, assets arising from employee benefits and deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts, non-current assets (or disposal groups) held for sale and discontinued operations.	AS 28 does not specifically exclude such assets
3.	*Impairment Testing for an Intangible Asset with an Indefinite Useful Life*	Ind AS 36 requires annual impairment testing for an intangible asset with an indefinite useful life or not yet available for use and goodwill acquired in a business combination.	AS 28 does not require the annual impairment testing for goodwill unless there is an indication of impairment.
4.	*Additional Guidance*	Ind AS 36 gives additional guidance on, *inter alia*, the following aspects: (a) estimating the value in use of an asset; (b) for managements to assess the reasonableness of the assumptions on which cash flows are based; and (c) using present value techniques in measuring an asset's value in use.	AS 28 does not provide such guidance
5.	*Reversal of Goodwill*	Ind AS 36 prohibits the recognition of reversals of impairment loss for goodwill.	AS 28 requires that the impairment loss recognised for goodwill should be reversed in a subsequent period when it was caused by a specific external event of an exceptional nature that is not expected to recur and subsequent external events

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			that have occurred that reverse the effect of that event
6.	*Bottom up and Top-Down Test*	In Ind AS 36, goodwill is allocated to cash-generating units (CGUs) or groups of CGUs that are expected to benefit from the synergies of the business combination from which it arose. There is no bottom-up or top-down approach for allocation of goodwill	AS 28, goodwill is allocated to CGUs only when the allocation can be done on a reasonable and consistent basis. If that requirement is not met for a specific CGU under review, the smallest CGU to which the carrying amount of goodwill can be allocated on a reasonable and consistent basis must be identified and the impairment test carried out at this level. Thus, when all or a portion of goodwill cannot be allocated reasonably and consistently to the CGU being tested for impairment, two levels of impairment tests are carried out, viz., bottom-up test and top-down test.
7.	*Usage for arriving at value in use*	Ind AS 36 uses the word 'fair value' for arriving at value in use.	AS 28 uses 'net selling value' for arriving at value in use.
8.	*Disclosure*	Ind AS 36 requires certain additional disclosures as compared to AS 28.	Disclosures given in AS 28 are less than what is required in Ind AS 36.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Apex Ltd. is engaged in manufacturing of steel utensils. It owns a building for its headquarters. The building used to be fully occupied for internal use. However, recently the company has undertaken a massive downsizing exercise as a result of which 1/3rd of the building became vacant. This vacant portion has now been given for on lease for 6 years.

   Determine the CGU of the building.

2. ABC Ltd. has three cash-generating units: A, B and C, the carrying amounts of which as on 31st March, 20X1 are as follows: **(₹ in crore)**

Cash-generating units	Carrying amount	Remaining useful life
A	500	10
B	750	20
C	1,100	20

ABC Ltd. also has two corporate assets having a remaining useful life of 20 years.

(₹ in crore)

Corporate asset	Carrying amount	Remarks
X	600	The carrying amount of X can be allocated on a reasonable basis (i.e., pro rata basis) to the individual cash-generating units.
Y	200	The carrying amount of Y cannot be allocated on a reasonable

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		basis to the individual cash-generating units.

Recoverable amount as on 31st March, 20X1 is as follows:

Cash-generating units	Recoverable amount (₹ in crore)
A	600
B	900
C	1,400
ABC Ltd.	3,200

Calculate the impairment loss, if any. Ignore decimals.

3. Parent acquires an 80% ownership interest in Subsidiary for ₹ 2,100 on 1st April, 20X1. At that date, Subsidiary's net identifiable assets have a fair value of ₹ 1,500. Parent chooses to measure the non-controlling interests as the proportionate interest of Subsidiary's net identifiable assets. The assets of Subsidiary together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Since other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of ₹ 500 related to those synergies has been allocated to other cash-generating units within Parent. On 31st March, 20X2, Parent determines that the recoverable amount of cash-generating unit Subsidiary is ₹ 1,000. The carrying amount of the net assets of Subsidiary, excluding goodwill, is ₹ 1,350.

   Allocate the impairment loss on 31st March, 20X2.

4. A Ltd. purchased a machinery of ₹ 100 crore on 1st April, 20X1. The machinery has a useful life of 5 years. It has nil residual value. A Ltd. adopts straight line method of depreciation for depreciating the machinery. Following information has been provided as on 31st March, 20X2:

Financial year	Estimated future cash flows (₹ in crore)
20X2-20X3	15
20X3-20X4	30
20X4-20X5	40
20X5-20X6	10

   Discount rate applicable : 10%

   Fair value less costs to sell as on 31st March, 20X2 : ₹ 70 crore

   Calculate the impairment loss, if any.

5. Assuming in the above question, as on 31st March, 20X3, there is no change in the estimated future cash flows and discount rate. Fair value less costs to sell as on 31st March, 20X3 is ₹ 40 crore.

   Advise, how it should deal with under Ind AS 36.

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6. A Ltd. purchased an asset of ₹ 100 lakh on 1st April, 20X0. It has useful life of 4 years with no residual value. Recoverable amount of the asset is as follows:

As on	Recoverable amount
31st March, 20X1	₹ 60 lakh
31st March, 20X2	₹ 40 lakh
31st March, 20X3	₹ 28 lakh

Calculate the amount of impairment loss or its reversal, if any, on 31st March, 20X1, 31st March, 20X2 and 31st March, 20X3.

7. On 31st March, 20X1, XYZ Ltd. makes following estimate of cash flows for one of its asset located in USA:

Year	Cash flows
20X1-20X2	US $ 80
20X2-20X3	US $ 100
20X3-20X4	US $ 20

Following information has been provided:

Particulars	India	USA
Applicable discount rate	15%	10%

Exchange rates are as follows:

As on	Exchange rate
31st March, 20X1	₹ 45/US $
31st March, 20X2	₹ 48/US $
31st March, 20X3	₹ 51/US $
31st March, 20X4	₹ 55/US $

Calculate value in use as on 31st March, 20X1.

8. Cash flow is ₹ 100, ₹ 200 or ₹ 300 with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows.

9. Cash flow of ₹ 1,000 may be received in one year, two years or three years with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows assuming applicable discount rate of 5%, 5.25% and 5.5% in year 1, 2 and 3, respectively.

10. Calculate expected cash flows in each of the following cases:

(a) the estimated amount falls somewhere between ₹ 50 and ₹ 250, but no amount in the range is more likely than any other amount.

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(b) the estimated amount falls somewhere between ₹ 50 and ₹ 250, and the most likely amount is ₹ 100. However, the probabilities attached to each amount are unknown.

(c) the estimated amount will be ₹ 50 (10 per cent probability), ₹ 250 (30 per cent probability), or ₹ 100 (60 per cent probability).

11. Elia limited is a manufacturing company which deals in to manufacturing of cold drinks and beverages. It is having various plants across India. There is Machinery A in the Baroda plant which is used for the purpose of bottling. There is one more machinery which is Machinery B clubbed with Machinery A. Machinery A can individually have an output and also sold independently in the open market. Machinery B cannot be sold in isolation and without clubbing with Machine A it cannot produce output as well. The Company considers this group of assets as a Cash Generating Unit and an Inventory amounting to ₹ 2 lakh and Goodwill amounting to ₹ 1.50 lakhs is included in such CGU.

Machinery A was purchased on 1st April 20X3 for ₹ 10 lakhs and residual value is ₹ 50 thousand. Machinery B was purchased on 1st April, 20X5 for ₹ 5 lakhs with no residual value. The useful life of both Machine A and B is 10 years. The Company expects following cash flows in the next 5 years pertaining to Machinery A. The incremental borrowing rate of the company is 10%.

Year	Cash Flows from Machinery A
1	1,50,000
2	1,00,000
3	1,00,000
4	1,50,000
5	1,00,000 (excluding Residual Value)
Total	**6,00,000**

On 31st March, 20X8, the professional valuers estimated that the current market value of Machinery A is ₹ 7 lakhs. The valuation fee was ₹ 1 lakh. There is a need to dismantle the machinery before delivering it to the buyer. The dismantling cost is ₹ 1.50 lakhs. Specialised packaging costs would be ₹ 25 thousand and legal fees would be ₹ 75 thousand.

The Inventory has been valued in accordance with Ind AS 2. The recoverable value of CGU is ₹ 10 Lakh as on 31st March, 20X8. In the next year, the company has done the assessment of recoverability of the CGU and found that the value of such CGU is ₹ 11 Lakhs ie on 31st March, 20X9. The recoverable value of Machine A is ₹ 4,50,000 and combined Machine A and B is ₹ 7,60,000 as on 31st March, 20X9.

Required:

a) Compute the impairment loss on CGU and carrying value of each asset after charging impairment loss for the year ending 31st March, 20X8 by providing all the relevant working notes to arrive at such calculation.

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b) Compute the prospective depreciation for the year 20X8-20X9 on the above assets.

c) Compute the carrying value of CGU as at 31st March, 20X9.

12. E Ltd. owns a machine used in the manufacture of steering wheels, which are sold directly to major car manufacturers.

- The machine was purchased on 1st April, 20X1 at a cost of ₹ 5,00,000 through a vendor financing arrangement on which interest is being charged at the rate of 10% per annum.
- During the year ended 31st March, 20X3, E Ltd. sold 10,000 steering wheels at a selling price of ₹ 190 per wheel.
- The most recent financial budget approved by E Ltd.'s management, covering the period 1st April, 20X3 – 31st March, 20X8, including that the company expects to sell each steering wheel for ₹ 200 during 20X3-20X4, the price rising in later years in line with a forecast inflation of 3% per annum.
- During the year ended 31st March, 20X4, E Ltd. expects to sell 10,000 steering wheels. The number is forecast to increase by 5% each year until 31st March, 20X8.
- E Ltd. estimates that each steering wheel costs ₹ 160 to manufacture, which includes ₹ 110 variable costs, ₹ 30 share of fixed overheads and ₹ 20 transport costs.
- Costs are expected to rise by 1% during 20X4-20X5, and then by 2% per annum until 31st March, 20X8.
- During 20X5-20X6, the machine will be subject to regular maintenance costing ₹ 50,000.
- In 20X3-20X4, E Ltd. expects to invest in new technology costing ₹ 1,00,000. This technology will reduce the variable costs of manufacturing each steering wheel from ₹ 110 to ₹ 100 and the share of fixed overheads from ₹ 30 to ₹ 15 (subject to the availability of technology, which is still under development).
- E Ltd. is depreciating the machine using the straight line method over the machine's 10 year estimated useful life. The current estimate (based on similar assets that have reached the end of their useful lives) of the disposal proceeds from selling the machine is ₹ 80 000 net of disposal costs. E Ltd. expects to dispose of the machine at the end of March, 20X8.
- E Ltd. has determined a pre-tax discount rate of 8%, which reflects the market's assessment of the time value of money and the risks associated with this asset.

Assume a tax rate of 30%.

Determine the value in use of the machine in accordance with Ind AS 36?

13. PQR Ltd. is the company which has performed well in the past but one of its major assets, an item of equipment, suffered a significant and unexpected deterioration in performance.

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Management expects to use the machine for a further four years after 31st March 20X6, but at a reduced level. The equipment will be scrapped after four years. The financial accountant for PQR Ltd. has produced a set of cash-flow projections for the equipment for the next four years, ranging from optimistic to pessimistic. CFO thought that the projections were too conservative, and he intended to use the highest figures each year. These were as follows:

	₹ '000
Year ended 31st March 20X7	276
Year ended 31st March 20X8	192
Year ended 31st March 20X9	120
Year ended 31st March 20Y0	114

The above cash inflows should be assumed to occur on the last day of each financial year. The pre-tax discount rate is 9%. The machine could have been sold at 31st March 20X6 for ₹ 6,00,000 and related selling expenses in this regard could have been ₹ 96,000. The machine had been revalued previously, and at 31st March 20X6 an amount of ₹ 36,000 was held in revaluation surplus in respect of the asset. The carrying value of the asset at 31st March 20X6 was ₹ 6,60,000. The Indian government has indicated that it may compensate the company for any loss in value of the assets up to its recoverable amount.

Calculate impairment loss, if any and revised depreciation of asset. Also suggest how Impairment loss, if any would be set off and how compensation from government be accounted for?

14. On 1st January Year 1, Entity Q purchased a machine costing ₹ 2,40,000 with an estimated useful life of 20 years and an estimated zero residual value. Depreciation is computed on straight-line basis. The asset had been re-valued on 1st January Year 3 to ₹ 2,50,000, but with no change in useful life at that date. On 1st January Year 4 an impairment review showed the machine's recoverable amount to be ₹ 1,00,000 and its estimated remaining useful life to be 10 years.

Calculate:

a) The carrying amount of the machine on 31st December Year 2 and the revaluation surplus arising on 1 January Year 3.

b) The carrying amount of the machine on 31st December Year 3 (immediately before the impairment).

c) The impairment loss recognised in the year to 31st December Year 4 and its treatment thereon

d) The depreciation charge in the year to 31st December Year 4.

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Note: During the course of utilization of machine, the company did not opt to transfer part of the revaluation surplus to retained earnings.

Answers

1. CGU of the building is Apex Ltd. as a whole as the primary purpose of the building is to serve as a corporate asset.

2. **Allocation of corporate assets**

The carrying amount of X is allocated to the carrying amount of each individual cash-generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

				(₹ in crore)
Particulars	**A**	**B**	**C**	**Total**
Carrying amount	500	750	1,100	2,350
Useful life	10 years	20 years	20 years	—
Weight based on useful life	1	2	2	—
Carrying amount (after assigning weight)	500	1,500	2,200	4,200
Pro-rata allocation of X	12% (500/4,200)	36% (1,500/4,200)	52% (2,200/4,200)	100%
Allocation of carrying amount of X	72	216	312	600
Carrying amount (after allocation of X)	572	966	1,412	2,950

Calculation of impairment loss

Step I: Impairment losses for individual cash-generating units and its allocation

(a) Impairment loss of each cash-generating units

			(₹ in crore)
Particulars	**A**	**B**	**C**
Carrying amount (after allocation of X)	572	966	1,412
Recoverable amount	600	900	1400
Impairment loss	-	66	12

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(b) Allocation of the impairment loss between cash-generating units and corporate asset X, on a pro rata basis, as follows

				(₹ in crore)
Allocation to	**B**		**C**	
X	15	(66 x 216/966)	3	(12 x 312/1,412)
Other assets in cash-generating units	51	(66 x 750/ 966)	9	(12 x 1,100/ 1,412)
Impairment loss	66		12	

Step II: Impairment losses for the larger cash-generating unit, i.e., ABC Ltd. as a whole

						(₹ in crore)
Particulars	**A**	**B**	**C**	**X**	**Y**	**ABC Ltd.**
Carrying amount	500	750	1,100	600	200	3,150
Impairment loss (Step I)	-	(51)	(9)	(18)	-	(78)
Carrying amount (after Step I)	500	699	1,091	582	200	3,072
Recoverable amount						3,200
Impairment loss for the 'larger' cash-generating unit					Nil	

3. Non-controlling interests is measured as the proportionate interest of Subsidiary's net identifiable assets, i.e., ₹ 300 (20% of ₹ 1,500). Goodwill is the difference between the aggregate of the consideration transferred and the amount of the non-controlling interests (₹ 2,100 + ₹ 300) and the net identifiable assets (₹ 1,500), i.e., ₹ 900.

Since, the assets of Subsidiary together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets, therefore, Subsidiary is a cash-generating unit. Since other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of ₹ 500 related to those synergies has been allocated to other cash-generating units within Parent. Because the cash-generating unit comprising Subsidiary includes goodwill within its carrying amount, it should be tested for impairment annually, or more frequently if there is an indication that it may be impaired.

Testing Subsidiary (cash-generating unit) for impairment

Goodwill attributable to non-controlling interests is included in Subsidiary's recoverable amount of ₹ 1,000 but has not been recognised in Parent's consolidated financial statements. Therefore, the carrying amount of Subsidiary should be grossed up to include goodwill

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attributable to the non-controlling interests, before being compared with the recoverable amount of ₹ 1,000. Goodwill attributable to Parent's 80% interest in Subsidiary at the acquisition date is ₹ 400 after allocating ₹ 500 to other cash-generating units within Parent. Therefore, goodwill attributable to the 20% non-controlling interests in Subsidiary at the acquisition date is ₹ 100.

Testing subsidiary for impairment on 31st March, 20X2

On 31st March, 20X2	Goodwill of subsidiary (₹)	Net identifiable assets (₹)	Total (₹)
Carrying amount	400	1,350	1,750
Unrecognised non-controlling interests	100	-	100
Adjusted carrying amount	**500**	**1,350**	**1,850**
Recoverable amount			1,000
Impairment loss			**850**

Allocating the impairment loss

The impairment loss of ₹ 850 should be allocated to the assets in the unit by first reducing the carrying amount of goodwill.

Therefore, ₹ 500 of the ₹ 850 impairment loss for the unit is allocated to the goodwill. If the partially owned subsidiary is itself a cash-generating unit, the goodwill impairment loss should be allocated to the controlling and non-controlling interests on the same basis as that on which profit or loss is allocated. In this case, profit or loss is allocated on the basis of relative ownership interests. Because goodwill is recognised only to the extent of Parent's 80% ownership interest in Subsidiary, Parent recognises only 80% of that goodwill impairment loss (i.e., ₹ 400).

The remaining impairment loss of ₹ 350 is recognised by reducing the carrying amounts of Subsidiary's identifiable assets.

Allocation of the impairment loss for Subsidiary on 31st March, 20X2

On 31st March, 20X2	Goodwill of subsidiary (₹)	Net identifiable assets (₹)	Total (₹)
Carrying amount	400	1,350	1,750
Impairment loss	(400)	(350)	(750)
Carrying amount after impairment loss	**-**	**1,000**	**1,000**

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4. Value in use of the machinery as on 31st March, 20X2 can be calculated as follows:

Financial year	Estimated cash flows (₹ in crore)	Present value factor @ 10%	Present value
20X2-20X3	15	0.9091	13.64
20X3-20X4	30	0.8264	24.79
20X4-20X5	40	0.7513	30.05
20X5-20X6	10	0.6830	6.83
			75.31

The recoverable amount of the machinery is ₹ 75.31 crore (higher of value in use of ₹ 75.31 crore and fair value *less* costs to sell of ₹ 70 crore). The carrying of the machinery is ₹ 80 crore (after providing for one year depreciation @ ₹ 20 crore). Therefore, the impairment loss of ₹ 4.69 crore should be provided in the books. Further, the impaired carrying value of ` 75.31 crore will be depreciated, on a straight-line basis, over the remaining four years.

5. Value in use of the machinery as on March 31,20X3 can be calculated as follows:

Financial year	Estimated cash flows (₹ in crore)	Present value factor @ 10%	Present value
20X3-20X4	30	0.9091	27.27
20X4-20X5	40	0.8264	33.06
20X5-20X6	10	0.7513	7.51
			67.84

The recoverable amount of the machinery is ₹ 67.84 crore (higher of value in use of ₹ 67.84 crore and fair value *less* costs to sell of ₹ 40 crore). Carrying amount of the machinery at the end of the year 20X2 is ₹ 56.48 crore (after providing for two years depreciation (100 – 20 - 4.69) - 18.83).

However, as per paragraph 116 of Ind AS 36, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount. Reason being, the underlying reasons for the original impairment have not been removed, and the service potential of the asset has not increased.

Therefore, the impairment loss of ₹ 4.69 crore should not be reversed.

6. As on 31st March, 20X1

Carrying amount of the asset (opening balance)	₹ 100 lakh
Depreciation (₹ 100 lakh /4 years)	₹ 25 lakh
Carrying amount of the asset (closing balance)	₹ 75 lakh

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Recoverable amount (given)	₹ 60 lakh

Therefore, an impairment loss of ₹ 15 lakh should be recognised as on 31st March, 20X1. Depreciation for subsequent years should be charged on the carrying amount of the asset (after providing for impairment loss), i.e., ₹ 60 lakh.

As on 31st March, 20X2

Carrying amount of the asset (opening balance)	₹ 60 lakh
Depreciation (₹ 60 lakh /3 years)	₹ 20 lakh
Carrying amount of the asset (closing balance)	₹ 40 lakh

Therefore, no impairment loss should be recognised as on 31st March, 20X2.

As on 31st March, 20X3

Carrying amount of the asset (opening balance)	₹ 40 lakh
Depreciation (₹ 40 lakh / 2 years)	₹ 20 lakh
Carrying amount of the asset (closing balance)	₹ 20 lakh
Recoverable amount (given)	₹ 28 lakh

Since, the recoverable amount of the asset exceeds the carrying amount of the asset by ₹ 8 lakh, impairment loss recognised earlier should be reversed. However, reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

Carrying amount as on 31st March, 20X3 had no impairment loss being recognised would have been ₹ 25 lakh. Therefore, the reversal of an impairment loss of ₹ 5 lakh should be done as on 31st March, 20X3.

7.

Year	Cash flows (US $)	Present value factor @ 10%	Discounted cash flows (US $)
20X1-20X2	80	0.9091	72.73
20X2-20X3	100	0.8264	82.64
20X3-20X4	20	0.7513	15.03
Total Discounted cash flows in US $			170.40
Exchange rate as on 31st March, 20X1, i.e., date of calculating value in use			₹45/US $
Value in use as on 31st March, 20X1			₹ 7,668

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8.

Cash flows	Probability	Expected cash flow
100	10%	10
200	60%	120
300	30%	90
Total		220

The expected cash flow is ₹ 220.

9.

Year	Cash flows	P.V.F.	Present value	Probability	Expected cash flows
1	1,000	0.95238	952.38	10%	95.24
2	1,000	0.90273	902.73	60%	541.64
3	1,000	0.85161	851.61	30%	255.48
Total					892.36

The expected present value is ₹ 892.36.

10. (a) the estimated expected cash flow is ₹ 150 [(50 + 250)/2].

(b) the estimated expected cash flow is ₹ 133.33 [(50 + 100 + 250)/3].

(c) the estimated expected cash flow is ₹ 140 [(50 × 0.10) + (250 × 0.30) + (100 × 0.60)].

11. (a) Computation of impairment loss and carrying value of each of the asset in CGU after impairment loss

(i) Calculation of carrying value of Machinery A and B before impairment

Machinery A		
Cost	(A)	₹ 10,00,000
Residual Value		₹ 50,000
Useful life		10 years
Useful life already elapsed		5 years
Yearly depreciation	(B)	₹ 95,000
WDV as at 31st March, 20X8 [A- (B x 5)]		**₹ 5,25,000**
Machinery B		
Cost	(C)	₹ 5,00,000
Residual Value		-
Useful life		10 years
Useful life already elapsed		3 years

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Yearly depreciation	(D)	₹ 50,000
WDV as at 31st March, 20X8 [C- (D x 3)]		**₹ 3,50,000**

(ii) Calculation of Value-in-use of Machinery A

Period	Cash Flows (₹)	PVF	PV
1	1,50,000	0.909	1,36,350
2	1,00,000	0.826	82,600
3	1,00,000	0.751	75,100
4	1,50,000	0.683	1,02,450
5	1,00,000	0.621	62,100
5	50,000	0.621	31,050
Value in use			**4,89,650**

(iii) Calculation of Fair Value less cost of disposal of Machinery A

	₹
Fair Value	7,00,000
Less: Dismantling cost	(1,50,000)
Packaging cost	(25,000)
Legal Fees	(75,000)
Fair value less cost of disposal	**4,50,000**

(iv) Calculation of Impairment loss on Machinery A

	₹
Carrying Value	5,25,000
Less: Recoverable Value ie higher of Value-in-use and Fair value less cost of disposal	4,89,650
Impairment Loss	**35,350**

(v) Calculation of Impairment loss of CGU

1. First goodwill will be impaired fully and then the remaining impairment loss of ₹ 75,000 will be allocated to Machinery A and B.

2. If we allocate remaining impairment loss to Machinery A and B on pro-rata basis, it would come to ₹ 45,000 on Machinery A. However, the impairment loss of Machinery A cannot exceed ₹ 35,350. Hence, impairment to CGU will be as follows:

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	Carrying value before impairment loss	Impairment loss	Carrying value after impairment loss
	₹	₹	₹
Machinery A	5,25,000	35,350	4,89,650
Machinery B	3,50,000	39,650*	3,10,350
Inventory	2,00,000	-	2,00,000
Goodwill	1,50,000	1,50,000	-
Total	**12,25,000**	**2,25,000**	**10,00,000**

* Balancing figure.

(b) Carrying value after adjustment of depreciation

	₹
Machinery A [4,89,650 – {(4,89,650 - 50,000) / 5}]	4,01,720
Machinery B [3,10,350 – (3,10,350 / 7)]	2,66,014
Inventory	2,00,000
Goodwill	-
Total	**8,67,734**

(c) Calculation of carrying value of CGU as on 31st March, 20X9

The revised value of CGU is ₹ 11 Lakh. However, impaired goodwill cannot be reversed. Further, the individual assets cannot be increased above the lower of recoverable value or Carrying Value as if the assets were never impaired.

Accordingly, the carrying value as on 31st March, 20X9 assuming that the impairment loss had never incurred, will be:

	Carrying Value	Recoverable Value	Final CV as at 31st Mar 20X9
Machinery A	4,30,000	4,50,000	4,30,000
Machinery B	3,00,000	(7,60,000 – 4,50,000) 3,10,000	3,00,000
Inventory	2,00,000	2,00,000	2,00,000
Goodwill	-		
Total	**9,30,000**	**9,60,000**	**9,30,000**

Hence, the impairment loss to be reversed will be limited to ₹ 62,266 only (₹ 9,30,000 – ₹ 8,67,734).

Note: It is assumed that value of inventory is same in 20X9 as it was in 20X8.

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12. Calculation of the value in use of the machine owned by E Ltd. includes the projected cash inflow (i.e. sales income) from the continued use of the machine and projected cash outflows that are necessarily incurred to generate those cash inflows (i.e cost of goods sold). Additionally, projected cash inflows include ₹ 80,000 from the disposal of the asset in March, 20X8. Cash outflows include routing capital expenditures of ₹ 50,000 in 20X5-20X6

As per Ind AS 36, estimates of future cash flows shall not include:

- Cash inflows from receivables
- Cash outflows from payables
- Cash inflows or outflows expected to arise from future restructuring to which an entity is not yet committed
- Cash inflows or outflows expected to arise from improving or enhancing the asset's performance
- Cash inflows or outflows from financing activities
- Income tax receipts or payments.

Hence in this case, cash flows do not include financing interest (i.e. 10%), tax (i.e. 30%) and capital expenditures to which E Ltd. has not yet committed (i.e. ₹ 1,00,000). They also do not include any savings in cash outflows from these capital expenditures, as required by Ind AS 36.

The cash flows (inflows and outflows) are presented below in nominal terms. They include an increase of 3% per annum to the forecast price per unit (B), in line with forecast inflation. The cash flows are discounted by applying a discount rate (8%) that is also adjusted for inflation.

Note: Figures are calculated on full scale and then rounded off to the nearest absolute value.

Year ended	20X3-20X4	20X4-20X5	20X5-20X6	20X6-20X7	20X7-20X8	Value in use
Quantity (A)	10,000	10,500	11,025	11,576	12,155	
Price per unit (B)	₹ 200	₹ 206	₹ 212	₹ 219	₹ 225	
Estimated cash inflows (C=A x B)	₹ 20,00,000	₹ 21,63,000	₹ 23,37,300	₹ 25,35,144	₹ 27,34,875	
Misc. cash inflow disposal proceeds (D)					₹ 80 000	
Total estimated cash inflows (E=C+D)	₹ 20,00,000	₹ 21,63,000	₹ 23,37,300	₹ 25,35,144	₹ 28,14,875	
Cost per unit (F)	₹ 160	₹ 162	₹ 165	₹ 168	₹ 171	
Estimated cash outflows	(₹16,00,000)	(₹17,01,000)	(₹18,19,125)	(₹19,44,768)	(₹20,78,505)	

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(G = A x F)						
Misc. cash outflow: maintenance costs (H)			(₹ 50,000)			
Total estimated cash outflows (I=G+H)	(₹16,00,000)	(₹17,01,000)	(₹18,69,125)	(₹19,44,768)	(₹20,78,505)	
Net cash flows (J=E-I)	₹ 4,00,000	₹ 4,62,000	₹ 4,68,175	₹ 5,90,376	₹ 7,36,370	
Discount factor 8%* (K)	0.9259	0.8573	0.7938	0.7350	0.6806	
Discounted future cash flows (L=J x K)	₹ 3,70,360	₹ 3,96,073	₹ 3,71,637	₹ 4,33,926	₹ 5,01,173	₹20,73,169

* Since the future cash flows are estimated on a pre-tax basis, the discount rate is also determined on a pre-tax basis.

13. Carrying amount of asset on 31st March 20X6 = ₹ 6,60,000

Calculation of Value in Use:

Year ended	Cash flow ₹	Discount factor @ 9%	Amount ₹
31st March, 20X7	2,76,000	0.9174	2,53,202
31st March, 20X8	1,92,000	0.8417	1,61,606
31st March, 20X9	1,20,000	0.7722	92,664
31st March, 20Y0	1,14,000	0.7084	80,758
		Total (Value in Use)	**5,88,230**

Calculation of Recoverable amount:

Particulars	Amount (₹)
Value in use	5,88,230
Fair value less costs of disposal (6,00,000 – 96,000)	5,04,000
Recoverable amount (Higher of value in use and fair value less costs of disposal)	5,88,230

Calculation of Impairment loss:

Particulars	Amount (₹)
Carrying amount	6,60,000
Less: Recoverable amount	(5,88,230)
Impairment loss	71,770

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Calculation of Revised carrying amount:

Particulars	Amount (₹)
Carrying amount	6,60,000
Less: Impairment loss	(71,770)
Revised carrying amount	5,88,230

Calculation of Revised Depreciation:

Revised carrying amount – Residual value

Remaining life = (5,88,230 - 0) / 4 = ₹ 1,47,058 per annum

Set off of Impairment loss:

The impairment loss of ₹ 71,770 must first be set off against any revaluation surplus in relation to the same asset. Therefore, the revaluation surplus of ₹ 36,000 is eliminated against impairment loss, and the remainder of the impairment loss ₹ 35,770 (₹ 71,770 – ₹ 36,000) is charged to profit and loss.

Treatment of Government compensation:

Any compensation by the government would be accounted for as such when it becomes receivable. At this time, the government has only stated that it may reimburse the company and therefore credit should not be taken for any potential government receipt.

14. (a) Calculation of Carrying amount of machine at the end of Year 2

	₹
Cost of machine	2,40,000
Accumulated depreciation for 2 years [2 years × (2,40,000 ÷ 20)]	(24,000)
Carrying amount of the machine at the end of Year 2	2,16,000

(b) Calculation of carrying amount of the machine on 31 December Year 3

	₹
Carrying amount at the beginning of Year 3	2,16,000
Revaluation done at the beginning of Year 3	2,50,000
Revaluation surplus	34,000

(c) Calculation of Impairment loss at the end of Year 4

When machine is revalued on 1 January Year 3, depreciation is charged on the revalued amount over its remaining expected useful life.

Valuation at 1 January (re-valued amount)	2,50,000
Accumulated depreciation in Year 3 (2,50,000 / 18)	(13,889)
Carrying amount of the asset at the end of Year 3	2,36,111
On 1 January Year 4, recoverable amount of the machine	1,00,000

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Impairment loss (2,36,111 – 1,00,000)	1,36,111

An impairment loss of ₹ 34,000 will be taken to other comprehensive income (reducing the revaluation surplus for the asset to zero)

The remaining impairment loss of ₹ 1,02,111 (1,36,111 – 34,000) is recognised in the Statement of Profit and Loss for the Year 4.

(d) Calculation of depreciation charge in the Year 4

Carrying value of the machine at the beginning of Year 4	₹ 1,00,000
Estimated remaining useful life	10 years
Depreciation charge is (₹ 1,00,000 / 10 years)	₹ 10,000

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UNIT 5 :
INDIAN ACCOUNTING STANDARD 38 : INTANGIBLE ASSETS

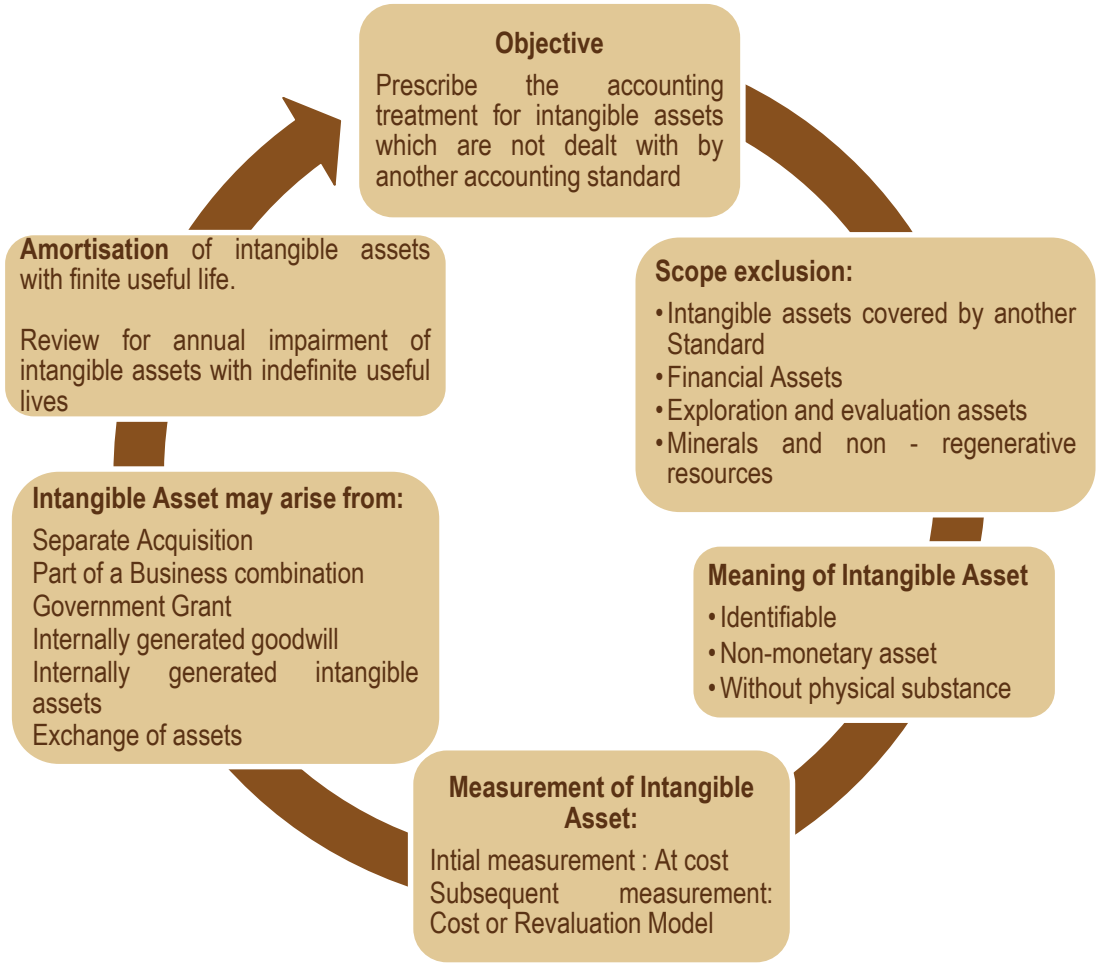
LEARNING OUTCOMES

After studying this unit, you will be able to

- State the scope of the standard
- Define and identify intangible assets by applying the criteria given in the standard
- Measure the intangible assets on initial recognition
- Analyse the principles of measurement under various modes of acquisition
- Apply the recognition and measurement principles on internally intangible assets
- Measure the intangible assets on subsequent recognition
- Interpret the concept of useful life of an intangible asset and its amortisation
- Examine the principles of de-recognition
- Produce the disclosures required in the standard

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UNIT OVERVIEW



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5.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognize an intangible asset if, and only if, specified criteria are met. This standard specifies the requirement of recognition, measurement and disclosures of Intangible Assets.

The Standard states that intangible assets are initially measured at cost, subsequently measured at cost or using the revaluation model, and amortised on a systematic basis over their useful lives unless the asset has an indefinite useful life, in which case it is not amortised but tested for impairment.

5.2 SCOPE

5.2.1 Applicability

This Standard shall be applied to all intangible assets, except:

(a) intangible assets that are within the scope of another Standard, for example:

- Intangible assets held for sale in the ordinary course of business (Ind AS 2)
- Deferred tax assets (Ind AS 12)
- Leases of intangibles assets (Ind AS 116)
- Assets arising from employee benefits (Ind AS 19)
- Financial assets (Ind AS 32)
- Goodwill arising in a business combination (Ind AS 103)
- Deferred acquisition costs and intangible assets arising from insurance contract (Ind AS 104)
- Non-current intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) (Ind AS 105)
- Assets arising from contracts with customers (Ind AS 115)

(b) financial assets, as defined in Ind AS 32, *Financial Instruments: Presentation*;

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(c) the recognition and measurement of exploration and evaluation assets (see Ind AS 106, *Exploration for and Evaluation of Mineral Resources*); and

(d) expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.

5.2.2 Intangible assets contained in or on a physical substance

Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film. In determining whether an asset that incorporates both tangible and intangible elements should be treated under Ind AS 16, Property, Plant and Equipment, or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant.

For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

The standard is also applicable to expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (eg a prototype), the physical element of the asset is secondary to its intangible component, ie the knowledge embodied in it.

5.2.3 Intangible assets on leases

Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of Ind AS 116 and are within the scope of this Standard.

5.2.4 Intangible assets used in the extractive and insurance industries

This Standard does not apply to expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of insurance contracts. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure incurred (such as start-up costs), in extractive industries or by insurers.

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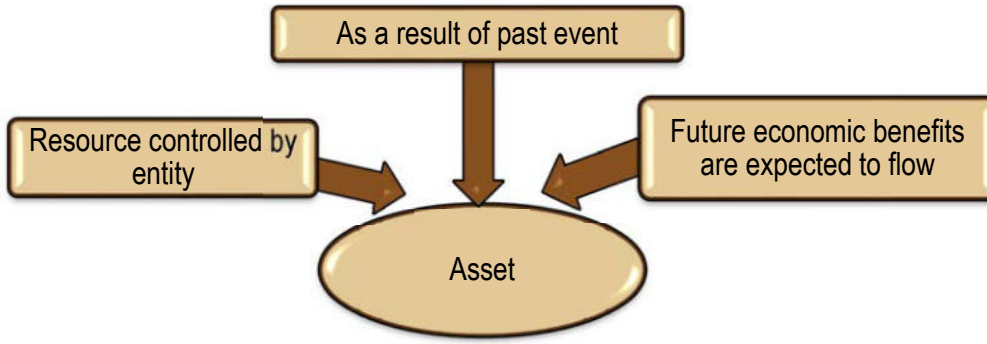
5.2.5 Amortisation method specified in this standard not to apply to intangible assets arising from service concession arrangements in respect of toll roads

The amortisation method specified in this Standard does not apply to an entity that opts to amortise the intangible assets arising from service concession arrangements in respect of toll roads recognized in the financial statements for the period ending immediately before the beginning of the first Ind AS reporting period as per the optional exemption given in Ind AS 101, First-time Adoption of Indian Accounting Standards.

5.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.
- An **asset*** is a resource:



  (a) controlled by an entity as a result of past events; and

  (b) from which future economic benefits are expected to flow to the entity.

- **Carrying amount** is the amount at which an asset is recognized in the balance sheet after deducting any accumulated amortisation and accumulated impairment losses thereon.
- **Cost** is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognized in accordance with the specific

* The definition of an asset in this Standard is not revised following the revision of the definition of an asset in the *Conceptual Framework for Financial Reporting under Indian Accounting Standards* issued in 2021 by the Institute of Chartered Accountants of India.

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requirements of other Indian Accounting Standards, for e.g Ind AS 102, *Share-based Payment*.

- **Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.
- **Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.
- **Entity-specific value** is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Ind AS 113, *Fair Value Measurement*.)
- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- An **intangible asset** is an identifiable non-monetary asset without physical substance.
- **Monetary assets** are money held and assets to be received in fixed or determinable amounts of money.
- **Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- The **residual value** of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
- **Useful life** is:

  (a) the period over which an asset is expected to be available for use by an entity; or

  (b) the number of production or similar units expected to be obtained from the asset by an entity.

5.4 IDENTIFICATION OF INTANGIBLE ASSETS

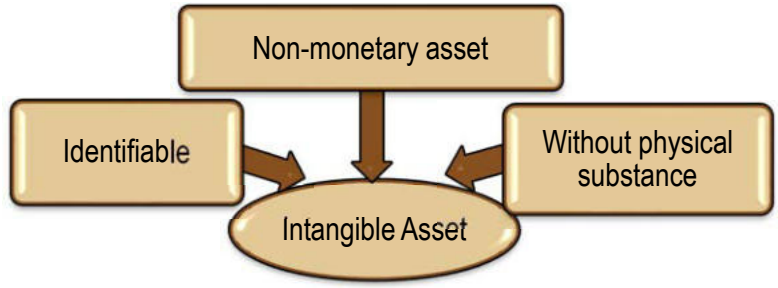
5.4.1 Meaning of Intangible asset

An intangible asset is an identifiable non-monetary asset without physical substance. The key components of this definition are:

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(i) Identifiability; and

(ii) Asset



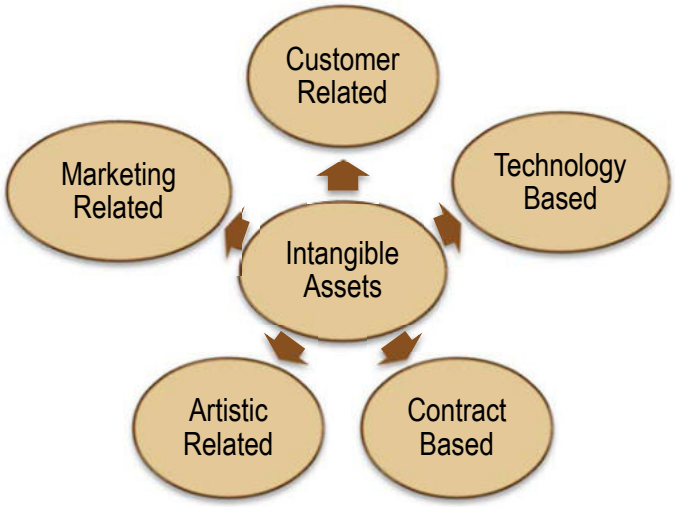
Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as:

- Scientific or technical knowledge
- Design and implementation of new processes or systems
- Licenses
- Intellectual property
- Market knowledge and trademarks (including brand names and publishing titles).

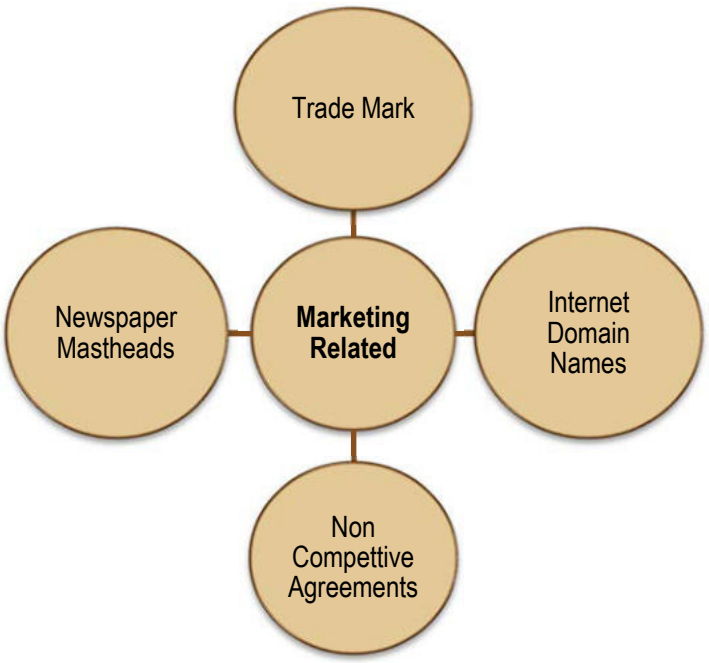
Common examples of items encompassed by these broad headings are:

- Computer software
- Patents
- Copyrights
- Motion picture films
- Customer lists
- Mortgage servicing rights
- Fishing licences
- Import quotas
- Franchises
- Customer or supplier relationships
- Customer loyalty
- Market share and marketing rights.

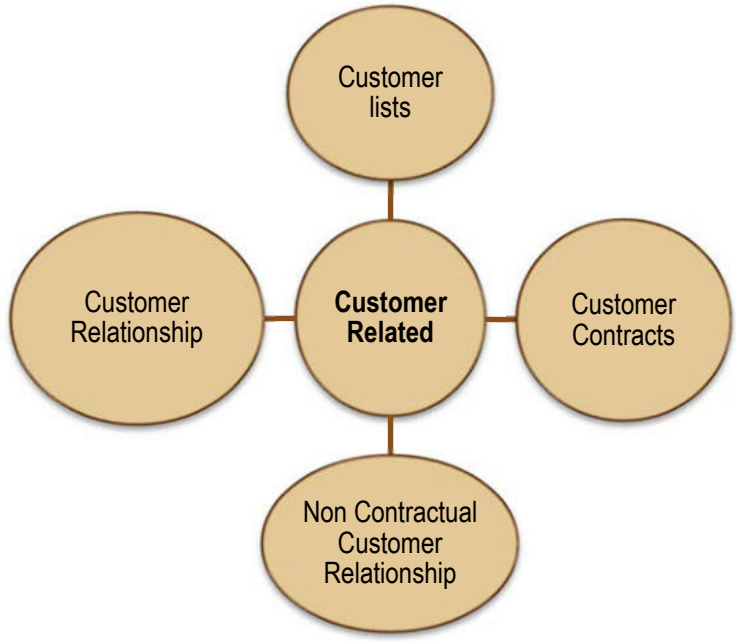
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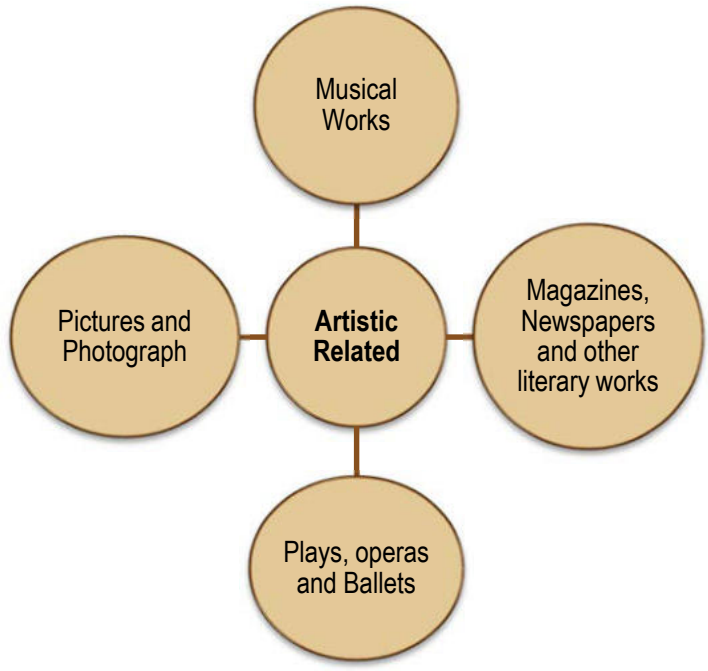


Let's run through some examples of each broad category listed above:

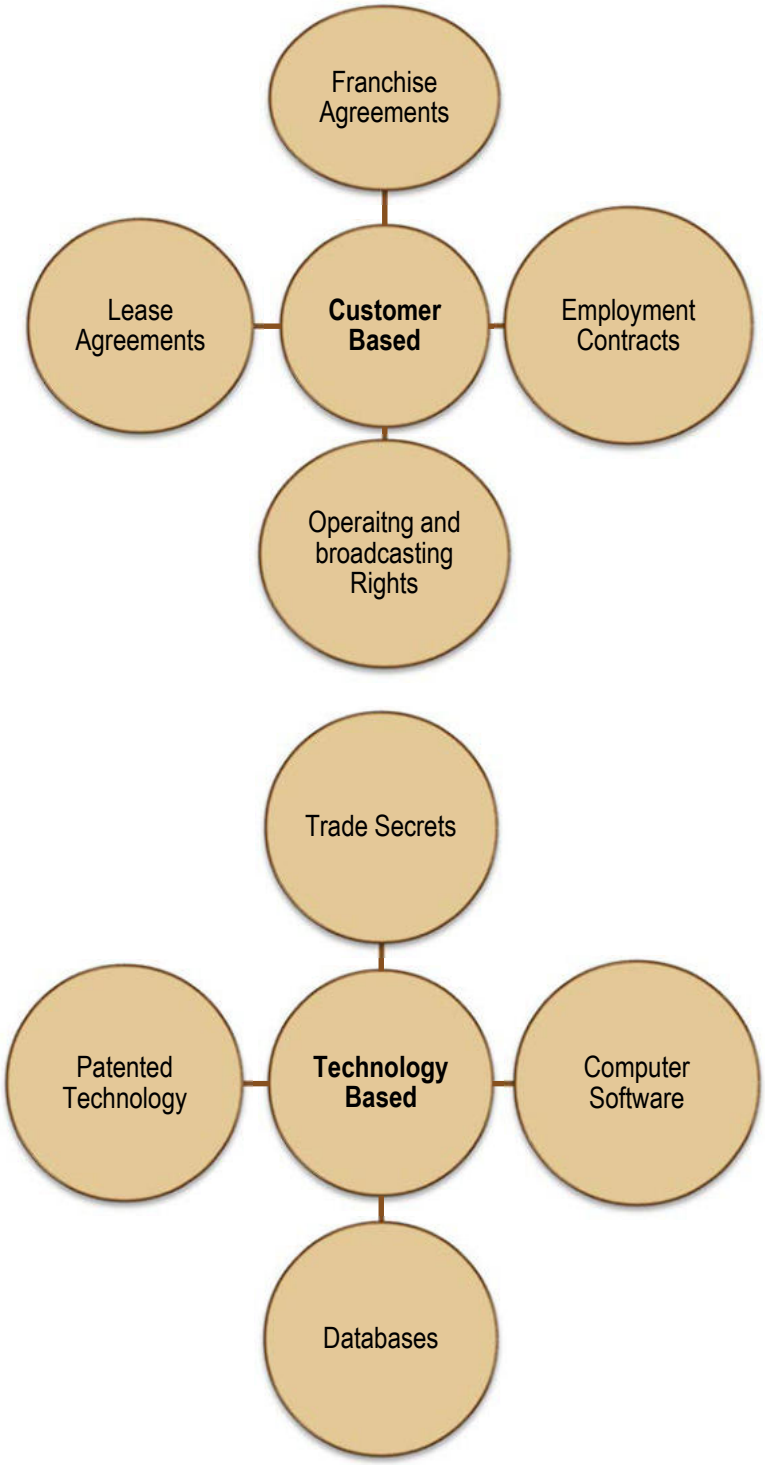


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Not necessarily all of the above items meet the conditions of recognizing as an Intangible Assets within purview of this standard:

- Identifiability
- Control over a Resource (Asset) and
- Existence of Future Economic Benefits.

Note: If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognized as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognized at the acquisition date.

Let us understand each concept one by one.

5.4.2 Identifiability

The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognized in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements.

An asset is identifiable if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Illustration 1: Identifiability

Sun Ltd. has an expertise in the consulting business. In years gone by, the Company gained a 30% market share for its services business and intends to recognize it as an intangible asset.

Evaluate whether the action taken by the company is justified.

Solution

Market share does not meet the definition of intangible assets as is not identifiable i.e. it is neither separable and nor has arisen from contractual or legal rights.

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5.4.3 Asset

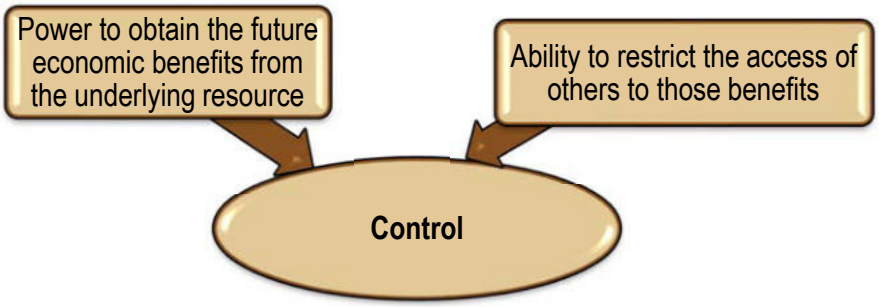
An asset is a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

5.4.3.1 Control

An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law.



In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary a condition for control because an entity may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An entity controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

Example 1

An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset.

For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

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An entity may have a portfolio of customers or a market share and expect that, because of its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (e.g. portfolio of customers, market shares, customer relationships and customer loyalty) to meet the definition of intangible assets. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.

Illustration 2 : Control

Company XYZ Ltd. has provided training to its staff on various new topics like GST, Ind AS etc. to ensure the compliance as per the required law. Discuss whether the company can recognize such cost of staff training as intangible asset.

Solution

It is clear that the company will obtain the economic benefits from the work performed by the staff as it increases their efficiency. But it does not have control over them because staff could choose to resign the company at any time.

Hence the company lacks the ability to restrict the access of others to those benefits. Therefore, the staff training cost does not meet the definition of an intangible asset.

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5.4.3.2 Future economic benefits

The future economic benefits flowing from an intangible asset may include:

(a) Revenue from the sale of products or services;

(b) Cost savings; or

(c) Other benefits resulting from the use of the asset by the entity.

For example: The use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

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Illustration 3: Identifiability of Intangible assets

Pluto Ltd. intends to open a new retail store in a new location in the next few weeks. Pluto Ltd. has spent a substantial sum on a series of television advertisements to promote this new store. The Company has paid an amount of ₹ 8,00,000 for advertisements before 31st March, 20X1. ₹ 7,00,000 of this sum relates to advertisements shown before 31st March, 20X1 and ₹ 1,00,000 to advertisements shown in April, 20X1. Since 31st March, 20X1, the Company has paid for further advertisements costing ₹ 4,00,000.

Pluto Ltd. is of view that such costs can be carried forward as intangible assets. Since market research indicates that this new store is likely to be highly successful.

Analyse the treatment of the above costs in the financial statements for the year ended 31st March, 20X1.

Solution

Under Ind AS 38 – *Intangible Assets* – intangible assets can only be recognized if they are **identifiable** and have a **cost** which can be reliably measured.

These criteria are very difficult to satisfy for internally developed intangibles.

For these reasons, Ind AS 38 specifically prohibits recognizing advertising expenditure as an intangible asset. The issue of how successful the store is likely to be does not affect this prohibition. Therefore, such costs should be recognized as expenses.

However, the costs would be recognized on accrual basis. Therefore, of the advertisements paid for before 31st March, 20X1, ₹ 7,00,000 would be recognized as an expense and ₹ 1,00,000 as a pre-payment in the year ended 31st March, 20X1. The cost of advertisements amounting ₹ 4,00,000 paid for since 31st March, 20X1 would be charged as expenses in the year ended 31st March, 20X2.

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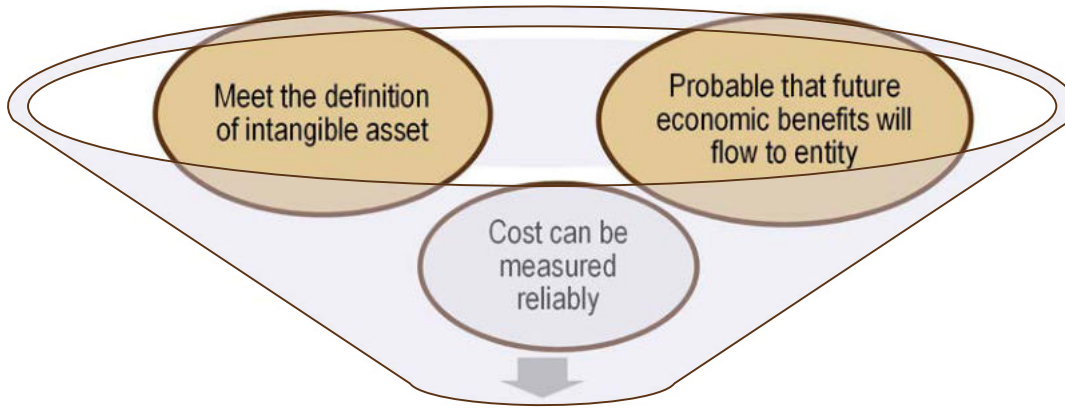
5.5 RECOGNITION OF INTANGIBLE ASSET

5.5.1 Recognition of Intangible assets – general principles

Provided that an item meets the definition of an intangible asset, it should be recognized in the financial statements if, and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.



Intangible Asset -Recognition Criteria

- **This requirement applies to:**

  (a) costs incurred initially to acquire or internally generate an intangible asset; and

  (b) those incurred subsequently to add to, replace part of, or service it.

- An entity should assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

- The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly, most subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in this Standard.

- In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. Therefore, only rarely will

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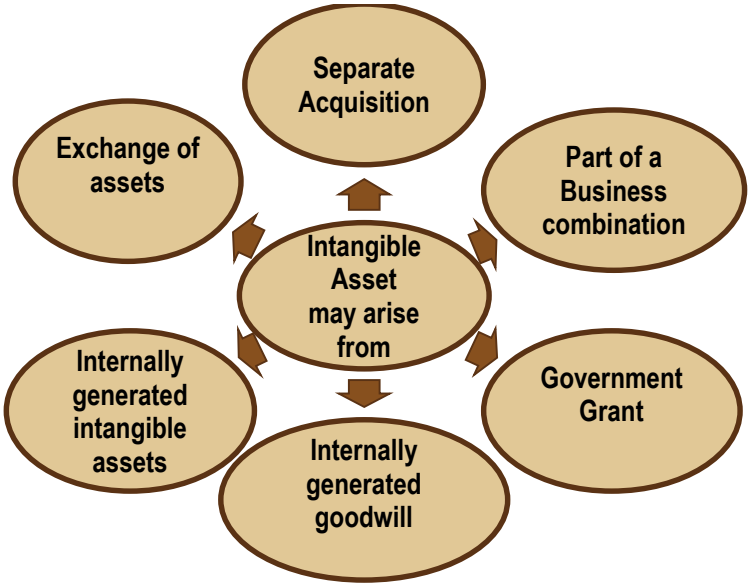
subsequent expenditure — expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset — be recognized in the carrying amount of an asset.

- Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally acquired or internally generated) is always recognized in profit or loss as incurred. This is because such expenditure cannot be distinguished from expenditure to develop the business as a whole.

5.6 MEASUREMENT OF INTANGIBLE ASSET

An intangible asset should be measured initially at cost.

Intangible assets may be acquired or can be self-generated. The below diagram reflects the method and mode by which Intangible assets may arise:



5.6.1 Separate acquisition

5.6.1.1 Recognition criteria for intangible assets acquired separately

Generally, the price an entity pays to acquire separately an intangible asset will reflect expectations about the probability that the expected future economic benefits associated with asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow.

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Therefore, the probability recognition criterion specified above is always considered to be satisfied for separately acquired intangible assets.

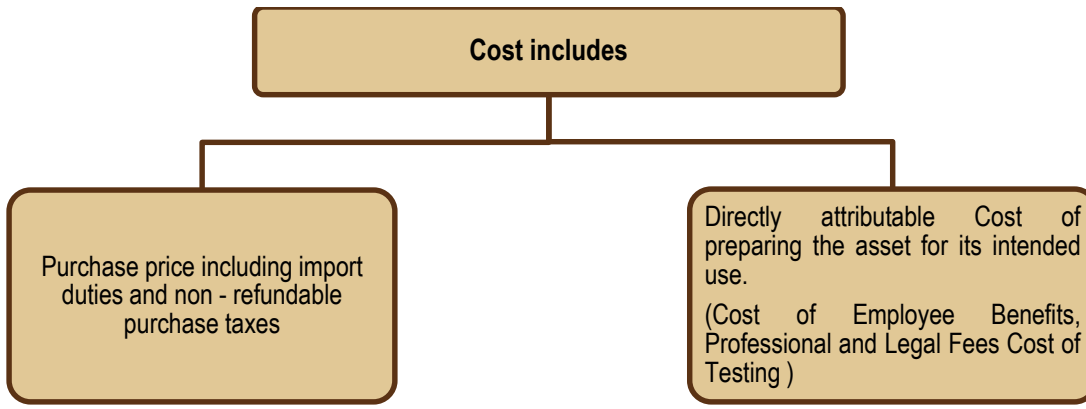
In addition, the cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

5.6.1.2 Measurement of cost for intangible assets acquired separately

The cost of a separately acquired intangible asset comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

(b) any directly attributable cost of preparing the asset for its intended use.

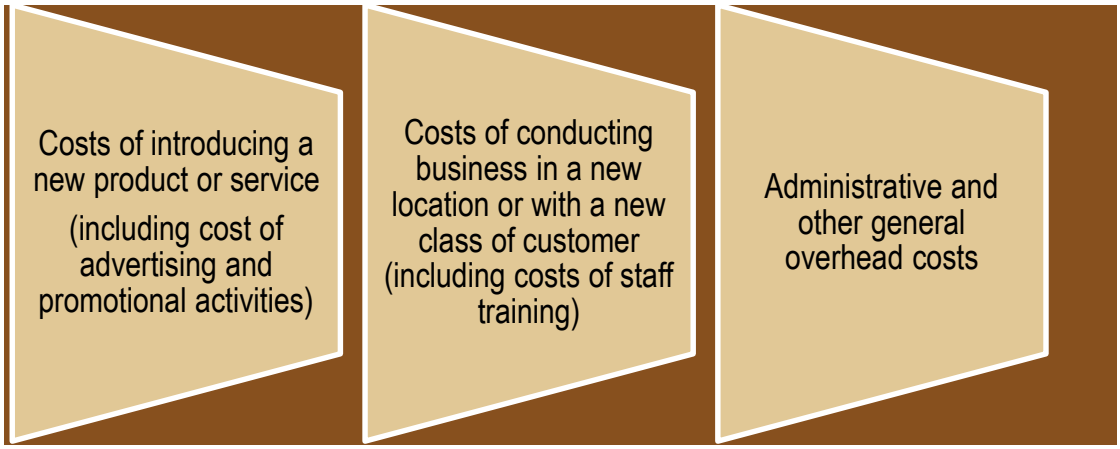


Examples of directly attributable costs are:

- Employee benefits cost (as defined in Ind AS 19) arising directly from bringing the asset to its working condition
- Professional Fees arising directly from bringing the asset to its working condition
- Costs of testing - whether the asset is working properly.

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Examples of expenditures that are not part of the cost of an intangible asset are:



Deferred Consideration

If payment for an intangible asset is deferred beyond normal credit terms, then cost of such Intangible asset is the cash price equivalent. The difference between this amount and the total payments is recognized as interest expense over the period of credit unless it is capitalised in accordance with Ind AS 23, Borrowing Costs.

Cessation of capitalisation

Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management.

For example, the following costs are not included in the carrying amount of an intangible asset:

(a) costs incurred in using or redeploying an intangible asset;

(b) costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and

(c) initial operating losses, such as those incurred while demand for the asset's output builds up.

Example 2 - Separate Acquisition

Jupiter Ltd acquires new energy efficient technology that will significantly reduce its energy costs for manufacturing.

	Costs incurred include	Cost to be capitalised as per Ind AS 38
Cost of new solar technology	10,00,000	10,00,000

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Trade discount provided	(1,00,000)	(1,00,000)
Training course for staff in new technology	50,000	-
Initial testing of new technology	35,000	35,000
Losses incurred while other parts of plant shut down during testing and training	25,000	-
Total	**10,10,000**	**9,35,000**

Illustration 4: Separate Acquisition

Venus India Private Ltd. acquired a software for its internal use costing ₹ 10,00,000. The amount payable for the software was ₹ 6,00,000 immediately and ₹ 4,00,000 in one year time. The other expenditure incurred were:

Purchase tax : ₹ 1,00,000

Entry Tax : 10% (recoverable later from tax department)

Legal fees: ₹ 87,000

Consultancy fees for implementation : ₹ 1,20,000

Cost of capital of the company is 10%.

Calculate the cost of the software on initial recognition using the principles of Ind AS 38 Intangible Assets.

Solution

Particulars	Amount in ₹
Cash paid	6,00,000
Deferred consideration (₹ 4,00,000 / 1.1)	3,63,636
Purchase Tax	1,00,000
Entry tax (not to be considered as it is a refundable tax)	-
Legal fees	87,000
Consultancy fees for implementation	1,20,000
Total cost to be capitalised	**12,70,636**

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5.6.2 Acquisition as part of a business combination

5.6.2.1 Recognition criteria for intangible assets acquired as part of a business combination

- In accordance with Ind AS 103, *Business Combinations*, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. The fair value of an intangible asset will reflect market participants' expectations at the acquisition date about the probability that the expected future economic benefits embodied in the asset will flow to the entity.
- In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations.
- An acquirer recognizes at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognized by the acquiree before the business combination.
- This means that the acquirer recognizes as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset. An acquiree's in-process research and development project meets the definition of an intangible asset when it:

  (a) meets the definition of an asset; and

  (b) is identifiable, ie is separable or arises from contractual or other legal rights.

Measuring fair value

- If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset.
- When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities that uncertainty enters into the measurement of the asset's fair value.
- An intangible asset acquired in a business combination might be separable, but only together with a related contract, identifiable asset or liability. In such cases, the acquirer recognizes the intangible asset separately from goodwill, but together with the related item.
- The acquirer may recognize a group of complementary intangible assets as a single asset provided the individual assets have similar useful lives. For example, the terms 'brand' and 'brand name' are often used as synonym for trademarks and other marks.

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Illustration 5: Business Combination

On 31st March, 20X1, Earth India Ltd. paid ₹ 50,00,000 for a 100% interest in Sun India Ltd. At that date Sun Ltd.'s net assets had a fair value of ₹ 30,00,000. In addition, Sun Ltd. also held the following rights:

- *Trademark named "GRAND" – valued at ₹ 1,80,000 using a discounted cash flow technique.*
- *Sole distribution rights to an electronic product; future cash flows from which are estimated to be ₹ 1,50,000 per annum for the next 6 years.*

10% is considered an appropriate discount rate.

The 6-year, 10% annuity factor is 4.36.

Calculate goodwill and other intangible assets arising on acquisition.

Solution

Particulars	Amount	Amount
Purchase consideration (A)		50,00,000
Net asset acquired	30,00,000	
Trademark	1,80,000	
Distribution rights (1,50,000 x 4.36)	6,54,000	
Total (B)		(38,34,000)
Goodwill on acquisition		11,66,000

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5.6.3 Acquisition by way of a government grant

An intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may happen when a government transfers or allocates to an entity, intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

In accordance with Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, an entity should recognize both the intangible asset and the grant initially at fair value.

If an entity chooses not to recognize the asset initially at fair value, the entity recognizes the asset initially at a nominal amount (the other treatment permitted by Ind AS 20) plus any expenditure that is directly attributable to preparing the asset for its intended use.

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5.6.4 Exchange of assets

One or more intangible assets may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an intangible asset is measured at fair value (even if an entity cannot immediately derecognize the asset given up) unless either:

(a) the exchange transaction lacks commercial substance; or

(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

- If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.
- An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:
  - (a) the configuration (ie risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
  - (b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and
  - (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.
- No intangible asset can be recognized unless its cost can be measured reliably. If an entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost. However, if the fair value of the asset received is more clearly evident, then fair value of the asset received is taken up as cost.
- The fair value of an intangible asset is reliably measurable if:
  - (a) the variability in the range of reasonable fair value measurements is not significant for that asset; or
  - (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

Illustration 6: Exchange of Asset

Sun Ltd. acquired a software from Earth Ltd. in exchange for a telecommunication license. The telecommunication license is carried at ₹ 5,00,000 in the books of Sun Ltd. The Software is carried at ₹ 10,000 in the books of the Earth Ltd. which is not the fair value.

Pass journal entries in the following situations in the books of Sun Ltd. and Earth Ltd.:

1) Fair value of software is ₹ 5,20,000 and fair value of telecommunication license is ₹ 5,00,000.

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2) *Fair value of software is not measurable. However, similar telecommunication license is transacted by another company at ₹ 4,90,000.*

3) *Neither fair value of software nor telecommunication license could be reliably measured.*

Solution

₹ in '000

Situation	Sun Ltd.	Earth Ltd.
1	Software Dr. 500 To Telecommunication license 500 To Profit on Exchange Nil	Telecommunication license Dr. 520 To Software 10 To Profit on Exchange 510
2	Software Dr. 490 Loss on Exchange Dr. 10 To Telecommunication license 500 **Note:** The company may first recognize Impairment loss and then record an entry. The effect is the same as impairment loss will also be charged to Income Statement.	Telecommunication license Dr. 490 To Software 10 To Profit on Exchange 480
3	Software Dr. 500 To Telecommunication license 500	Telecommunication license Dr. 10 To Software 10

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5.6.5 Internally generated goodwill

This standard prohibits the recognition of internally generated goodwill as an asset.

Internally generated goodwill is not recognized as an asset because it is not an identifiable resource (i.e. it is not separable, nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill.

Differences between the fair value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the fair value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

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5.6.6 Internally generated intangible assets

- It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of difficulty in:

  (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and

  (b) determining the cost of the asset reliably.

  Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, this standard includes additional recognition criteria for internally generated intangible assets which expand on the general recognition criteria.

- To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

  (a) a research phase; and

  (b) a development phase.

- If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Items that should not be recognized as internally generated intangible assets

This standard prohibits the recognition of internally generated goodwill as an asset. Some other internally generated items that are prohibited to be recognized as intangible assets are brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognized as intangible assets.

Research phase

- **Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- No intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.
- In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognized as an expense when it is incurred.

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- Examples of research activities are:

  (a) activities aimed at obtaining new knowledge;

  (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

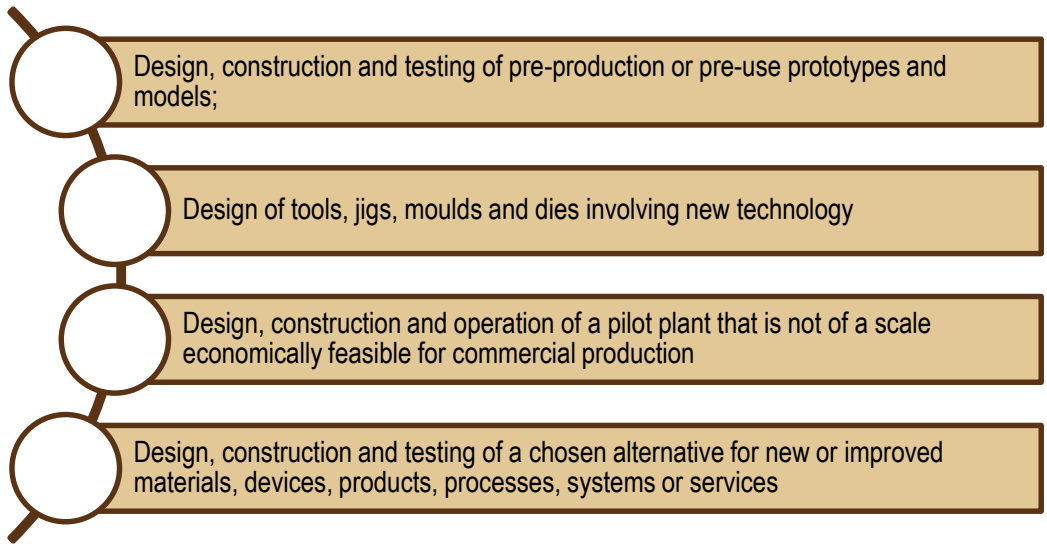
  (c) the search for alternatives for materials, devices, products, processes, systems or services; and

  (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

- **Examples of development activities are:**



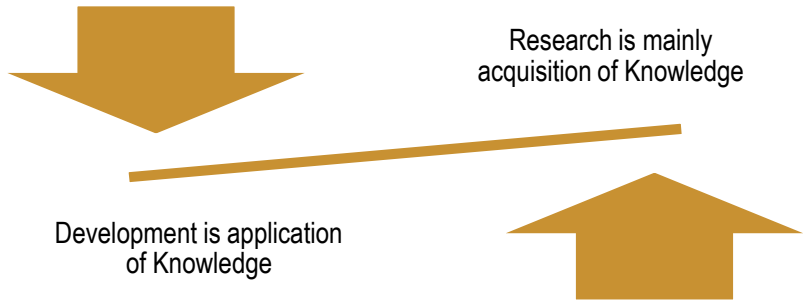
An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an entity can demonstrate all of the following:

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Technical feasibility of completion of Intangible asset to make it available for use or sale
Intention to complete the intangible asset and use or sell it
Ability to use or sell the intangible asset.
How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
Adequate resources (like technical, financial or others) to complete the development.
Ability to measure reliably the expenditure attributable to the intangible asset during its development.

- In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.
- To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in Ind AS 36, *Impairment of Assets*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in Ind AS 36.
- Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.
- An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

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Cost of an internally generated asset

The cost of an internally generated intangible asset for the purpose of initial measurement at recognition is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria including the additional criteria specified above.

Cost -Inclusions

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management.

Examples of directly attributable costs are:

- Costs of materials and services used or consumed in generating the intangible asset
- Costs of employee benefits (as defined in Ind AS 19) arising from the generation of the intangible asset
- Fees to register a legal right
- Amortisation of patents and licences that are used to generate the intangible asset

The specific guidance is given for borrowing costs to be capitalized as part of the cost of a self-generated intangible asset.

This standard prohibits reinstatement of expenditure previously recognized as an expense.

Cost - Exclusions

The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

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(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and

(c) expenditure on training staff to operate the asset.

Illustration 7

Venus Ltd. is preparing its accounts for the year ended 31st March, 20X2 and is unsure how to treat the following items.

1. *Company has completed a big marketing and advertising campaign costing ₹ 2,40,000. The finance director had authorised this campaign on the basis that it would create ₹ 5,00,000 of additional profits over the next three years.*
2. *A new product was developed during the year. The expenditure aggregated ₹ 1,50,000 of which ₹ 1,00,000 was incurred prior to 30th September, 20X1, the date on which it became clear that the product was technically viable. The new product will be launched in the next four months and its recoverable amount is estimated at ₹ 70,000.*
3. *Staff participated in a training programme which cost the company ₹ 3,00,000. The training organization had made a presentation to the directors of Baxter outlining that incremental profits to the business over the next twelve months would be ₹ 5,00,000.*

What amounts should appear as assets in Venus Ltd.'s balance sheet as at 31st March, 20X2?

Solution

The treatment in Venus Ltd.'s balance sheet as at 31st March, 20X2 will be as follows:

1. **Marketing and advertising campaign:** no asset will be recognized because it is not possible to identify future economic benefits that are attributable only to this campaign. All of the expenditure should be expensed in the statement of profit and loss account.
2. **New product:** development expenditure appearing in the statement of financial position will be valued at ₹ 50,000. The expenditure prior to the date on which the product becomes technically feasible is recognized in the statement of profit and loss account as an expense.
3. **Training programme**: no intangible asset will be recognized, because staff are not under the control of Venus Ltd. and when staff leave the benefits of the training, whatever they may be, also leave.

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Illustration 8 : Development Phase

Expenditure on a new production process in 20X1-20X2:

	₹
1st April to 31st December	*2,700*
1st January to 31st March	*900*
	3,600

The production process met the intangible asset recognition criteria for development on 1st January, 20X2. The amount estimated to be recoverable from the process is ₹ 1,000.

Expenditure incurred for development of the process in financial year 20X2-20X3 is ₹ 6,000. Asset was brought into use on 31st March, 20X3 and is expected to be useful for 6 years.

What is the carrying amount of the intangible asset at 31st March, 20X2 and 31st March, 20X3. Also determine the charge to profit or loss for 20X1-20X2?

At 31st March, 20X4, the amount estimated to be recoverable from the process is ₹ 5,000.

Determine the carrying amount of the intangible asset at 31st March, 20X4 and the charge to profit or loss for 20X3-20X4 on account of impairment loss.

Solution

1)	**Expenditure to be transferred to profit or loss in 20X1-20X2**	₹
	Total Expenditure	3,600
	Less: Expenditure during development phase	(900)
	Expenditure to be transferred to profit or loss	2,700
2)	**Carrying amount of intangible asset on 31st March, 20X2**	
	Expenditure during development phase will be capitalised	₹ 900
	(Recoverable amount is higher being ₹ 1,000, hence no impairment)	
3)	**Carrying amount of intangible asset on 31st March, 20X3**	
	Carrying amount of intangible asset on 31st March, 20X2	₹ 900
	Add: Further expenditure during development phase	6,000
	Total capital expenditure on development phase	6,900
4)	**Expenditure to be charged to profit or loss in 20X3-20X4**	
	Opening balance of Intangible Asset	6,900

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Less: Amortisation for the year (6,900 / 6)	(1,150)
Carrying amount of intangible asset	5,750
Less: Recoverable amount	(5,000)
Amount charged to profit or loss (Impairment Loss)	750

5) Carrying Amount of Intangible Asset on 31st March, 20X4

Value of intangible asset will be recoverable amount i.e. ₹ 5,000

*****

5.7. RECOGNITION OF AN EXPENSE

- Expenditure on an intangible item should be recognized as an expense when it is incurred unless:
  - (a) it forms part of the cost of an intangible asset that meets the recognition criteria; or
  - (b) the item is acquired in a business combination and cannot be recognized as an intangible asset. In such case, it forms part of the amount recognized as goodwill at the acquisition date.
- This standard states that the following types of expenditure should always be recognized as an expense:
  - (a) expenditure on research (except when it is acquired as part of a business combination);
  - (b) expenditure on start-up activities (ie start-up costs), unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with Ind AS 16. Start-up costs may consist of:
    - (i) establishment costs such as legal and secretarial costs incurred in establishing a legal entity;
    - (ii) expenditure to open a new facility or business (ie pre-opening costs);
    - (iii) expenditures for starting new operations or launching new products or processes (ie pre-operating costs);
  - (c) expenditure on training activities;
  - (d) expenditure on advertising and promotional activities (including mail order catalogues); and
  - (e) expenditure on relocating or reorganizing part or all of an entity.

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- More generally, if expenditure does not give rise to an intangible asset:
  (a) for the supply of goods, an expense is recognized when the entity has a right to access those goods. An entity has a right to access goods when it owns them. Similarly, it has a right to access goods when they have been constructed by a supplier in accordance with the terms of a supply contract and the entity could demand delivery of them in return for payment.
  (b) for a supply of services, the entity recognizes the expenditure as an expense when it receives the services. Services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service, for example, to deliver an advertisement to customers.
- This does not preclude an entity from recognizing a prepayment as an asset when payment for goods has been made in advance of the entity obtaining a right to access those goods or in advance of the entity receiving those services.
- Expenditure on an intangible item that was initially recognized as an expense should not be recognized as part of the cost of an intangible asset at a later date.

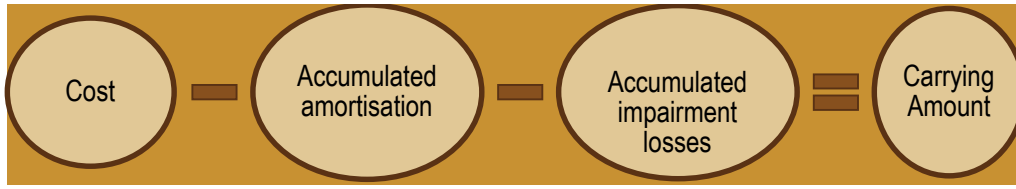
5.8 MEASUREMENT AFTER RECOGNITION

An entity should choose either the cost model or the revaluation model as its accounting policy.



5.8.1 Cost model

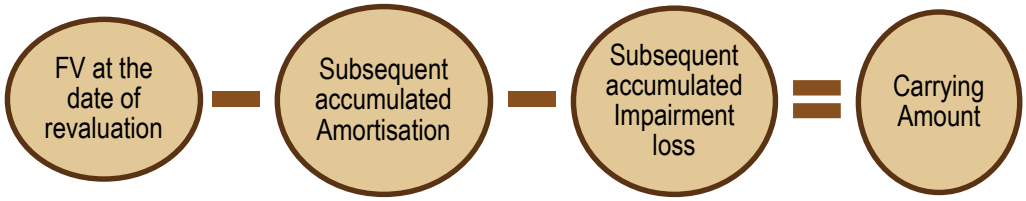
After initial recognition, an intangible asset is carried at its cost less any accumulated amortisation and any accumulated impairment losses.



5.8.2 Revaluation model

After initial recognition, an intangible asset is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

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- For the purpose of revaluations under this Standard, fair value is measured by reference to an active market.
- The revaluation model does not allow:

  (a) the revaluation of intangible assets that have not previously been recognized as assets; or

  (b) the initial recognition of intangible assets at amounts other than cost.
- The revaluation model is applied after an asset has been initially recognized at cost. However, if only part of the cost of an intangible asset is recognized as an asset because the asset did not meet the criteria for recognition until part of the way through the process, the revaluation model may be applied to the whole of that asset.
- Also, the revaluation model may be applied to an intangible asset that was received by way of a Government grant and recognized at a nominal amount.

Frequency of revaluations

- Revaluations should be made with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value.
- The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued. If the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary.
- Some intangible assets may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for intangible assets with only insignificant movements in fair value.

Scope of revaluations

- If an intangible asset is accounted for using the revaluation model, all the other assets in its class should also be accounted for using the same model, unless there is no active market for those assets.
- If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset is carried at its cost less any accumulated amortisation and impairment losses.

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- A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations.
- If the fair value of a revalued intangible asset can no longer be measured by reference to an active market, the carrying amount of the asset is its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.
- The fact that an active market no longer exists for a revalued intangible asset may indicate that the asset may be impaired and that it needs to be tested in accordance with Ind AS 36. If the fair value of the asset can be measured by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date.

Accumulated amortisation at the date of revaluation

- When an intangible asset is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

  (a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated amortisation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

  (b) the accumulated amortisation is eliminated against the gross carrying amount of the asset.

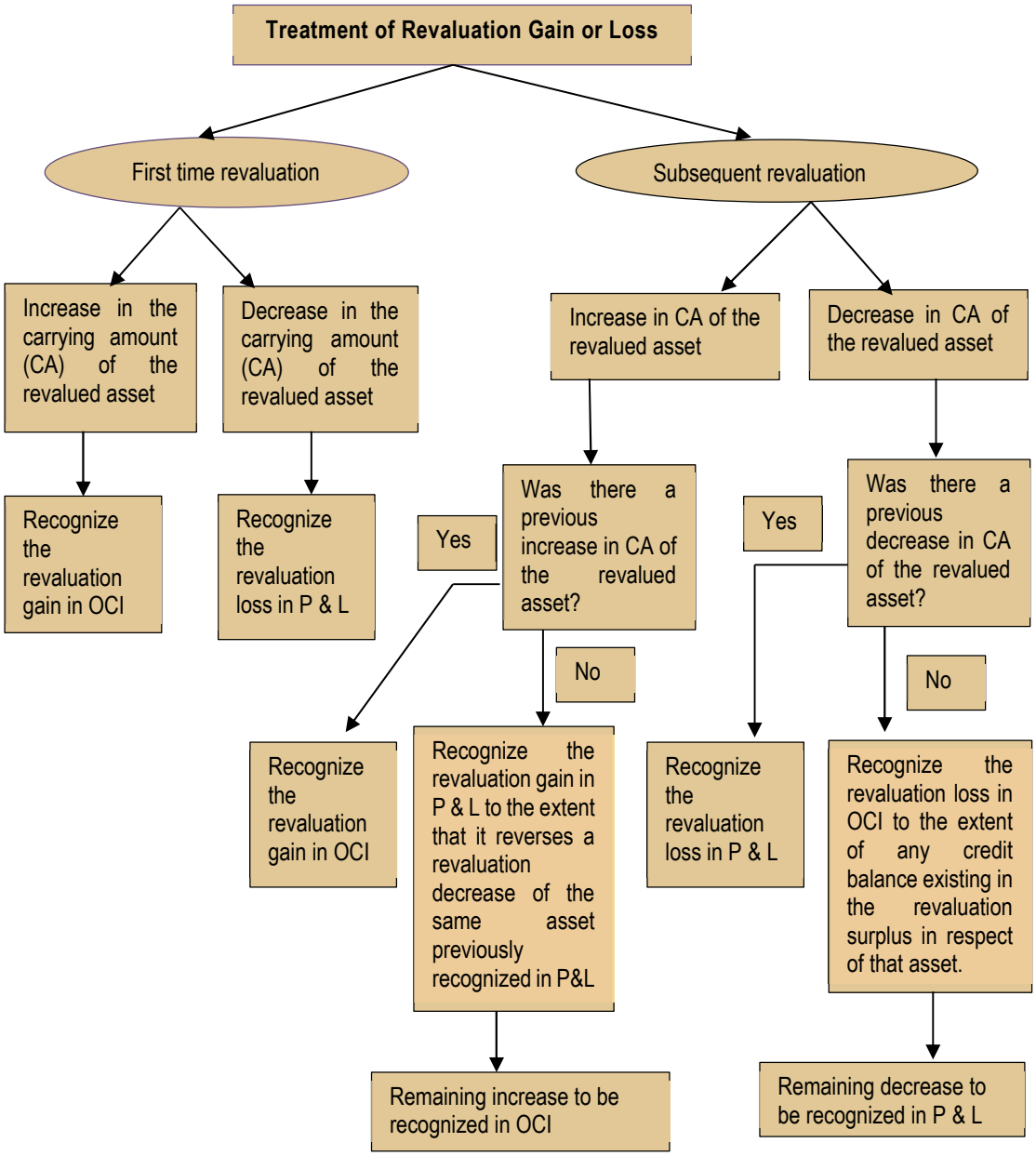
Treatment of surplus or deficit arising on revaluation

- If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus.
- However, the increase shall be recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit or loss.
- If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in profit or loss.
- However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.
- The cumulative revaluation surplus included in equity may be transferred directly to retained

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earnings when the surplus is realised. The whole surplus may be realised on the retirement or disposal of the asset. Some realisation of the revaluation surplus may occur, however, through the use of the intangible asset.

- The amount of the surplus realised is the difference between amortisation based on the revalued carrying amount of the asset and amortisation that would have been recognized based on the asset's historical cost. The transfer from revaluation surplus to retained earnings is not made through profit or loss.



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Illustration 9 : Revaluation Model

1. *Saturn Ltd. acquired an intangible asset on 31st March, 20X1 for ₹ 1,00,000. The asset was revalued at ₹ 1,20,000 on 31st March, 20X2 and ₹ 85,000 on 31st March, 20X3.*
2. *Jupiter Ltd. acquired an intangible asset on 31st March, 20X1 for ₹ 1,00,000. The asset was revalued at ₹ 85,000 on 31st March, 20X2 and at ₹ 1,05,000 on 31st March, 20X3.*

For both the companies, the year ends on 31st March, and they both use the revaluation model.

Recommend how each of these transactions should be dealt with in the financial statements. Discuss the treatment for revaluation of intangible asset. Ignore computation of amortization on them for ease of understanding.

Solution

Saturn Ltd.

₹ 20,000 revaluation increase on 31st March, 20X2 should be credited to the revaluation reserve and recognized in other comprehensive income. ₹ 20,000 of the revaluation decrease on 31st March, 20X3 should be debited to revaluation reserve and remaining ₹ 15,000 should be recognized as an expense.

Jupiter Ltd.

₹ 15,000 revaluation decrease on 31st March, 20X2 should be recognized as an expense in the Statement of Profit and loss. ₹ 15,000 out of the ₹ 20,000 increase on 31st March, 20X3 should be recognized as income. The remaining ₹ 5,000 should be credited to revaluation reserve and recognized in other comprehensive income.

Note: The above amount will be different if amortization of intangible asset is taken into consideration.

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5.9 USEFUL LIFE

- The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not amortised and tested for impairment.

Finite or indefinite useful life

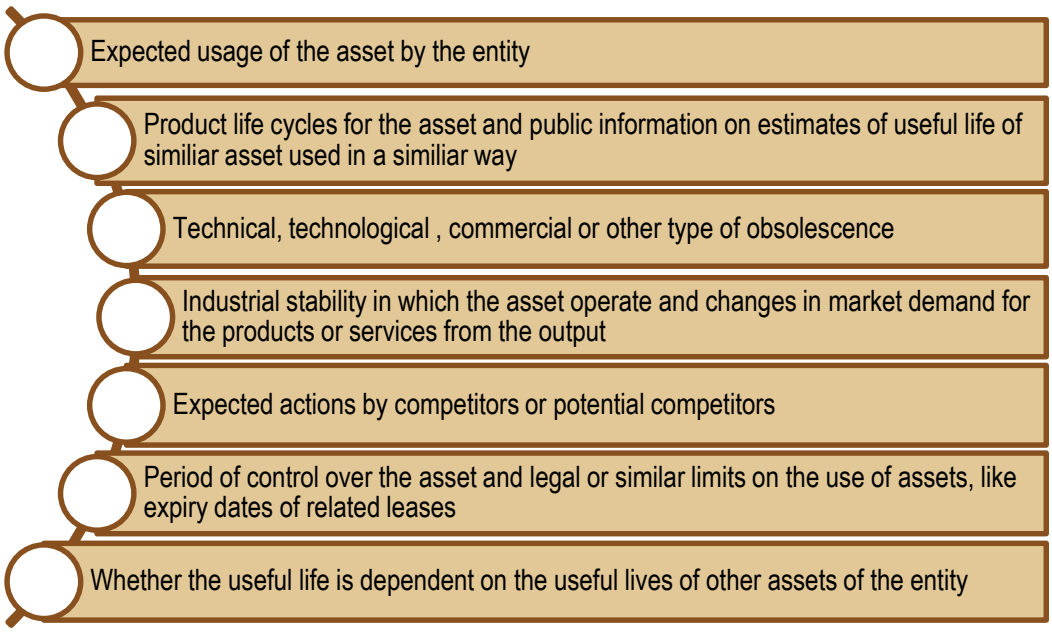
- Entities are required to assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life.

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- An intangible asset should be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Factors for consideration in determining useful life

- Many factors are considered in determining the useful life of an intangible asset, including:



- The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level.
- A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.
- This standard notes that, given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it will often be the case that their useful life is short. Expected future reductions in the selling price of an item that was produced using an intangible asset could indicate the expectation of technological or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.
- The useful life of an intangible asset may be very long or even indefinite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

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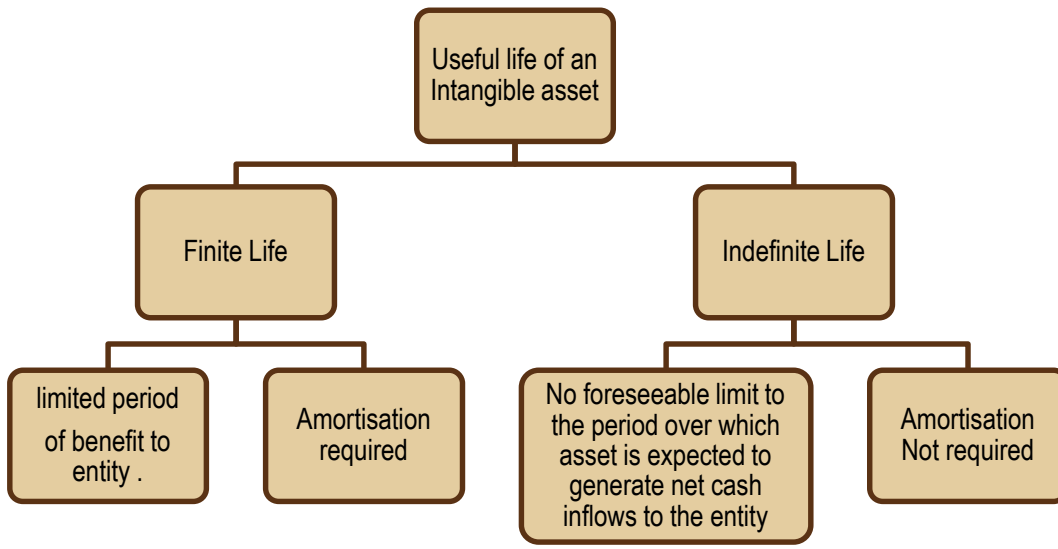
Intangible asset arising from contractual or other legal rights

- The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights but may be shorter depending on the period over which the entity expects to use the asset.
- If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.
- Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

  (a) there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;

  (b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and

  (c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.
- If the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.
- The useful life of a reacquired right recognized as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.



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5.10 INTANGIBLE ASSETS WITH FINITE USEFUL LIVES

5.10.1 Depreciable amount to be amortised over the asset's useful life

- The depreciable amount of an intangible asset with a finite useful life is allocated on a systematic basis over its useful life. The depreciable amount of an asset is defined as the cost of an asset, or other amount substituted for cost, less its residual value.
- Amortisation is usually recognized in profit or loss. However, sometimes the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the amortisation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see Ind AS 2, *Inventories*).

5.10.2 Residual Value

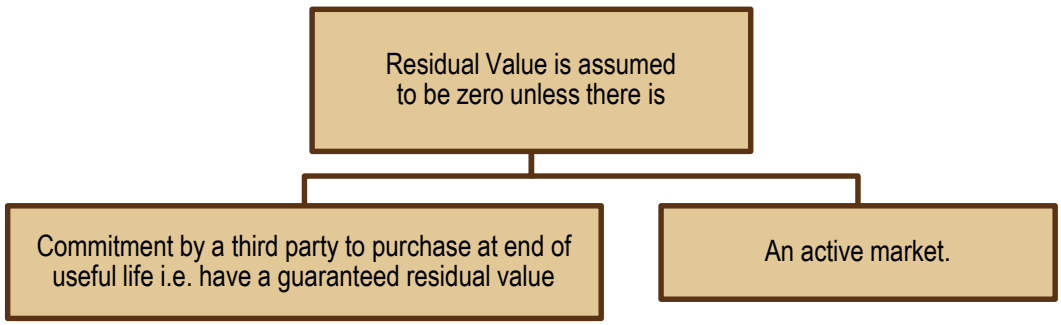
- The residual value of an intangible asset with a finite useful life should be assumed to be zero unless:

  (a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

  (b) there is an active market (as defined in Ind AS 113) for the asset and:

    (i) residual value can be determined by reference to that market; and

    (ii) it is probable that such a market will exist at the end of the asset's useful life.

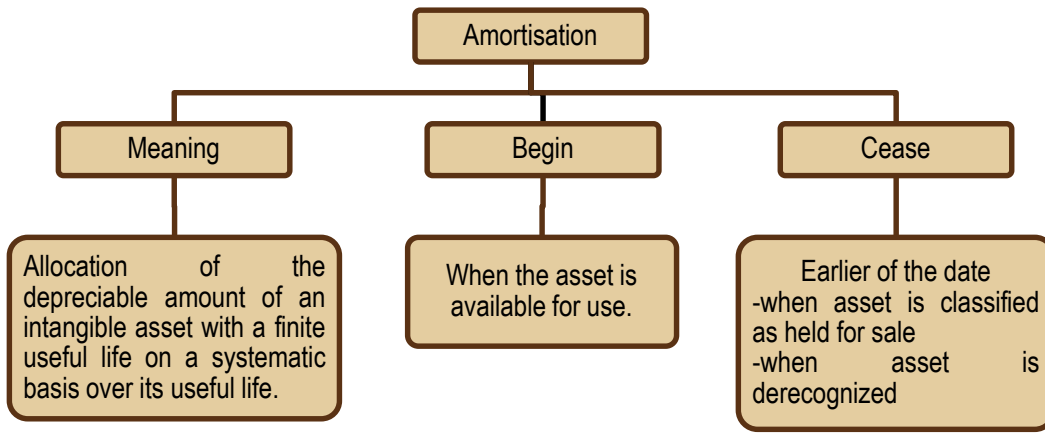


- The residual value is reviewed at least at each financial year-end. An estimate of an asset's residual value is based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used.

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- A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.
- The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

5.10.3 Amortisation period



Commencement of amortisation

Amortisation commences from the date when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Cessation of amortisation

Amortisation ceases at the earlier of:

(a) the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105; and

(b) the date that the asset is derecognized.

Amortisation of an intangible asset with a finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105.

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Review of amortisation period

The amortisation period for an intangible asset with a finite useful life should be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period should be changed accordingly. Such change is accounted for as a change in accounting estimates in accordance with Ind AS 8.

5.10.4 Amortisation method

The amortisation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method should be used.

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method.

In choosing an appropriate amortisation method, an entity could determine the predominant limiting factor that is inherent in the intangible asset. For example, the contract that sets out the entity's rights over its use of an intangible asset might specify the entity's use of the intangible asset as a predetermined number of years (i.e. time), as a number of units produced or as a fixed total amount of revenue to be generated.

Identification of such a predominant limiting factor could serve as the starting point for the identification of the appropriate basis of amortisation, but another basis may be applied if it more closely reflects the expected pattern of consumption of economic benefits.

The amortisation method for an intangible asset with a finite useful life should be reviewed at least at each financial year-end. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method should be changed to reflect the changed pattern. Such change is accounted for as a change in accounting estimates in accordance with Ind AS 8.

Amortisation method based on revenue

There is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate.

The revenue generated by an activity that includes the use of an intangible asset typically reflects factors that are not directly linked to the consumption of the economic benefits embodied in the intangible asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

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This presumption can be overcome only in the limited circumstances:

(a) in which the intangible asset is expressed as a measure of revenue, as described in paragraph 98C; or

(b) when it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated.

In the circumstance in which the predominant limiting factor that is inherent in an intangible asset is the achievement of a revenue threshold, the revenue to be generated can be an appropriate basis for amortisation. For example, an entity could acquire a concession to explore and extract gold from a gold mine. The expiry of the contract might be based on a fixed amount of total revenue to be generated from the extraction (for example, a contract may allow the extraction of gold from the mine until total cumulative revenue from the sale of gold reaches ₹ 2 billion) and not be based on time or on the amount of gold extracted.

In another example, the right to operate a toll road could be based on a fixed total amount of revenue to be generated from cumulative tolls charged (for example, a contract could allow operation of the toll road until the cumulative amount of tolls generated from operating the road reaches ₹ 100 lakh). In the case in which revenue has been established as the predominant limiting factor in the contract for the use of the intangible asset, the revenue that is to be generated might be an appropriate basis for amortising the intangible asset, provided that the contract specifies a fixed total amount of revenue to be generated on which amortisation is to be determined.

Example 3 - An acquired customer list

A direct-mail marketing company acquires a customer list and expects that it will be able to derive benefit from the information on the list for at least one year, but no more than three years.

The customer list would be amortised over management's best estimate of its useful life, say 18 months. Although the direct-mail marketing company may intend to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date it was acquired. The customer list also would be reviewed for impairment in accordance with Ind AS 36, *Impairment of Assets,* by assessing at the end of each reporting period whether there is any indication that the customer list may be impaired.

Example 4 - An acquired patent that expires in 15 years

The product protected by the patented technology is expected to be a source of net cash inflows for at least 15 years. The entity has a commitment from a third party to purchase that patent in five years for 60 per cent of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in five years.

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The patent would be amortised over its five-year useful life to the entity, with a residual value equal to the present value of 60 per cent of the patent's fair value at the date it was acquired. It may be noted that the estimated useful life has to be considered with reference to the entity only though the total life of the patent is much higher i.e., 15 years. The patent would also be reviewed for impairment in accordance with Ind AS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example 5 - An acquired copyright that has a remaining legal life of 50 years

An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.

It needs to be noted that although the remaining legal life of the patent is 50 years, however the useful life from the entity's perspective is only 30 years. The copyright would be amortised over its 30-years estimated useful life. The copyright also would be reviewed for impairment in accordance with Ind AS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example 6 - An acquired broadcasting licence that expires in five years

The broadcasting licence is renewable every 10 years if the entity provides at least an average level of service to its customers and complies with the relevant legislative requirements. The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition. The acquiring entity intends to renew the licence indefinitely and evidence supports its ability to do so. Historically, there has been no compelling challenge to the licence renewal. The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future. Therefore, the licence is expected to contribute to the entity's net cash inflows indefinitely.

The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity's net cash inflows indefinitely. Therefore, the licence would not be amortised until its useful life is determined to be finite. The licence would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 7 - The broadcasting licence in Example 6

The licensing authority subsequently decides that it will no longer renew broadcasting licences, but rather will auction the licences. At the time the licensing authority's decision is made, the entity's broadcasting licence has three years until it expires. The entity expects that the licence will continue to contribute to net cash inflows until the licence expires.

Because the broadcasting licence can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired licence would be amortised over its remaining three-year useful life and immediately tested for impairment in accordance with Ind AS 36.

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Example 8 - An acquired airline route authority between two European cities that expires in three years

The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals are routinely granted at a minimal cost and historically have been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service indefinitely between the two cities from its hub airports and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.

Since the facts and circumstances support the acquiring entity's ability to continue providing air service indefinitely between the two cities, the intangible asset related to the route authority is treated as having an indefinite useful life. Therefore, the route authority would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 9 An acquired trademark used to identify and distinguish a leading consumer product that has been a market-share leader for the past eight years

The trademark has a remaining legal life of five years but is renewable every 10 years at little cost. The acquiring entity intends to renew the trademark continuously and evidence supports its ability to do so. An analysis of (1) product life cycle studies, (2) market, competitive and environmental trends, and (3) brand extension opportunities provide evidence that the trademarked product will generate net cash inflows for the acquiring entity for an indefinite period.

The trademark would be treated as having an indefinite useful life because it is expected to contribute to net cash inflows indefinitely. Though the remaining legal life is five years, the possibility that it can be renewed every ten years and the entity's intention to renew the same leads to the conclusion that the trademark has an indefinite useful life. Therefore, the trademark would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 10- A trademark acquired 10 years ago that distinguishes a leading consumer product

The trademark was regarded as having an indefinite useful life when it was acquired because the trademarked product was expected to generate net cash inflows indefinitely. However, unexpected competition has recently entered the market and will reduce future sales of the product. Management estimates that net cash inflows generated by the product will be 20 per cent less for the foreseeable future. However, management expects that the product will continue to generate net cash inflows indefinitely at those reduced amounts.

As a result of the projected decrease in future net cash inflows, the entity determines that the estimated recoverable amount of the trademark is less than its carrying amount, and an

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impairment loss is recognized. Since it is still regarded as having an indefinite useful life, the trademark would continue not to be amortised but would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 11 - Trademark for a line of products that was acquired several years ago in a business combination

At the time of the business combination the acquiree had been producing the line of products for 35 years with many new models developed under the trademark. At the acquisition date the acquirer expected to continue producing the line, and an analysis of various economic factors indicated there was no limit to the period the trademark would contribute to net cash inflows. Consequently, the trademark was not amortised by the acquirer. However, management has recently decided that production of the product line will be discontinued over the next four years.

Since the useful life of the acquired trademark is no longer regarded as indefinite, the carrying amount of the trademark would be tested for impairment in accordance with Ind AS 36 and amortised over its remaining four-year useful life.

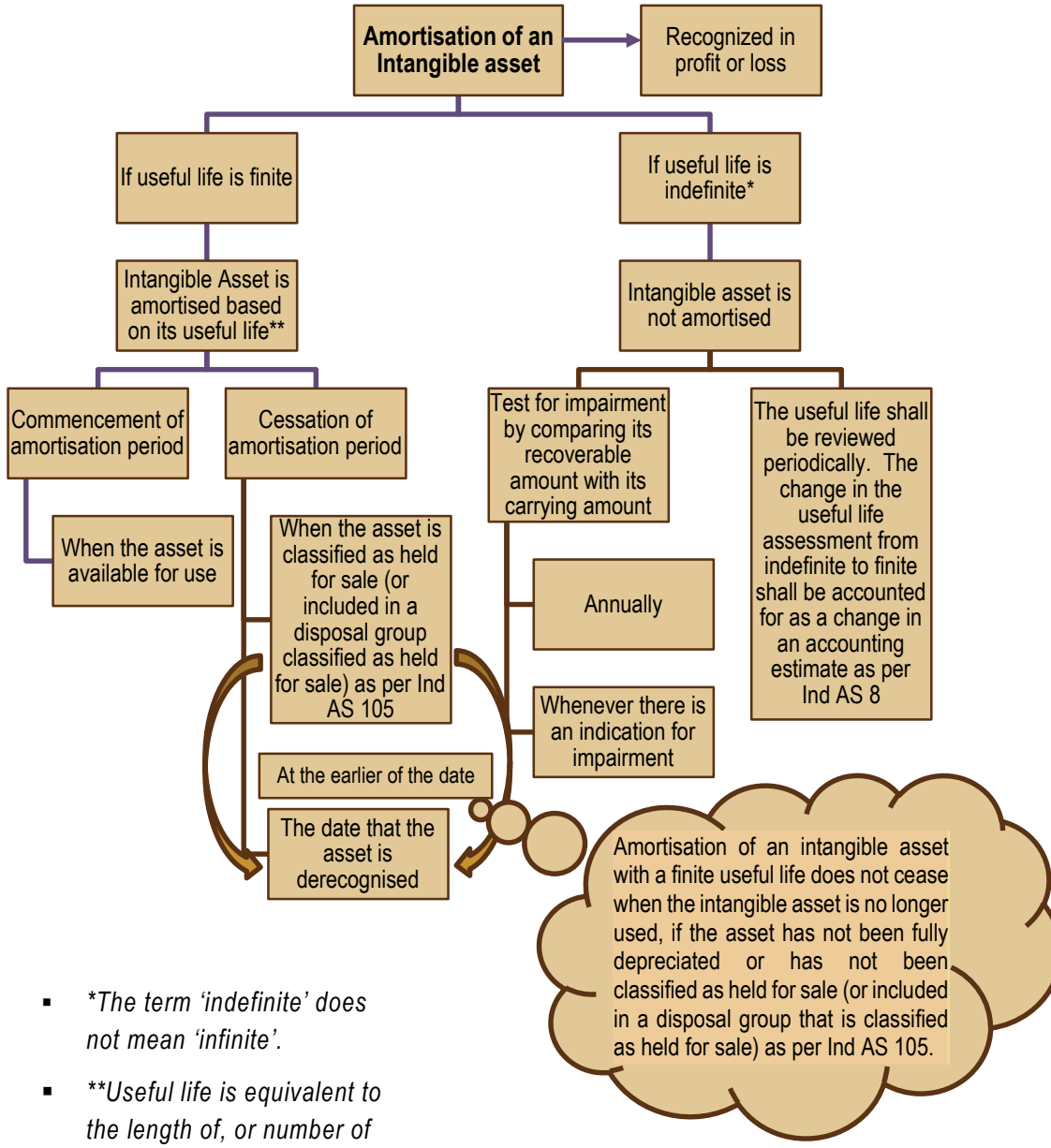
5.11 INTANGIBLE ASSETS WITH INDEFINITE USEFUL LIVES

- An intangible asset with an indefinite useful life should not be amortised.
- In accordance with Ind AS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount

  (a) annually; and

  (b) whenever there is an indication that the intangible asset may be impaired.
- The useful life of an intangible asset that is not being amortised should be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite is accounted for as a change in an accounting estimate in accordance with Ind AS 8.
- In accordance with Ind AS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment by comparing its recoverable amount, determined in accordance with Ind AS 36, with its carrying amount, and recognizing any excess of the carrying amount over the recoverable amount as an impairment loss.

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- **The term 'indefinite' does not mean 'infinite'.*
- ***Useful life is equivalent to the length of, or number of production or similar units*

5.12 IMPAIRMENT

- To determine whether an intangible asset is impaired, an entity applies Ind AS 36. That Standard explains when and how an entity reviews the carrying amount of its assets, how it

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determines the recoverable amount of an asset and when it recognizes or reverses an impairment loss.

- For an intangible asset with indefinite useful lives, an impairment review is required at least annually.

5.13 RETIREMENTS AND DISPOSALS

- An intangible asset should be derecognized:

  (a) on disposal; or

  (b) when no future economic benefits are expected from its use or disposal.

  The disposal of an intangible asset may occur in a variety of ways (e.g. by sale, by entering into a finance lease, or by donation).

- The gain or loss arising from the derecognition of an intangible asset should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It is to be recognized in profit or loss when the asset is derecognized (unless Ind AS 116 requires otherwise on a sale and leaseback). Gains should not be classified as revenue.

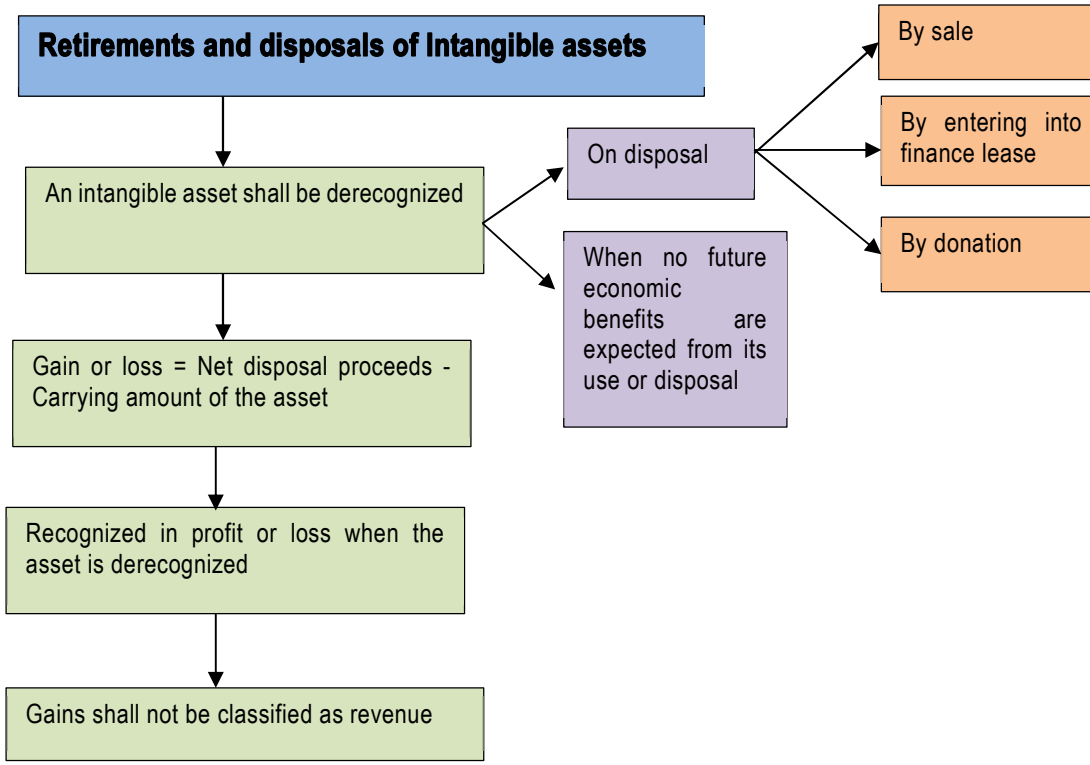
- If in accordance with the recognition principle an entity recognizes in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognizes the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.

- The date of disposal of an intangible asset is the date that the recipient obtains control of that asset in accordance with the requirements for determining when a performance obligation is satisfied as per Ind AS 115. Ind AS 116 applies to disposal by a sale and leaseback.

- In the case of a reacquired right in a business combination, if the right is subsequently reissued (sold) to a third party, the related carrying amount, if any, should be used in determining the gain or loss on reissue.

- The amount of consideration to be included in the gain or loss arising from the derecognition of an intangible asset is determined in accordance with the requirements for determining the transaction price (as per Ind AS 115). Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.

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5.14 DISCLOSURE

1) Disclosure – general

An entity should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

a) whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;

b) the amortisation methods used for intangible assets with finite useful lives;

c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;

d) the line item(s) of the statement of profit and loss in which any amortisation of intangible assets is included; and

e) a reconciliation of the carrying amount at the beginning and end of the period showing:

(i) additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;

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(ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;

(iii) increases or decreases during the period resulting from revaluations and from impairment losses recognized or reversed in other comprehensive income;

(iv) impairment losses recognized in profit or loss during the period;

(v) impairment losses reversed in profit or loss during the period;

(vi) any amortisation recognized during the period;

(vii) net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and

(viii) other changes in the carrying amount during the period.

2) Intangible assets having an indefinite useful life

For an intangible asset assessed as having an indefinite useful life, financial statement should disclose the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.

3) Intangible assets that are individually material

Financial statement should disclose a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.

4) Intangible assets acquired by way of government grant

For intangible assets acquired by way of a government grant and initially recognized at fair value, the financial statement should disclose:

a) the fair value initially recognized for these assets;

b) their carrying amount; and

c) whether they are measured after recognition under the cost model or the revaluation model.

5) Title restrictions and capital commitments

The financial statement should also disclose:

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the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and the amount of contractual commitments for the acquisition of intangible assets.

6) Intangible assets carried at revalued amounts

If intangible assets are accounted for at revalued amounts, an entity should disclose the following:

a) by class of intangible assets:

(i) the effective date of the revaluation;

(ii) the carrying amount of revalued intangible assets; and

(iii) the carrying amount that would have been recognized had the revalued class of intangible assets been measured after recognition using the cost model; and

b) the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders.

If necessary, it is acceptable to aggregate the classes of revalued assets into larger classes for disclosure purposes. However, classes are not aggregated if this would result in the combination of a class of intangible assets that includes amounts measured under both the cost and revaluation models.

7) Research and development expenditure

An entity should disclose the aggregate amount of research and development expenditure recognized as an expense during the period.

8) Other information

An entity is encouraged, but not required, to disclose the following information:

a) a description of any fully amortised intangible asset that is still in use; and

b) a brief description of significant intangible assets controlled by the entity but not recognized as assets because they did not meet the recognition criteria in this Standard or because they were acquired or generated before this standard was effective.

Illustration 10

X Limited engaged in the business of manufacturing fertilisers entered into a technical collaboration agreement with a foreign company Y Limited. As a result, Y Limited would provide the technical know-how enabling X Limited to manufacture fertiliser in a more efficient way.

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X Limited paid ₹ 10,00,00,000 for the use of know-how for a period of 5 years. X Limited estimates the production of fertiliser as follows:

Year	*(In metric tons)*
1	*50,000*
2	*70,000*
3	*1,00,000*
4	*1,20,000*
5	*1,10,000*

At the end of the 1st year, it achieved its targeted production. At the end of 2nd year, 65,000 metric tons of fertiliser was being manufactured, and X Limited considered to revise the estimates for the next 3 years. The revised figures are 85,000, 1,05,000 and 1,15,000 metric tons for year 3, 4 & 5 respectively.

Advise how X Limited will amortise the technical know-how fees as per Ind AS 38.

Solution

Based on the above data, it may be suitable for X Ltd. to use unit of production method for amortisation of technical know-how.

The total estimated unit to be produced 4,50,00 MT. The technical know-how will be amortised on the basis of the ratio of yearly production to total production.

The first-year charge should be a proportion of 50,000 / 4,50,000 on ₹ 10,00,00,000

= ₹ 1,11,11,111.

At the end of 2nd year, as per revised estimate the total number of units to be produced in future are 3,70,000 MT (i.e. 65,000 + 85,000 + 1,05,000 + 1,15,000).

The amortisation for second year will be 65,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111)

ie 1,56,15,615.

Amortisation for remaining years (unless the estimates are again revised):

Year 3 = 85,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) ie. ₹ 2,04,20,420

Year 4 = 1,05,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) ie. ₹ 2,52,25,225

Year 5 = 1,15,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) ie. ₹ 2,76,27,628

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Illustration 11

X Ltd. purchased a patent right on 1st April, 20X1, for ₹ 3,00,000, which has a legal life of 15 years. However, due to the competitive nature of the product, the management estimates a useful life of only 5 years. Straight-line amortisation is determined by the management to be the best method. As at 1st April, 20X2, management is uncertain that the process can actually be made economically feasible, and decides to write down the patent to an estimated market value of ₹ 1,50,000 and decides to amortise over 2 years. As at 1st April, 20X3, having perfected the related production process, the asset is now appraised at a value of ₹ 3,00,000. Furthermore, the estimated useful life is now believed to be 4 more years.

Determine the value of intangible asset at the end of each financial year.

Solution

Value as on 31st March, 20X2

Original cost	₹ 3,00,000
Less: Amortisation (3,00,000 x 1/5)	(₹ 60,000)
Net Value	₹ 2,40,000

Value as on 31st March, 20X3

On 1st April, 20X2, the impairment is recorded by writing down the asset to the estimated value of ₹ 1,50,000, which necessitates a ₹ 90,000 charge to profit & loss (carrying value, ₹ 2,40,000 less fair value ₹ 1,50,000).

Amortisation provided for the financial year 20X2-20X3 is ₹ 75,000 (₹ 1,50,000/2)

Net value is = ₹ 1,50,000 – ₹ 75,000 = ₹ 75,000.

Value as on 31st March, 20X4

As of 1st April, 20X3, the carrying value of the patent is ₹ 75,000.

Revalued amount of patent is ₹ 3,00,000.

Out of total revaluation gain of ₹ 2,25,000, ₹ 90,000 will be charged to profit & loss and balance amount of ₹ 1,35,000 (₹ 2,25,000 – ₹ 90,000) will be credited to revaluation reserve.

Amortisation provided for the financial year 20X3-20X4 is ₹ 75,000 (₹ 3,00,000 / 4)

Net value is = ₹ 3,00,000 – ₹ 75,000 = ₹ 2,25,000.

Similarly, Value as on March 31, 20X5 = ₹ 2,25,000 – ₹ 75,000 = ₹ 1,50,000

Value as on March 31, 20X6 = ₹1,50,000 – ₹ 75,000 = ₹ 75,000

Value as on March 31, 20X7 = ₹ 75,000 – ₹ 75,000 = Nil

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Illustration 12

X Pharmaceutical Ltd. seeks your opinion in respect of following accounting transactions:

1. *Acquired a 4 year license to manufacture a specialised drug at a cost of ₹ 1,00,00,000 at the start of the year. Production commenced immediately.*
2. *Also purchased another company at the start of year. As part of that acquisition, X Pharmacy Ltd. acquired a brand with a fair value of ₹ 3,00,00,000 based on sales revenue. The life of the brand is estimated at 15 years.*
3. *Spent ₹ 1,00,00,000 on an advertising campaign during the first six months. Subsequent sales have shown a significant improvement and it is expected this will continue for 3 years.*
4. *It has commenced developing a new drug 'Drug-A'. The project cost would be ₹ 10,00,00,000. Clinical trial proved successful and such drug is expected to generate revenue over the next 5 years.*

   Cost incurred (accumulated) till 31st March, 20X1 is ₹ 5,00,00,000.

   Balance cost incurred during the financial year 20X1-20X2 is ₹ 5,00,00,000.
5. *It has also commenced developing another drug 'Drug B'. It has incurred ₹ 50,00,000 towards research expenses till 31st March, 20X2. The technological feasibility has not yet been established.*

Advise how the above transactions will be accounted for in the books of account of X Pharmaceutical Ltd.

Solution

X Pharmaceutical Ltd. is advised as under:

1. It should recognize the drug license as an intangible asset because it is a separate external purchase, separately identifiable asset and considered successful in respect of feasibility and probable future cash inflows.

   The drug license should be recorded at ₹ 1,00,00,000.
2. It should recognize the brand as an intangible asset because it is purchased as part of acquisition and it is separately identifiable. The brand should be amortised over a period of 15 years.

   The brand will be recorded at ₹ 3,00,00,000.
3. The advertisement expenses of ₹ 1,00,00,000 should be expensed off.

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4. The development cost incurred during the financial year 20X1-20X2 should be capitalised.

Cost of intangible asset (Drug A) as on 31st March, 20X2	
Opening cost	₹ 5,00,00,000
Development cost	₹ 5,00,00,000
Total cost	₹ 10,00,00,000

5. Research expenses of ₹ 50,00,000 incurred for developing 'Drug B' should be expensed off since technological feasibility has not yet established.

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5.15 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Reliance Industries Limited' for the financial year 2021-2022 with respect to Intangible assets and Intangible assets under development and accounting policy with respect to Intangible assets.

Balance Sheet

As at 31st March, 2022

(₹ in crore)

	Notes	As at 31st March 2022	As at 31st March 2021
Assets			
Non-Current Assets			
Property, Plant and Equipment	1	2,23,824	2,92,092
Capital Work-in-Progress	1	19,267	20,765
Intangible Assets	1	15,802	14,741
Intangible Assets Under Development	1	15,395	12,070
Financial Assets			
Investments	2	3,30,493	2,52,620
Loans	3	41,951	64,073
Other Financial Assets	4	2,247	1,625
Other Non-Current Assets	5	7,297	4,968
Total Non-Current Assets		6,56,276	6,62,954

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1. Property, Plant & Equipment, Capital Work-In-Progress, Intangible Assets and Intangible Assets under Development

(₹ in crore)

Description	Gross Block				Depreciation / Amortisation and Depletion				Net Block	
	As at 01-04-2021	Additions / Adjustments	Deductions / Adjustments^	As at 31-03-2022	As at 01-04-2021	For the Year #	Deductions / Adjustments^	As at 31-03-2022	As at 31-03-2022	As at 31-03-2021
Property, Plant and Equipment										
Own Assets:										
Land	38,968	38	45	**38,961**	-	-	-	-	**38,961**	38,968
Buildings	19,600	1,198	4	**20,794**	7,756	751	1	**8,506**	**12,288**	11,844
Plant & Machinery	3,26,321	8,546	72,630	**2,62,237**	1,13,275	5,164	3,413	**1,15,026**	**1,47,211**	2,13,046
Electrical Installations	10,186	439	3,102	**7,523**	4,336	695	624	**4,407**	**3,116**	5,850
Equipments $	5,246	907	103	**6,050**	3,358	580	40	**3,898**	**2,152**	1,888
Furniture & Fixtures	623	42	6	**659**	446	33	3	**476**	**183**	177
Vehicles	693	102	17	**778**	490	78	13	**555**	**223**	203
Ships	505	3	-	**508**	345	16	-	**361**	**147**	160
Aircrafts & Helicopters	46	-	-	**46**	40	1	-	**41**	**5**	6
Sub-Total	**4,02,188**	**11,275**	**75,907**	**3,37,556**	**1,30,046**	**7,318**	**4,094**	**1,33,270**	**2,04,286**	**2,72,142**
Right-of-Use Assets:										
Land	17,693	1	5	**17,689**	1,704	170	-*	**1,874**	**15,815**	15,989
Plant & Machinery	4,630	-	-	**4,630**	669	238	-	**907**	**3,723**	3,961
Ships	10	-	-	**10**	10	-	-	**10**	**-**	-
Sub-Total	**22,333**	**1**	**5**	**22,329**	**2,383**	**408**	**-**	**2,791**	**19,538**	**19,950**
Total (A)	**4,24,521**	**11,276**	**75,912**	**3,59,885**	**1,32,429**	**7,726**	**4,094**	**1,36,061**	**2,23,824**	**2,92,092**
Intangible Assets **										
Technical Knowhow Fees	5,119	34	477	**4,676**	3,324	139	27	**3,436**	**1,240**	1,795
Software	976	39	1	**1,014**	869	45	-*	**914**	**100**	107
Development Rights	43,014	3,868	-	**46,882**	30,208	2,278	-	**32,486**	**14,396**	12,806
Others	1,084	192	-	**1,276**	1,051	159	-	**1,210**	**66**	33
Total (B)	**50,193**	**4,133**	**478**	**53,848**	**35,452**	**2,621**	**27**	**38,046**	**15,802**	**14,741**
Total (A + B)	**4,74,714**	**15,409**	**76,390**	**4,13,733**	**1,67,881**	**10,347**	**4,121**	**1,74,107**	**2,39,626**	**3,06,833**
Previous Year	4,68,723	11,053	5,062	**4,74,714**	1,62,245	9,270	3,634	**1,67,881**	**3,06,833**	3,06,478
Capital Work-in-Progress									**19,267**	**20,765**
Intangible Assets under Development									**15,395**	**12,070**

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ACCOUNTING POLICY

Intangible assets:

Intangible Assets are stated at cost of acquisition net of recoverable taxes, trade discount and rebates less accumulated amortisation/depletion and impairment losses, if any. Such cost includes purchase price, borrowing costs, and any cost directly attributable to bringing the asset to its working condition for the intended use, net charges on foreign exchange contracts and adjustments arising from exchange rate variations attributable to the Intangible Assets.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the entity and the cost can be measured reliably.

Other Indirect Expenses incurred relating to project, net of income earned during the project development stage prior to its intended use, are considered as pre-operative expenses and disclosed under Intangible Assets Under Development.

Gains or losses arising from derecognition of an Intangible Asset are measured as the difference between the net disposal proceeds and the carrying amount of the asset and are recognized in the Statement of Profit and Loss when the asset is derecognized. The Company's intangible assets comprises assets with finite useful life which are amortised on a straight-line basis over the period of their expected useful life.

A summary of amortisation/depletion policies applied to the Company's Intangible Assets to the extent of depreciable amount is as follows:

- *Technical Know-How - Over the useful life of the underlying assets ranging from 5 years to 35 years.*
- *Computer Software - Over a period of 5 years.*
- *Development Rights - Depleted using the unit of production method. The cost of producing wells along with its related facilities including decommissioning costs are depleted in proportion of oil and gas production achieved vis-à-vis Proved Developed Reserves. The cost for common facilities including its decommissioning costs are depleted using Proved Reserves*
- *Others - In case of Jetty, the aggregate amount amortised to date is not less than the aggregate rebate availed by the Company*

The Company assesses at each reporting date as to whether there is any indication that any Intangible Assets may be impaired. If any such indication exists, the recoverable

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amount of an intangible asset is estimated to determine the extent of impairment, if any.

An impairment loss is recognized in the Statement of Profit and Loss to the extent, asset's carrying amount exceeds its recoverable amount. The recoverable amount is higher of an asset's fair value less cost of disposal and value in use. Value in use is based on the estimated future cash flows, discounted to their present value using pre-tax discount rate that reflects current market assessments of the time value of money and risk specific to the assets

The impairment loss recognized in prior accounting period is reversed if there has been a change in the estimate of recoverable amount.

(Source: Annual Report 2021-2022 - 'Reliance Industries Limited')



5.16 SIGNIFICANT DIFFERENCES IN IND AS 38 *VIS-À-VIS* AS 26

S. No.	Particular	Ind AS 38	AS 26
1.	Exclusions	Ind AS 38 does not include any such exclusion specifically as these are covered by other accounting standards. Ind AS 38 contains a scope exclusion with regard to the amortisation method for intangible assets arising from service concession arrangements in respect of toll roads recognized in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP	Paragraph 5 of AS 26, does not apply to accounting issues of specialised nature that arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares.
2.	Definition of intangible assets	In Ind AS 38, the requirement for the asset to be held for use in the production or supply of goods or services, for rental to others, or for	AS 26 defines an intangible asset as an identifiable non-monetary asset without physical substance held for use in the production or

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		administrative purposes has been removed from the definition of an intangible asset. (Para 8 of Ind AS 38)	supply of goods or services, for rental to others, or for administrative purposes
3.	Identifiability	Ind AS 38 requires an asset to be treated as meeting the identifiability criterion in the definition of an intangible asset when it is separable (ie it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so), or when it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.	AS 26 does not define 'identifiability', but states that an intangible asset could be distinguished clearly from goodwill if the asset was separable, but that separability was not a necessary condition for identifiability.
4.	Separately acquired intangible assets	As per Ind AS 38, in the case of separately acquired intangibles, the criterion of probable inflow of expected future economic benefits is always considered satisfied, even if there is uncertainty about the timing or the amount of the inflow.	There is no such provision in AS 26.
5.	Revenue based amortisation method	In Ind AS 38 there is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate. Ind AS 38 allows use of revenue-	AS 26 does not specifically deal with revenue-based amortisation method.

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		based method of amortisation of intangible asset, in a limited way.	
6.	Payment deferred beyond normal credit terms	Under Ind AS 38, if payment for an intangible asset is deferred beyond normal credit terms, the difference between this amount and the total payments is recognized as interest expense over the period of credit unless it is capitalised as per Ind AS 23.	There is no such provision in AS 26
7.	Intangible assets acquired in business combination	Ind AS 38 deals in detail in respect of intangible assets acquired in a business combination.	AS 26 refers only to intangible assets acquired in an amalgamation in the nature of purchase and does not refer to business combinations as a whole.
8.	Subsequent expenditure on in process research and development project	Ind AS 38 gives guidance for the treatment of such expenditure. (Paragraphs 42 and 43 of Ind AS 38)	AS 26 is silent regarding the treatment of subsequent expenditure on an in-process research and development project acquired in a business combination
9.	Intangible assets acquired free of charge or for a nominal consideration by way of government grant	As per Ind AS 38, when intangible assets are acquired free of charge or for nominal consideration by way of government grant, an entity should, in accordance with Ind AS 20, record both the grant and the intangible asset at fair value. An alternative course that is sometimes followed is to record both asset and grant at a nominal amount. (Paragraph 44 of Ind AS 38)	As per AS 26, intangible assets acquired free of charge or for nominal consideration by way of government grant is recognized at nominal value or at acquisition cost, as appropriate plus any expenditure that is attributable to making the asset ready for intended use. (Paragraph 33 of AS 26).
10.	Useful life of an intangible asset	The rebuttable presumption is not there in Ind AS 38. Ind AS 38 recognizes that the useful life of an	AS 26 is based on the assumption that the useful life of an intangible asset is always finite, and includes

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		intangible asset can even be indefinite subject to fulfillment of certain conditions, in which case it should not be amortised but should be tested for impairment.	a rebuttable presumption that the useful life cannot exceed ten years from the date the asset is available for use
11.	Guidance on certain issues	In Ind AS 38, guidance is available on cessation of capitalisation of expenditure (Paragraph 30 of Ind AS 38), de-recognition of a part of an intangible asset (Paragraph 115 of Ind AS 38) and useful life of a reacquired right in a business combination (Paragraph 94 of Ind AS 38).	There is no such guidance in AS 26 on these aspects.
12.	Valuation model as accounting policy	Ind AS 38 permits an entity to choose either the cost model or the revaluation model as its accounting policy	In AS 26, revaluation model is not permitted.
13.	Intangible assets recognized as an expense	Ind AS 38 provides more guidance on recognition of intangible items recognized as expense. Ind AS 38 clarifies that in respect of prepaid expenses, recognition of an asset would be permitted only upto the point at which the entity has the right to access the goods or upto the receipt of services.	Further, unlike AS 26 mail order catalogues have been specifically identified as a form of advertising and promotional activities which are required to be expensed.
14.	Amortisation lower than under SLM	Ind AS 38 does not contain any such provision.	As per AS 26 (paragraph 73), there will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under straight-line method.
15.	Subsequent increase of	Under Ind AS 38, the residual value is reviewed at least at each	However, AS 26 specifically requires that the residual value is

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	residual value for changes in prices or value	financial year-end. If it increases to an amount equal to or greater than the asset's carrying amount, amortisation charge is zero unless the residual value subsequently decreases to an amount below the asset's carrying amount.	not subsequently increased for changes in prices or value.
16.	Intangible assets retired from use and held for sale	Ind AS 38 does not include such intangible assets since they would be covered by Ind AS 105.	Intangible assets retired from use and held for sale are covered by AS 26.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. X Ltd. is engaged in the business of publishing Journals. They acquired 100% stake in Y Ltd., a company in the same industry. X Ltd. paid purchase consideration of ₹ 10,00,00,000 and fair value of net assets acquired is ₹ 8,50,00,000. The purchase consideration includes payment for the following as well:

   (a) ₹ 30,00,000 for obtaining the skilled staff of Y Ltd.

   (b) ₹ 50,00,000 by way of payment towards 'Non-compete Fee' so as to restrict Y Ltd. to compete in the same line of business for next 5 years.

   However, the above items (a) and (b) are not forming part of the net assets acquired of ₹ 8,50,00,000.

   Determine how the above transactions be accounted for by X Ltd.

2. X Ltd. purchased a franchise from a restaurant chain at a cost of ₹ 1,00,00,000 and the franchise has 10 years life. In addition, the franchise agreement mentions that the franchisee would also pay the franchisor royalty as a percentage of sales made.

   Advise whether the franchise rights be treated as an intangible asset under Ind AS 38.

3. An entity regularly places advertisements in newspapers advertising its products and includes a reply slip that informs individuals replying to the advertisement that the entity may pass on the individual's details to other sellers of similar products, unless the individual ticks a box in the advertisement.

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Over a period of time the entity has assembled a list of customers' names and addresses. The list is provided to other entities for a fee. The entity would like to recognize an asset in respect of the expected future economic benefits to be derived from the list.

Evaluate whether the customer list be treated as an intangible asset under Ind AS 38.

4. A software company X Ltd. is developing new software for the telecom industry. It employs 100 employs engineers trained in that particular discipline who are engaged in the development of the software. X Ltd. feels that it has an excellent HR policy and does not expect any of its employees to leave in the near future. It wants to recognize these set of engineers as a human resources asset in the form of an intangible asset.

   Advise X Ltd. on the above issue.

5. X Ltd. has acquired a telecom license from Government to operate mobile telephony in two states of India.

   Recommend the cost of acquisition to be capitalised as an intangible asset under Ind AS 38.

6. X Ltd. purchased a standardised finance software at a list price of ₹ 30,00,000 and paid ₹ 50,000 towards purchase tax which is non-refundable. In addition to this, the entity was granted a trade discount of 5% on the initial list price. X Ltd. incurred cost of ₹ 7,00,000 towards customisation of the software for its intended use. X Ltd. also purchased a 5-year maintenance contract with the vendor company of ₹ 2,00,000.

   Identify at what cost the intangible asset will be recognized.

7. X Limited in a business combination, purchased the net assets of Y Limited for ₹ 4,00,000 on 31st March, 20X1. The assets and liabilities position of Y Limited just before the acquisition is as follows:

Assets	**Cost (in ₹)**
Property, Plant & Equipment	1,00,000
Intangible asset 1	20,000
Intangible asset 2	50,000
Cash & Bank	1,30,000
Liabilities	
Trade payable	50,000

The fair market value of the PPE, intangible asset 1 and intangible asset 2 is available and they are ₹ 1,50,000, ₹ 30,000 and ₹ 70,000 respectively.

Recommend how would X Limited account for the net assets acquired from Y Limited.

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8. X Ltd. acquired Y Ltd. on 30th April, 20X1. The purchase consideration is ₹ 50,00,000. The fair value of the tangible assets is ₹ 45,00,000. The company estimates the fair value of "in-process research and development projects" at ₹ 10,00,000. No other Intangible asset is acquired by X Ltd. in the transaction. Further, cost incurred by X Ltd. in relation to that research and development project is as follows:

   (a) ₹ 5,00,000 – as research expenses

   (b) ₹ 2,00,000 – to establish technological feasibility

   (c) ₹ 7,00,000 – for further development cost after technological feasibility is established.

   Determine at what amount the intangible asset be measured under Ind AS 38.

9. X Ltd. acquired a patent right of manufacturing drug from Y Ltd. In exchange X Ltd. gives its intellectual property right to Y Ltd. Current market value of the patent and intellectual property rights are ₹ 20,00,000 and ₹ 18,00,000 respectively.

   Compute the value of patent right for initial recognition in the books of X Ltd. in following two situations:

   (a) X Ltd. did not pay any cash to Y Ltd.

   (b) X Ltd. pays ₹ 2,00,000 to Y Ltd.

10. X Garments Ltd. spent ₹ 1,00,00,000 towards promotions for a fashion show by way of various on-road shows, contests etc.

    After that event, it realised that the brand name of the entity got popular and resultantly, subsequent sales have shown a significant improvement. It is further expected that this hike will have an effect over the next 2-3 years.

    Advise how the entity should account for the above cost incurred on promoting such show.

11. An entity is developing a new production process. During 20X1-20X2, expenditure incurred was ₹ 1,000, of which ₹ 900 was incurred before 1st March, 20X2 and ₹ 100 was incurred between 1st March, 20X2 and 31st March, 20X2. The entity is able to demonstrate that at 1st March, 20X2, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 500.

    During 20X2-20X3, expenditure incurred is ₹ 2,000. At the end of 20X3, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 1,900.

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Tabulate the accounting treatment of expenditure incurred in 20X1-20X2 and 20X2-20X3 as per relevant Ind AS. Ignore effects of amortisation.

12. X Ltd. is engaged in developing computer software. The expenditures incurred by X Ltd. in pursuance of its development of software is given below:

    (a) Paid ₹ 2,00,000 towards salaries of the program designers.

    (b) Incurred ₹ 5,00,000 towards other cost of completion of program design.

    (c) Incurred ₹ 2,00,000 towards cost of coding and establishing technical feasibility.

    (d) Paid ₹ 7,00,000 for other direct cost after establishment of technical feasibility.

    (e) Incurred ₹ 2,00,000 towards other testing costs.

    (f) A focus group of other software developers was invited to a conference for the introduction of this new software. Cost of the conference aggregated to ₹ 70,000.

    On 15th March, 20X1, the development phase was complete, and a cash flow budget was prepared. Net profit for the year was estimated to be equal ₹ 40,00,000.

    Interpret how X Ltd. should account for the above-mentioned cost.

13. X Ltd. has started developing a new production process in financial year 20X1-20X2. Total expenditure incurred till 30th September, 20X1, was ₹ 1,00,00,000. The expenditure on the development of the production process meets the recognition criteria on 1st July, 20X1. The records of X Ltd. show that, out of total ₹ 1,00,00,000, ₹ 70,00,000 were incurred during July to September, 20X1. X Ltd. publishes its financial results quarterly.

    Determine how X Ltd. should account for the development expenditure.

14. X Ltd. decides to revalue its intangible assets on 1st April, 20X1. On the date of revaluation, the intangible assets stand at a cost of ₹ 1,00,00,000 and accumulated amortisation is ₹ 40,00,000. The intangible assets are revalued at ₹ 1,50,00,000.

    Analyse how should X Ltd. account for the revalued intangible assets in its books of account.

15. One of the senior engineers at XYZ has been working on a process to improve manufacturing efficiency and, consequently, reduce manufacturing costs. This is a major project and has the full support of XYZ's board of directors. The senior engineer believes that the cost reductions will exceed the project costs within twenty-four months of their implementation. Regulatory testing and health and safety approval was obtained on 1st June 20X5. This removed uncertainties concerning the project, which was finally completed on 20th April 20X6. Costs of ₹ 18,00,000, incurred during the year till 31st March 20X6, have been recognized as an intangible asset. An offer of ₹ 7,80,000 for the new developed technology has been

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received by potential buyer but it has been rejected by XYZ. Utkarsh believes that the project will be a major success and has the potential to save the company ₹ 12,00,000 in perpetuity. Director of research at XYZ, Neha, who is a qualified electronic engineer, is seriously concerned about the long-term prospects of the new process and she is of the opinion that competitors would have developed new technology at some time which would require to replace the new process within four years. She estimates that the present value of future cost savings will be ₹ 9,60,000 over this period. After that, she thinks that there is no certainty about its future.

Advise the appropriate accounting treatment for the aforesaid issue for the year ended 31st March, 20X6.

Answers

1. X Ltd. should recognize an intangible asset in respect of the consideration paid towards 'Non-Compete Fee'.

However, amount paid for obtaining skilled staff amounting to ₹ 30,00,000 does not meet the definition of intangible asset since X Ltd. has not established any right over the resource and the same should be expensed. The entity has insufficient control over the expected future economic benefits arising from the team of skilled staff.

Therefore, ₹ 50,00,000 will be separately recognized as an intangible asset, whereas amount paid for obtaining skilled staff does not meet the recognition criteria for being identified as a separate intangible asset. However, since it is acquired as part of a business combination, it forms part of the goodwill recognized at the acquisition date.

The value of goodwill would be ₹ 1,00,00,000 (₹ 1,50,00,000 – ₹ 50,00,000).

2. The franchise rights meets the identification criterion of an intangible asset since it arises from the contractual rights. It is acquired separately and it's cost can be measured reliably. In addition, X Ltd. will have future economic benefits and control over them from the franchise rights.

X Ltd. should recognize the franchise right as intangible asset and amortise it over 10 years. Royalty as a percentage of sales paid to the franchisor would be a charge to the profit and loss in the books of the X Ltd.

3. In this situation, the entity has no legal rights to the customer relationship, but exchange transactions have taken place that evidence separability of the asset and the control that the entity is able to exercise over the asset. Therefore, the list is an intangible asset. However, the entity may not recognize the asset because the cost of generating the customer list internally cannot be distinguished from the cost of developing the business as

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a whole. It does not meet the conditions specified to recognize an internally generated intangible asset.

4. Although, without doubt the skill sets of the employees make them extremely valuable to the company, however it does not have control over them. Merely having good HR policies would not make them eligible to be recognized as an intangible asset.

5. Cost of acquisition of the telecom license can be capitalised as an intangible asset under the head Licenses, as the cost is ascertainable, and it will lead to future economic benefits for X Ltd.

6. In accordance with Ind AS 38, the cost of a separately acquired intangible asset is its purchases price and non-refundable purchase taxes, after deducting trade discounts and rebates and any directly attributable cost of preparing the asset for its intended use.

Therefore, the initial cost of the asset should be:

	Amount (₹)
List price	30,00,000
Less: Trade discount (5%)	(1,50,000)
	28,50,000
Non-refundable purchase tax	50,000
Customisation cost	7,00,000
Total cost	36,00,000

The maintenance contract of ₹ 2,00,000 is an expense and therefore should be taken as a prepaid expense and charged to profit and loss over a period of 5 years.

7. X Limited will account for the assets acquired from Y Limited in following manner:

Assets	**Amount (₹)**
Property, plant and equipment	1,50,000
Goodwill	70,000
Intangible asset 1	30,000
Intangible asset 2	70,000
Cash & Bank	1,30,000
Liabilities	
Trade payable	50,000

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Note 1- Goodwill is the difference between fair value of net assets acquired and purchase consideration paid when is calculated as follow:

Goodwill = ₹ 4,00,000 – ₹ (1,50,000 + 70,000 + 30,000 + 1,30,000 – 50,000) = ₹ 70,000.

8. X Ltd. should initially recognize the acquired "in house research and development project'' at its fair value i.e., ₹ 10,00,000. Research cost of ₹ 5,00,000 and cost of ₹ 2,00,000 for establishing technical feasibility should be charged to profit & loss. Costs incurred from the point of technological feasibility/asset recognition criteria until the time when development costs are incurred are capitalised. So the intangible asset should be recognized at ₹ 17,00,000 (₹ 10,00,000 + ₹ 7,00,000).

9. If an entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

The transaction at the fair value of the asset received adjusted for any cash received or paid. Therefore, in case (a) patent is measured at ₹ 18,00,000, in case (b) it is measured at ₹ 20,00,000 (18,00,000 + 2,00,000).

10. Expenditure of ₹ 1,00,00,000 though increased future economic benefits, but it does not result in creation of an intangible asset.

Such promotional cost should be expensed off.

11. At the end of the financial year 20X2, the production process is recognized as an intangible asset at a cost of ₹ 100 (expenditure incurred since the date when the recognition criteria were met, i.e., 1st March, 20X2). ₹ 900 expenditure incurred before 1st March, 20X2 is recognized as an expense because the recognition criteria were not met until 1st March, 20X2. This expenditure does not form part of the cost of the production process recognized in the balance sheet.

At the end of 20X3, the cost of the production process is ₹ 2,100 (₹ 100 expenditure recognized at the end of 20X2 plus ₹ 2,000 expenditure recognized in 20X3). The entity recognizes an impairment loss of ₹ 200 to adjust the carrying amount of the process before impairment loss (₹ 2,100) to its recoverable amount (₹ 1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Ind AS 36 are met.

12. Costs incurred in creating computer software, should be charged to research & development expenses when incurred until technical feasibility/asset recognition criteria have been established for the product. Here, technical feasibility is established after completion of detailed program design.

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In this case, ₹ 9,00,000 (salary cost of ₹ 2,00,000, program design cost of ₹ 5,00,000 and coding and technical feasibility cost of ₹ 2,00,000) would be recorded as expense in Profit and Loss since it belongs to research phase.

Cost incurred from the point of technical feasibility are capitalised as software costs. But the conference cost of ₹ 70,000 would be expensed off.

In this situation, direct cost after establishment of technical feasibility of ₹ 7,00,000 and testing cost of ₹ 2,00,000 will be capitalised.

The cost of software capitalised is = ₹ (7,00,000 + 2,00,000) = ₹ 9,00,000.

13. X Ltd. should recognize the intangible asset at ₹ 70,00,000 and ₹ 30,00,000 which was already recognized as an expense in first quarter should not be capitalised.

14. The intangible assets are revalued to ₹ 1,50,00,000 on an amortised replacement cost basis, which is a 2.5 times increase from its net value. Thereby applying the existing ratio of accumulated depreciation to the cost the revalued gross amount would be ₹ 2,50,00,000 gross and ₹ 1,00,00,000 on amortisation.

Alternatively, the net block can be increased by ₹ 90,00,000.

15. Ind AS 38 'Intangible Assets' requires an intangible asset to be recognized if, and only if, certain criteria are met. Regulatory approval on 1st June 20X5 was the last criterion to be met, the other criteria have been met as follows:

- Intention to complete the asset is apparent as it is a major project with full support from board
- Finance is available as resources are focused on project
- Costs can be reliably measured
- Benefits are expected to exceed costs – (in 2 years)

Since the project was completed on 20th April, 20X6, on 31st March, 20X6, the amount of ₹ 15,00,000 (₹ 18,00,000 x 10/12) should be capitalised in the balance sheet of year ending 20X5-20X6 representing expenditure since 1st June 20X5.

The expenditure incurred prior to 1st June 20X5 which is ₹ 3,00,000 (2/12 x ₹ 18,00,000) should be recognized as an expense, retrospective recognition of expense as an asset is not allowed.

Ind AS 36 'Impairment of assets' requires an intangible asset not yet available for use to be tested for impairment annually.

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Cash flow of ₹ 12,00,000 in perpetuity would clearly have a present value in excess of ₹ 12,00,000 and hence there would be no impairment. However, the research director is technically qualified, so impairment tests should be based on her estimate of a four-year remaining life and so present value of the future cost savings of ₹ 9,60,000 should be considered in that case.

₹ 9,60,000 is greater than the offer received (fair value less costs to sell) of ₹ 7,80,000 and so ₹ 9,60,000 should be used as the recoverable amount.

So, the carrying amount should be consequently reduced to ₹ 9,60,000.

Calculation of Impairment loss of intangible asset under development:

Particulars	₹
Carrying amount	15,00,000
Less: Recoverable amount	9,60,000
Impairment loss	5,40,000

Impairment loss of ₹ 5,40,000 is to be recognised in the profit and loss for the year 20X5-20X6.

Necessary adjusting entry to correct books of account will be:

		₹	₹
Operating expenses- Development expenditure	Dr.	3,00,000	
Operating expenses–Impairment loss	Dr.	5,40,000	
To Intangible asset under development			8,40,000

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UNIT 6 :
INDIAN ACCOUNTING STANDARD 40 : INVESTMENT PROPERTY

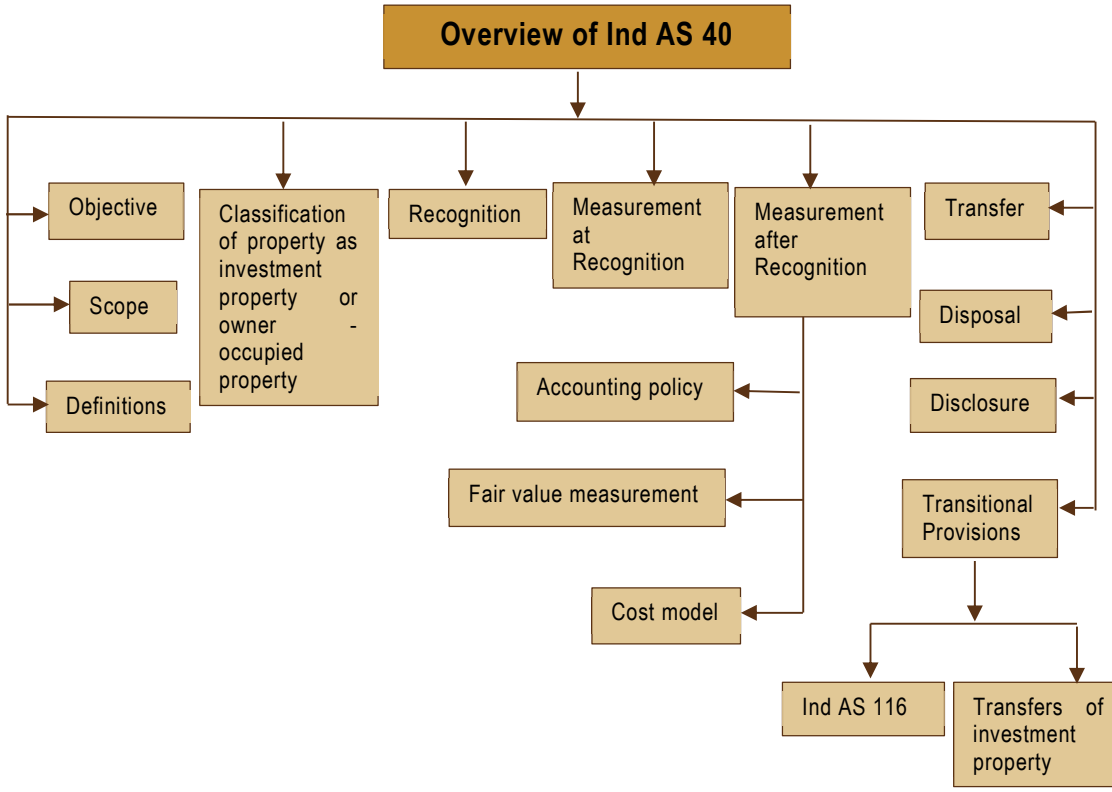
LEARNING OUTCOMES

After studying this unit, you will be able to

- List the objective and scope of this standard.
- Define the terms like investment property and owner-occupied property.
- Identify and recognize an investment property.
- Measure the investment property in accordance with the standard.
- Comply with disclosure requirements.

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UNIT OVERVIEW



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6.1 OBJECTIVE

The objective of this standard is to prescribe the accounting treatment for property (land and/or buildings) held to earn rentals or for capital appreciation (or both) and related disclosure requirements. Ind AS 40 prescribes the cost model for accounting for investment property.

6.2 SCOPE

1) Ind AS 40 should be applied in the recognition, measurement and disclosure of investment property.

2) This Standard does not apply to:

   a) biological assets related to agricultural activity (see Ind AS 41 '*Agriculture'* and Ind AS 16 '*Property, Plant and Equipment')*; and

   b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

6.3 RELEVANT DEFINITIONS

The following are the key Investment Property-related definitions:

1) **Investment property** is property (land or a building — or part of a building — or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

   a) use in the production or supply of goods or services or for administrative purposes; or

   b) sale in the ordinary course of business.

   Property mentioned in (a) above would be covered under Ind AS 16 '*Property, Plant and Equipment'* and property specified in (b) above would be dealt with under Ind AS 2 '*Inventories'*.

2) **Owner-occupied property** is property held (by the owner or by the lessee as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes.

   Ind AS 16 '*Property, Plant and Equipment'* applies to owner-occupied property and Ind AS 116 '*Leases'* applies to owner-occupied property held by a lessee as a right-of-use asset.

3) **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in

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an orderly transaction between market participants at the measurement date. (See Ind AS 113 '*Fair Value Measurement*').

4) **Cost** is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other Ind AS, e.g. Ind AS 102, *Share Based Payment*.

5) **Carrying amount** is the amount at which an asset is recognized in the balance sheet.



6.4 CLASSIFICATION OF PROPERTY AS INVESTMENT PROPERTY OR OWNER-OCCUPIED PROPERTY

1) Nature of Investment property

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independent of the other assets held by an entity. This distinguishes investment property from owner-occupied property. Accordingly, investment properties could represent a cash generating unit since they generate cash inflows that are largely independent of the cash inflows from other assets or group of assets, thus meeting the definition of cash generating unit laid down in Ind AS 36, '*Impairment of Assets*'.

The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. Ind AS 16 'Property, Plant and Equipment' applies to owner-occupied property and Ind AS 116 applies to owner-occupied property held by a lessee as a right-of-use asset.

2) Examples of investment property

The following are examples of investment property:

a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)

c) a building owned by the entity (or a right-of-use asset relating to a building held by the entity) and leased out under one or more operating leases.

d) a building that is vacant but is held to be leased out under one or more operating leases.

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e) property that is being constructed or developed for future use as investment property.

3) Examples of items which are not investment property

The following are examples of items that are not investment property and are therefore outside the scope of this Standard:

a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see Ind AS 2, *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.

b) owner-occupied property (see Ind AS 16 and Ind AS 116), including, (among other things)

(i) property held for future use as owner-occupied property,

(ii) property held for future development and subsequent use as owner-occupied property,

(iii) property occupied by employees (whether or not the employees pay rent at market rates) and

(iv) owner-occupied property awaiting disposal.

c) property leased to another entity under a finance lease.

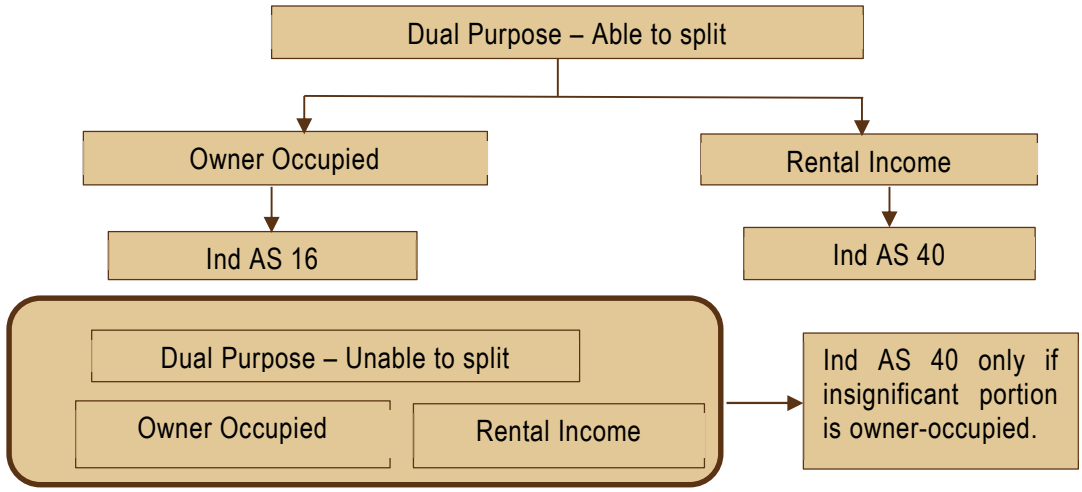
Not Investment Property

Sale in the ordinary course of business **Ind AS 2**	Owner - occupied property **Ind AS 16**	Employee occupied property **Ind AS 16**

4) Property held for more than one purpose

In circumstances when property is held partly for capital appreciation and/or rentals, and partly for production or supply of goods or services or for administrative purposes, the two parts are accounted for separately if they could be sold, or leased out separately under a finance lease, separately. If they could not be sold (or leased out under a finance lease) separately, the property is accounted for as an investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

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Examples 1 - 3

1. Sun Ltd owns a building having 15 floors of which it uses 5 floors for its office; the remaining 10 floors are leased out to tenants under operating leases. According to law company could sell legal title to the 10 floors while retaining legal title to the other 5 floors.

   In the given scenario, the remaining 10 floors should be classified as investment property since they are able to split the title between the floors.

2. Moon Ltd uses 35% of the office floor space of the building as its head office. It leases the remaining 65% to tenants, but it is unable to sell the tenant's space or to enter into finance leases related solely to it.

   Therefore, the company should not classify the property as an investment property as the 35% of the floor space used by the company is significant.

3. An entity owns a hotel, which includes a health and fitness centre, housed in a separate building that is part of the premises of the entire hotel. The owner operates the hotel and other facilities on the hotel with the exception of the health and fitness centre, which can be sold or leased out under a finance lease. The health and fitness centre will be leased to an independent operator. The entity has no further involvement in the health and fitness centre. In this scenario, management should classify the hotel and other facilities as property, plant and equipment in accordance with Ind AS 16 and the health and fitness centre as investment property under Ind AS 40.

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If the health and fitness centre could not be sold or leased out separately on a finance lease, then because the owner-occupied portion is not insignificant, the whole property would be treated as an owner-occupied property.

5) Ancillary services

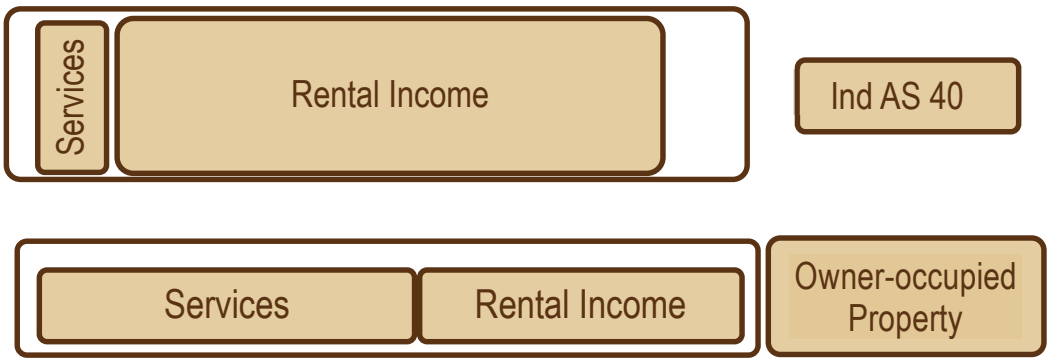
In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

In other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

Example 4

The owner of an office building provides security and maintenance services to the lessees who occupy the building. In such a case, since the services provided are insignificant, the property would be treated as an investment property.

If an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. In such a case, an owner-managed hotel is owner-occupied property, rather than investment property.



6) Difficulty in deciding classification under investment property

It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract. The terms of such contracts vary widely. At one end of the spectrum, the owner's position may, in

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substance, be that of a passive investor. At the other end of the spectrum, the owner may simply have outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

Judgement is needed to determine whether a property qualifies as investment property. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and with the related guidance as discussed above. The standard requires an entity to disclose these criteria based upon which it distinguishes investment property from owner-occupied property and from property held from sale in the ordinary course of business when classification is difficult.

Judgement is also required to determine whether the acquisition of Investment Property is the acquisition of an asset or a group of assets or a business combination within the scope of Ind AS 103, *Business Combinations*. Reference should be made to Ind AS 103 to determine whether it is a business combination. The discussion in the above points relates to whether or not property is owner-occupied property or investment property and not to determining whether or not the acquisition of property is a business combination as defined in Ind AS 103. Determining whether a specific transaction meets the definition of a business combination as defined in Ind AS 103 and includes an investment property as defined in this Standard requires the separate application of both Standards.

7) Property leased to other group members – treatment of same asset differently in the individual financial statements and the consolidated financial statements

In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary. The property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group. However, from the perspective of the entity that owns it, the property is investment property if it meets the definition of Investment Property. Therefore, the lessor treats the property as investment property in its individual financial statements.

Tabular summarisation

S. No.	Property	Does it meet definition of investment property	Which Ind AS is Applicable
1.	Owned by a company and leased out under an operating lease	Yes	Ind AS 40

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2.	Held as a right-to-use asset and leased out under an operating lease	Yes	Ind AS 40
3.	Held as a right-to-use asset and leased out under finance lease	No	Ind AS 116
4.	Property acquired with a view for development and resale	No	Ind AS 2
5.	Property partly owner occupied and partly leased out under operating lease	Depends	Ind AS 16 Ind AS 40
6.	Land held for currently undetermined use	Yes	Ind AS 40
7.	Property occupied by employees paying rent at less than market rate	No	Ind AS 16
8.	Investment property held for sale	No	Ind AS 105
9.	Existing investment property that is being redeveloped for continued use as investment property	Yes	Ind AS 40

6.5 RECOGNITION

1) General principle

An owned investment property shall be recognized as an asset when, and only when:

a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

b) the cost of the investment property can be measured reliably.

This general principle is used to consider whether capitalisation is appropriate both in respect of the cost incurred initially to acquire or construct an owned investment property and costs incurred subsequently to add to, replace part of, or service a property.

An investment property held by a lessee as a right-of-use asset shall be recognized in accordance with Ind AS 116.

2) Subsequent costs

Day-to-day servicing costs

Under the recognition principle set out above, an entity does not recognize in the carrying amount of an investment property the costs of the day-to-day servicing of such a property. Rather, these costs are recognized in the profit or loss as incurred. Costs of day-to-day servicing are primarily the cost of labour and consumables and may include the cost of minor parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the property.

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Replacement costs

Parts of investment properties may have been acquired through replacement. Under the recognition principle, an entity recognizes costs incurred to replace parts of the original property in the carrying amount of investment property if they meet the recognition criteria. The carrying amount of those parts that are replaced is derecognized in accordance with the derecognition provisions of this Standard.

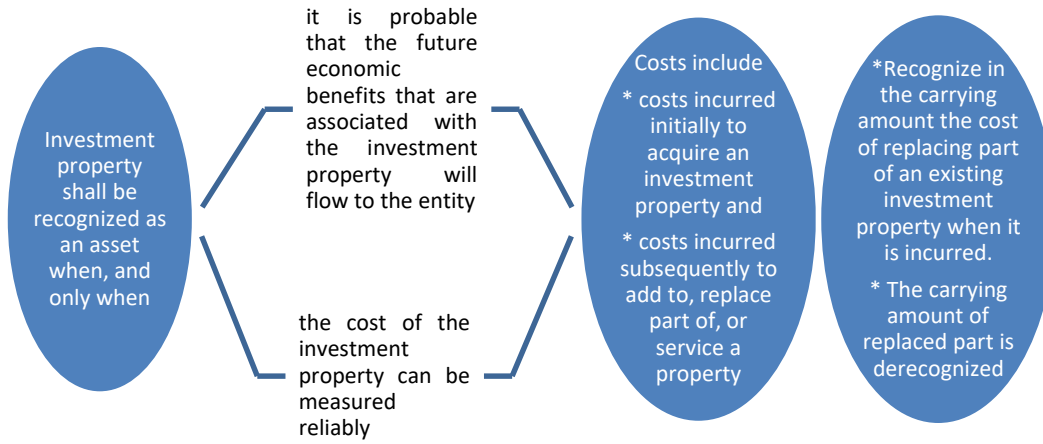


Illustration 1

X Limited owns a building which is used to earn rentals. The building has a carrying amount of ₹ 50,00,000. X Limited recently replaced interior walls of the building and the cost of new interior walls is ₹ 5,00,000. The original walls have a carrying amount of ₹ 1,00,000.

Advise, how X Limited should account for the above costs.

Solution

Under the recognition principle, an entity recognizes in the carrying amount of an investment property the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met and the carrying amount of those parts that are replaced is derecognized.

So, X Limited should add the cost of new walls and remove the carrying amount of old walls.

The new carrying amount of the building = ₹ 50,00,000 + ₹ 5,00,000 – ₹ 1,00,000

= ₹ 54,00,000.

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6.6 MEASUREMENT AT RECOGNITION

1) Measurement at recognition - general

An owned investment property should be measured initially at its cost. Transaction costs are included in the initial measurement.

Cost Inclusions

The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure (e.g. professional fees for legal services, property transfer taxes and other transaction costs).

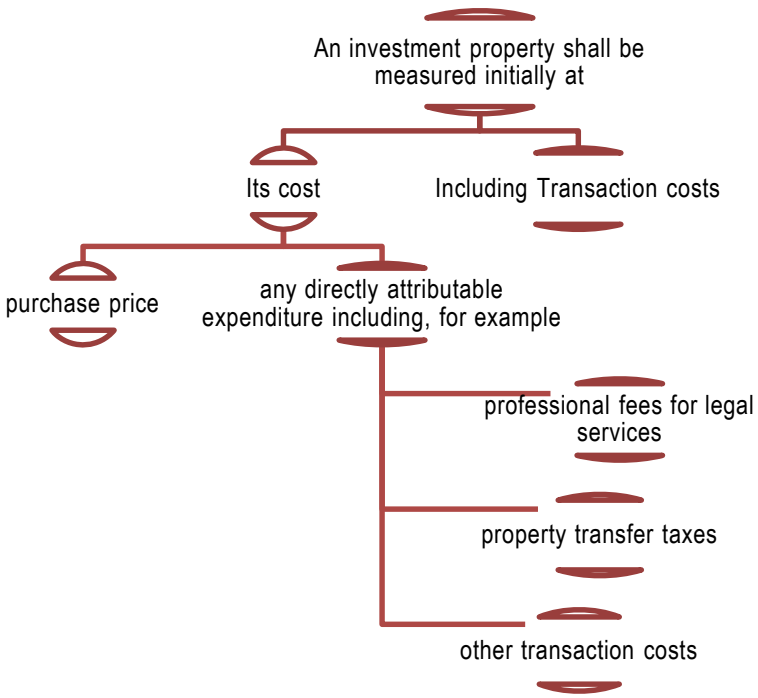
Cost Exclusions

The cost of an investment property is not increased by:

a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),

b) operating losses incurred before the investment property achieves the planned level of occupancy, or

c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.



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Illustration 2

Netravati Ltd. purchased a commercial office space as an Investment Property, in the Global Trade Centre Commercial Complex, for ₹ 5 crores. However, for purchasing the same, the Company had to obtain membership of the Global Trade Centre Commercial Complex Association by paying ₹ 6,25,000 as a one-time joining fee. Netravati Ltd. wants to write off the one-time joining fees paid as an expense under Membership and Subscription Charges and value the investment property at ₹ 5 crores. Advise.

Comment whether your answer will change if the office space was purchased with the intention of using it as an administrative centre of the company.

Solution

Cost of Investment Property

As per Ind AS 40, the cost of a purchased investment property comprises its purchase price and any directly attributable expenditure (e.g. professional fees for legal services, property transfer taxes and other transaction costs). Accordingly, on initial recognition, the one-time joining fee of ₹ 6,25,000 should be added to the purchase price. Therefore, the investment property should be measured at ₹ 5,06,25,000 (i.e. cost of the commercial office space + one-time joining fee). Writing off the amount of ₹ 6,25,000 to the P&L is not appropriate.

Use as Administrative Office

If the property is used as an administrative centre, it is not an investment property, but rather an 'owner occupied property'. Hence, Ind AS 16 will be applicable.

Even under Ind AS 16, all direct costs relating to the acquisition of the asset should be added to the purchase price. Hence, cost of the asset under Ind AS 16 would be ₹ 5,06,25,000.

*****

Illustration 3

X Limited purchased a building for ₹ 30,00,000 on 1st May, 20X1 with an intention to earn rentals. The purchase price was funded by a loan, interest on which is payable @ 5%. Property transfer taxes and direct legal costs of ₹ 1,00,000 and ₹ 20,000 respectively were incurred in acquiring the building. X Limited redeveloped the building into retail shops for rent under operating leases to independent third parties. Expenditures on redevelopment were:

- *₹ 2,00,000 planning permission.*
- *₹ 7,00,000 construction costs (including ₹ 40,000 refundable purchase taxes)*

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The building does not qualify the substantial period criteria for redevelopment of property under Ind AS 23.
Compute the cost of the building as per Ind AS 40.

Solution

As per Ind AS 40, the cost of a purchased investment property comprises its purchase price and any directly attributable expenditure (e.g. professional fees for legal services, property transfer taxes and other transaction costs).

Accordingly, cost of the building is arrived at as under:

Particulars		Amount in ₹	Total ₹
Purchase price			30,00,000
Add:	Property transfer taxes		1,00,000
	Direct legal costs		20,000
	Fee for planning permission		2,00,000
	Construction costs	7,00,000	
	Less: Refundable purchase taxes	40,000	6,60,000
Cost of the building as per Ind AS 40			**39,80,000**

Note: Since the building does not qualify the substantial period criteria for redevelopment of property under Ind AS 23, borrowing cost of loan fund has not been capitalised.

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2) Deferred payments

If payment for an investment property is deferred, its cost is the cash price equivalent. The difference between this amount and the total payments is recognized as interest expense over the period of credit.

Illustration 4

X Limited purchased a land worth of ₹ 1,00,00,000. It has option either to pay full amount at the time of purchases or pay for it over two years for a total cost of ₹ 1,20,00,000.

Determine the cost of the building under both the payment methods.

Solution

Using either payment method, the cost will be ₹ 1,00,00,000. If the second payment option is used, ₹ 20,00,000 will be treated as interest expenses over the credit period of 2 years.

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3) Investment property acquired through exchange of another asset

One or more investment properties may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an investment property is measured at fair value unless:

a) the exchange transaction lacks commercial substance or

b) the fair value of neither the asset received, nor the asset given up is reliably measurable.

The acquired asset is measured in this way even if an entity cannot immediately derecognize the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred, or

b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange, and

c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction as mentioned above shall reflect the post-tax cash flows. The result of these analysis may be clear without an entity having to perform detailed calculations.

The fair value of an asset is reliably measurable if:

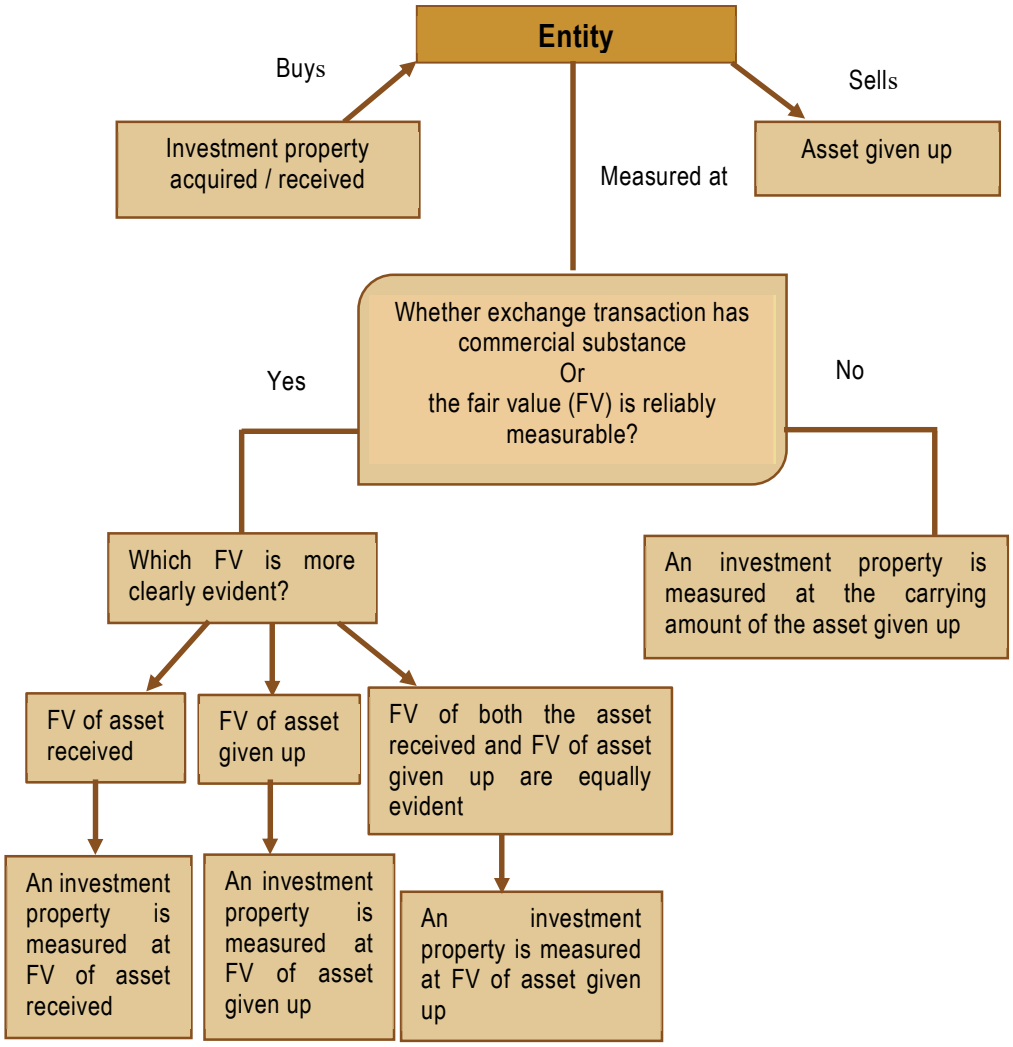
a) the variability in the range of reasonable fair value measurements is not significant for that asset or

b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

If the entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

An investment property held by a lessee as a right-of-use asset shall be measured initially at its cost in accordance with Ind AS 116.

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Example 5

Sun Ltd acquired a building in exchange of a warehouse whose fair value is ₹ 5,00,000 and payment of cash is ₹ 2,00,000. The fair value of the building received by the Company is ₹ 8,00,000. The company decided to keep that building for rental purposes.

The building is acquired with the purpose to earn rentals. Hence, it is a case of Investment Property acquired in exchange for a combination of monetary and non-monetary asset.

Therefore, **Journal entry at the time of acquisition is :**

Investment Property (Building) (5,00,000 + 2,00,000)	Dr.	7,00,000	
To Cash			2,00,000
To PPE (Property, Plant and Equipment) i.e. Warehouse			5,00,000

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Note: When the fair value of both the asset given up and acquired is mentioned, it is presumed that both the fair values are equally evident. In such a case, the fair value of the asset given up is considered as the cost of the asset purchased.

However, if the fair value of property acquired is more clearly evident, then the fair value of the asset acquired is considered. In such a situation, the Journal Entry at the time of acquisition (taking information given in the above example) would be

Investment Property (Building)	Dr.	8,00,000	
To Cash			2,00,000
To PPE (Warehouse)			5,00,000
To Gain on Sale of PPE			1,00,000

6.7 MEASUREMENT AFTER RECOGNITION

1) Accounting Policy

An entity shall adopt as its accounting policy the cost model for all of its investment property.

Cost Model

After initial recognition, an entity shall measure investment property:

(a) in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*, if it meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale);

(b) in accordance with Ind AS 116 if it is held by a lessee as a right-of-use asset and is not held for sale in accordance with Ind AS 105; and

(c) in accordance with the requirements in Ind AS 16 for cost model in all other cases.

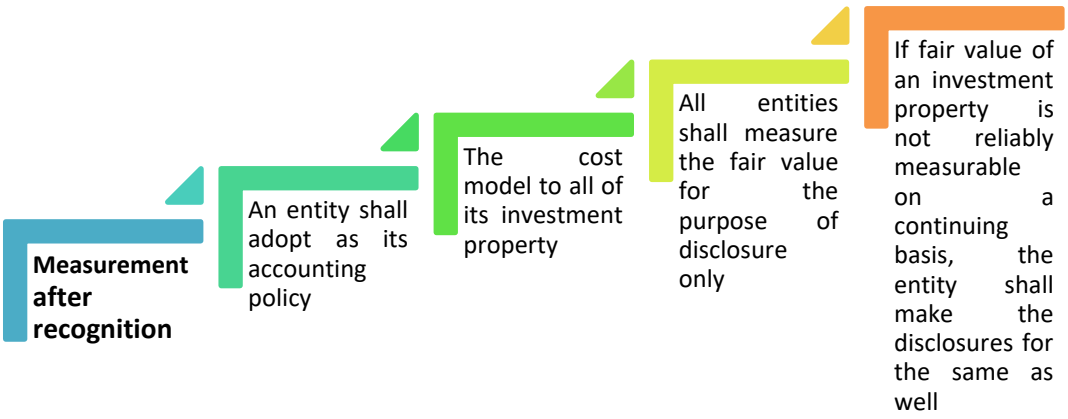
Entities are required to measure the fair value of investment property, for the purpose of disclosure even though they are required to follow the cost model. An entity is encouraged, but not required, to measure the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognized and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

2) Fair Value Measurement

While measuring the fair value of investment property in accordance with Ind AS 113, an entity should ensure that the fair value reflects, among other things, rental income from current leases and other assumptions that market participants would use when pricing investment property under current market conditions.

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When a lessee measures fair value of an investment property that is held as a right-of-use asset, it shall measure the right-of-use asset, and not the underlying property at fair value.



3) Inability to measure fair value reliably

There is a rebuttable presumption that an entity can reliably measure the fair value of an investment property on a continuing basis.

Situations when fair value is not reliably measurable:

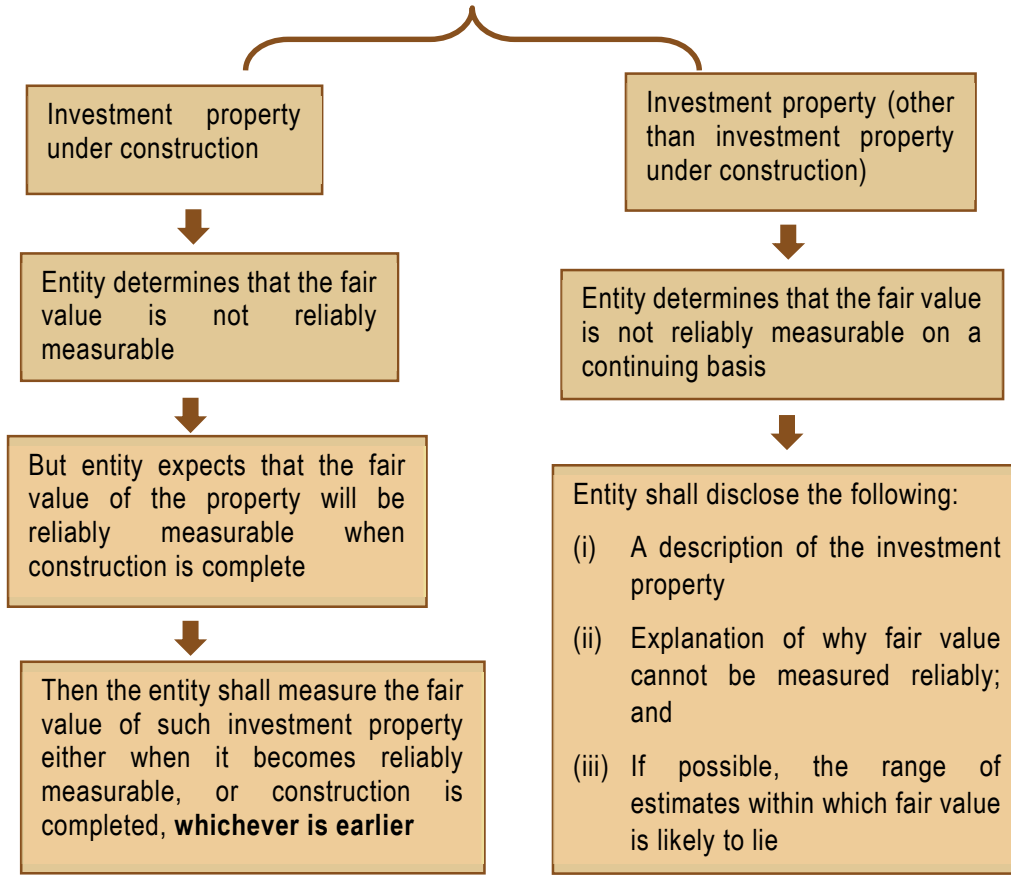
- In **exceptional** cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property after a change in use) that the fair value of the property will **not** be reliably measurable on a continuing basis.
- The usefulness of a single point measure of fair value which is required gets negated in the above exceptional cases due to – (a) great variability in the range of reasonable fair value measurements, and (b) high difficulty in the assessment the probabilities of the various outcomes.
- This arises when, and only when

  (a) the market for comparable properties is inactive (e.g. there are few recent transactions, price quotations are not current or observed transaction prices indicate that the seller was forced to sell) and

  (b) alternative reliable measurements of fair value (for example, based on discounted cash flow projections) are not available.

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Treatment when Fair Value is not reliably measurable



Important Points:

- Once an entity becomes able to measure reliably the fair value of an investment property under construction for which the fair value was not previously measured, it should measure the fair value of that property.
- Once construction of that property is complete, it is presumed that fair value can be measured reliably. If this is not the case, the entity should make the disclosures as mentioned under investment property (other than investment property under construction) above.
- The presumption that the fair value of investment property under construction can be measured reliably can be rebutted only on initial recognition. An entity that has measured the fair value of an item of investment property under construction may not conclude that the fair value of the completed investment property cannot be measured reliably.

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- ❖ In the exceptional cases when an entity is compelled, for the reason given above to make the disclosures, it should determine the fair value of all its other investment property, including investment property under construction. In these cases, although an entity may make the disclosures as required for one investment property, the entity should continue to determine the fair value of each of the remaining properties for disclosure as required.
- ❖ If an entity has previously measured the fair value of an investment property, it shall continue to measure the fair value of that property until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available.

6.8 TRANSFERS

1) An entity shall transfer a property to, or from, investment property when, and only when, there is a change in use. A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use. Examples of evidence of a change in use include:

   a) commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;

      Ind AS 40 ⇨ Ind AS 16

   b) commencement of development with a view to sale, for a transfer from investment property to inventories;

      Ind AS 40 ⇨ Ind AS 2

   c) end of owner-occupation, for a transfer from owner-occupied property to investment property; or

      Ind AS 16 ⇨ Ind AS 40

   d) inception of an operating lease to another party, for a transfer from inventories to investment property.

      Ind AS 2 ⇨ Ind AS 40

2) When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognized (eliminated from the balance sheet) and does not reclassify it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment.

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3) Transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

Illustration 5

Moon Ltd. has purchased a building on 1st April, 20X1 at a cost of ₹ 10 million. The building was used as a factory by the Moon Ltd. and was measured under cost model. The expected useful life of the building is estimated to be 10 years. Due to decline in demand of the product, the Company does not need the factory anymore and has rented out the building to a third party from 1st April, 20X5. On this date, the fair value of the building is ₹ 8 million. Moon Ltd. uses cost model for accounting of its investment property.

Determine the value of the building on reclassification as investment property.

Solution

	(₹ Million)
Carrying amount of the building after depreciation of 4 years (10-10/10 x 4)	6
The company has applied cost model under Ind AS 16 till now.	
There is no impairment as the fair value is greater than the carrying amount of building.	
Revaluation Surplus credited to Other Comprehensive Income (not applicable since cost model is used under Ind AS 16)	---
Building initially recognized as Investment Property (Cost model Ind AS 40)	6

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6.9 DISPOSALS

1) An investment property should be derecognized (eliminated from the balance sheet)
   a. on disposal or
   b. when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.
2) The disposal of an investment property may be achieved by:
   a. sale or
   b. entering into a finance lease.
3) The date of disposal for investment property that is sold is the date the recipient obtains control of the investment property in accordance with the requirements for determining when a performance obligation is satisfied in Ind AS 115. Ind AS 116 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

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4) De-recognition of replaced parts:

   a. If, in accordance with the recognition principle in paragraph 16, an entity recognizes in the carrying amount of an asset the cost of a replacement for part of an investment property, it derecognizes the carrying amount of the replaced part.

   b. A replaced part may not be a part that was depreciated separately.

   c. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

5) Gains or losses arising from the retirement or disposal of investment property should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognized in profit or loss (unless Ind AS 116 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.

6) The amount of consideration to be included in the gain or loss arising from the derecognition of an investment property is determined in accordance with the requirements for determining the transaction price as per Ind AS 115. Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.

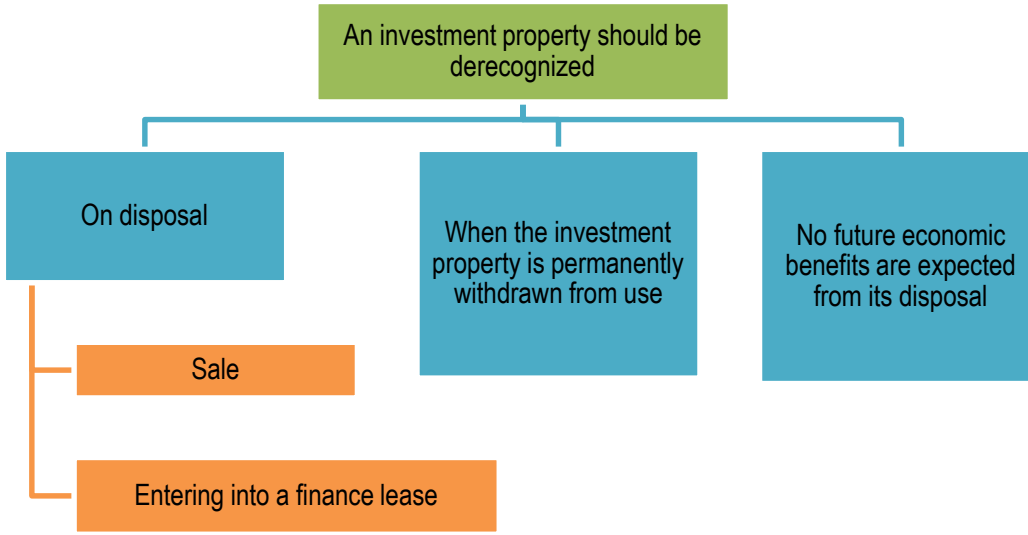
7) An entity applies Ind AS 37 or other Standards, as appropriate, to any liabilities that it retains after disposal of an investment property.

8) Compensation from third parties for investment property that was impaired, lost or given up shall be recognized in profit or loss when the compensation becomes receivable.

9) Impairments or losses of investment property, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

Items	Treatment
Impairments of investment property	Recognized in accordance with Ind AS 36
Retirements or disposals of investment property	Recognized in accordance with Ind AS 40
Compensation from third parties for investment property that was impaired, lost or given up	Recognized in profit or loss when it becomes receivable
The cost of assets restored, purchased or constructed as replacements	Determined in accordance with Ind AS 40

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S. No.	Particular	Detail
1.	Date of disposal for investment property	• The date is when the recipient obtains control of the investment property for determining when a performance obligation is satisfied. • Ind AS 116 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.
2.	Measurement of consideration receivable on disposal	• The consideration receivable on disposal of an investment property is recognized initially **at fair value** • If payment for an investment property is deferred, the consideration received is recognized initially at the **cash price equivalent**. • The **difference** between the nominal amount of the consideration and the cash price equivalent **is recognized as interest revenue**
3.	Compensation	• Compensation from third parties for investment property that was impaired, lost or given up **shall be recognized in profit or loss when the compensation becomes receivable.**

Example 6

Sun Ltd, an aeronautics company is having a building which is given on an operating lease. The book value of such building in the books is ₹ 2,00,000.

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Case -A

Pluto Ltd. offers to buy the building at ₹ 4,00,000.

Bank	Dr.	4,00,000	
To Investment Property			2,00,000
To Gain on disposal			2,00,000

Case-B

Pluto Ltd. offers to take the building on finance lease for 10 years at a lease rental of ₹ 80,000 p.a. The present value of minimum lease payments is ₹ 3,20,000.

Lease Receivable	Dr.	3,20,000	
To Investment Property			2,00,000
To Gain on Disposal			1,20,000

6.10 DISCLOSURE

The disclosures below apply in addition to those in Ind AS 116. In accordance with Ind AS 116, the owner of an investment property provides lessors' disclosures about leases into which it has entered. A lessee that holds an investment property as a right-of-use asset provides lessees' disclosures as required by Ind AS 116 and lessors' disclosures as required by Ind AS 116 for any operating leases into which it has entered.

An entity should disclose:

1) its accounting policy for measurement of investment property.
2) when classification is difficult, the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.
3) the extent to which the fair value of investment property (as measured for disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognized and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.
4) the amounts recognized in profit or loss for:
   a) rental income from investment property;
   b) direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period; and
   c) direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period.
5) the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.

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6) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

7) In addition to the general disclosures required above, an entity is required to disclose:

   a) the depreciation methods used;

   b) the useful lives or the depreciation rates used;

   c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;

8) An entity is also required to provide a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:

   a) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognized as an asset;

   b) additions resulting from acquisitions through business combinations;

   c) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;

   d) depreciation;

   e) the amount of impairment losses recognized, and the amount of impairment losses reversed, during the period in accordance with Ind AS 36;

   f) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;

   g) transfers to and from inventories and owner-occupied property; and

   h) other changes.

9) An entity is also required to disclose the fair value of investment property. In the exceptional cases when an entity cannot measure the fair value of the investment property reliably, it should disclose:

   a) a description of the investment property;

   b) an explanation of why fair value cannot be measured reliably; and

   c) if possible, the range of estimates within which fair value is highly likely to lie.

6.11 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'GMR Infrastructure Limited' for the financial year 2021-2022 with respect to 'Investment Property' and its accounting policy thereon.

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Consolidated balance sheet as at March 31, 2022

(₹ in crore)

Particulars	Notes	March 31, 2022	March 31, 2021
ASSETS			
Non-current assets			
Property, plant and equipment	3	9,400.91	9,021.22
Capital work-in-progress	3	10,162.63	6,615.65
Investment properties	4	-	534.51

4. Investment property

(₹ in crore)

Particulars	Investment property		Investment property under construction	Total
	Land	Buildings		
Gross carrying amount				
As at April 01, 2020	**202.74**	**39.76**	**3,252.56**	**3,495.06**
Acquisitions during the year	1.68	-	-	1.68
Expenses capitalised during the year	-	-	291.52	291.52
Disposals (refer note 48(i))	(51.12)	(13.07)	(2,945.48)	(3,009.67)
Asset classified as held for sale (refer note 34(b) and (c))	(64.93)	-	(171.63)	(236.56)
Other adjustments	-	-	(5.00)	(5.00)
As at March 31, 2021	**88.37**	**26.69**	**421.97**	**537.03**
Acquisitions during the year	1.33	-	-	1.33
Expenses capitalised during the year	0.10	-	35.16	35.26
Disposals	(0.80)	-	-	(0.80)
Transfer on account of composite scheme of arrangement (refer note 34(d))	(89.00)	(26.69)	(457.13)	(572.82)
As at March 31, 2022	**-**	**-**	**-**	**-**
Accumulated depreciation				
As at April 01, 2020	**-**	**3.78**	**-**	**3.78**
Charge for the year	-	0.90	-	0.90
Disposals	-	(2.16)	-	(2.16)
As at March 31, 2021	**-**	**2.52**	**-**	**2.52**
Charge for the year	-	0.34	-	0.34
Transfer on account of composite scheme of arrangement (refer note 34(d))	-	(2.86)	-	(2.86)
As at March 31, 2022	**-**	**-**	**-**	**-**
Net carrying amount				
As at March 31, 2021	**88.37**	**24.17**	**421.97**	**534.51**
As at March 31, 2022	**-**	**-**	**-**	**-**

Notes :

(a) Information regarding income and expenditure of investment property **(included in discontinued operations)**:

(₹ in crore)

Particulars	March 31, 2022	March 31, 2021
Rental income derived from investment property	2.24	4.71
Less: Direct operating expenses (including repairs and maintenance) generating rental income	(0.84)	(2.53)
Less: Direct operating expenses (including repairs and maintenance) that did not generate rental income	(0.01)	(2.52)
Profit/ (loss) arising from investment property before depreciation	**1.39**	**(0.34)**
Less: Depreciation for the year	(0.34)	(0.90)
Profit/ (loss) arising from investment property	**1.05**	**(1.24)**

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(b) Investment property under construction including land as at March 31, 2022 represents Nil acres (March 31, 2021 : 1,284 acres) of land held by the Group consisting of Nil acres (March 31, 2021 : 814 acres) of land held by GKSIR for the purpose of SEZ at Krishnagiri and Nil acres (March 31, 2021 : 470 acres) of land held by various other entities.

(c) Investment property of the Group has been pledged for the borrowing taken by the Group. Refer note 18 and note 23.

(d) Certain investment properties are leased to tenants under long-term operating leases with rentals payable monthly. Refer note 40 for details on future minimum lease rentals.

(e) Refer to note 39 (b) for disclosure of other commitments for investment property.

(f) Fair value hierarchy disclosures for investment property have been provided in note 50.

ACCOUNTING POLICY

Investment property

Investment properties are measured initially at cost, including transaction costs. Subsequent to initial recognition, investment properties are stated at cost less accumulated depreciation and accumulated impairment loss, if any.

The cost includes borrowing costs for long-term construction projects if the recognition criteria are met.

Depreciation is recognized using straight line method so as to write off the cost of the investment property less their residual values over their useful lives specified in Schedule II to the Companies Act, 2013, or in the case of assets where the useful life was determined by technical evaluation, over the useful life so determined. Depreciation method is reviewed at each financial year end to reflect the expected pattern of consumption of the future benefits embodied in the investment property. The estimated useful life and residual values are also reviewed at each financial year end and the effect

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of any change in the estimates of useful life/ residual value is accounted on prospective basis. Freehold land and properties under construction are not depreciated.

Investment properties are derecognized either when they have been disposed off or when they are permanently withdrawn from use and no future economic benefit is expected from their disposal.

The difference between the net disposal proceeds and the carrying amount of the asset is recognized in profit or loss in the period of derecognition.

Investment property under construction

Investment property under construction represents expenditure incurred in respect of capital projects and are carried at cost. Cost includes land, related acquisition expenses, development/construction costs, borrowing costs and other direct expenditure.

(Source: Annual Report 2021-2022 - GMR Infrastructure Limited)

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. On 1st April, 20X1 an entity acquired an investment property (building) for ₹ 40,00,000. Management estimates the useful life of the building as 20 years measured from the date of acquisition. The residual value of the building is ₹ 2,00,000. Management believes that the straight-line depreciation method reflects the pattern in which it expects to consume the building's future economic benefits. What is the carrying amount of the building on 31st March, 20X2?

2. X Limited has an investment property (building) which is carried in Balance Sheet on 31st March, 20X1 at ₹ 15,00,000. During the year X Limited has stopped letting out the building and used it as its office premise. On 31st March, 20X1, management estimates the recoverable amount of the building as ₹ 10,00,000 and its remaining useful life as 20 years and residual value is nil. How should X Limited account for the above investment property as on 31st March, 20X1?

3. In financial year 20X1-20X2, X Limited incurred the following expenditure in acquiring property consisting of 6 identical houses each with separate legal title including the land on which it is built.

   The expenditure incurred on various dates is given below:

   On 1st April, 20X1 - Purchase cost of the property ₹ 1,80,00,000.

   On 1st April, 20X1 – Non-refundable transfer taxes ₹ 20,00,000 (not included in the purchase cost).

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On 2nd April, 20X1- Legal cost related to property acquisition ₹ 5,00,000.

On 6th April, 20X1- Advertisement campaign to attract tenants ₹ 3,00,000.

On 8th April, 20X1 - Opening ceremony function for starting business ₹ 1,50,000.

Throughout 20X1-20X2, incurred ₹ 1,00,000 towards day-to-day repair maintenance and other administrative expenses.

X Limited uses one of the six houses for office and accommodation of its few staffs. The other five houses are rented to various independent third parties.

How X Limited will account for all the above-mentioned expenses in the books of account?

4. X Ltd. is engaged in the construction industry and prepares its financial statements up to 31st March each year. On 1st April, 20X1, X Ltd. purchased a large property (consisting of land) for ₹ 2,00,00,000 and immediately began to lease the property to Y Ltd. on an operating lease. Annual rentals were ₹ 20,00,000. On 31st March, 20X5, the fair value of the property was ₹ 2,60,00,000. Under the terms of the lease, Y Ltd. was able to cancel the lease by giving six months' notice in writing to X Ltd. Y Ltd. gave this notice on 31st March, 20X5 and vacated the property on 30th September, 20X5. On 30th September, 20X5, the fair value of the property was ₹ 2,90,00,000. On 1st October, 20X5, X Ltd. immediately began to convert the property into ten separate flats of equal size which X Ltd. intended to sell in the ordinary course of its business. X Ltd. spent a total of ₹ 60,00,000 on this conversion project between 30th September, 20X5 to 31st March, 20X6. The project was incomplete at 31st March, 20X6 and the directors of X Ltd. estimate that they need to spend a further ₹ 40,00,000 to complete the project, after which each flat could be sold for ₹ 50,00,000.

   Examine and show how the three events would be reported in the financial statements of X Ltd. for the year ended 31st March, 20X6 as per Ind AS.

5. Shaurya Limited owns a Building A which is specifically used for the purpose of earning rentals. The Company has not been using the building A or any of its facilities for its own use for a long time. The company is also exploring the opportunities to sell the building if it gets the reasonable amount in consideration.

   Following information is relevant for Building A for the year ending 31st March, 20X2:

   Building A was initially purchased at the cost of ₹ 10 crores. At that time, the useful life of the building was estimated to be 20 years; out of which 5 years have been expired as on 1st April, 20X1. The company follows straight line method for depreciation.

   During the year, the company has invested in another Building B with the purpose to hold it for capital appreciation. The property was purchased on 1st April, 20X1 at the cost of

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₹ 2 crores. Expected life of the building is 40 years. As usual, the company follows straight line method of depreciation.

Further, during the year 20X1-20X2 the company earned/incurred following direct operating expenditure relating to Building A and Building B:

Rental income from Building A	=	₹ 75 lakhs
Rental income from Building B	=	₹ 25 lakhs
Sales promotion expenses	=	₹ 5 lakhs
Fees & Taxes	=	₹ 1 lakhs
Ground rent	=	₹ 2.5 lakhs
Repairs & Maintenance	=	₹ 1.5 lakhs
Legal & Professional	=	₹ 2 lakhs
Commission and brokerage	=	₹ 1 lakhs

The company does not have any restrictions and contractual obligations against Property - A and B. For complying with the requirements of Ind AS, the management sought an independent report from the specialists so as to ascertain the fair value of buildings A and B. The independent valuer has valued the fair value of property as per the valuation model recommended by International valuation standards committee. Fair value has been computed by the method by streamlining present value of future cash flows namely, discounted cash flow method.

The other key inputs for valuation are as follows:

The estimated rent per month per square feet for the period is expected to be in the range of ₹ 50 - ₹ 60. And it is further expected to grow at the rate of 10 percent per annum for each of 3 years. The weighted discount rate used is 12% to 13%.

Assume that the fair value of properties based on discounted cash flow method is measured at ₹ 10.50 crores. The treatment of fair value of properties is to be given in the financials as per the requirements of Indian accounting standards.

What would be the treatment of Building A and Building B in the balance sheet of Shaurya Limited? Provide detailed disclosures and computations in line with relevant Indian accounting standards. Treat it as if you are preparing a separate note or schedule, of the given assets in the balance sheet.

6. X Ltd owned a land property whose future use was not determined as at 31st March 20X1. How should the property be classified in the books of X Ltd as at 31st March 20X1?

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During June 20X1, X Ltd commenced construction of office building on it for own use. Presuming that the construction of the office building will still be in progress as at 31st March 20X2

(a) How should the land property be classified by X Ltd in its financial statements as at 31st March 20X2?

(b) Will there be a change in the carrying amount of the property resulting from any change in use of the investment property?

(c) Whether the change in classification to, or from, investment properties is a change in accounting policy to be accounted for in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors?

(d) Would your answer to (a) above be different if there were to be a management intention to commence construction of an office building for own use; however, no construction activity was planned by 31st March 20X2?

Answers

1. Cost of the asset is ₹ 40,00,000.

Depreciable amount = Cost less Residual value = ₹ (40,00,000 - 2,00,000) = ₹ 38,00,000

Depreciation for the year = Depreciable amount/useful life

= ₹ 38,00,000/20

= ₹ 1,90,000.

Carrying amount = Cost less accumulated depreciation

= ₹ (40,00,000 - 1,90,000) = ₹ 38,10,000.

2. At 31st March, 20X1, X Limited must transfer the property from investment property to property, plant and equipment since there is a change in use of the said building.

The transfer should be made at its carrying amount i.e., ₹ 15,00,000.

Since recoverable amount of the property as on 31st March, 20X1 is ₹ 10,00,000, impairment loss ₹ 5,00,000 should be recognized in the Statement of Profit and Loss. So, the carrying amount of Investment property at 31st March, 20X1 would be ₹ 10,00,000.

The entity must disclose the reclassification.

From April, 20X1, X Limited will depreciate the building over its remaining useful life of 20 years.

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3. The cost of the property = ₹ (1,80,00,000 + 20,00,000 + 5,00,000) = ₹ 2,05,00,000.

Since five houses out of six are being rented, so 5/6th of the property cost will be accounted for as an investment property and 1/6th of the property cost will be accounted for as owner-occupied property.

Cost of the investment property = ₹ 2,05,00,000 x 5/6 = ₹ 1,70,83,333

Cost of the owner-occupied property = ₹ (2,05,00,000 - 1,70,83,333) = ₹ 34,16,667.

All other costs, i.e., advertisement expenses, ceremony expenses and repair maintenance expenses will be expensed off as and when incurred.

4. From 1st April, 20X1, the property would be regarded as an investment property since it is being held for its investment potential rather than being owner occupied or developed for sale.

The property would be measured under the cost model. This means it will be measured at ₹ 2,00,00,000 at each year end.

On 30th September, 20X5, the property ceases to be an investment property. X Ltd. begins to develop it for sale as flats.

As per para 59 of Ind AS 40, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes. Hence, the carrying value of the reclassified property will be ₹ 2,00,00,000.

Since the lease of the property is an operating lease, rental income of ₹ 10,00,000 (₹ 20,00,000 x 6/12) would be recognized in P/L for the year ended 31st March, 20X6.

The additional costs of ₹ 60,00,000 for developing the flats which were incurred up to and including 31st March, 20X6 would be added to the 'cost' of inventory to give a closing cost of ₹ 2,60,00,000.

The total selling price of the flats is expected to be ₹ 5,00,00,000 (10 x ₹ 50,00,000). Since the further costs to develop the flats total ₹ 40,00,000, their net realisable value is ₹ 4,60,00,000 (₹ 5,00,00,000 – ₹ 40,00,000), so the flats will be measured at a cost of ₹ 2,60,00,000.

The flats will be shown in inventory as a current asset.

5. Investment property is held to earn rentals or for capital appreciation or both. Ind AS 40 shall be applied in the recognition, measurement and disclosure of investment property. An investment property shall be measured initially at its cost. After initial recognition, an entity

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shall measure all of its investment properties in accordance with Ind AS 16's requirements for cost model.

The measurement and disclosure of Investment property as per Ind AS 40 in the balance sheet would be depicted as follows:

INVESTMENT PROPERTIES:	
Particulars	**Period ended 31st March, 20X2 (₹ in crores)**
Gross Amount:	
Opening balance (A)	10.00
Additions during the year (B)	2.00
Closing balance (C) = (A) + (B)	12.00
Depreciation:	
Opening balance (D)	2.50
Depreciation during the year (E) (0.5 + 0.05)	0.55
Closing balance (F) = (D) + (E)	3.05
Net balance (C) - (F)	8.95

The changes in the carrying value of investment properties for the year ended 31st March, 20X2 are as follows:

Amount recognized in Profit and Loss with respect to Investment Properties

Particulars	Period ending 31st March, 20X2 (₹ in crores)
Rental income from investment properties (0.75 + 0.25)	1.00
Less: Direct operating expenses generating rental income (5 + 1 + 2.5 + 1.5 + 2 + 1)	(0.13)
Profit from investment properties before depreciation and indirect expenses	0.87
Less: Depreciation	(0.55)
Profit from earnings from investment properties before indirect expenses	0.32

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Disclosure Note on Investment Properties acquired by the entity

The investment properties consist of Property A and Property B. As at 31st March, 20X2, the fair value of the properties is ₹ 10.50 crores. The valuation is performed by independent valuers, who are specialists in valuing investment properties. A valuation model as recommended by International Valuation Standards Committee has been applied. The Company considers factors like management intention, terms of rental agreements, area leased out, life of the assets etc. to determine classification of assets as investment properties.

The Company has no restrictions on the realisability of its investment properties and no contractual obligations to purchase, construct or develop investment properties or for repairs, maintenance and enhancements.

Description of valuation techniques used and key inputs to valuation on investment properties:

Valuation technique	Significant unobservable inputs	Range (Weighted average)
Discounted cash flow (DCF) method	- Estimated rental value per sq. ft. per month	- ₹ 50 to ₹ 60
	- Rent growth per annum	- 10% every 3 years
	- Discount rate	- 12% to 13%

6. As per paragraph 8(b) of Ind AS 40, any land held for currently undetermined future use, should be classified as an investment property. Hence, in this case, the land would be regarded as held for capital appreciation. Hence the land property should be classified by X Ltd as investment property in the financial statements as at 31st March 20X1.

As per Para 57 of the Standard, an entity can change the classification of any property to, and from, an investment property when and only when evidenced by a change in use. A change occurs when the property meets or ceases to meet the definition of investment property and there is evidence of the change in use. Mere management's intention for use of the property does not provide evidence of a change in use.

(a) Since X Ltd has commenced construction of office building on it for own use, the property should be reclassified from investment property to owner occupied as at 31st March 20X2.

(b) As per Para 59, transfers between investment property, owner occupied and inventories do not change the carrying amount of the property transferred and they do not change the cost of the property for measurement or disclosure purposes.

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(c) No. The change in classification to, or from, investment properties is due to change in use of the property. No retrospective application is required and prior period's financial statements need not be re-stated.

(d) Mere management intentions for use of the property do not evidence change in use. Since X Ltd. has no plans to commence construction of the office building during 20X1-20X2, the property should continue to be classified as an investment property by X Ltd. in its financial statements as at 31st March 20X2.

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UNIT 7 :
INDIAN ACCOUNTING STANDARD 105 : NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

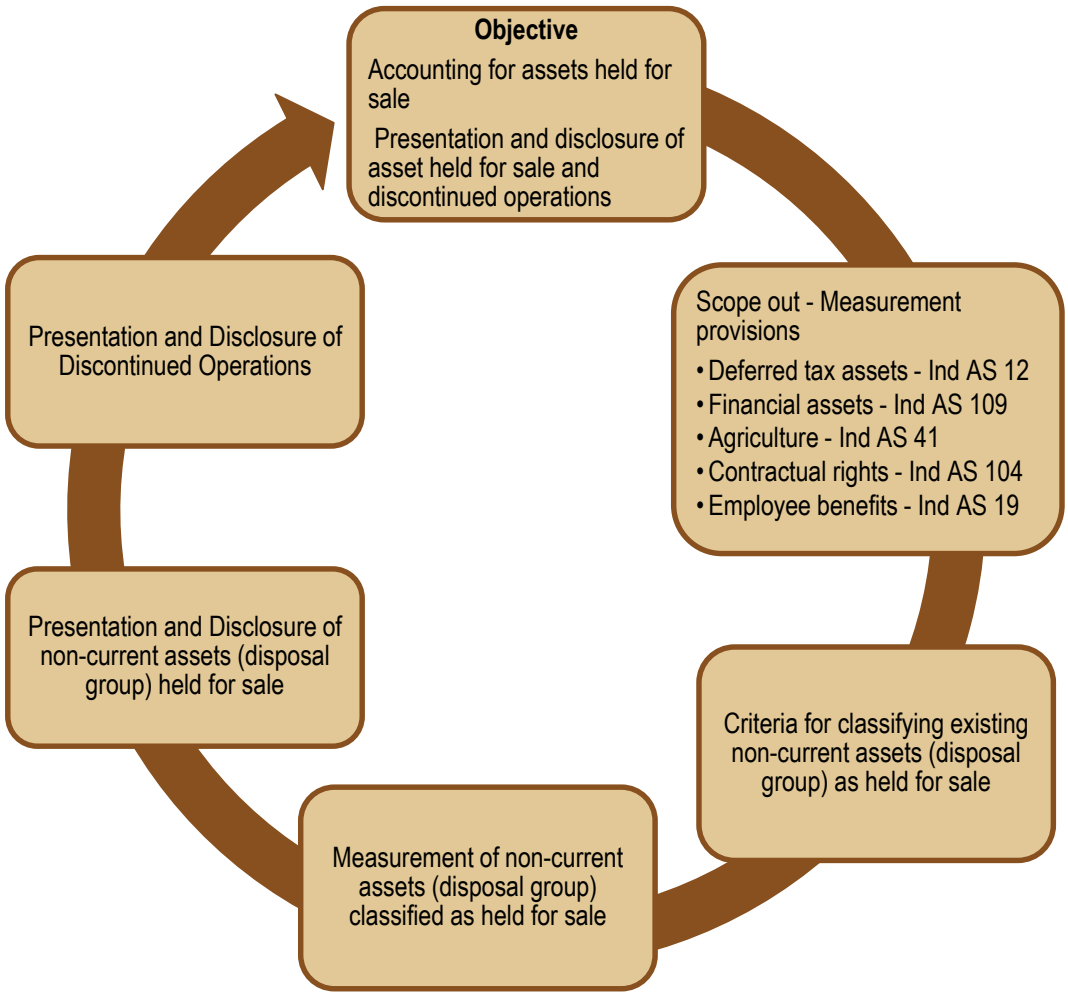
LEARNING OUTCOMES

After studying this unit, you will be able to

- List out the objective and scope of the standard
- Define the terms non-current asset, disposal group, cash generating unit and discontinued operations
- Examine the criteria for classifying non-current assets (or disposal group) as held for sale
- Measure non-current assets (or disposal group) classified as held for sale
- Present and disclose non-current assets (or disposal group) classified as held for sale
- Present and disclose discontinued operations as per the standard.
- Elaborate significant differences between Ind AS 105 and AS 24

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UNIT OVERVIEW



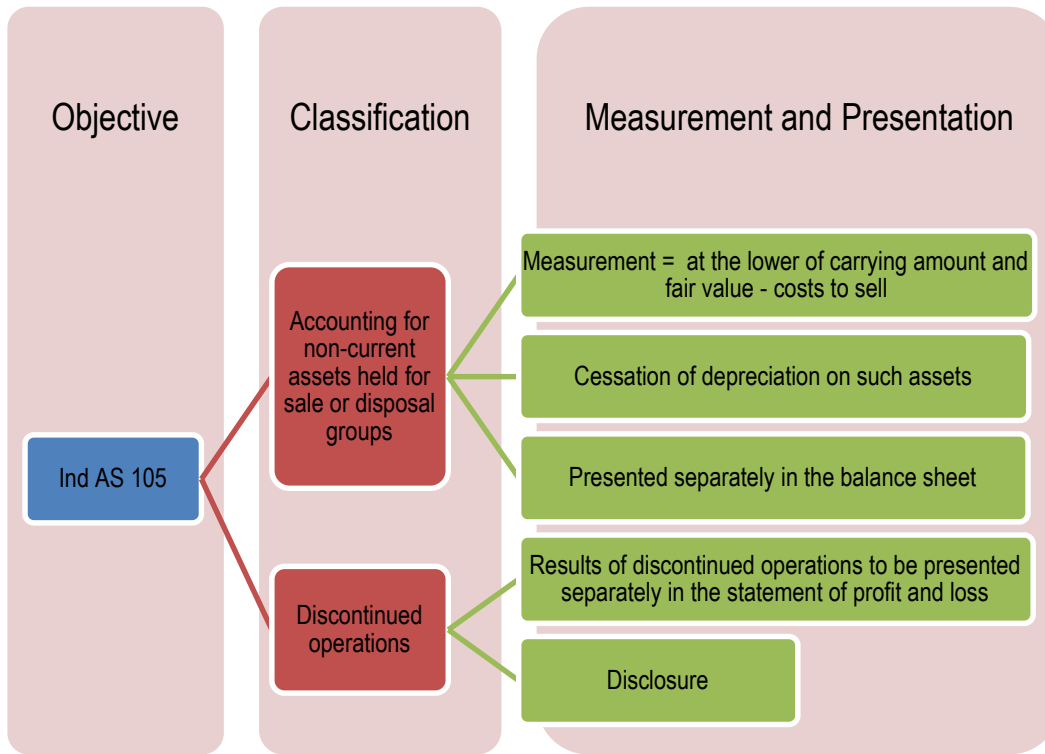
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7.1 OBJECTIVE

- Non-Current assets held for sale are presented separately from other assets in the Balance Sheet as their classification will change and the value will be principally recovered through sale transaction rather than through continuous use in operations of the entity. This standard specifies the accounting for assets held for sale.
- Results of Discontinuing Operations should be separately presented in the Statement of Profit and loss as it affects the ability of the entity to generate future cash flows. This standard specifies the presentation and disclosure of discontinued operations.

The disclosure information provided in the standard enhances the ability of users of financial statements to make projections of an entity's cash flows, earnings-generating capacity, and financial position by segregating information about held for sale assets and discontinued operations from the information about continuing operations.

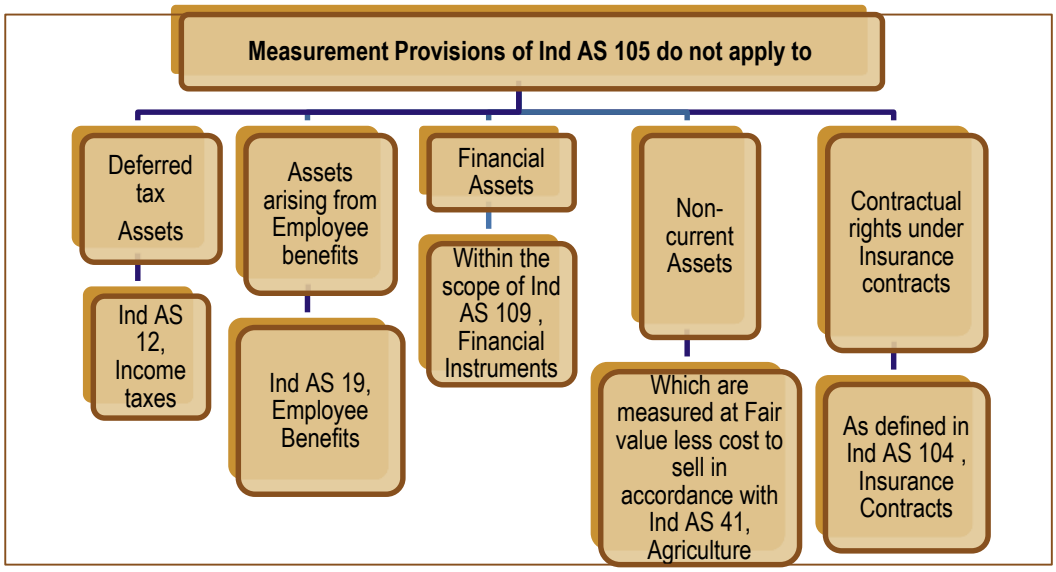
Hence, two core objectives of the standard are as follows:



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7.2 SCOPE

- The classification and presentation requirements of this Ind AS apply to all recognised non-current assets and to all disposal groups of an entity.
- The measurement requirements of this Ind AS also apply to all recognised non-current assets and to all disposal groups of an entity except few exceptions mentioned below.
- Assets classified as non-current in accordance with Ind AS 1, Presentation of Financial Statements, shall not be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with this Ind AS.
- The classification, presentation and measurement requirements in this Ind AS applicable to a non-current asset (or disposal group) that is classified as held for sale apply also to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners.
- Scoped out non-current assets: The measurement provisions of this Ind AS do not apply to the following assets (which are covered by the Ind AS listed either as individual assets or as part of a disposal group):



- Disposal groups may include both scoped-in and scoped-out non-current assets. If a disposal group includes any scoped-in non-current asset(s), the measurement requirements of this Ind AS apply to the group as a whole, so that the group is measured at the lower of its carrying amount and fair value less costs to sell.

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- The disclosure requirements of this Ind AS, for non-current assets held for sale and discontinued operations, remove the need to provide disclosures in accordance with other standards, unless that standard has specific disclosure requirements:
  - for non-current assets (or disposal group) classified held for sale or discontinued operations; or
  - for measurement of assets or liabilities within a disposal group that are not within the measurement scope of Ind AS 105.

  However, this does not remove the need to provide additional disclosures to comply with Ind AS.

7.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **Cash-generating unit is a** smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- **Component of an entity comprises** operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.
- **Costs to distribute** are the incremental costs directly attributable to the distribution, excluding finance costs and income tax expense.
- **Costs to sell** are the incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.
- **Current asset -** An entity classifies an asset as current when:
  (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
  (b) it holds the asset primarily for the purpose of trading;
  (c) it expects to realise the asset within twelve months after the reporting period; or
  (d) the asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.
- A **discontinued operation** is a component of an entity that either has been disposed of or is classified as held for sale and:
  (a) represents a separate major line of business or geographical area of operations; or

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(b) is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or

(c) is a subsidiary acquired exclusively with a view to resale.

- **Disposal group** is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. A disposal group may be a group of *cash-generating units*, a single cash-generating unit, or part of a cash-generating unit.

  The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with Ind AS 36 'Impairment of Assets', or if it is an operation within such a cash generating unit.

- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Ind AS 113)

- **Firm purchase commitment** is an agreement with an unrelated party, binding on both parties and usually legally enforceable, that (a) specifies all significant terms, including the price and timing of the transactions, and (b) includes a disincentive for non-performance that is sufficiently large to make performance highly probable.

- **Highly Probable** Significantly more likely than probable. (Probable means more likely than not)

- **Non-current assets** are assets that do not meet the definition of current assets.

- **Recoverable amount** is the higher of an asset's fair value less costs of disposal and its value in use.

- **Value in use** is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

7.4 CLASSIFICATION OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) AS HELD FOR SALE OR AS HELD FOR DISTRIBUTION TO OWNERS

An entity is required to classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

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Asset must be

- **available for immediate sale in its present condition** and
- **Sale must be highly probable**

are the two key requirements to classify a non-current asset as held for sale.

It may be noted that if an asset is being sold individually, Ind AS 105 applies **only if it is a non-current asset**. A current asset being sold as an individual asset (i.e. not as part of a disposal group) is never classified as held for sale**.** Where a group of assets is being disposed of in a single transaction, its classification and presentation requirements apply to the disposal group as a whole, including current assets and liabilities forming part of the group.

7.4.1 Available for Immediate Sale

The asset (or disposal group) must be available for **immediate sale** in its **present condition**. The terms that are usual and customary for sale of similar assets (or disposal group) doesn't disqualify to being classified as held for sale.

However, they will not be considered as available for immediate sale if they continue to be vital for the entity's ongoing operations or being refurbished to enhance their value. Thus, an asset (or disposal group) cannot be classified as a non-current asset (or disposal group) held for sale, if the entity intends to sell it in a **distant future**.

Examples 1- 5- Available for Immediate Sale

1. A property being used as a headquarters by the entity needs to be vacated before it can be sold. The time required to vacate the building is usual and customary for sale of such assets. Hence the property can be considered as available for immediate sale.

   However, if property can be vacated only after a replacement is available then this may indicate that the property is not available for immediate sale, but only after the replacement becomes available.

2. An entity can't classify a manufacturing facility as held for sale if prior to selling the facility it needs to clear a backlog of uncompleted orders.

   However, if entity intends to sell the manufacturing facility along with the uncompleted orders it can be considered as available for immediate sale.

3. An entity plans to renovate some of its property to increase its value prior to selling it to a third party. The entity is already searching for a buyer at current market values. But due to the plans to renovate the property prior to sale, the property may not be meeting the condition of available for immediate sale.

4. A company has put a property on the market and expects that all the conditions of classification as held for sale are met. Any buyer will undertake searches and valuations

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before making an offer and exchanging contracts: Such conditions are normal for properties and any delays that might arise from such legal processes do not preclude the property from being classified as held for sale.

5. When minor pre-selling activities are outstanding, and those activities are usually performed immediately before an asset is transferred, the asset could nevertheless be appropriately treated as available for immediate sale.

   However, when an asset is still in the course of construction, and significant activities will need to be performed before it can be transferred, it is unlikely that it could be regarded as available for immediate sale.

7.4.2 Sale must be highly probable

This Standard defines 'highly probable' as 'significantly more likely than probable' where probable means more likely than not.

Ind AS 105 prescribes following five conditions to be satisfied for the sale to qualify as highly probable:

1. The appropriate level of management must be committed to a plan to sell the asset (or disposal group).
2. An active programme to trace a buyer and complete the selling plan must have been initiated.
3. The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
4. The sale transaction is expected to be completed within one year from the date of classification (subject to exception specified in section 7.4.3.2 below)
5. Significant changes to or withdrawal from the plan to sell the asset are unlikely.

The likelihood of shareholders' approval should also be considered as part of assessment if it is required in the jurisdiction.

Examples 6 & 7- Requiring shareholder's approval

6 At the end of the reporting period, ABC Company's board of directors has approved a plan to sell a non-current asset. The eventual disposal requires approval by a majority of company's shareholders through a formal vote which will take place after the reporting period. At the end of the reporting period, a majority of the company's shareholders have provided the company with signed irrevocable agreements stating that they will vote in favour of the disposal. The 'highly probable' test is met because the shareholders have irrevocably committed to approving the transaction and, therefore, the vote by the shareholders is merely a formality.

7. Company XYZ holds an 85 per cent interest in a subsidiary, Company ABC. At the year end, the board of directors of Company ABC has approved a plan to sell a non-current asset to Company XYZ. The eventual disposal requires approval by a majority of Company ABC's

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shareholders through a formal vote which will take place after the reporting period. For a transaction with a major shareholder (in this case, the parent), the minority shareholders are given protection in law if the value of the transaction exceeds a specified threshold. The law prevents Company XYZ from participating in the formal vote on such a transaction. Company ABC has not received any undertakings to vote in a particular manner from any of the shareholders. It is possible that the proposed transaction may be controversial, and the outcome of the shareholder vote is uncertain. From Company ABC's perspective, the 'highly probable' test is not met at the end of the reporting period because the outcome of the formal vote by the remaining shareholders is too uncertain.

7.4.3 Other Key Points

7.4.3.1 Loss of Control in Subsidiary

An entity which has committed to a sale plan which involves loss of control of subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements when the criteria set out above is met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

7.4.3.2 Exception to the period of One year

An entity can still classify an asset (or disposal group) as held for sale, even if the timeframe of one year to conclude the sale transaction has lapsed. For this:

(i) the delay must have been caused by the events or circumstances which are beyond the control of the entity; and

(ii) there must be sufficient evidence that the entity is still committed to it selling plan.

Examples 8 - 10

8. An entity is committed to its selling plan of a manufacturing facility in its present condition and so classifies it as held for sale. After a firm purchase commitment, the buyer's inspection identifies environmental damages not previously known to exist. The entity is required by the buyer to make good the damage, which will extend the period required to complete the sale beyond one year. However, the entity has initiated actions to make good the damage and satisfactory rectification is highly probable. In this situation, exception to one-year requirement will be met.

9. An entity in the mining industry is committed to a plan to sell a disposal group that represents a significant portion of its regulated operations. The sale requires regulatory approval, which could extend the period required to complete the sale beyond one year. Actions necessary to obtain approval cannot be initiated until after a buyer is known and a firm purchase commitment is obtained. However, a firm purchase commitment is highly probable within one year. In this situation, the exception to the one-year requirement will be met.

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10. A company is committed to a plan to sell a non-current asset and classifies the asset as held for sale. During the initial one-year period, the market conditions deteriorated and, as a result, the asset could not be sold by the end of that period. During that period, the company actively solicited but did not receive any reasonable offers to purchase the asset and, in response, the Company reduced its asking price. The asset continues to be actively marketed at a price that is reasonable given the change in market conditions. In this situation, the exception to the one-year requirement will be met. At the end of the initial one-year period, the asset would continue to be classified as held for sale.

7.4.3.3 Sale includes exchange

Sale transaction includes exchange of non-current assets for other non-current assets when the exchange has commercial substance in accordance with Ind AS 16 Property, Plant and Equipment.

7.4.3.4 Asset acquired exclusively with a view to subsequent disposal

When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, the non-current asset (or disposal group) is classified as held for sale at the acquisition date if both of the following conditions are satisfied:

a) The one-year requirement is met subject to exceptions mentioned in section 7.4.3.2 above; and

b) It is highly probable that any other criteria (refer section 7.4.1 and 7.4.2 above) that is not met at the acquisition date will be met within a short period following the acquisition (usually within three months).

Example 11

An entity has acquired a building exclusively with a view of its subsequent disposal. The management is highly confident that the property can be sold in one year. The property requires refurbishing it to enhance its value which is highly probable to be completed in less than a period of three months. The building will be classified as held for sale on the date of acquisition itself even though it is not immediately available for sale.

7.4.3.5 Criteria met after reporting period

If the criteria of held for sale are met after the reporting period, an entity should not classify a non-current asset (or disposal group) as held for sale in those financial statements when issued. However, when those criteria are met after the reporting period but before the approval of the financial statements for issue, the entity shall disclose the information specified in section 7.6.3 – Disclosures.

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7.4.3.6 Classification as held for distribution

A non-current asset (or disposal group) is classified as held for distribution to owners when the entity is committed to distribute the asset (or disposal group) to the owners. The assets must be available for immediate distribution in their present condition and the distribution must be highly probable. For the distribution to be highly probable, actions to complete the distribution must have been initiated and should be expected to be completed within one year from the date of classification. Actions required to complete the distribution should indicate that it is unlikely that significant changes to the distribution will be made or that the distribution will be withdrawn.

The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the distribution is highly probable. For an entity to classify a non-current asset (or disposal group) as held for distribution to its owner, it is necessary to follow the same criteria as required for classification as held for sale.

7.4.3.7 Non-current assets to be abandoned

Non-current assets (or disposal group) that need to be abandoned will not qualify to classify as held for sale because their carrying amount will be principally recovered through continuing use in the entity's operation rather through the sale. However, if the disposal group to be abandoned meets the criteria as prescribed in Ind AS 105 to be classified as a discontinued operation, then the disclosure regarding discontinued operation must be presented.

Example 12

In February 20X2, PQR Limited decides to abandon all of its coal mines, which constitute a major line of business. All work stops at the coal mines during the year ended 31st March 20X2. In the financial statements for the year ended 31st March 20X1, results and cash flows of the coal mines are treated as continuing operations. In the financial statements for the year ended 31st March 20X2, the results and cash flows of the coal mines are treated as discontinued operations and PQR Limited is required to make the disclosures as per Ind AS 105.

Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be used to the end of their economic life and non-current assets (or disposal groups) that are to be closed rather than sold.

Assets that are temporarily taken out of use are not to be accounted for as abandoned.

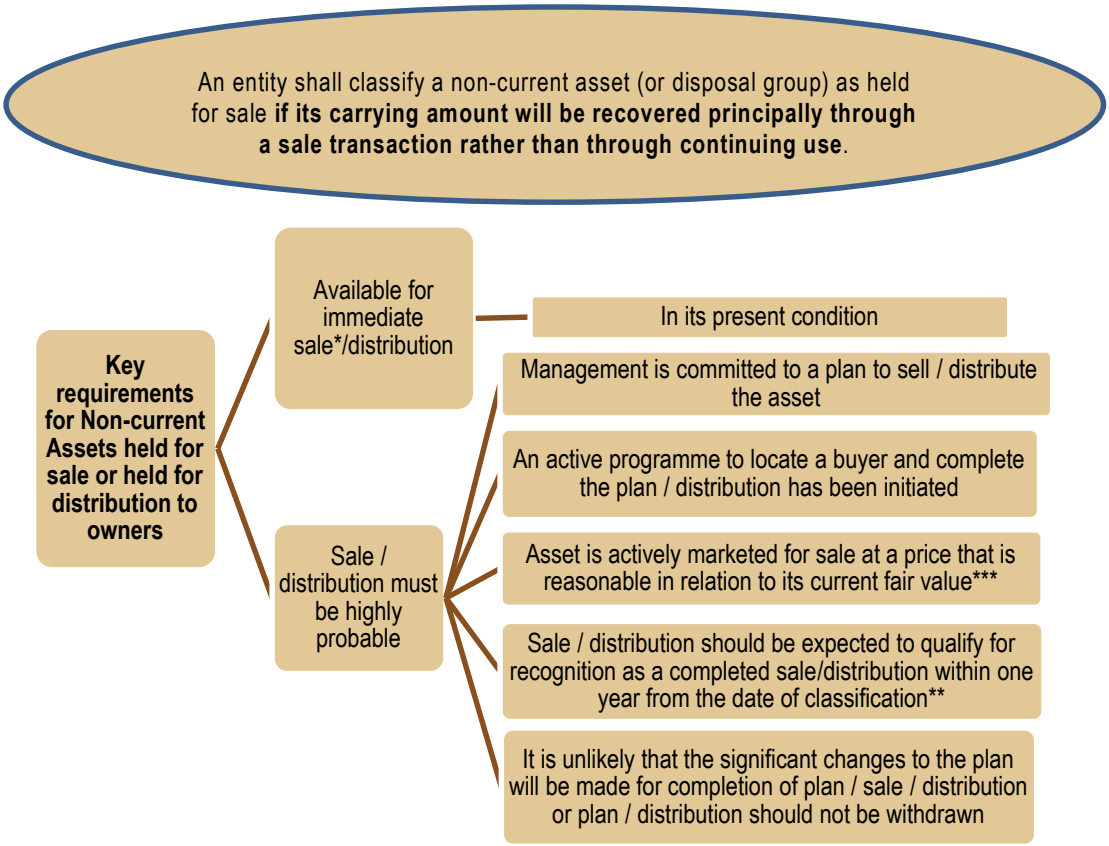
Example 13

Entity ceases to use a manufacturing plant because demand has declined. However, the plant is maintained in a workable condition and it is expected to be brought back into use in future when demand picks up.

It is neither to be treated as abandoned asset nor as held for sale because its carrying amount will be principally recovered through continuous use, therefore the entity will not stop charging depreciation or treat it as held for sale. This is because its carrying amount will be recovered principally through continuing use to the end of its economic life.

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*Sale transactions include exchanges of non-current assets for other non-current assets when the exchange has commercial substance

** If the entity remains committed to its plan to sell the asset (or disposal group), events or circumstances beyond the entity's control may extend the period to complete the sale beyond one year

*** Not applicable for non-current assets held for distribution to owners.

Note:

S.N.	Particular	Details
1.	Acquisition of non-current asset (or disposal group) with intention to subsequent sale within a year	Classify the non-current asset (or disposal group) as held for sale subject to the conditions specified in the above chart
2.	Non-current assets that are to be abandoned	It shall not be classified as held for sale since its carrying amount will be recovered principally through continuing use and not from sale

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7.5 MEASUREMENT OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) CLASSIFIED AS HELD FOR SALE

7.5.1 Measurement at the lower of carrying amount and fair value less cost to sell

- An entity should measure a non-current asset (or disposal group) classified as held for sale at the **lower** of its **carrying amount** and **fair value less costs to sell**.
- An entity shall measure a non-current asset (or disposal group) classified as held for distribution to owners at the lower of its carrying amount and fair value less costs to distribute.
- If a newly acquired asset (or disposal group) meets the criteria to be classified as held for sale, it will be measured on initial recognition at the lower of its carrying amount had it not been so classified (for example, cost) and fair value less costs to sell. Hence, if the asset (or disposal group) is acquired as part of a business combination, it will be measured at fair value less costs to sell.
- Immediately **before the initial classification** of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) is measured in accordance with **applicable Ind AS**.
- On subsequent remeasurement of a disposal group, the carrying amounts of any assets and liabilities that are not within the scope of the measurement requirements of this Ind AS but are included in a disposal group classified as held for sale, should be remeasured in accordance with applicable Ind AS before the fair value less costs to sell of the disposal group is remeasured.
- When the sale is expected to occur beyond one year, the entity should measure the costs to sell at their present value. Any increase in the present value of the costs to sell that arises from the passage of time shall be presented in profit or loss as a financing cost.

7.5.2 Recognition of impairment losses and reversals

- An entity should recognise an impairment loss for any initial or subsequent write-down of the asset (or disposal group) to fair value less costs to sell, to the extent that it has not been recognised in accordance with subsequent remeasurement of scoped out assets and liabilities as mentioned above.
- An entity should recognise a gain for any subsequent increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognised either in accordance with this Ind AS or previously in accordance with Ind AS 36.

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- Depreciation and amortization shall be immediately stopped from the moment the asset has been classified as held for sale.
- Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be recognised.
- An entity should recognise a gain for any subsequent increase in fair value less costs to sell of a disposal group:

  (a) to the extent that it has not been recognised in the remeasurement of scoped out non-current assets, current assets and liablities; but

  (b) not in excess of the cumulative impairment loss that has been recognised, either in accordance with this Ind AS or previously in accordance with Ind AS 36, on the non-current assets that are within the scope of the measurement requirements of this Ind AS.
- The impairment loss (or any subsequent gain) recognised for a disposal group should reduce (or increase) the carrying amount of the non-current assets in the group that are within the scope of the measurement requirements of this Ind AS. The impairment loss shall be allocated to disposal groups in the following order:

  (i) first, to reduce the carrying amount of any goodwill allocated to the disposal group; and

  (ii) then to the other assets of the disposal group pro rata on the basis of the carrying amount of each asset in the group.
- A gain or loss not previously recognised through remeasurement by the date of the sale of a non-current asset (or disposal group) should be recognised at the date of derecognition.

  Requirements relating to derecognition are set out in:

  (a) paragraphs 67–72 of Ind AS 16 *'Property, Plant and Equipment'*; and

  (b) paragraphs 112–117 of Ind AS 38, '*Intangible Assets',* for intangible assets.

Illustration 1 - Measurement prior to classification as held for sale

Entity ABC owns an item of property and it was stated at the following amounts in its last financial statements:

31st March, 20X1	***₹***
Cost	*12,00,000*
Depreciation	*(6,00,000)*
Net book value	*6,00,000*

The asset is depreciated at an annual rate of 10% i.e. ₹ 1,20,000 p.a.

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Entity ABC closes its books as on 31st March each year. During July, 20X1, entity ABC decides to sell the asset and on 1st August it meets the conditions to be classified as held for sale.

Analyse what will be the treatment of the property in the books for the year 20X1-20X2.

Solution

At 31st July, entity ABC should ensure that the asset is measured in accordance with Ind AS 16. It should be depreciated by further ₹ 40,000 (₹ 1,20,000 x 4/12) and should be carried at ₹ 5,60,000 before it is measured in accordance with Ind AS 105.

Note: From the date the asset is classified as held for sale no further depreciation will be charged.

*****

Example 14 - Classification as held for sale

A Ltd. acquired a property for ₹ 2,00,000. After few years, the cumulative depreciation on the property of ₹ 80,000 has been recognised and subsequently the property is classified as held for sale under Ind AS 105.

At the time of classification as held for sale it will be measured at lower of its carrying amount which is ₹ 1,20,000 (2,00,000 – 80,000) and fair value less costs to sell as estimated at ₹ 1,00,000.

Accordingly, there is a write-down on initial classification of property as held for sale and accordingly the property is carried at ₹ 1,00,000. A loss of ₹ 20,000 is recognised in profit or loss.

On next reporting date, the property's fair value less costs to sell is estimated at ₹ 85,000. Accordingly, a loss of ₹ 15,000 is recognised in profit or loss and the property is carried at ₹ 85,000.

Subsequently, the property is sold for ₹ 90,000. A gain of ₹ 5,000 will be recognised.

Example 15 - Disposal group classified as Held for Sale:

Disposal Group	Carrying amount at the reporting date before classification as held for sale ₹	Carrying amount as remeasured immediately before classification as held for sale ₹
Goodwill	1,500	1,500

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Property, Plant and Equipment (carried at revalued amounts)	4,600	4,000
Building (carried at cost)	5,700	5,700
Inventory	2,400	2,200
Investment in Equity Instruments	1,800	1,500
Total	**16,000**	**14,900**

The entity should recognise the loss of ₹ 1,100 (₹ 16,000 - ₹ 14,900), in accordance with applicable Ind AS, immediately before classifying it as held for sale. This difference of ₹ 1,100 reflects routine accounting entries (such as revaluation). This amount shall not be considered as impairment loss.

The entity estimated that fair value less costs to sell of the disposal group amounts to ₹ 13,000.

Since the entity has classified a disposal group as held for sale it should measure it at the lower of its carrying amount ₹ 14,900 and fair value less costs to sell ₹ 13,000 which comes to ₹ 13,000.

The entity should recognises an impairment loss of ₹ 1,900 (₹ 14,900 – 13,000) when the disposal group is initially classified as held for sale.

The Inventory and Investment is remeasured as per Ind AS 2 and Ind AS 109 at not more than fair value at the date of remeasurement i.e. immediately before classified as held for sale.

This impairment loss of ₹ 1,900 is allocated to remaining assets in the proportion of their carrying value other than inventory and investment in equity instrument.

The allocation of impairment loss can be illustrated as follows:

Disposal Group	**Carrying amount as remeasured immediately before classification as held for sale (as per applicable Ind AS)** ₹	**Allocated Impairment Loss** ₹	**Carrying amount after allocation of Impairment Loss** ₹
Goodwill	1,500	(1,500)	-
Property, Plant and Equipment			

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(carried at revalued amounts)	4,000	(165)	3,835
Building (carried at cost)	5,700	(235)	5,465
Inventory	2,200	-	2,200
Investments in equity instruments	1,500	-	1,500
Total	**14,900**	**(1,900)**	**13,000**

Firstly, the impairment loss reduces the amount of goodwill in the disposal group. Then, the remaining impairment loss is recognised to other assets pro-rata based on the carrying amount of those assets.

Suppose, at the end of reporting period the fair value less cost to sell is increased and estimated at ₹ 15,500.

The maximum impairment loss reversal allowed will be ₹ 1,900 being impairment loss recognised earlier.

Reversal of impairment loss on Goodwill is not allowed under Ind AS 36 'Impairment of Assets'.

Example 16 - Reversal of Impairment Losses

A freehold property was originally acquired for ₹ 40,00,000. Some years later, after cumulative depreciation of ₹ 11,00,000 has been recognised, an impairment loss of ₹ 3,50,000 is recognised, taking the carrying amount to ₹ 25,50,000, which represents the estimated value in use of the property. Shortly thereafter, as a consequence of a proposed move to new premises, the freehold property is classified as held for sale.

At the time of classification as held for sale:

- carrying amount is ₹ 25,50,000; and
- fair value less costs to sell is assessed at ₹ 25,00,000.

Accordingly, the initial write-down on classification as held for sale is ₹ 50,000 and the property is carried at ₹ 25,00,000. Following classification as held for sale, no further depreciation is recognised.

At the next reporting date, the property market has improved and fair value less costs to sell is reassessed at ₹ 26,50,000. The gain of ₹ 1,50,000 is less than the cumulative impairment losses recognised to date (₹ 3,50,000 + ₹ 50,000 = ₹ 4,00,000). Accordingly, it is credited in profit or loss and the property is carried at ₹ 26,50,000.

Six months after that, the property market has continued to improve, and fair value less costs to sell is now assessed at ₹ 30,00,000. This further gain of ₹ 3,50,000 is, however, in excess of the

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cumulative impairment losses recognised to date (₹ 3,50,000 + ₹ 50,000 – ₹ 1,50,000 = ₹ 2,50,000). Accordingly, a restricted gain of ₹ 2,50,000 is credited in profit or loss and the property is carried at ₹ 29,00,000.

Subsequently, the property is sold for ₹ 30,00,000, at which time a gain of ₹ 1,00,000 is recognised.

7.5.3 Changes to a plan of sale

- If an entity has classified an asset (or disposal group) as held for sale, but the held for sale criteria is no longer met, the entity should cease to classify the asset (or disposal group) as held for sale.
- The entity shall measure a non-current asset that ceases to be classified as held for sale (or ceases to be included in a disposal group classified as held for sale) at the lower of:
  (a) its carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been classified as held for sale; and
  (b) its recoverable amount at the date of the subsequent decision not to sell.
- The entity shall include any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held for sale in profit or loss from continuing operations in the period in which the held for sale criteria is no longer met.
- Financial statements for the periods since classification as held for sale / distribution to owners shall be amended accordingly if the disposal group or non-current asset that ceases to be classified as held for sale / distribution to owners is a subsidiary, joint operation, joint venture, associate, or a portion of an interest in a joint venture or an associate.
- If an entity removes an individual asset or liability from a disposal group classified as held for sale, the remaining assets and liabilities of the disposal group will continue to be measured as a group only if the group meets the criteria for classification as held for sale. Otherwise:
  (a) the remaining non-current assets of the group that individually meet the criteria to be classified as held for sale shall be measured individually at the lower of their carrying amounts and fair values less costs to sell at that date; and
  (b) any non-current assets that do not meet the criteria shall cease to be classified as held for sale.

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Example 17: Remeasuring non-current assets that are no longer held for sale

Company ABC has several operations including the manufacture and sale of leisure equipment.

Company ABC financial year ends on 31 March. In April, Company ABC adopts a plan to sell all of the assets and liabilities of the leisure equipment operations. Having met the requirements of Ind AS 105 at the end of the first quarter, Company ABC appropriately classifies those assets and liabilities as a disposal group held for sale.

In September, Company ABC decides not to sell certain existing trademarks and licence arrangements associated with the leisure equipment operations. Subsequent to the sale of the other assets and liabilities, Company ABC will continue to generate revenue (and incur the associated costs) from its trademarks and licences.

Company ABC should reclassify the trademarks and licence arrangements out of assets held for sale and remeasure them at the lower of (1) their carrying amounts before being classified as held for sale less any amortisation expense that would have been recognised if they had not been classified as held for sale, and (2) their recoverable amount at the date of the subsequent decision not to sell.

If this requirement triggers an adjustment to the carrying amounts of the trademarks and licences, assuming that the assets were not revalued in accordance with Ind AS 38 before classification as held for sale, the adjustment should be included in profit or loss from continuing operations in the period in which the held for sale criteria are no longer met. The adjustment should be included in the same caption in the statement of profit and loss used to present other gains or losses, if any, on held for sale items not meeting the definition of discontinued operations.

If the remaining assets and liabilities of the leisure equipment operations continue to meet the conditions to be accounted for as held for sale, Company ABC should continue to classify those remaining assets and liabilities as held for sale.

Illustration 2

S Ltd purchased a property for ₹ 6,00,000 on 1st April, 20X1. The useful life of the property is 15 years. On 31st March, 20X3, S Ltd classified the property as held for sale. The impairment testing provides the estimated recoverable amount of ₹ 4,70,000.

The fair value less cost to sell on 31st March, 20X3 was ₹ 4,60,000. On 31st March, 20X4 management changed the plan, as property no longer met the criteria of held for sale. The recoverable amount as at 31st March, 20X4 is ₹ 5,00,000.

Recommend the accounting treatment of events for the year ending 31st March, 20X3 and 31st March, 20X4 and value the property at the end of 20X3 and 20X4.

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Solution

(a) Value of property immediately before the classification as held for sale as per Ind AS 16 as on 31st March, 20X3

	₹	
Purchase Price	6,00,000	
Less: Accumulated Depreciation	80,000	(for two years)
Less: Impairment loss	50,000	(5,20,000-4,70,000)
Carrying Amount	**4,70,000**	

On initial classification as held for sale on 31st March, 20X3, the value will be lower of:

Carrying amount after impairment	₹ 4,70,000
Fair Value less Cost to sell	₹ 4,60,000

On 31st March, 20X3, Non-current asset classified as held for sale will be recorded at ₹ 4,60,000.

Depreciation of ₹ 40,000 and Impairment Loss of ₹ 60,000 (50,000 +10,000) is charged in profit or loss for the year ended 31st March, 20X3.

(b) On 31st March, 20X4, held for sale property is reclassified as criteria is not met. The value will be lower of:

Carrying amount immediately before classification on 31st March, 20X3	₹ 4,70,000
Less: Depreciation based on 13 years balance life	(₹ 36,154)
Carrying amount had the asset is not classified as held for sale	₹ 4,33,846
Recoverable Amount	₹ 5,00,000

Property will be valued at ₹ 4,33,846 on 31st March, 20X4

Adjustment to the carrying amount of ₹ 26,154 (₹ 4,60,000 - 4,33,846) is charged to the profit or loss.

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7.6 PRESENTATION AND DISCLOSURES OF A NON-CURRENT ASSET (OR DISPOSAL GROUP) CLASSIFIED AS HELD FOR SALE

7.6.1 Non – current assets and disposal groups classified as held for sale

- Entity shall present and disclose information about non- current asset (or disposal group) classified as held for sale in such a manner that enable the user of financial statements to evaluate financial effects of non-current asset (or disposal group) classified as held for sale.

7.6.2 Presentation

- An entity is required to present a non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the balance sheet.
- The liabilities of a disposal group classified as held for sale should be presented separately from other liabilities in the balance sheet. Those assets and liabilities should not be offset and presented as a single amount.
- The major classes of assets and liabilities classified as held for sale should be separately disclosed either in the balance sheet or in the notes, except when the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition.
- An entity should present separately any cumulative income or expense recognised in other comprehensive income relating to a non-current asset (or disposal group) classified as held for sale.
- If the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition, disclosure of the major classes of assets and liabilities is not required.
- Comparative amounts for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the balance sheets for prior periods are not reclassified or re-presented to reflect the classification in the balance sheet for the latest period presented. For example, if an asset qualifies as held for sale during 20X2, it should be classified as such in the balance sheet at the end of 20X2, but not in the 20X1 comparative balance sheet.
- Any gain or loss on the remeasurement of a non-current asset (or disposal group) classified

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as held for sale that does not meet the definition of a discontinued operation shall be included in profit or loss from continuing operations.

Example 18: Presentation of Disposal group

Property, Plant and Equipment	4,900
Inventory	1,700
Investment in equity instruments	1,400
Liabilities	(3,300)
Net Carrying Amount	**4,700**

An amount of ₹ 400 relating to these assets has been recognised in other comprehensive income and accumulated in equity.

The presentation of disposal group in entity's Balance Sheet is as follows:

Assets	**20X1-20X2**	**20X2-20X3**
Non –Current Assets		
AAA	X	X
BBB	X	X
CCC	X	X
	X	**X**
Current Assets		
DDD	X	X
EEE	X	X
	X	**X**
Assets Classified as Held for Sale	**8,000**	**-**
	X	X
Total Assets	**X**	**X**
Equity and Liabilities		
Equity attributable to equity holders of the parent		
FFF	X	X
GGG	X	X
Amounts recognised in other comprehensive income and accumulated in equity relating to assets held for sale	**400**	**-**
	X	X

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Non-Controlling Interests	X	X
Total Equity	X	X
Non-Current Liabilities		
HHH	X	X
III	X	X
	X	X
Current Liabilities		
KKK	X	X
LLL	X	X
MMM	X	X
Liabilities directly associated with assets classified as held for sale	3,300	-
	X	X
Total liabilities	X	X
Total Equity and liabilities	X	X

7.6.3 Disclosures

An entity should disclose the following information in the notes to the financial statements in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

(a) Description of the non-current asset (or disposal group);

(b) Description of facts and circumstances of the sale, or leading to the expected disposal and the expected manner and timing of that disposal;

(c) Gain or loss recognised and if not presented separately on the face of the statement of profit and loss, the caption in the statement of profit and loss that includes that gain or loss.

(d) If applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance of Ind AS 108 Operating Segments.

(e) If there is a change of plan to sell, a description of facts and circumstances leading to the decision and the effect of the decision on the results of operations for the period and any prior periods presented.

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7.7 DISCONTINUED OPERATIONS

7.7.1 Discontinued operation – definition

- Ind AS 105 defines Discontinued Operation as a component of an entity that either has been disposed of or is classified as held for sale and:

  (a) represents a separate major line of business or geographical area of operations; or

  (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or

  (c) is a subsidiary acquired exclusively with a view to resale.

Examples 19-22 – Discontinued Operations

19. Company XYZ has 5 different operating segments, one of which solely produces consumer goods. All of the consumer goods production facilities are situated in Central Europe. XYZ also has other operations in Central Europe for other operating segments. In April 20X1, XYZ disposed of its consumer goods segment which meets the definition of a component of a business and represents a separate major line of business and would therefore be considered as a discontinued operation.

20. A group has announced that it is closing an engineering contracting segment. Although no new contracts are being undertaken, all existing contracts will be completed and the business will be run down accordingly. In this situation, the operation will have ceased to be used when the contracting activity has been completed (that is, at the end of the last contract). In the period during which existing contracts are completed, the group is continuing to carry out a revenue-earning activity, albeit that the activity is being wound down, and so it does not qualify as a discontinued operation.

21. A company carried out a merchandise wholesaling business that is operated from several leasehold premises throughout the country. The business has been closed, all stocks have been disposed of, and employees have been made redundant before the end of three months into the next financial year. At that time, some debtors remain to be collected, and costs will continue to be incurred in respect of the vacated premises until the leases are disposed of. In this case, the former activity of merchandise wholesaling has ceased. The outstanding future transactions do not constitute the continuation of the activity and, consequently, the operation has been discontinued.

22. XYZ Company has one business segment, and it operates in the UK, the US and Australia. Each of these operations represents a component of XYZ and a major geographical area of operations. Management has decided to sell the US operation, which met the criteria to be classified as held for sale during the year. The US operation

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should be disclosed in XYZ's financial statements as a discontinued operation, despite the fact that there has been no change to the number of business segments.

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. In other words, a component of an entity will be a cash-generating unit or a group of cash-generating units while being held for use.

Illustration 3

Identify whether each of the following scenarios give rise to a discontinued operation and/or classification of assets as held for sale:

S. No	*Particulars*
1	*MNO disposes of a component of the entity by selling the underlying assets. The sales transaction is incomplete at the reporting date.*
2	*PQR has ceased activities that meet the definition of a discontinued operation without selling any assets.*
3	*STU ceases activities and has already completed the sale of the underlying assets at the reporting date.*
4	*VWX will sell or has sold assets that are within the scope of Ind AS 105 but does not discontinue any of its operations.*

Solution

Discontinued operations and assets held for sale

S. No	Particulars	Discontinued operation Yes/No	Assets held for sale Yes/No
1	MNO disposes of a component of the entity by selling the underlying assets. The sales transaction is incomplete at the reporting date.	Yes	Yes
2	PQR has ceased activities that meet the definition of a discontinued operation without selling any assets.	Yes	No
3	STU ceases activities and has already completed the sale of the underlying assets at the reporting date.	Yes	No

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4	VWX will sell or has sold assets that are within the scope of Ind AS 105 but does not discontinue any of its operations.	No	Yes

*****

Illustration 4

Sun Ltd is a retailer of takeaway food like burger and pizzas. It decides to sell one of its outlets located in Chandani Chowk in New Delhi. The company will continue to run 200 other outlets in New Delhi.

All criteria mentioned in Ind AS 105 for classification of assets as held for sale were first met on 1st October, 20X1. The outlet will be sold in June, 20X2.

Management believes that outlet is a discontinued operation and wants to present the results of outlet as 'discontinued operations'.

Analyse the opinion of the management with respect to the accounting treatment of the outlet.

Solution

The Chandani Chowk outlet is a disposal group; it is not a discontinued operation as it is only one outlet. It is not a major line of business or geographical area, nor a subsidiary acquired with a view to resale.

****

7.7.2 Separate presentation of discontinued operations

An entity should present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

This allows the user to distinguish between the operations which will continue in the future and those which will not and make it more predictable the ability of entity to generate future cash flows.

When the amounts relating to discontinued operations are presented separately, the comparative figures for prior periods are also re-presented, so that the disclosures relate to all operations that have been discontinued by the end of the reporting period for the latest period presented.

7.7.3 Presentation in the statement of profit and loss

- An entity shall disclose a single amount in the statement of profit and loss comprising the total of:

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(a) the post-tax profit or loss of discontinued operations; and

(b) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

- In addition, this single amount must be analysed into:

  (a) the revenue, expenses and pre-tax profit or loss of discontinued operations;

  (b) the related income tax expense as required by paragraph 81(h) of Ind AS 12;

  (c) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and

  (d) the related income tax expense as required by paragraph 81(h) of Ind AS 12.

- The analysis may be presented in the notes or in the statement of profit and loss. If it is presented in the statement of profit and loss it should be presented in a section identified as relating to discontinued operations, i.e. separately from continuing operations. The analysis is not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition.

- Entities are required to disclose the amount of income from continuing operations and from discontinued operations attributable to owners of the parent. These disclosures may be presented either in the notes or in the statement of profit and loss.

7.7.4 Disclosures in the statement of cash flows

Disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either in the notes or in the financial statements. These disclosures are not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition.

7.7.5 Disclosures of Earnings per share

Earnings per share amounts should be shown separately when an entity reports discontinued operations. Paragraph 68 of Ind AS 33 requires an entity that reports discontinued operations to present basic and diluted per share amounts for discontinued operations, either in the statement of profit and loss or in the notes to the financial statements. This disclosure is required in addition to the presentation of basic and diluted per share amounts for profit or loss from continuing operations and profit or loss for the year, both of which should be shown in the statement of profit and loss with equal prominence.

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7.7.6 Adjustment to prior period disposals

Adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period should be classified separately in discontinued operations. The nature and amount of such adjustments are disclosed. Examples of circumstances in which these adjustments may arise include the following:

(a) the resolution of uncertainties that arise from the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser;

(b) the resolution of uncertainties that arise from and are directly related to the operations of the component before its disposal, such as environmental and product warranty obligations retained by the seller; and

(c) the settlement of employee benefit plan obligations, provided that the settlement is directly related to the disposal transaction.

7.7.7 Change to a plan of sale

If an entity ceases to classify a component of an entity as held for sale, the results of operations of the component previously presented in discontinued operations should be reclassified and included in income from continuing operations for all periods presented. The amounts for prior periods should be described as having been re-presented.

7.7.8 Loss of Control in Subsidiary

An entity that is committed to a sale plan involving loss of control of a subsidiary should disclose the information as above when the subsidiary is a disposal group that meets the definition of a discontinued operation.

Example 23: Presentation of Discontinued Operations in the Statement of profit and loss.

Statement of profit and loss for the year ended 31st March, 20X3

	20X1-20X2	20X2-20X3
Continuing Operations		
Revenue	XX	XX
Cost of Sales	**(XX)**	**(XX)**
Gross Profit	XX	XX
Other Income	XX	XX
Distribution Costs	(XX)	(XX)

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Administrative Expenses	(XX)	(XX)
Other Expenses	(XX)	(XX)
Finance Costs	(XX)	(XX)
Share of Profit of Associates	XX	XX
Profit before Tax	XX	XX
Income Tax Expense	(XX)	(XX)
Profit for the period from Continuing Operation	**XX**	**XX**
Discontinued Operations		
Profit for the period from discontinued Operations*	**XX**	**XX**
Profit for the period	XX	XX
Attributable to:		
Owner of the parent		
Profit for the period from continuing operations	XX	XX
Profit for the period from discontinued operations	XX	XX
Profit for the period attributable to owners of the parent	XX	XX
Non-Controlling Interests		
Profit for the period from continuing operations	XX	XX
Profit for the period from discontinued operations	XX	XX
Profit for the period attributable to non-controlling interests	XX	XX
	XX	XX

* the required analysis would be given in the notes.

7.8 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Hindustan Unilever Limited' for the financial year 2021-2022 with respect to 'Assets held for Sale' and its accounting policy thereon.

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Standalone Balance Sheet

as at 31st March, 2022

(All amounts in ₹ crores, unless otherwise stated)

Particulars	Note	As at 31st March, 2022	As at 31st March, 2021
ASSETS			
Non-current assets			
Current assets			
Inventories	11	3,890	3,383
Financial assets			
Investments	6	3,510	2,683
Loans	7	34	34
Trade receivables	12	1,932	1,648
Cash and cash equivalents	13	988	1,740
Bank balances other than cash and cash equivalents mentioned above	14	2,630	2,581
Other financial assets	8	1,070	1,116
Other current assets	15	580	438
Assets held for sale	16	13	17
Total - Current assets (B)		**14,647**	**13,640**
TOTAL ASSETS [(A) + (B)]		**69,737**	**68,116**

NOTE 16 ASSETS HELD FOR SALE

Non-current assets or disposal groups comprising of assets and liabilities are classified as 'held for sale' when all the following criteria are met: (i) decision has been made to sell, (ii) the assets are available for immediate sale in its present condition, (iii) the assets are being actively marketed and (iv) sale has been agreed or is expected to be concluded within 12 months of the Balance Sheet date.

Subsequently, such non-current assets and disposal groups classified as 'held for sale' are measured at the lower of its carrying value and fair value less costs to sell. Non-current assets held for sale are not depreciated or amortised.

	As at 31st March, 2022	As at 31st March, 2021
Groups of assets held for sale		
Land	2	3
Buildings	11	14
Plant and equipment	-	0
Furniture and fixtures	0	0
	13	**17**

The Company has sold land with net book value (NBV) of ₹1 crore (31st March, 2021: ₹0 crore), buildings with NBV of ₹3 crores (31st March, 2021: ₹1 crore) and plant & equipment with NBV of ₹0 crore (31st March, 2021: Nil). The gain on such sale has been credited to the standalone statement of profit and loss under exceptional items.

(Source: Annual Report 2021-2022 - 'Hindustan Unilever Limited')

7.9 SIGNIFICANT DIFFERENCES IN IND AS 105 *VIS-À-VIS* AS 24

S.No.	Particular	Ind AS 105	AS 24
1.	*Scope and Objective*	Ind AS 105 specifies the accounting for non-current assets held for sale, and the	AS 24 establishes principles for reporting information about *discontinuing operations*. But

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		presentation and disclosure of *discontinued operations*. Ind AS 105 applies to all recognised non-current assets and to all disposal groups of an entity. (*Paragraph 1 of Ind AS 105)*	in AS 24, there is no concept of discontinued operations. It does not deal with the non-current assets held for sale; property, plant and equipment retired from active use and held for sale, which are dealt in AS 10 'Property, Plant and Equipment'. *('Objective' of AS 24)*
2.	*Discontinued vs Discontinuing Operations*	Under Ind AS 105, a discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale and represents a separate major line of business or geographical area of operations, is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or is a subsidiary acquired exclusively with a view to resale. The standard lays down criteria for classifying an asset as held for sale. *(Paragraph 32 of Ind AS 105)*	Under AS 24, a discontinuing operation is a component of an entity that it is disposing off substantially in its entirety or in piecemeal or abandoning and represents the major line of business or geographical area of operations and that can be distinguished operationally and for financial reporting purposes. *(Paragraph 3 of AS 24)*
3.	*Time Period*	As per Ind AS 105, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification with certain exceptions.	AS 24 does not specify any time period in this regard as it relates to discontinuing operations
4.	*Initial Disclosure Event*	Ind AS 105 does not mention so as it relates to discontinued operation.	AS 24 specifies about the disclosure information required in respect to a discontinuing operation in financial

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			statements for the period in which the initial disclosure event occurs. *(Paragraph 15 of AS 24)*
5.	*Measurement*	Under Ind AS 105, non-current assets (disposal groups) held for sale are measured at the lower of carrying amount and fair value less costs to sell and are presented separately in the balance sheet.	AS 24 requires to apply the principles set out in other relevant Accounting Standards, e.g., AS 10 requires that the items of property, plant and equipment retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.
6.	*Abandonment of Assets*	Ind AS 105 specifically mentions that abandonment of assets should not be classified as held for sale. *(Paragraph 13 of Ind AS 105)*	In AS 24, abandonment of assets is classified as a discontinuing operation; however, changing the scope of an operations or the manner in which it is conducted is not abandonment and hence not a discontinuing operation. *(Paragraph 7 of AS 24)*
7.	*Guidance Regarding Measurement of Changes to a Plan of Change*	Ind AS 105 provides guidance regarding changes to the plan to sell non-current assets (or disposal groups) which are classified as held for sale. *(Paragraphs 26-29 of Ind AS 105)*	AS 24 does not give any specific guidance regarding this aspect.

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Questions

1. On 28th February, 20X1, Entity X becomes committed to a plan to sell a property. However, it plans certain renovations to increase its value prior to selling it. The renovations are expected to be completed within a short span of time i.e., 2 months.

   Comment whether the property can be classified as held for sale at the reporting date i.e. 31st March, 20X1.

2. On 1st March, 20X1, entity R decides to sell one of its factories. An agent is appointed and the factory is actively marketed. As on 31st March, 20X1, it is expected that the factory will be sold by 28th February, 20X2. However, in May 20X1, the market price of the factory deteriorated. Entity R believed that the market would recover and thus did not reduce the price of the factory. The company's accounts are authorised for issue on 26th June, 20X1.

   Recommend whether the factory should be shown as held for sale as on 31st March, 20X1.

3. On 1st June, 20X1, entity X plans to sell a group of assets and liabilities, which is classified as a disposal group. On 31st July, 20X1, the Board of Directors approves and becomes committed to the plan to sell the manufacturing unit by entering into a firm purchase commitment with entity Y. However, since the manufacturing unit is regulated, the approval from the regulator is needed for sale. The approval from the regulator is customary and highly probable to be received by 30th November, 20X1 and the sale is expected to be completed by 31st March, 20X2. Entity X follows December year end.

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The assets and liabilities attributable to this manufacturing unit are as under:

(Amount in ₹)

Particulars	Carrying value as on 31st December, 20X0	Carrying value as on 31st July, 20X1
Goodwill	500	500
Plant and Machinery	1,000	900
Building	2,000	1,850
Debtors	850	1,050
Inventory	700	400
Creditors	(300)	(250)
Loans	(2,000)	(1,850)
	2,750	2,600

The fair value of the manufacturing unit as on 31st December, 20X0 is ₹ 2,000 and as on 31st July, 20X1 is ₹ 1,850. The cost to sell is ₹ 100 on both these dates. The disposal group is not sold at the period end i.e., 31st December, 20X1. The fair value as on 31st December, 20X1 is lower than the carrying value of the disposal group as on that date.

Required:

1. Assess whether the manufacturing unit can be classified as held for sale and reasons there for. If yes, then at which date?
2. Measure the manufacturing unit on the date of classification as held for sale.
3. Measure the manufacturing unit at the end of the year.

4. Following is the extract of the consolidated financial statements of A Ltd. for the year ended on:

Asset/ (liability)	Carrying amount as on 31st March, 20X1 (In ₹ '000)
Attributed goodwill	200
Intangible assets	950
Financial asset measured at fair value through other comprehensive income	300

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Property, plant & equipment	1,100
Deferred tax asset	250
Current assets – inventory, receivables and cash balances	600
Current liabilities	(850)
Non-current liabilities – provisions	(300)
Total	**2,250**

On 15th September 20X1, Entity A decided to sell the business. It noted that the business meets the condition of disposal group classified as held for sale on that date in accordance with Ind AS 105. However, it does not meet the conditions to be classified as discontinued operations in accordance with that standard.

The disposal group is stated at the following amounts immediately prior to reclassification as held for sale.

Asset/ (liability)	**Carry amount as on 15th September 20X1 (In ₹ '000)**
Attributed goodwill	200
Intangible assets	930
Financial asset measured at fair value through other comprehensive income	360
Property, plant & equipment	1,020
Deferred tax asset	250
Current assets – inventory, receivables and cash balances	520
Current liabilities	(870)
Non-current liabilities – provisions	(250)
Total	**2,160**

Entity A proposed to sell the disposal group at ₹ 19,00,000. It estimates that the costs to sell will be ₹ 70,000. This cost consists of professional fee to be paid to external lawyers and accountants.

As at 31st March 20X2, there has been no change to the plan to sell the disposal group and entity A still expects to sell it within one year of initial classification. Mr. X, an accountant of

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Entity A remeasured the following assets / liabilities in accordance with respective standards as on 31st March 20X2:

Available for sale:	(In ₹ '000)
Financial assets	410
Deferred tax assets	230
Current assets- Inventory, receivables and cash balances	400
Current liabilities	900
Non- current liabilities- provisions	250

The disposal group has not been trading well and its fair value less costs to sell has fallen to ₹ 16,50,000.

Compute the value of all assets/ labilities within the disposal group as on the following dates in accordance with Ind AS 105:

(a) 15 September, 20X1 and

(b) 31st March, 20X2

5. CK Ltd. prepares the financial statement under Ind AS for the quarter and the year ended 30th June, 20X1. During the 3 months ended 30th June, 20X1, the following events occurred:

On 1st April, 20X1, the Company has decided to sell one of its divisions as a going concern following a recent change in its geographical focus. The proposed sale would involve the buyer acquiring the non-monetary assets (including goodwill) of the division, with the Company collecting any outstanding trade receivables relating to the division and settling any current liabilities.

On 1st April, 20X1, the carrying amount of the assets of the division were as follows:

- Purchased Goodwill – ₹ 60,000
- Property, Plant & Equipment (average remaining estimated useful life two years) - ₹ 20,00,000
- Inventories - ₹ 10,00,000

From 1st April, 20X1, the Company has started to actively market the division and has received number of serious enquiries. On 1st April, 20X1 the directors estimated that they would receive ₹ 32,00,000 from the sale of the division. Since 1st April, 20X1, market condition has improved and as on 1st August, 20X1 the Company received and accepted a firm offer to purchase the division for ₹ 33,00,000.

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The sale is expected to be completed on 30th September, 20X1 and ₹ 33,00,000 can be assumed to be a reasonable estimate of the value of the division as on 30th June, 20X1. During the period from 1st April to 30th June inventories of the division costing ₹ 8,00,000 were sold for ₹ 12,00,000. At 30th June, 20X1, the total cost of the inventories of the division was ₹ 9,00,000. All of these inventories have an estimated net realisable value that is in excess of their cost.

Suggest how the proposed sale of the division will be reported in the interim financial statements for the quarter ended 30th June, 20X1 giving relevant explanations.

6. Identify which of the following is a disposal group at 31st March 20X1:

(1) On 21st March 20X1, XYZ announced the Board's intention to sell its shares in a subsidiary company, Alpha, contingent upon the approval of Alpha's shareholders. It seems unlikely that approval will be granted in the near future and no specific potential buyer has been identified.

(2) PQR has entered into a contract to sell the entire delivery fleet of vehicles operated from its warehouse to a competitor, ABC, on 14th March 20X1. The assets will be transferred on 28th April 20X1 from which date the Group will outsource its delivery activities to another company, LMN.

(3) On 16th January 20X1, DEF's management and shareholders approved a plan to sell its retail business in Mumbai and a consultant is hired to manage the sale. As at 31st March 20X1 agreement had been signed although due diligence and the negotiation of final terms are still in process. The transaction is expected to be completed in April 20X1.

Answers

1. The property cannot be classified as held for sale at the balance sheet date as it is not available for sale immediately in its present condition. Although the renovations are expected to be completed within a short span 2 months, this fact is not relevant for classification. The delay in the timing of the transfer of the property imposed by the Entity X demonstrates that the property is not available for immediate sale.

However, if the PPE meets the criteria for held for sale by 30th April, 20X1 (i.e., 2 months from 28th February, 20X1) and the accounts are not authorised by that date, then necessary disclosures need to be given in the financial statements.

2. The factory ceases to meet the definition of held for sale post the balance sheet date but before the financial statements are authorised for issue, as it is not actively marketed at a

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reasonable price. But, since the market conditions deteriorated post the balance sheet date, the asset will be classified as held for sale as at 31st March, 20X1.

3. Assessing whether the manufacturing unit can be classified as held for sale

The manufacturing unit can be classified as held for sale due to the following reasons:

(a) The disposal group is available for immediate sale and in its present condition. The regulatory approval is customary and it is expected to be received in one year. The date at which the disposal group must be classified as held for sale is 31st July, 20X1, i.e., the date at which management becomes committed to the plan.

(b) The sale is highly probable as the appropriate level of management i.e., board of directors in this case have approved the plan.

(c) A firm purchase agreement has been entered with the buyer.

(d) The sale is expected to be complete by 31st March, 20X2, i.e., within one year from the date of classification.

Measurement of the manufacturing unit as on the date of classification as held for sale

Following steps need to be followed:

Step 1: Immediately before the initial classification of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) shall be measured in accordance with applicable Ind AS.

This has been done and the carrying value of the disposal group as on 31st July, 20X1 is determined at ₹ 2,600. The difference between the carrying value as on 31st December, 20X0 and 31st July, 20X1 is accounted for as per the relevant Ind AS.

Step 2: An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

The fair value less cost to sell of the disposal group as on 31st July, 20X1 is ₹ 1,750 (i.e. 1,850 - 100). This is lower than the carrying value of ₹ 2,600. Thus, an impairment loss needs to be recognised and allocated first towards goodwill and thereafter pro-rata between non-current assets of the disposal group which are within the scope of Ind AS 105 based on their carrying value.

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Thus, the assets will be measured as under:

Particulars	Carrying value – 31st July, 20X1	Impairment	Carrying value as per Ind AS 105 – 31st July, 20X1
Goodwill	500	(500)	-
Plant and Machinery	900	(115)	785
Building	1,850	(235)	1,615
Debtors	1,050	-	1,050
Inventory	400	-	400
Creditors	(250)	-	(250)
Loans	(1,850)	-	(1,850)
	2,600	(850)	1,750

Measurement of the manufacturing unit as on the date of classification as at the year end

The measurement as at the year-end shall be on similar lines as done above.

The assets and liabilities in the disposal group not within the scope of this Standard are measured as per the respective Standards.

The fair value less cost to sell of the disposal group as a whole is calculated. This fair value less cost to sell as at the year-end shall be compared with the carrying value as at the date of classification as held for sale. It is provided that the fair value as on the year end is less than the carrying amount as on that date – thus the impairment loss shall be allocated in the same way between the assets of the disposal group falling within the scope of this standard as shown above.

4. (a) As at 15th September, 20X1

The disposal group should be measured at ₹ 18,30,000 (19,00,000-70,000). The impairment write down of ₹ 3,30,000 (₹ 21,60,000 – ₹ 18,30,000) should be recorded within profit from continuing operations.

The impairment of ₹ 3,30,000 should be allocated to the carrying values of the appropriate non-current assets.

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Asset/ (liability)	Carrying value as at 15th September, 20X1	Impairment	Revised carrying value as per Ind AS 105
Attributed goodwill	200	(200)	-
Intangible assets	930	(62)	868
Financial asset measured at fair value through other comprehensive income	360	-	360
Property, plant & equipment	1,020	(68)	952
Deferred tax asset	250	-	250
Current assets – inventory, receivables and cash balances	520	-	520
Current liabilities	(870)	-	(870)
Non-current liabilities – provisions	(250)	-	(250)
Total	2,160	(330)	1,830

The impairment loss is allocated first to goodwill and then prorata to the other assets of the disposal group within Ind AS 105 measurement scope. Following assets are not in the measurement scope of the standard- financial asset measured at other comprehensive income, the deferred tax asset or the current assets. In addition, the impairment allocation can only be made against assets and is not allocated to liabilities.

(b) As on 31 March, 20X2:

All of the assets and liabilities, outside the scope of measurement under Ind AS 105, are remeasured in accordance with the relevant standards. The assets that are remeasured in this case under the relevant standards are the financial asset measured at fair value through other comprehensive income (Ind AS 109), the deferred tax asset (Ind AS 12), the current assets and liabilities (various standards) and the non-current liabilities (Ind AS 37).

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Asset/ (liability)	Carrying amount as on 15th September, 20X1	Change in value to 31st March 20X2	Impair-ment	Revised carrying value as per Ind AS 105
Attributed goodwill	-	-	-	-
Intangible assets	868	-	(29)	839
Financial asset measured at fair value through other comprehensive income	360	50	-	410
Property, plant & equipment	952	-	(31)	921
Deferred tax asset	250	(20)	-	230
Current assets – inventory, receivables and cash balances	520	(120)	-	400
Current liabilities	(870)	(30)	-	(900)
Non-current liabilities – provisions	(250)	-	-	(250)
Total	**1,830**	**(120)**	**(60)**	**1,650**

5. The decision to offer the division for sale on 1st April, 20X1 means that from that date the division has been classified as held for sale. The division available for immediate sale, is being actively marketed at a reasonable price and the sale is expected to be completed within one year.

The consequence of this classification is that the assets of the division will be measured at the lower of their existing carrying amounts and their fair value less cost to sell. Here the division shall be measured at their existing carrying amount ie ₹ 30,60,000 since it is less than the fair value less cost to sell ₹ 32,00,000.

The increase in expected selling price will not be accounted for since earlier there was no impairment to division held for sale.

The assets of the division need to be presented separately from other assets in the balance sheet. Their major classes should be separately disclosed either on the face of the balance sheet or in the notes.

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The Property, Plant and Equipment shall not be depreciated after 1st April, 20X1 so its carrying value at 30th June, 20X1 will be ₹ 20,00,000 only. The inventories of the division will be shown at ₹ 9,00,000.

The division will be regarded as discontinued operation for the quarter ended 30th June, 20X1. It represents a separate line of business and is held for sale at the year end.

The Statement of Profit and Loss should disclose, as a single amount, the post-tax profit or loss of the division on classification as held for sale.

Further, as per Ind AS 33, EPS will also be disclosed separately for the discontinued operation.

6. Presented as held for sale

(2) PQR's fleet is classified as held for sale because it constitutes a group of assets to be sold in their present condition and the sale is highly probable at the reporting date (as a contract has been entered into).

(3) DEF's sale of its retail business will not be completed until the final terms (e.g. of purchase price) are agreed. However, the business is ready for immediate sale and the sale is highly probable unless other evidence after the reporting date but before the financial statements are approved for issue, comes to light to indicate the contrary.

Not presented as held for sale

(1) XYZ's shares in Alpha are not available for an immediate sale as shareholders' approval is required. Also no specific potential buyer has been identified. In taking these facts into consideration for the assessment of whether the sale is highly probable, it is clearly not highly probable.

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UNIT 8:
INDIAN ACCOUNTING STANDARD 116 : LEASES

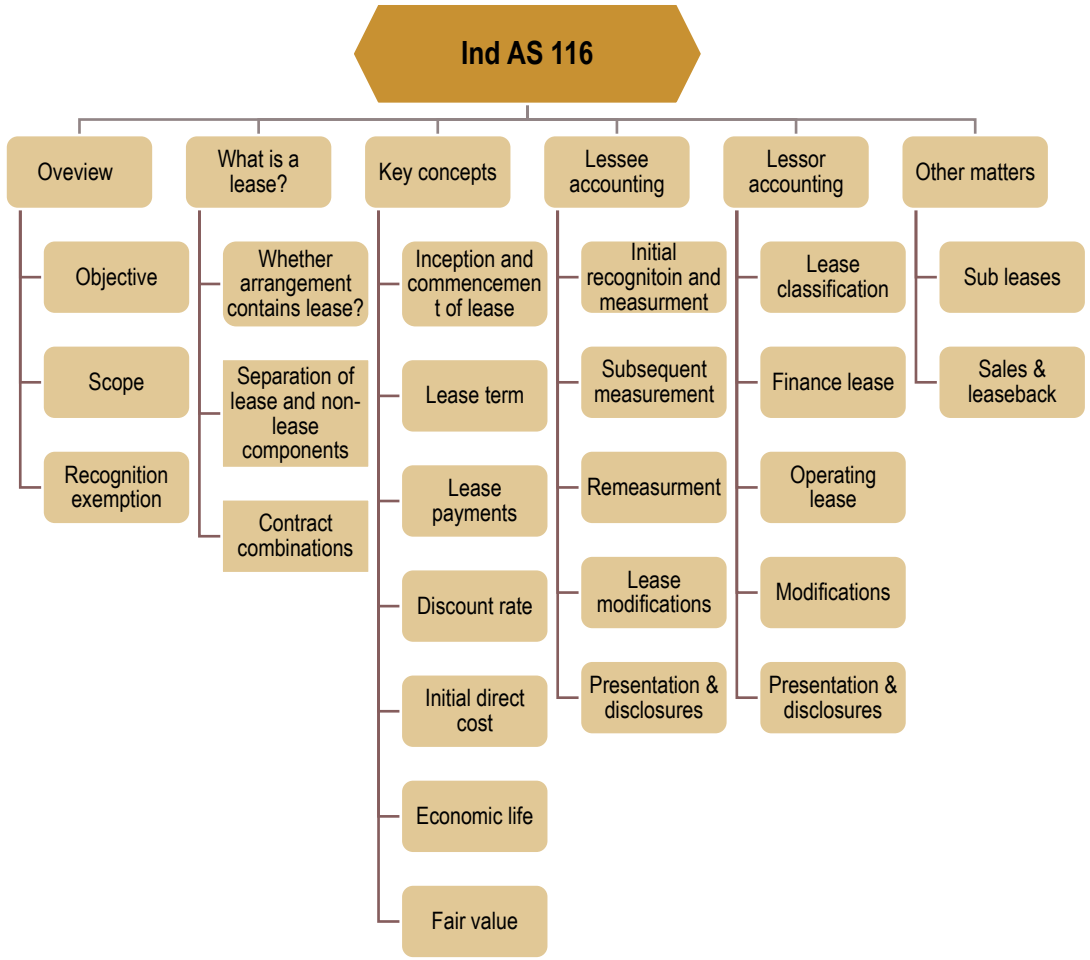
LEARNING OUTCOMES

After studying this unit, you will be able to:

- List the scope and explain the definitions given in the standard
- Comprehend the criteria for recognition of lease
- Analyse whether an arrangement contains a lease
- Identify and separate the lease and non-lease components of a contract
- Demonstrate the concept of inception and commencement of lease
- Determine lease term
- Identify other key concepts like lease payments, discount rate and economic life
- Provide the accounting in the books of lessee with respect to recognition, measurement, presentation and disclosure aspects
- Learn the accounting in the books of lessor with respect to recognition, measurement, presentation and disclosure aspects
- Produce accounting for subleases and sale and lease back transactions
- Apply the transitional provisions on applying Ind AS 116 for the first time.

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UNIT OVERVIEW



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8.1 OVERVIEW

The Ministry of Corporate Affairs (MCA) has notified new standard on leases i.e Ind AS 116 vide its notification dated 30th March, 2019. Lease accounting has undergone significant changes on introduction of Ind AS 116 which is fully converged with IFRS 16. This new standard replaced the erstwhile Ind AS 17 and is effective from financial periods beginning on or after 1st April, 2019.

Ind AS 17 was based on dual classification model of operating and finance leases with different classification and measurement guidance for each of them. The dual classification model did not account for the assets and liabilities associated with the rights and obligations that arise out of the most "operating" leases.

Under Ind AS 116, leases are accounted for based on a 'right-of-use model'. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the time when it makes the underlying asset available for use by the lessee. Ind AS 116, Leases, requires most leases to be recognized on the balance sheet and requires enhanced disclosures. It is believed that this will result in a more faithful representation of lessees' assets and liabilities and greater transparency about the lessee's obligations and leasing activities. However, Ind AS 116 does not make fundamental changes to existing lessor accounting model.

8.1.1 Objective

The objective of this standard is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity. This standard requires an entity to consider the terms and conditions of contracts and all relevant facts and circumstances, and to apply the standard consistently to contracts with similar characteristics and in similar circumstances.

For many reporting entities, leasing is an important way to obtain access to property. A leasing arrangement conveys the use of an asset from one party to another without transferring ownership. The leasing arrangement may take various forms. Some arrangements are clearly within the scope of lease accounting, for example, property lease that provides an explicit contractual right to use a building for a specified period of time in exchange for consideration. However, the right to use an asset can also be conveyed through arrangements that are not leases in form. Therefore, it is very critical to assess as to which arrangement contains a lease for assessing correct impact on financial position.

Ind AS 116, Leases, identifies arrangements that are to be accounted for as leases. This unit discusses how to identify which arrangements, or components within an arrangement, should be

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accounted for under Ind AS 116 and sets out the principles for the recognition, measurement, presentation and disclosure of leases.

8.1.2 Scope

Ind AS 116 shall be applied to ALL LEASES, including leases of Right-of-Use (ROU) assets in a sub-lease, **EXCEPT** for:

S.N.	Particulars	Reason
1	Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources	Within the scope of Ind AS 106 *'Exploration for and Evaluation of Mineral Resources'*
2	Leases of biological assets held by a lessee	Within the scope of Ind AS 41 *'Agriculture'*
3	Service concession arrangements	Within the scope of Appendix D of Ind AS 115 *'Revenue from Contracts with Customers'*
4	Licences of intellectual property granted by a lessor	Within the scope of Ind AS 115 *'Revenue from Contracts with Customers'*
5#	Rights held by a lessee under licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights	Within the scope of Ind AS 38 *'Intangible Assets'*

#A lessee may, but is not required to, apply Ind AS 116 to leases of intangible assets other than those described herein.

8.1.3 Recognition Exemptions

In addition to above scope exclusions, a lessee can elect not to apply Ind AS 116's recognition requirements to:

1. Short-term leases; and
2. Leases for which the underlying asset is of low value

If a lessee **elects to apply** the above recognition exemption, the lessee shall recognise **the lease payments** associated with those leases as an expense on **either a straight-line basis over the lease term or another systematic basis**, if that basis is more representative of the pattern of the lessee's benefit.

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Short term leases:

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset. As the determination is made at the commencement date, a lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months.

The short-term lease exemption can be made by **class of underlying asset** to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations.

For example, consider an entity which has leased several items of office equipment - some of them for less than 12 months and some for more than 12 months, with none containing purchase options. Assuming that the items of office equipment are all considered to be of the same class if the entity wishes to use the short-term lease exemption it must apply for that exemption for all the leases with terms of 12 months or less. The leases with terms longer than 12 months will be accounted for in accordance with the general recognition and measurement requirements for lessees.

A lessee that makes this election must make certain quantitative and qualitative disclosures about short-term leases. Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy.

Illustration 1 - Short-term lease

Scenario A:

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates.

Analyze whether the lessee can take a short-term exemption in accordance with Ind AS 116.

Scenario B:

Assume the same facts as Scenario A except, at the lease commencement date, the lessee is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain.

Advise will your answer be different in this case.

Solution:

Scenario A:

As the lessee is reasonably certain to exercise the extension option (Refer section 8.2 lease term), the lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee will not account for the lease as a short-term lease.

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Scenario B:

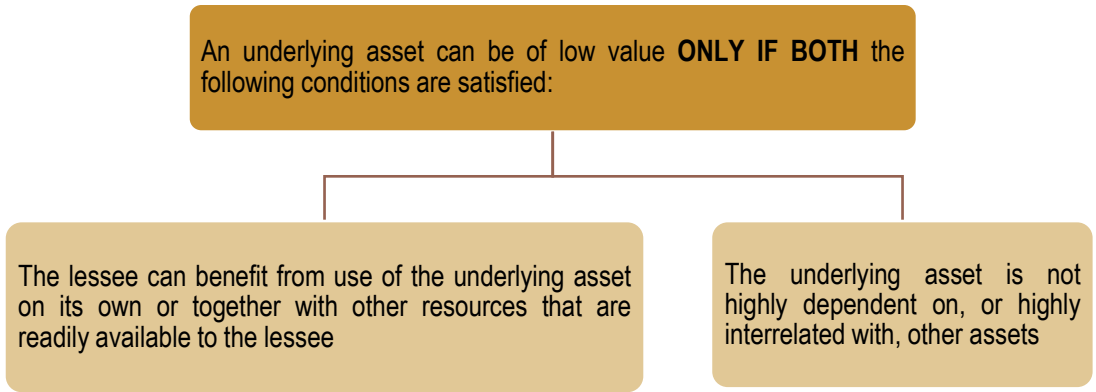
In this case, the lease term is less than 12 months, i.e., nine months. Thus, the lessee may account for the said lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis.

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Leases of low-value assets:

Lessees can also make an election for leases for which the underlying asset is of low value (i.e., low-value assets).

Though Ind AS 116 does not explicitly define the leases of low-value assets, it provides the conditions based on which an asset can be treated as of low-value and the said exemption can be availed accordingly for such low-value asset(s). Following are the conditions:



This can be understood with the help of the following **example**:

An entity may lease a car for use in its business and the lease includes the use of the tyres attached to the car. To use the tyres for their intended purpose, they can only be used with the car and as such, they are dependent on, or highly interrelated with the car. Therefore, the tyres would not qualify for the low-value asset exemption.

The election for leases for which the underlying asset is of low value can be made on a **lease-by-lease basis**. For example, an entity enters into a rental contract for a large number of laptops. Each laptop within the contract constitutes an identified asset. Entity has considered that the value of individual laptop would be low, even though the contract for all the laptops is not. The conditions of Para B5 of Ind AS 116 are satisfied i.e., the entity can benefit from use of an individual laptop together with other resources that are already available and each laptop does not need other assets to make it functional. Consequently, each laptop qualifies as a low value asset and the entity can elect to apply the low-value exemption to all the laptops under the contract.

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The exemption for leases of low — value items intend to capture leases that are high in volume but low in value — e.g. leases of small IT equipment (laptops, mobile phones, simple printers), leases of office furniture etc. Ind AS 116 is silent on any threshold to determine the value for classifying any asset as low value assets.

The following boxes depicts the important points regarding the leases of low-value assets:

Value of an underlying asset to be assessed based on the value of the asset when it is new, regardless of the age of the asset being leased*

Leases of low-value assets are exempted regardless of whether those leases are material to the lessee

Examples of low-value underlying assets can include:
- tablet
- personal computers,
- small items of office furniture
- telephones

The assessment performed on an absolute basis. It is not affected by the size, nature or circumstances of the lessee.

*A lease of an underlying asset does not qualify as a lease of low value asset if the nature of the asset is such that, when new, the asset is typically not of low value. ***For e.g.***, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

Head leases do not qualify as low value assets:

It is very important to note that if a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset. (Refer section 8.6.1 sublease)

Then, what should be the approach for such leases when the said exemptions are taken?

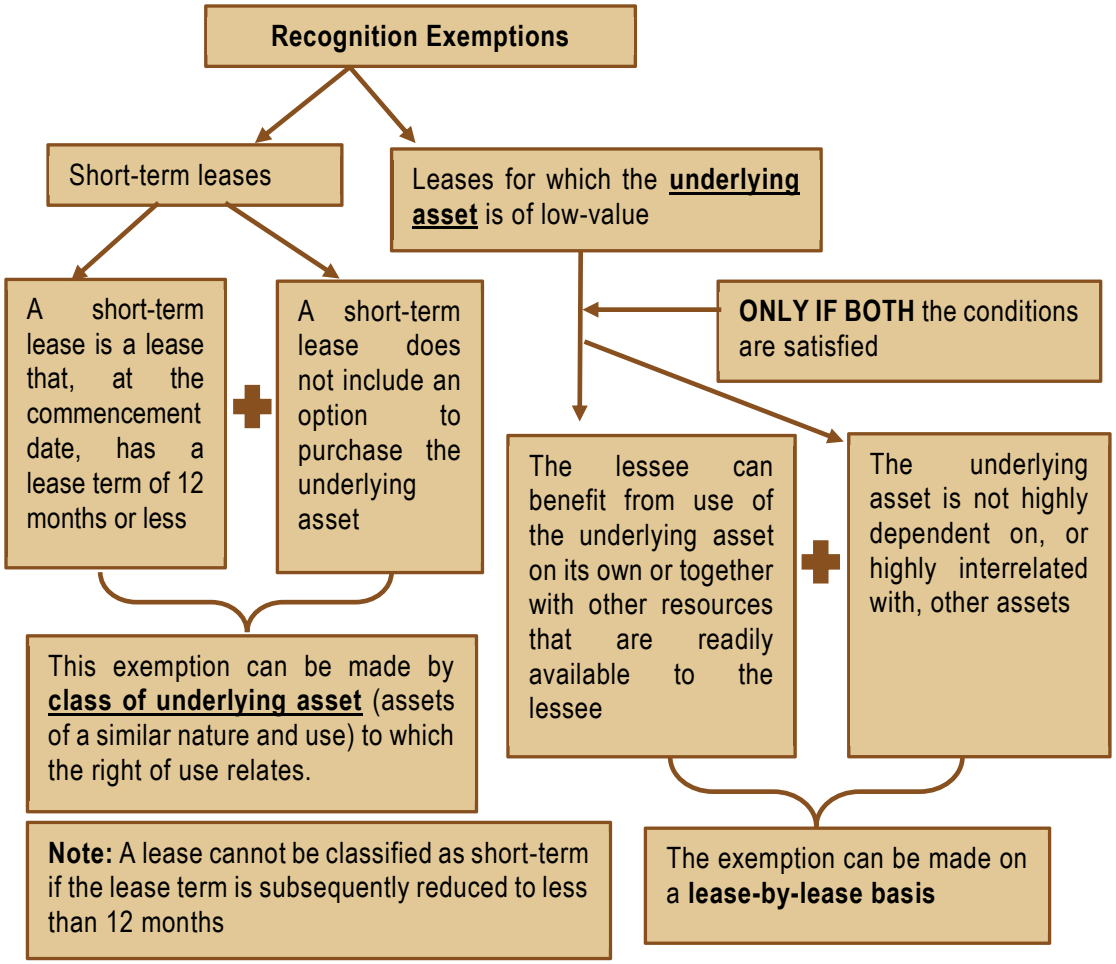
The lease payments shall be recognised as an expense on either a Straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.

If a lessee accounts for "short-term leases" as per the approach mentioned above, it shall consider the lease to be a "new lease" for the purposes of Ind AS 116 if:

(a) there is a lease modification; ***OR***

(b) there is any change in the lease term

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Note:

1. The exemption for leases of low—value items intend to capture leases that are high in volume but low in value.
2. If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset.

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8.2 WHAT IS A LEASE?

At the inception of a contract, an entity shall assess whether the contract is or contains a lease. For the purpose, a lease is defined as a contract, or part of a contract that conveys the **right to control** the use of an **identified asset** for a **period of time** in **exchange for consideration**.

Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the inception of the contract.

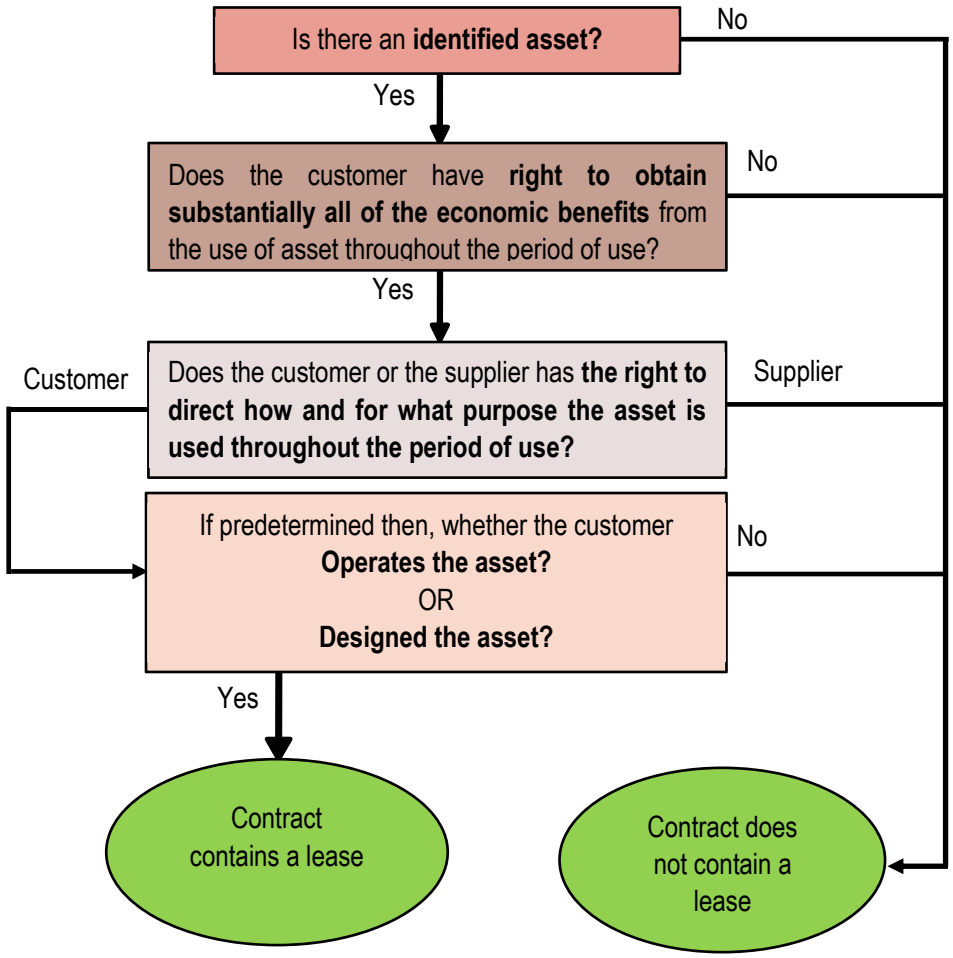
The inception date is defined as the ***earlier*** of the following dates:

- date of a lease agreement
- date of commitment by the parties to the principal terms and conditions of the lease

'A period of time' may be described in terms of the amount of use of an identified asset (***for e.g.***, the number of production units that an item of equipment will be used to produce). It includes any non-consecutive periods of time.

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8.2.1 Whether an Arrangement Contains Lease?



Comparison with AS 19:

AS 19 neither does provide additional guidance regarding "right to direct", nor does it provide any guidance regarding cases of pre-determined activities. AS 19, in general, considers right to use an identified asset.

8.2.1.1 Identified Asset

An arrangement only contains a lease if there is an **identified asset**. Under Ind AS 116, an identified asset can be explicitly specified in a contract or implicitly specified at the time that the asset is made available for use by the customer.

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Illustration 2 - Asset implicitly specified in a contract

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of rolling stock specifically designed for Customer XYZ.

The rolling stock is designed to transport materials used in Customer XYZ's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract but Supplier ABC owns only one rolling stock that is suitable for Customer XYZ's use. If the rolling stock does not operate properly, the contract requires Supplier ABC to repair or replace the rolling stock.

Comment whether there is an identified asset.

Solution:

Yes, the said rolling stock is an identified asset.

Though the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier ABC must use it to fulfil the contract.

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Illustration 3 (Asset implicitly specified in a contract):

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of a car. The specification of the car is specified in the contract (i.e., brand, type, colour, options, etc.). At inception of the contract, the car is not yet built.

State whether there is an identified asset.

Solution:

Yes, the said car is an identified asset.

Though the car cannot be identified at inception of the contract, it is **implicitly specified** at the time the same will be made available to Customer XYZ.

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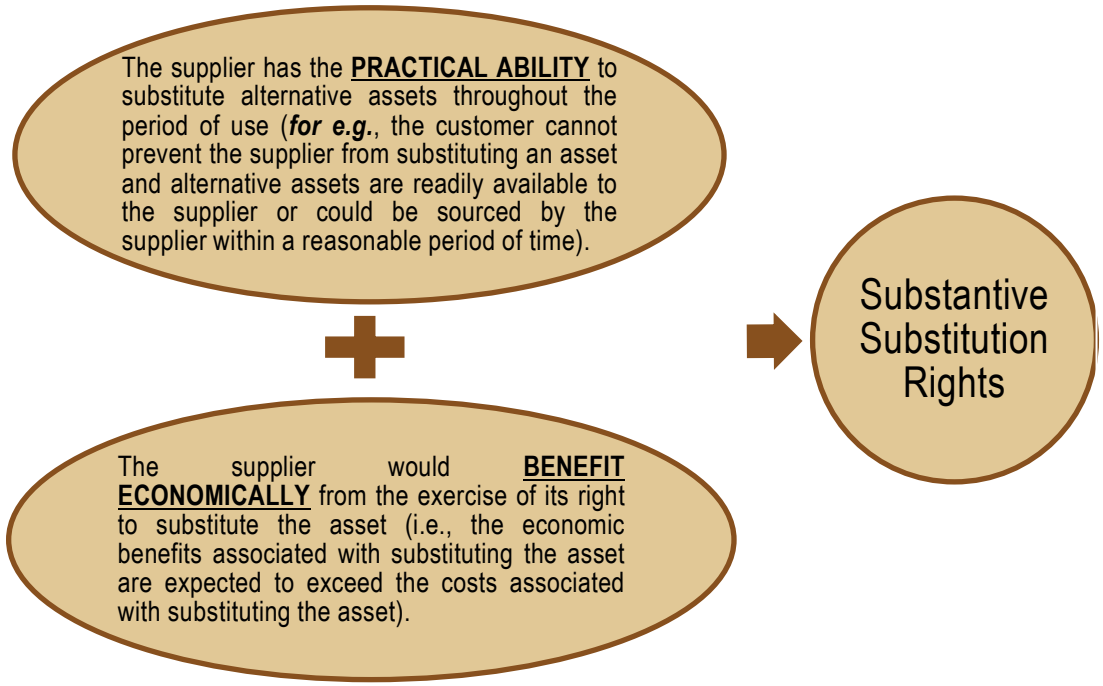
Substantive Substitution Rights:

This is a very important concept since without evaluating this condition, the conclusion as to whether there is an identified asset cannot be attained. So, even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use.

A supplier's right to substitute an asset is **SUBSTANTIVE** when **BOTH** of the following conditions are met:

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The conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract.

In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective. Examples of factors to consider include (1) transportation costs of relocating one asset to a location where it can be used to satisfy the arrangement or to move the output from the production location to the customer, (2) foregone production resulting from down time necessary to switch assets and other disruptions to the suppliers' business, (3) excess operational costs to convert an asset that may not have produced identical output, etc.

Further, if the supplier has a right or an obligation to substitute the asset only on or after either a **particular date**, or the occurrence of a specified event, the supplier's substitution right is **not substantive** because the supplier does **not have the practical ability** to substitute alternative assets **throughout the period of use**.

An entity's evaluation of whether a supplier's substitution right is substantive is based on **facts and circumstances at inception** of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur. Ind AS 116 provides the following examples of circumstances that, at inception of the contract, are not likely to occur and, thus, are **excluded** from the evaluation of whether a supplier's substitution right is substantive throughout the period of use:

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(1) An agreement by a future customer to pay an above market rate for use of the asset	(2) The introduction of new technology that is not substantially developed at inception of the contract
(3) A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract	(4) A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract

The requirement that a substitution right must **benefit the supplier economically** in order to be substantive is a new concept. In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. ***For e.g.***, if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because a supplier concludes that the cost of substitution is not significant does not automatically mean that it would economically benefit from the right of substitution.

Ind AS 116 further clarifies that a customer should **presume** that a supplier's substitution right is **not substantive** when the customer **cannot readily determine** whether the supplier has a substantive substitution right. This requirement is intended to clarify that a **customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive**. However, suppliers should have sufficient information to make a determination of whether a substitution right is substantive.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (***for e.g.***, a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

Illustration 4 - Substantive Substitution Rights

Scenario A:

An electronic data storage provider (supplier) provides services through a centralised data centre that involve the use of a specified server (Server No. 10). The supplier maintains many identical

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servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute for another server without the customer's consent throughout the period of use.

Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimize the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Analyze whether the substitution rights are substantive and whether there is an identified asset.

Scenario B:

Assume the same facts as in Scenario A except that Server No. 10 is customized, and the supplier does not have the practical ability to substitute the customized asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Analyze whether the substitution rights are substantive and whether there is an identified asset.

Solution

Scenario A:

The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute for the server and would benefit economically from such a substitution. Thus, there is no identified asset.

However, if the customer could not readily determine whether the supplier had a substantive substitution right (***for e.g.***, there is insufficient transparency into the supplier's operations), the customer would **presume** the substitution right is not substantive and conclude that there is an identified asset.

Scenario B:

The substitution right is not substantive, and Server No. 10 would be an identified asset because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset. In this case, neither of the conditions of a substitution right is met (whereas both the conditions must be met for the supplier to have a substantive substitution right). Therefore, Server No 10 will be considered as an identified asset.

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Comparison with AS 19:

AS 19 does not include any requirement for substantive substitution right. Hence, even if a lessor has substantial substitution right, the contract may be accounted for as a lease under AS 19.

Identified Asset – Physically Distinct:

An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building may also be considered physically distinct if it can be used independent of the other floors. Similarly, a capacity or other portion of an asset that is not physically distinct (***for e.g.***, a capacity portion of a fibre optic cable) is not an identified asset unless it represents **substantially all** of the capacity of the asset and thereby provides the customer with the **right to obtain substantially all of the economic benefits** from use of the asset.

The term "substantially all" is not defined in Ind AS 116.

This can be better understood with the help of the following illustrations:

Illustration 5 (Identified Asset – Physically Distinct):

Customer XYZ enters into a 15-year contract with Supplier ABC for the right to use five fibres within a fibre optic cable between Mumbai and Pune. The contract identifies five of the cable's 25 fibres for use by Customer XYZ. The five fibres are dedicated solely to Customer XYZ's data for the duration of the contract term. Assume that Supplier ABC does not have a substantive substitution right.

Examine whether there is an identified asset.

Solution:

Yes, the said five fibres are identified assets because they are physically distinct and explicitly specified in the contract.

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Illustration 6 (Identified Asset – Not Physically Distinct):

Scenario A:

Customer XYZ enters into a ten-year contract with Supplier ABC for the right to transport oil from India to Bangladesh through Supplier ABC's pipeline. The contract provides that Customer XYZ will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Examine whether there is an identified asset.

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Scenario B:

Assume the same facts as in Scenario A, except that Customer XYZ has the right to use 65% of the pipeline's capacity throughout the term of the arrangement.

Assess whether there is an identified asset.

Solution:

Scenario A:

Yes, the capacity portion of the pipeline is an identified asset.

While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents **substantially all of the capacity** of the entire pipeline and thereby provides Customer XYZ with the **right to obtain substantially all of the economic benefits** from use of the pipeline.

Scenario B:

No, the capacity portion of the pipeline is **NOT** an identified asset.

Since 65% of the pipeline's capacity is **less than substantially all** of the capacity of the pipeline, Customer XYZ does **not have the right to obtain substantially all of the economic benefits** from use of the pipeline.

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8.2.1.2 Right to Control

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

(a) The right to obtain **substantially all of the economic benefits** from use of the identified asset; **and**

(b) The **right to direct the use** of the identified asset

The right to control the use of an asset may not necessarily be documented, in form, as a lease agreement. Often, the right to use an identified asset is embedded in an arrangement that may appear to be a supply arrangement or service contract. Therefore, a reporting entity should consider all of the terms of an arrangement to determine whether it contains a lease.

Further, if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

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Illustration 7 (Right to use for a portion of the term of contract):

ABC Ltd enters into a contract with XYZ Ltd, which grants ABC Ltd exclusive rights to use a specific grain storage facility over a five-year period in the months of May and June. During these months, ABC Ltd has the right to decide which crops are placed in storage and when to remove them. XYZ Ltd provides the loading and unloading services for the warehouse activities. During the other ten months each year, XYZ Ltd has the right to determine how the warehouse will be used.

Recommend which party has the right to control the use of the identified asset during the period of use.

Solution:

In the above case, ABC Ltd has the right to control the use of the identified asset during the period of use because they have the power to determine how the warehouse will be used during the contractually defined usage periods. The analysis should focus on the rights and economics of the use of the warehouse for the specified usage periods (May and June). During the period of use, ABC Ltd has the rights to determine how much of a crop to place in storage, and the timing of placing and removing it from storage. These rights are more significant to the economics of the use of the asset than the loading and unloading services performed by XYZ Ltd during the same period. ABC Ltd receives all of the economic benefit from use of the asset during those specified time periods. Therefore, contract contains a lease for the specified period of term.

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Right to Obtain Substantially All of the Economic Benefits:

The first criterion in the control assessment is to determine whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use, i.e., to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (***for e.g.***, by having exclusive use of the asset throughout that period).

A customer can obtain economic benefits either **directly** or **indirectly** (***for e.g.***, by using, holding or subleasing the asset). Economic benefits from use of an asset include:

- the asset's primary outputs (i.e., goods or services)
- any by-products (***for e.g.***, renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items.
- benefits from using the asset that could be realised from a commercial transaction with a third party (***for e.g.***, subleasing the asset)

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When assessing whether the customer has the right to obtain substantially all of the economic benefits from the use of an asset, an entity must consider the economic benefits that result from use of the asset within the **defined scope** of the customer's right to use the asset.

For example:

(a) if a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity considers only the economic benefits from use of the motor vehicle within that territory, and not beyond; or

(b) if a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity considers only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond.

A right that **solely protects** the supplier's interest in the underlying asset (***for e.g.***, limits on the number of miles a customer can drive a supplier's vehicle as explained in the above example) does not, in and of itself, prevent the customer from obtaining substantially all of the economic benefits from use of the asset and, therefore, are **not considered** when assessing whether a customer has the right to obtain substantially all of the economic benefits.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from the use of an asset as consideration (***for e.g.***, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use), that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

Illustration 8 (Right to obtain substantially all of the economic benefits):

Company MNO enters into a 15-year contract with Power Company PQR to purchase all of the electricity produced by a new solar farm. PQR owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and MNO will receive renewable energy credits that accrue from use of the solar farm.

Examine who has the right to substantial benefits from the solar farm.

Solution:

Company MNO has the right to obtain substantially all of the economic benefits from use of the solar farm over the 15-year period because it obtains:

- the electricity produced by the farm over the lease term — i.e. the primary product from use of the asset; and
- the renewable energy credits — i.e. the by-product from use of the asset.

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Although PQR receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the ownership of the solar farm. The tax credits do not relate to use of the solar farm and therefore are not considered in this assessment.

*****

Right to Direct the Use of the Identified Asset

The second criterion in the control assessment is to determine whether the customer has the right to direct the use of the identified asset throughout the period of use.

Decisions about **how and for what purpose an asset will be used** **are the most relevant factors** to consider when assessing which party directs the use of the identified asset. Because such rights determine the economic benefits that can be derived from using the asset during the period of use.

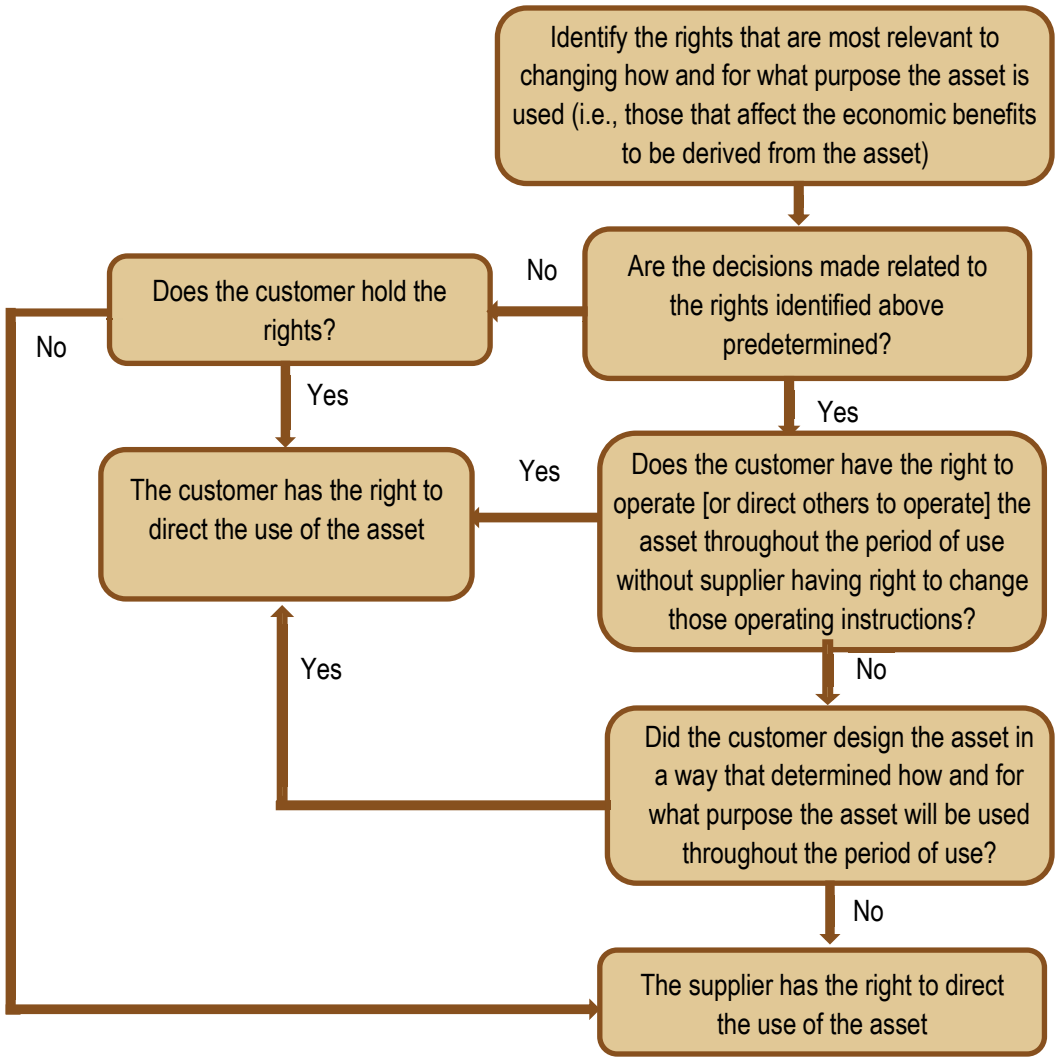
Decisions regarding **where and when the asset is to be used are likely to be more important** than how those decisions are implemented. For example, if a customer outsources operation of an asset to an outside service provider, the outsourcing does not typically influence the economic benefits that can be derived from the asset.

In some arrangements, the decisions related to how and for what purpose an asset is used, are already specified in the contract before the lease term commences. These decisions will need to be considered in conjunction with decisions made during the period of use to properly identify the party that directs the assets' use. Simply specifying the output prior to the term does not, on its own, constitute the ability to direct the use.

The following figure illustrates the analysis that should be used to determine which party has the right to direct the use of an identified asset.

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A customer has the right to direct the use of an identified asset whenever it has the right to direct **how and for what purpose** the asset is used throughout the period of use (i.e., it can **change** how and for what purpose the asset is used throughout the period of use). How and for what purpose an asset is used is a **SINGLE CONCEPT** (i.e., 'how' an asset is used is **not assessed separately** from 'for what purpose' an asset is used).

When evaluating whether a customer has the right to change how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the **decision-making rights that will most affect the economic benefits** that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

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Ind AS 116 provides the following examples of decision-making rights that grant the right to change how and for what purpose an asset is used:

Particulars	***Examples***
The right to change the type of output that is produced by the asset	(i) Deciding whether to use a shipping container to transport goods or for storage (ii) Deciding on the mix of products sold from a retail unit
The right to change when the output is produced	Deciding when an item of machinery or a power plant will be used
The right to change where the output is produced	(i) Deciding on the destination of a truck or a ship (ii) Deciding where a piece of equipment is used or deployed
The right to change whether the output is produced and the quantity of that output	Deciding whether to produce energy from a power plant and how much energy to produce from that power plant

Although **the decisions about maintaining and operating the asset** are often essential to the efficient use of that asset, the right to make those decisions, **in and by itself, does not result** in the right to change how and for what purpose the asset is used throughout the period of use.

The customer does **not need the right to operate** the underlying asset to have the right to direct its use, i.e., the customer may direct the use of an asset that is operated by the supplier's personnel. However, the right to operate an asset will often provide the customer with the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

The relevant decisions about how and for what purpose an asset is used are predetermined:

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when

- the most relevant decisions about how and for what purpose an asset is used are **predetermined by contractual restrictions** on the use of the asset (***for e.g.***, the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed) ***OR***
- the most relevant decisions about how and for what purpose an asset is used are, in effect, **predetermined by the design of the asset**

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In cases where the decisions about how and for what purpose an asset is used are predetermined, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- Has the **right to operate** the asset, ***OR*** **direct others to operate** the asset in a manner it determines, throughout the period of use without the supplier having the right to change those operating instructions ***OR***
- **Designed** the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Significant judgement may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Specifying the output of an asset before the period of use

If a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, the customer does **not have the right to direct the use of that asset unless** it designed the asset, ***OR*** specific aspects of the asset.

If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that does not give it any other relevant decision-making rights relating to the use of the asset (***for e.g.***, the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in an arrangement (i.e., a contract that does not contain a lease).

Protective rights

A supplier's protective rights, **in isolation, do not prevent the customer from having the right to direct the use** of an identified asset.

Protective rights typically define the scope of the customer's right to use the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests. For example, a contract may

(i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset,

(ii) require a customer to follow particular operating practices, or

(iii) require a customer to inform the supplier of changes in how an asset will be used.

Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

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Illustration 9 - Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a five-year period. The vehicle is identified in the contract. Supplier Y cannot substitute for another vehicle unless the specified vehicle is not operational (for e.g., if it breaks down). Under the contract:

- *Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (for e.g., hires a driver).*
- *Customer X decides how to use the vehicle (within contractual limitations). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.*
- *Supplier Y prohibits certain uses of the vehicle (for e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.*

Sate whether Customer X has the right to direct the use of the vehicle throughout the period of lease.

Solution:

Yes, Customer X has the right to direct the use of the identified vehicle throughout the period of use because it has the **right to change** how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered **protective rights** that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

*****

Illustration 10 - Right to direct the use of an asset

Entity A contracts with Supplier H to manufacture parts in a facility. Entity A designed the facility and provided its specifications. Supplier H owns the facility and the land. Entity A specifies how many parts it needs and when it needs the parts to be available. Supplier H operates the machinery and makes all operating decisions including how and when the parts are to be produced, as long as it meets the contractual requirements to deliver the specified number on the specified date. Assuming supplier H cannot substitute the facility and hence is an identified asset.

Examine which party has the right to control the use of the identified asset (i.e., equipment) during the period of use.

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Solution:

Entity A does not direct the use of the asset that most significantly drives the economic benefits because Supplier H determines how and when the equipment is operated once the contract is signed. Therefore, Supplier H has the right to control the use of the identified asset during the period of use. Although Entity A stipulates the product to be provided and has input into the initial decisions regarding the use of the asset through its involvement in the design of the asset, it does not have decision making rights over how and for what purpose the asset will be used over the asset during the period of use. This arrangement is a supply agreement, not a lease.

*****

Illustration 11 - Right to direct the use of an asset

Entity L enters into a five - year contract with Company A, a ship owner, for the use of an identified ship. Entity L decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent Entity L from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. Company A operates and maintains the ship and is responsible for safe passage.

State who has the right to direct the use of the ship during the period of use.

Solution:

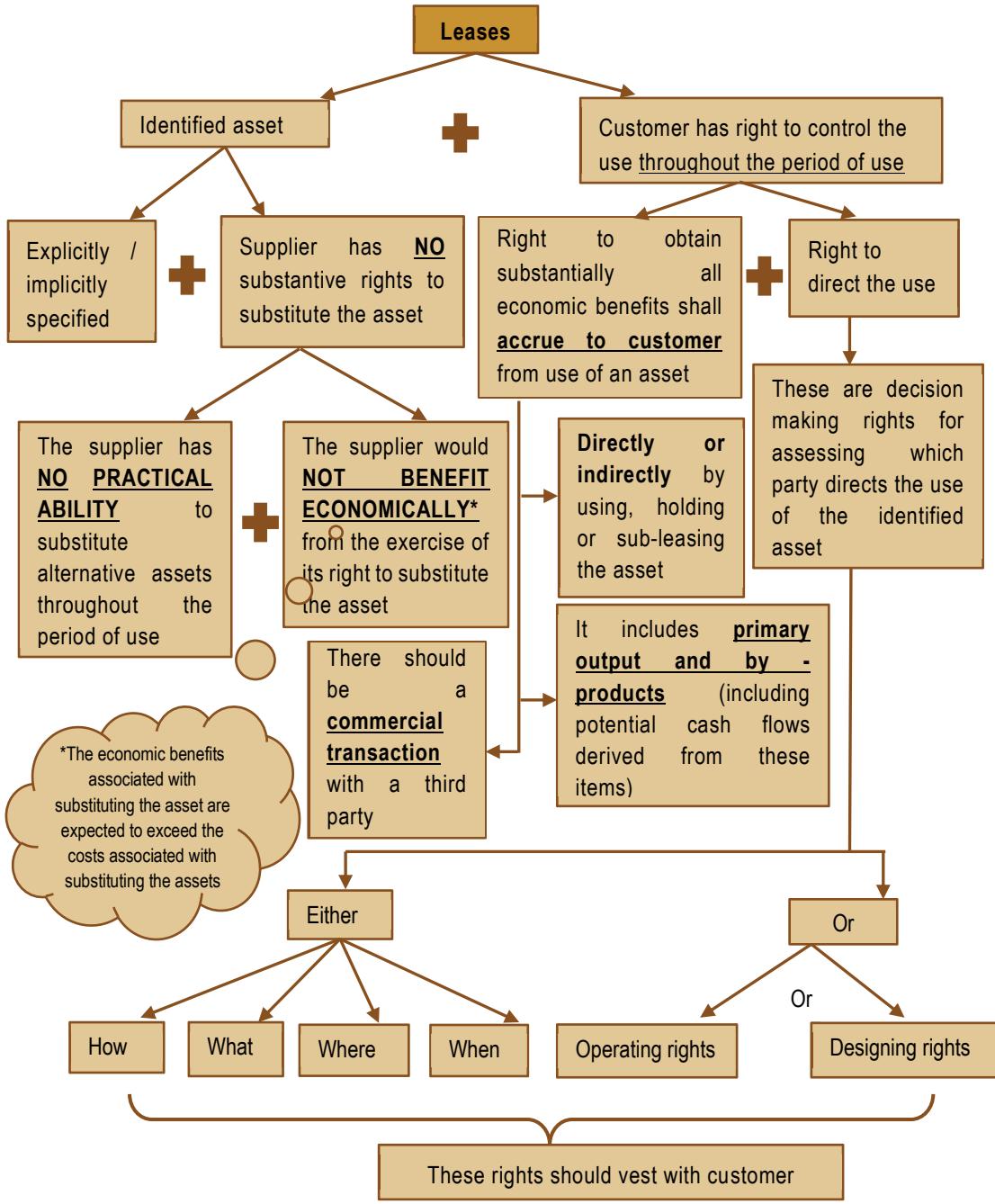
Entity L has the right to direct the use of the ship. The contractual restrictions are protective rights. In the scope of its right of use, Entity L determines how and for what purpose the ship is used throughout the five — year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. Entity L has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.

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The concept explained in para 8.2.1 has been summarised as follows:



*The economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset

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Note:

1. In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective.
2. If the supplier has a right or an obligation to substitute the asset only on or after either a **particular date**, or the occurrence of a specified event, the supplier's substitution right is **not substantive** because the supplier does **not have the practical ability** to substitute alternative assets **throughout the period of use**.
3. An entity's evaluation of whether a supplier's substitution right is substantive is based on **facts and circumstances at inception** of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur.
4. Contract terms that allow or require a supplier to substitute alternative assets only when the underlying **asset is not operating properly** (***for e.g.***, a normal warranty provision) or when a **technical upgrade** becomes available **do not create a substantive substitution right**.
5. Circumstances that, at inception of the contract, are not likely to occur and, thus, are **excluded** from the evaluation of whether a supplier's substitution right is substantive throughout the period of use.
6. The right to control the use of an asset may not necessarily be documented, in the form as a lease agreement.
7. Ind AS 116 further clarifies that a customer should **presume** that a supplier's substitution right is **not substantive** when the customer **cannot readily determine** whether the supplier has a substantive substitution right. This requirement is intended to clarify that a **customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive**.
8. An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. Similarly, a capacity or other portion of an asset that is not physically distinct is not an identified asset unless it represents **substantially all** of the capacity of the asset and thereby provides the customer with the **right to obtain substantially all of the economic benefits** from use of the asset.

8.2.2 Separation of Lease and Non-Lease Components

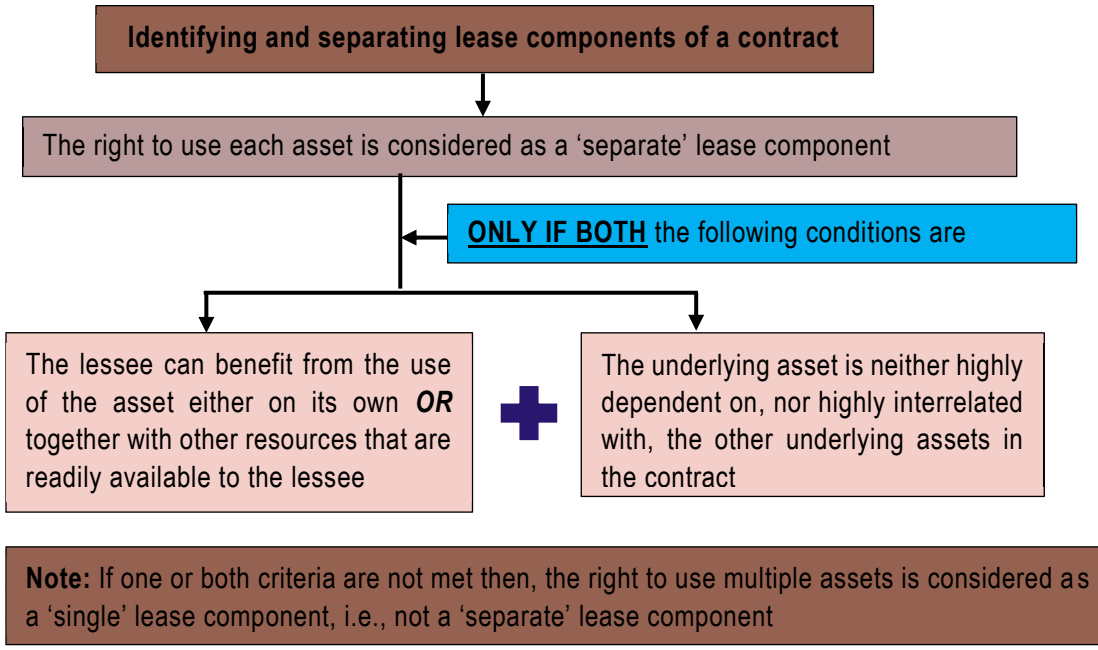
8.2.2.1 Identifying and separating lease components of a contract

Sometimes, there are contracts that contain rights to use multiple assets (***for e.g.***, a building and an equipment, multiple pieces of equipment, etc.). The right to use each such asset is considered as a 'separate' lease component **ONLY IF BOTH** the following conditions are satisfied:

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- The lessee can benefit from the use of the asset either on its own ***OR*** together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events) ***AND***
- The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

If one or both of these criteria are not met then, the right to use multiple assets is considered a 'single' lease component, i.e., not a 'separate' lease component.



Note: If one or both criteria are not met then, the right to use multiple assets is considered as a 'single' lease component, i.e., not a 'separate' lease component

Let us have a look at the following illustration to have a better understanding:

Illustration 12 - Identifying and separating lease components

Scenario A:

*A lessee enters a lease of an excavator and the related accessories (**for e.g.**, excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine.*

State how many lease and non-lease components are there.

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Scenario B:

*Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (**for e.g.**, to transport iron ores at another mine).*

Solution:

Scenario A:

The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories. Thus, from the perspective of the lessee, the contract contains one lease component.

Scenario B:

The lessee can benefit from the loading truck on its own or together with other readily available resources because the loading truck could be deployed for other uses independent of the excavator. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

Thus, from the perspective of the lessee, the contract contains two lease components, viz., a lease of the excavator (together with the accessories) and a lease of the loading truck.

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8.2.2.2. Separating lease components from non-lease components:

There may be many contracts containing a lease coupled with an agreement to purchase or sell other goods or services (i.e., the non-lease components under Ind AS 116). For example, a supplier may lease a truck and also operate the leased asset on behalf of a customer (i.e., provide a driver). This service is not related to securing the use of the truck. The only items that contribute to securing the output of the asset are lease components. In this example, only the use of the truck is considered a lease component. Similarly, costs incurred by a supplier to provide maintenance on an underlying asset, as well as the materials and supplies consumed as a result of the use of the asset, are not lease components.

The non-lease components are identified and accounted for separately from the lease component in accordance with other standards. ***For e.g.***, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to Ind AS 115 by lessors (suppliers).

Costs related to property taxes and insurance do not involve the transfer of a good or service. Consequently, if these costs are fixed in the contract, they should be included in the overall contract consideration to be allocated to the lease and non-lease components.

Lessee reimbursements – whether a separate component of a contract?

As already discussed above that under Ind AS 116, payments for maintenance activities, including common area maintenance (***for e.g.***, cleaning the common areas of a building, removing snow

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from a car park for employees and customers) and other goods or services transferred to the lessee (***for e.g.***, providing utilities or rubbish removal) are considered as **non-lease components** because they provide the lessee with a service.

But, in some leases, a lessee also may **reimburse (or make certain payments on behalf of)** the lessor that relate to the leased asset for activities and costs that do not transfer a good or service to the lessee (***for e.g.***, payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is).

Under Ind AS 116, such costs are **not separate components of the contract** because they do not represent payments for goods or services and are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components, if any).

Illustration 13 - Identifying different components in the contract

Entity L rents an office building from Landlord M for a term of 10 years. The rental contract stipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also requires Landlord M to perform all common area maintenance (CAM) during the term of the arrangement. Entity L makes a single monthly rental payment and does not pay for the maintenance separately. The office building has a useful life of 40 years and the HVAC system and office furniture each has a life of 15 years.

State what are the units of account in the lease.

Solution:

There are three components in the arrangement – the building assets (office building and HVAC), the office furniture, and the maintenance agreement.

The office building and HVAC system are one lease component because they cannot function independently of each other. The HVAC system was designed and tailored specifically to be integrated into the office building and cannot be removed and used in another building without incurring substantial costs. These building assets are a lease component because they are identified assets for which Entity L directs the use.

The office furniture functions independently and can be used on its own. It is also a lease component because it is a group of distinct assets for which Entity L directs the use.

The maintenance agreement is a non-lease component because it is a contract for service and not for the use of a specified asset.

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Optional exemption of using Practical Expedient to not to separate non-lease component

Ind AS 116 provides a practical expedient that permits lessees to make an **accounting policy election**, by **CLASS OF UNDERLYING ASSET**, to account for each separate lease component

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of a contract and any associated non-lease components as a **SINGLE LEASE COMPONENT**. It is important to note that such practical expedient is not permissible for lessor.

Making this election relieves the lessee of the obligation to perform a pricing allocation, although it will increase the total lease liability to be recorded on its balance sheet. This expedient is not available for lessors. Lessees that make the **policy election** to account for each separate lease component of a contract and any associated non-lease components as a **SINGLE LEASE COMPONENT**, **allocate ALL of the contract consideration to the lease component**.

It is very important to note that the practical expedient does not allow lessees to account for multiple lease components of a contract as a single lease component, if it meets the conditions provided in Section 8.2.2.1.

Comparison with AS 19:

AS 19 does not contain any guidance on separation of lease and non-lease components. It seems that AS 19 requires accounting for the entire contract including the non-lease components. The Scope of AS 19 mentions that "*AS 19 applies to contracts that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Examples include the supply of property, vehicles, and computers.*" Hence, one would be required to account for the entire contract as a lease under AS 19, without separating the non-lease components.

8.2.2.3 Determining and allocating the consideration in the contract – Lessee

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient, as discussed above, to account for each separate lease component of a contract and any associated non-lease components as a single lease component, are required to **allocate** the consideration in the contract to the lease and non-lease components on a **RELATIVE STAND-ALONE PRICE BASIS**.

Lessees are required to use **observable** stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees **estimate** stand-alone prices, maximizing the use of observable information.

Illustration 14 - Activities which are not components of a lease contract

Scenario A:

A lessee enters into a five-year lease of equipment, with fixed annual payments of ₹10,000. The contract contains fixed annual payments as follows: ₹8,000 for rent, ₹1,500 for maintenance and ₹500 for administrative tasks.

Explain how the consideration would be allocated.

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Scenario B:

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition.

Explain how the consideration would be allocated.

Solution:

Scenario A:

The contract contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee.

Assuming that the lessee does not elect to use the practical expedient as per para 15 of Ind AS 116, both the lessee and the lessor account for the lease of equipment and maintenance components separately and the administration charge is included in the total consideration to be allocated between those components. Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B:

The contract still contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term.

Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

*****

Illustration 15 - Allocating contract consideration to lease and non-lease components – Lessees

A lessee enters into a lease of equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	*₹ 80,000*
Maintenance	*₹ 10,000*
Total	***₹ 90,000***

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximizing the use of observable information, of the lease and non-lease components, as

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follows:	
Lease	*₹ 85,000*
Maintenance	*₹ 15,000*
Total	***₹ 1,00,000***

In the given scenario, assuming lessee has not opted the practical expedient, explain how will the lessee allocate the consideration to lease and non-lease component?

Solution:

The stand-alone price for the lease component represents 85% (i.e., ₹ 85,000 / ₹ 1,00,000) of total estimated stand-alone prices. The lessee allocates the consideration in the contract (i.e., ₹ 90,000), as follows:	
Lease	* ₹ 76,500
Maintenance	** ₹ 13,500
Total	**₹ 90,000**

* ₹ 90,000 x 85% ** ₹ 90,000 x 15%.

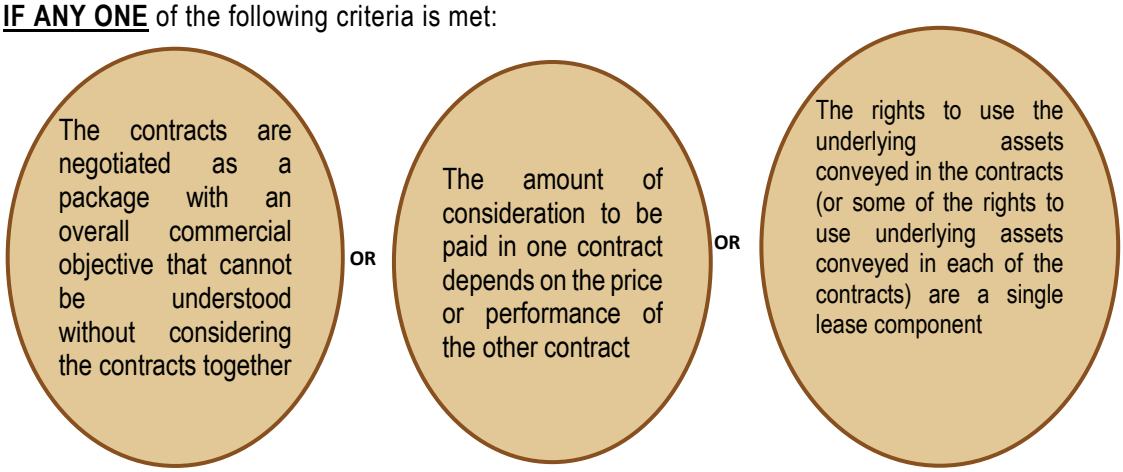
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8.2.2.4 Determining and allocating the consideration in the contract – Lessors:

Lessors are required to **allocate** the consideration in the contract to the lease and any associated non-lease components by applying paragraphs **73 – 90 of** Ind AS 115 *Revenue from Contracts with Customers.*

8.2.3 Contract Combinations

Ind AS 116 requires that two or more contracts entered into at or near the **same time** with the **same counterparty** (**or related parties of the counterparty**) be considered a **'single' contract IF ANY ONE** of the following criteria is met:



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8.2.4 Portfolio Application

Ind AS 116 applies to individual leases. However, entities that have a large number of leases of similar assets (***for e.g.***, leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis.

Thus, Ind AS 116 includes a practical expedient that allows entities to use a portfolio approach for leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio. If accounting for a portfolio, an entity uses estimates and assumptions that reflect the size and composition of the portfolio.

This approach is consistent with that under Ind AS 115. A decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

Comparison with AS 19:

AS 19 does not provide any guidance on combining contracts or portfolio application of principles.

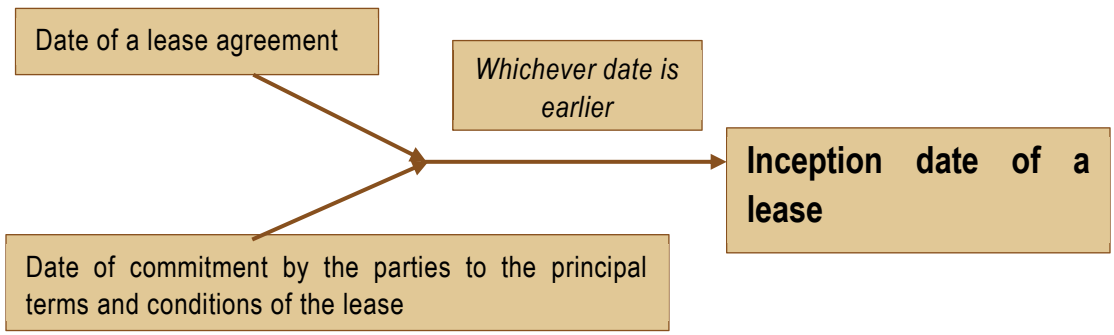
8.3 KEY CONCEPTS

8.3.1 Inception and Commencement of Lease

Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the **inception** of the contract.

The **inception date** is defined as the *earlier* of the following dates:

- date of a lease agreement
- date of commitment by the parties to the principal terms and conditions of the lease



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The **commencement date** is defined as the date on which a lessor makes an underlying **asset available for use** by a lessee. Where, the 'underlying asset' is an asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

In certain cases, the commencement date of the lease may be before the date stipulated in the lease agreement (***for e.g.***, the date on which rents become due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (***for e.g.***, during the period a lessee uses the leased space to construct its own leasehold improvements).

If a lessee takes possession of, or is given control over, the use of the underlying asset **before** it begins operations or making lease payments under the terms of the lease, **the lease term has commenced even if** the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date.

The timing of when lease payments begin under the contract **does not affect** the commencement date of the lease.

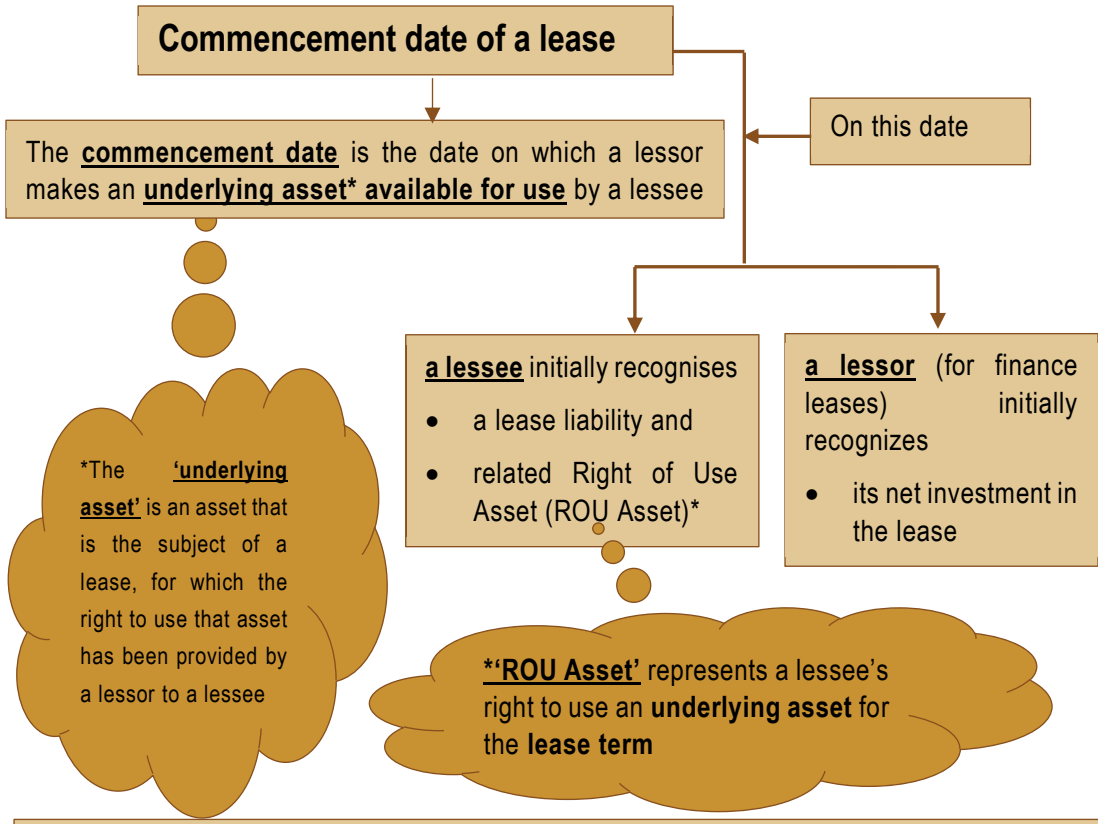
As discussed earlier, **inception date** is the date when an entity shall **assess** if the contract is or contains lease. While the **commencement date** is relevant because on that date**:**

(i) a lessee (except where the exemption of short-term lease or low-value asset is taken) **initially recognises a lease liability** and related Right of Use Asset (hereinafter referred to as "ROU Asset") on the commencement date

(ii) a lessor (for finance leases) initially recognises its net investment in the lease on the commencement date.

Where, **'ROU Asset'** is defined as an asset that represents a lessee's right to use an **underlying asset** for the **lease term**.

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Note:

- In certain cases, the commencement date of the lease may be before the date stipulated in the lease agreement.
- The timing of when lease payments begin under the contract **does not affect** the commencement date of the lease.

8.3.2 Lease Term

Determination of the lease term is a very crucial step before the calculation of the Lease Liability and the corresponding ROU Asset.

In simple terms, lease term is the **summation** of the following:

	Particulars	Years
1	Rent free period	XXX
2	Non-cancellable period	XXX

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3	Optional renewable periods (where lessee is reasonably certain to extend the lease)	XXX
4	Periods covered by option to terminate the lease (where lessee is reasonably certain not to terminate early)	XXX
	Total Lease terms	**XXXX**

The lease term begins at the lease **commencement date**. The lease term starts when the lessor makes the underlying asset available for use by the lessee and includes any rent-free periods provided.

The assessment of whether it is reasonably certain that a lessee will exercise an extension or termination option **should be done on lease commencement date.** An entity should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option. The assessment should not be based solely on the lessee's intentions, past practices, or estimates. It should focus on the factors that create an economic incentive for the lessee, including contract, asset, entity, or market-based factors. Example of relevant factors to consider are:

Contractual terms vis-a vis market rates	Asset related factors
1. Lease rentals in optional period, ex. Termination penalties and residual value guarantees	1. Specialised asset
2. Variable or contingent payment	2. Location of underlying asset
3. Terms and condition after initial optional period, ex. Purchase option	3. Availability of suitable alternatives
4. Cost relating to the termination of the lease and signing of new replacement lease	4. Existence of significant leasehold improvement

In certain cases, it can be more difficult to determine whether the exercise of the option is reasonably certain where the period from the commencement of the lease to the exercise date of an option is longer. The said difficulty arises from several factors. ***For e.g.***, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets such as those involving technology is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

An artificially short lease term (***for e.g.***, a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four-year lease term), may effectively create a

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significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may affect a lessee's decisions about whether it is reasonably certain to exercise a purchase or renewal option. ***For e.g.***, a company that leases a specialized facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the company while it searched for a replacement asset.

An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

A lessee may enter into a lease contract for non-consecutive periods. This is seen in the retail industry when retailers enter into contracts with shopping centers to lease the same retail space for certain non-consecutive months of the year (e.g., during an annual holiday period). Similar arrangements also exist when sports teams lease a sports stadium for particular non-consecutive days of the year. These arrangements will usually meet the definition of a lease because during the agreed period of use, the customer controls the right to use the underlying asset. In these arrangements, the lease term is the aggregate of the non-consecutive periods.

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Illustration 16 - Determining the lease term

Scenario A:

Entity ABC enters into a lease for equipment that includes a non-cancellable term of six years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity ABC is reasonably certain to exercise the renewal option.

Explain the lease term.

Scenario B:

Entity XYZ enters into a lease for a building that includes a non-cancellable term of eight years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity XYZ pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of eight years, and that value can only be realised through continued occupancy of the leased property.

Describe the lease term.

Scenario C:

Entity PQR enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity PQR for only the months of October, November and December during a non-cancellable term of seven years. The lessor agrees to provide the same retail space for each of the seven years.

Explain the lease term.

Solution:

Scenario A:

At the lease commencement date, the lease term is six years (being the non-cancellable period). The renewal period of two years is not taken into consideration since Entity ABC is not reasonably certain to exercise the option because there are no penalties or other factors which indicate that the entity will opt for renewal of lease.

Scenario B:

At the lease commencement, Entity XYZ determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period of eight years. Thus, at the lease commencement, Entity XYZ concludes that the lease term is ten years (being eight years of non-cancellable period plus the renewal period of two years where the lessee is reasonably certain to exercise the option).

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Scenario C:

At the lease commencement date, the lease term is 21 months (three months per year over the seven annual periods as specified in the contract), i.e., the period over which Entity PQR controls the right to use the underlying asset.

*****

Cancellable leases:

In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A 'contract' is defined as an agreement between two or more parties that creates enforceable rights and obligations.

An arrangement is **not enforceable** if:

(i) both the lessor and lessee each have the right to terminate the lease without permission from the other party; **AND**

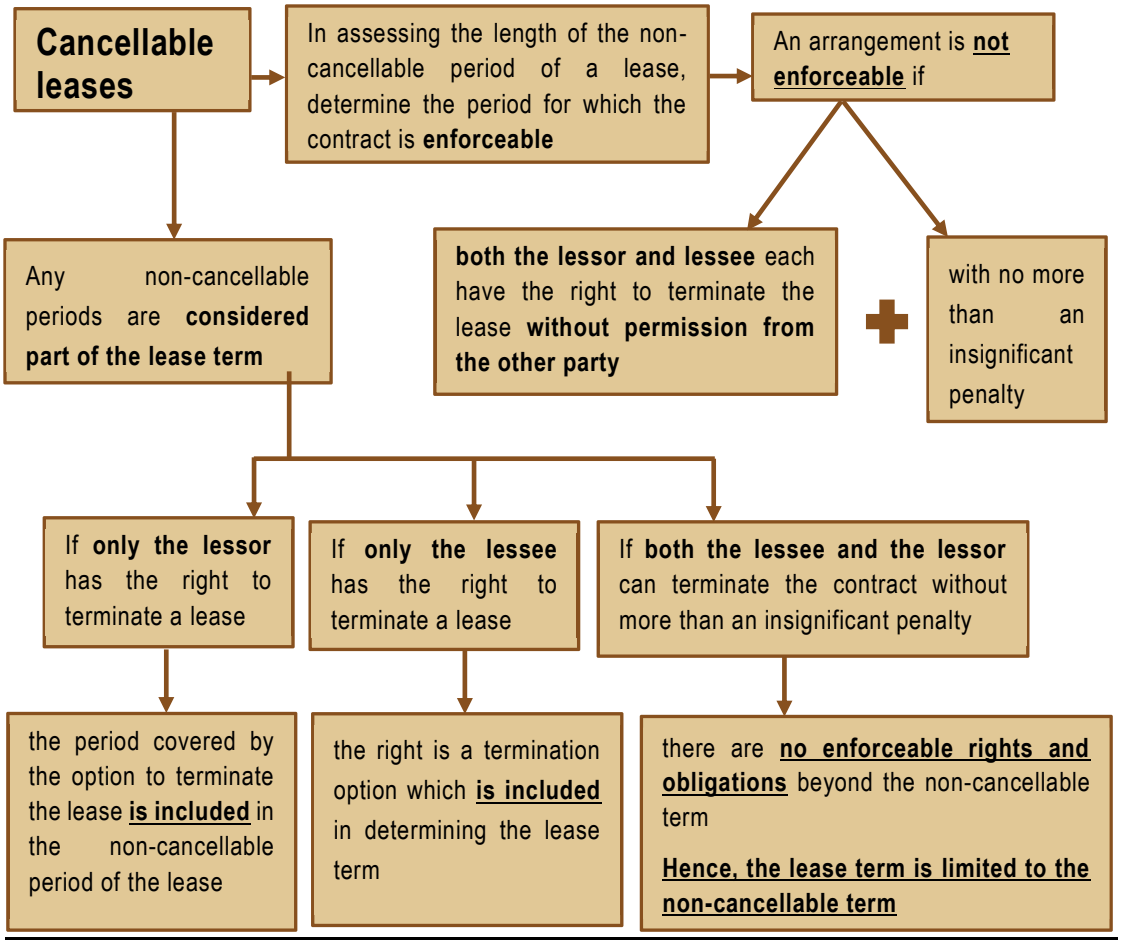
(ii) with no more than an insignificant penalty

Any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only the lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the non-cancellable period of the lease. If only the lessee has the right to terminate a lease, that right is a termination option that is considered when determining the lease term.

Ind AS 116 defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations. Thus, Ind AS 116 applies to contracts that are referred to as 'cancellable', month-to-month', 'at will', 'evergreen', 'perpetual' or 'rolling' if they create enforceable rights and obligations. These types of lease generally allow for the contract to continue beyond a non-cancellable period until one party gives notice to terminate the contract (***for e.g.***, the contract will roll monthly until the lessee or the lessor elect to terminate the contract). If both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then there are no enforceable rights and obligations beyond the non-cancellable term (i.e., the lease term is limited to the non-cancellable term). However, if only the lessee holds a renewal option, there may be other factors to consider determining whether the lessee is reasonably certain to extend the lease, including economic disincentives (as discussed above).

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This can be understood better with the help of the following illustrative situation:

Suppose the term of a contract is 10 years and the non-cancellable / lock-in period is 6 years. The lease term shall be as follows:

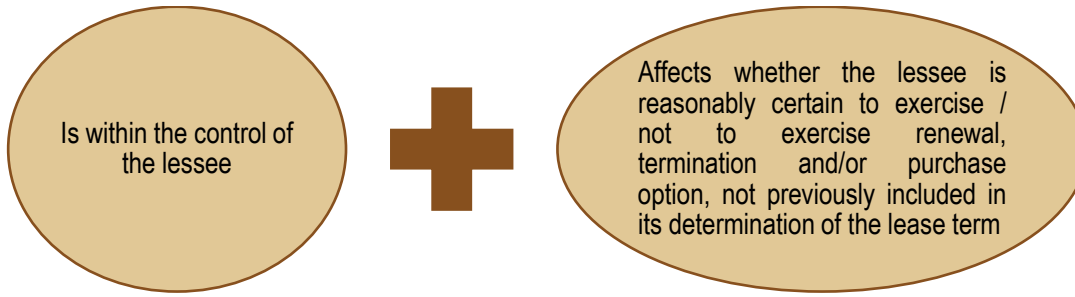
If the termination option is with 'Lessor'	If the termination option is with 'Lessee'	If the termination option is with 'Both' (i.e., any party can terminate)
The lease term shall be **10 years**. *Because even after 6th year, the lessee would be contractually bound until 10th year i.e. lessee cannot refuse*	The lease term shall be **10 years** assuming reasonable certainty. *Because after the expiry of 6th year, though the lessee is not contractually bound till 10th year, i.e., the lessee can*	The lease term shall be **6 years**. *Because after 6th year, either party can terminate the contract without the consent of the other party and hence,*

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to make the payment till the expiry of the contract and also, has the right to use the asset until 10th year, unless lessor terminates the contract.	*refuse to make payment anytime without lessor's permission but, it is assumed that the lessee is reasonably certain that it will not exercise this option to terminate. Hence, though there is no enforceable obligation from lessee's point of view beyond 6th year but, basis the said assumption, the lease term shall be 10 years.*	*the contract is not enforceable after 6th year ONLY in case there is insignificant penalty for termination.*

Reassessment of lease term and purchase options (for lessees):

After the lease commencement, Ind AS 116 requires lessees to monitor leases for **significant changes** that could trigger a change in the lease term. Lessees are required to **reassess** the lease term upon the occurrence of either a **significant event *OR*** a **significant change** in the circumstances that:



Following are some of the examples of significant events or significant changes in circumstances within the lessee's control:

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1) Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable

2) Making significant modifications or customisations to the underlying asset

3) Making a business decision that is directly relevant to the lessee's ability to exercise, or not to exercise, an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset)

4) Subleasing the underlying asset for a period beyond the exercise date of the option

Changes in market-based factors (***for e.g.***, a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and therefore, they **do not trigger a reassessment by themselves**.

Ind AS 116 also requires lessees to revise the lease term if there is change in the non-cancellable period of lease. Following are the example which leads to change in non-cancellable period of a lease:

Change in non-cancellable lease period

If the lessee **exercises an option** not previously included in the entity's determination of the lease term	If the lessee **does not exercise an option** previously included in the entity's determination of the lease term;
An event occurs that **contractually obliges the lessee** to exercise an option not previously included in the entity's determination of the lease term	An event occurs that **contractually prohibits** the lessee from exercising an option previously included in the entity's determination of the lease term.

As the lessee is required to reassess the lease term upon the occurrence of either a significant event or a significant change in the circumstances that is within the control of the lessee, the revision of the lease term often happens before the actual exercise of the option in these circumstances.

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Illustration 17 - Re-assessment of exercise of lease extension option

Retailer M enters into a five-year lease for a building floor, followed by two successive five-year renewal options. On the commencement date, Retailer M is not reasonably certain to exercise the extension option. At the end of third year, Retailer M extended to include another floor from year 4 due to a business acquisition. For this purpose, the lessee concludes a separate seven-year lease for an additional floor in the building already leased.

Analyze whether Retailer M required to reassess the lease term in this case.

Solution:

Ind AS 116 requires a lessee to reassess the lease term if there is change in business decision of the company which is directly relevant to exercising or not exercising an option to renew / extend the lease. In the given case, Retailer M at the end of third year has extended to include another floor in the same building on account of acquiring another company. As Retailer M has entered into fresh lease of another floor for a seven-year term, it is reasonably certain to exercise the renewal option of original lease for a further five-year term. Hence Retailer M will have to reassess the lease term at the end of third year.

*****

Illustration 18 - Re-assessment of non-cancellable period of lease

Company N has taken 10 vehicles on lease for an initial period of 5 years with an extension option at the option of the lessee for a further period of 5 years at the same rental amount. The remaining useful life of the vehicles as on the commencement date of the lease is 15 years. Company N determined at the commencement date that it is reasonably certain to exercise the extension option and hence it has taken a period of 10 years for the lease. At the end of 4th year, there is an announcement by the government that all the cars of this particular model have to be discontinued from the road within 1 year due to the change in the pollution norms in the country.

Examine will the lease term be reassessed in this case.

Solution:

In the given case, as per Ind AS 116, the announcement by the government to discontinue the use of the underlying asset will prohibit the lessee from exercising the extension option that was already included in the non-cancellable period by Company N and hence, Company N will reassess the non-cancellable period to exclude the extension option of 5 years.

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Reassessment of lease term and purchase options (for lessors):

Ind AS 116 requires the lessor to revise the lease term to account for the lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset, when exercise of such options was not already included in the lease term.

Comparison with AS 19:
AS 19 does not contain any guidance on re-assessment or changes to lease term.

8.3.3 LEASE PAYMENTS

Lease payments are defined as payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) fixed payments (including in-substance fixed payments), **less** any lease incentives

(b) variable lease payments that depend on an index or a rate

(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option

(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees.

For the lessors, lease payment instead includes residual value guarantees provided by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Exclusion of payments for calculating lease liability:

a. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

b. Variable lease payments that do not depend on index or rate.

8.3.3.1 Fixed lease payments

'Fixed payments' are defined as payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.

Fixed payments can either be a fixed amount paid at various intervals in a lease (e.g., a five-year equipment lease with annual lease payments of ₹ 20,000) or they can be payments that change

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over time (e.g., lease payments of ₹ 20,000 per month at lease commencement that increase annually by ₹ 2,500 per month).

Illustration 19 - Determining the fixed payments

Entity M and Lessor A enter into a 10-year lease of an office building for fixed annual lease payments of ₹ 200,000. Per the terms of the lease agreement, annual fixed lease payments comprise ₹ 170,000 for rent and ₹ 30,000 for real estate taxes.

State the fixed lease payments for the purpose of classifying the lease.

Solution:

The fixed lease payments are ₹ 2,00,000. Although real estate taxes are explicitly stated in the lease contract, they do not represent a separate non-lease component as they do not provide a separate good or service. The right to use the office building is the only component. The annual lease payments of ₹ 2,00,000 represent payments related to that single lease component.

*****

In-substance fixed lease payments:

As mentioned above, lease payments also include any in-substance fixed lease payments which are the payments that may, **in form**, contain variability but that, **in substance**, are unavoidable. Examples may include:

(a) if payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance.

Examples of those types of payments include:

- payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; ***OR***
- payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved.

(b) if there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In such a case, an entity shall consider the realistic set of payments to be lease payments.

(c) if there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In such a case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments.

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Illustration 20 - In substance fixed lease payments

Entity Q enters into a seven-year lease for a piece of machinery. The contract sets out the lease payments as follows.

– *If Q uses the machinery within a given month, then an amount of 2,000 accrues for that month.*

– *If Q does not use the machinery within a given month, then an amount of 1,000 accrues for that month.*

Explain what is considered as lease payment in this case.

Solution:

Q considers the contract and notes that although the lease payments contain variability based on usage, and there is a realistic possibility that Q may not use the machinery in some months, a monthly payment of 1,000 is unavoidable. Accordingly, this is an in-substance fixed payment, and is included in the measurement of the lease liability.

*****

Illustration 21 - In-substance fixed lease payment

Entity P enters into a five-year lease for office space with Entity Q. The initial base rent is ₹ 1 lakh per month. Rents increase by the greater of 1% of Entity P's generated sales or 2% of the previous rental rate on each anniversary of the lease commencement date.

Describe the lease payments for the purpose of measuring lease liability.

Solution:

In the given case, the lease payments for purposes of classifying the lease are the fixed monthly payments of ₹ 1 lakh plus the minimum annual increase of 2% of the previous rental rate. Entity P is required to pay no less than a 2% increase regardless of the level of sales activity; therefore, this minimum level of increase is in substance fixed lease payment.

*****

Illustration 22 - In substance fixed lease payments

Company N leases a production line. The lease payments depend on the number of operating hours of the production line – i.e., N has to pay ₹ 1,000 per hour of use. The annual minimum payment is ₹ 10,00,000. The expected usage per year is 1,500 hours.

Determine the lease payment.

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Solution:

The lease contains in substance fixed payments of ₹ 10,00,000 per year, which are included in the initial measurement of the lease liability. The additional ₹ 5,00,000 that Company N expects to pay per year are variable payments that do not depend on an index or a rate but usage.

*****

Lease incentives

'Lease incentives' is defined as payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an upfront cash payment to the lessee, payment of costs for the lessee (such as moving / transportation expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party.

For lessee, lease incentives that are paid or payable to lessee by the lessor are deductible from lease payments and reduce the initial measurement of lessee' ROU asset.

For lessors, lease incentives are also deducted from lease payments and affect the lease classification test. For finance leases, lease incentives that are payable to the lessee reduce the expected lease receivables at the commencement date and thereby the initial measurement of the lessor's net investment in the lease. Consequently, the selling profit or loss is not affected. For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term.

Lessor reimbursement for some (or all) of the costs a lessee incurs to complete leasehold improvements is a common example of a lease incentive. To determine whether a payment from the lessor to the lessee represents a lease incentive, a reporting entity should evaluate the nature of the improvement and determine whether it represents an asset for lessee or a lessor. If an improvement represents an asset for lessee, the lessor payment is a lease incentive that should be recorded as a reduction to fixed lease payments. On the other hand, reimbursement for an improvement that is an asset for lessor is not a lease incentive; it should be recorded as a reimbursement to the lessee for the cost of the asset of lessor.

8.3.3.2 Variable lease payments that depend on an index or a rate:

'Variable lease payments' are defined as the portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

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These may include, ***for e.g.***, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates. Such payments are **included** in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement).

Despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (for lessor) and a liability (for lessee) because they are **unavoidable** and **do not depend on any future activity** of the lessee. Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments.

Illustration 23 - Variable lease payments that depend on an index or rate

An entity enters into a 10-year lease of property. The lease payment for the first year is ₹ 1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108.

Determine the lease payments?

Solution:

At the lease commencement date, the lease payments are ₹ 1,000 per year for 10 years. The entity does not take into consideration the potential future changes in the index. At the end of year one, the payments have not changed and hence, the liability is not updated.

At the end of year two, when the lease payments change, the entity updates the remaining eight lease payments to ₹ 1,080 per year (i.e., ₹ 1,000 / 100 x 108).

*****

Variable lease payments that do not depend on an index or a rate:

Variable lease payments that do not depend on an index or rate and are **not, in substance, fixed** (as discussed above – In-substance fixed lease payments). Examples may include payments such as those based on performance (***for e.g.***, a percentage of sales) or usage of the underlying asset (***for e.g.***, the number of hours flown, the number of units produced), are **not included** as lease payments. Instead, they are recognised in profit or loss in the period in which the event that triggers the payment occurs (unless they are included in the carrying amount of another asset in accordance with other Ind AS).

In some cases, the variability may be resolved during the lease term, so that payments become fixed for the remainder of the lease term. The new fixed payments are then used to remeasure the lease liability (with an offset to the ROU Asset).

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When variable payments not included in consideration in the contract are recognized, lessees also allocate these amounts between lease and non-lease components on the same basis as the allocation of consideration in the contract. These payments include variable payments not based on an index or rate or the changes in variable payments based on an index or rate after the commencement date of the lease.

Illustration 24 - Variable lease payments that do not depend on an index or rate

Entity XYZ is a medical equipment manufacturer and a supplier of the related consumables. Customer ABC operates a medical centre. Under the agreement entered into by both parties, Entity XYZ grants Customer ABC the right to use a medical laboratory machine at no cost and Customer ABC purchases consumables for use in the equipment from Entity XYZ at ₹100 each.

The consumables can only be used for that equipment and Customer ABC cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer ABC estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer ABC has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract.

Analyze whether these payments affect the calculation of lease liability and ROU Asset. Further discuss how Entity XYZ and Customer ABC would allocate these lease payments.

Solution:

There are two components in the arrangement, viz., a lease of equipment and the purchase of consumables.

Even though Customer ABC may believe that it is highly unlikely to purchase lesser than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (for Entity XYZ and Customer ABC) and lease classification (for Entity XYZ).

Entity XYZ and Customer ABC would allocate the payments associated with the future payments to the lease and consumables component of the contract (assuming Customer ABC does not elect to combine lease and non-lease components for this class of asset).

If Customer ABC elects the practical expedient not to separate the associated non-lease component from the lease component and instead accounts for the lease component and the non-lease component as a single lease component, the future payments for the consumables will still constitute genuine variability. Hence there will also be no lease payments for purposes of initial measurement.

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Illustration 25 - Variable lease payments

Entity A enters into a five-year lease of an office building. The lease payments are ₹ 5,00,000 per year and the contract includes an additional water charge calculated as ₹ 0.50 per litre consumed. Payments are due at the end of year. Entity A elects to apply the practical expedient to combine lease and non-lease components

Solution:

As stated above, payments are due at the end of the year. Entity A elects to apply the practical expedient not to separate lease and non-lease components.

At the commencement date, Entity A measures the lease liability as the present value of the fixed lease payments (i.e. five annual payments of ₹ 5,00,000). Although Entity A has elected to apply the practical expedient to combine non-lease components (i.e. water charges) with the lease component, Entity A excludes the non-lease component from its lease liability because they are variable payments that depend on usage. That is, the nature of the costs does not become fixed just because Entity A has elected not to separate them from the fixed lease payments. Entity A recognises the payments for water – as a variable lease payment – in profit or loss when they are incurred.

In contrast, if B does not elect to apply the practical expedient to combine lease and non-lease components, then it recognises the payments for water – as an operating expense – in profit or loss when they are incurred.

*****

8.3.3.3 Exercise price of a purchase option

If the lessee is **reasonably certain** to exercise a purchase option, the exercise price is **included** as a lease payment, i.e., entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (as discussed earlier).

8.3.3.4. Penalties for terminating a lease

If it is **reasonably certain** that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is **excluded** from the lease payments. **Otherwise**, the lease termination penalty is **included** as a lease payment. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options (as discussed earlier).

8.3.3.5. Residual value guarantees (lessees):

'Residual value guarantee' is defined as a guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.

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For a lessee, lease payments include amounts expected to be **payable by the lessee** under residual value guarantees. A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least of a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. A lessee is required to remeasure the lease liability if there is a change in the amounts expected to be payable under a residual value guarantee.

Illustration 26 - Residual value guarantee included in lease payments

An entity (a lessee) enters into a lease and guarantees that the lessor will realise ₹ 20,000 from selling the asset to another party at the end of the lease. At lease commencement, based on the lessee's estimate of the residual value of the underlying asset, the lessee determines that it expects that it will owe ₹ 8,000 at the end of the lease. Whether the lessee should include the said payment of ₹ 8,000 as a lease payment?

Solution:

The lessee should include the amount of ₹ 8,000 as a lease payment because it is expected that it will owe the same to the lessor under the residual value guarantee.

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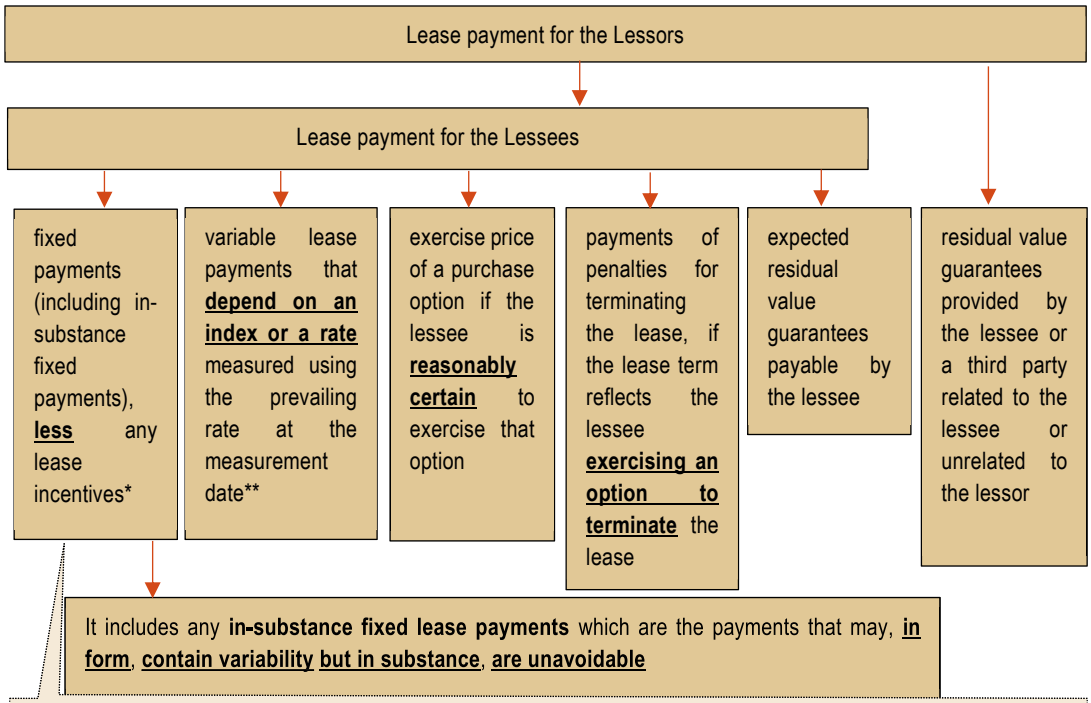
Residual value guarantees (lessors):

Ind AS 116 requires lessors to **include** in the lease payments, any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. This amount included in the lease payments is **different** from that for a lessee which only includes the amount expected to be payable by lessee only (as discussed above).

The concept explained in para 8.3.3 above can be summarized as follows:

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***Lease incentives**

- **For lessee -** lease incentives that are paid or payable to lessee by the lessor are deductible from lease payments and reduce the initial measurement of lessee' ROU asset.
- **For lessors -** lease incentives are also deducted from lease payments and affect the lease classification test.
  - **For finance leases**
    - lease incentives reduce the expected lease receivables at the commencement date and thereby the initial measurement of the lessor's net investment in the lease.
    - Selling profit or loss is not affected.
  - **For operating leases**
    - defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term.

**Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments.

Exclusion of payments for calculating lease liability:

a. **Lease payments allocated to non-lease components of a contract,** unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

b. Variable lease payments that **do not** depend on index or rate. They are recognised in profit or loss in the period in which the event that triggers the payment occurs.

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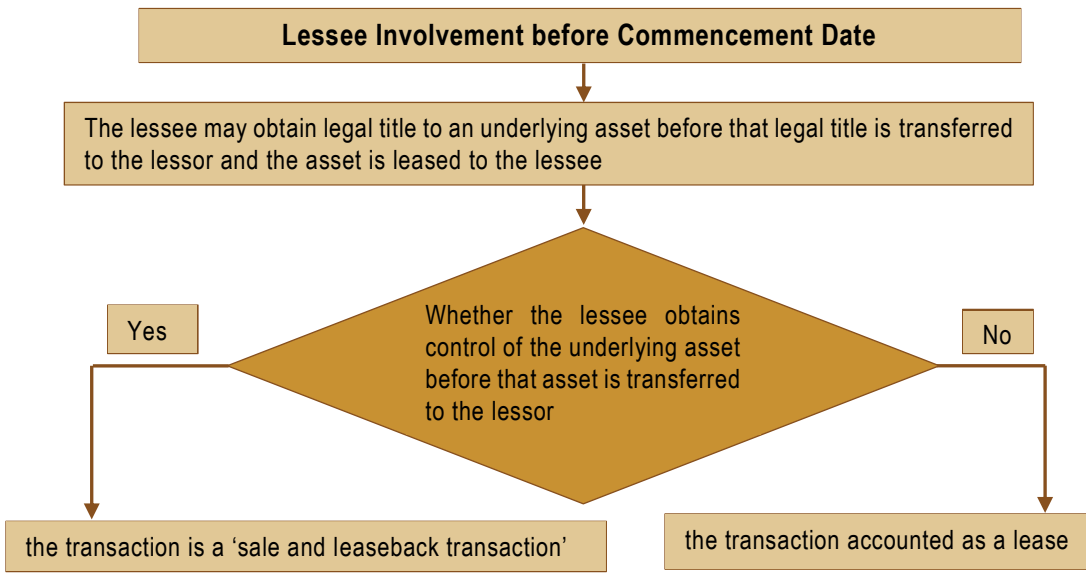
8.3.4 Lessee Involvement before Commencement Date

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Thus, based on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset since, payments for the right to use an underlying asset are the payments for a lease, regardless of the timing of those payments. Thus, if the lessee incurs such costs, they are accounted by applying other Ind AS (such as Ind AS 16, Property, Plant and Equipment).

The lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction. If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a 'sale and leaseback transaction' (Please refer Section 8.6.2 'Sale and Leaseback Transactions' for further discussion)

However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a 'sale and leaseback transaction'. ***For e.g.***, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset, but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but it is rather accounted as a lease.



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8.3.5 Initial Direct Costs

'Initial direct costs' are defined as **the incremental costs of obtaining a lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

Ind AS 116 requires lessees to include their initial direct costs in their initial measurement of the right-of-use asset.

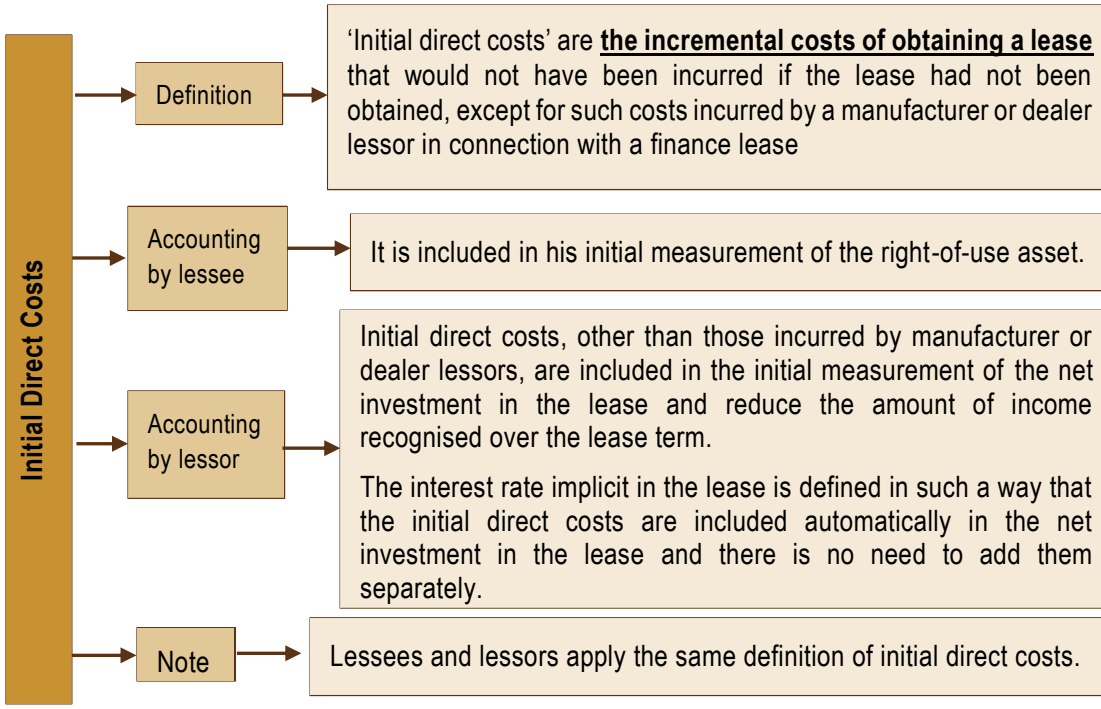
Examples of costs included and excluded from initial direct costs is provided below.

Included	Excluded
Commission (including payments to employees acting as selling agents)	Employee salaries
Legal fees resulting from the execution of the lease	Legal fees for services rendered before the execution of the lease
Lease document preparation costs incurred after the execution of the lease	Negotiating lease term and conditions
Certain payments to existing tenants to move out	Advertising
Consideration paid for a guarantee of a residual asset by an unrelated third party	Depreciation and amortization

Lessees and lessors apply the same definition of initial direct costs. The requirements under Ind AS 116 for initial direct costs are consistent with the concept of incremental costs in Ind AS 115, Revenue from Contracts with Customers.

For lessors, initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and there is no need to add them separately.

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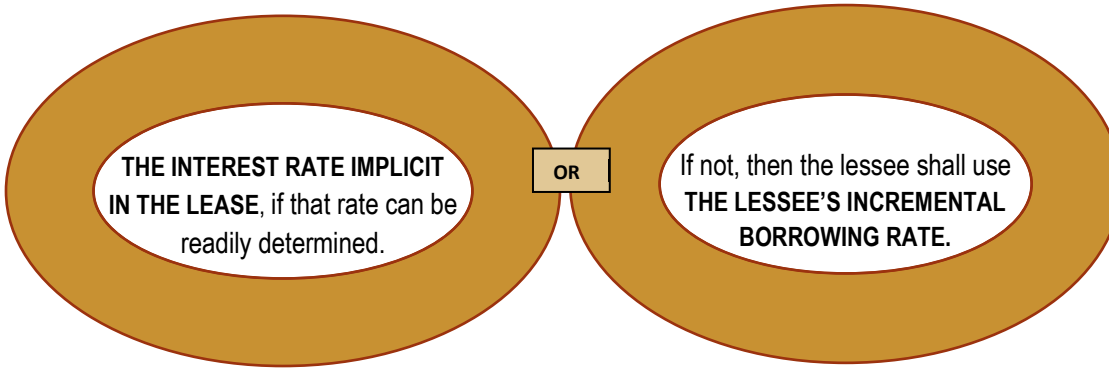


8.3.6 Discount Rates

Discount rates are used to determine the present value of the lease payments, which are used to determine Right of Use asset and Lease liability in case of a lessee and to measure a lessor's net investment in the lease.

For a Lessee

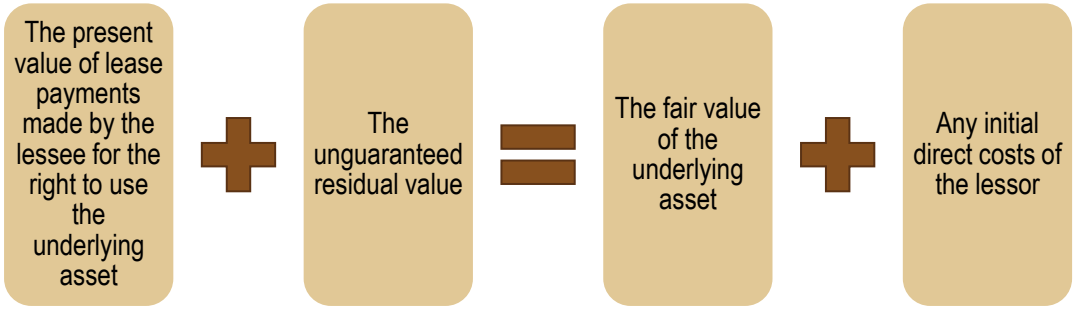
As per Ind AS 116, the Discount Rate to be used should be:



Where,

'Interest rate implicit in the lease' is defined as the rate of interest that causes the following:

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Lease payments are discounted using the interest rate implicit in the lease (as above and to be calculated from the perspective of lessor) if that rate can be readily determined. But, if that rate cannot be readily determined then, the lessee uses the incremental borrowing rate.

As discussed above, the lessee's **incremental borrowing rate** is the rate of interest that

— the lessee would have to pay to borrow over a **similar term**,

— and with a **similar security**,

— the funds necessary to obtain an asset of a **similar value** to the Right of use Asset

— in a **similar economic environment**.

In determining the incremental borrowing rate, the lessee considers borrowings with a similar term and security to the ROU Asset (**NOT the underlying asset**). ***For e.g.***, in the case of a five-year property lease, the lessee considers the borrowings with a similar term to the five-year ROU Asset (and NOT the property itself), which may have a significantly longer life. Observable rates (such as a property yield) can be used as a **starting point** to determine the incremental borrowing rate but adjustments need to be considered for an asset with a value similar to the ROU Asset. Other potential sources of adjustment may include the credit profile of the lessee, the borrowing currency, or the length of the lease term. It is likely that, in some cases, **significant judgement** will be needed to determine the incremental borrowing rate.

As discussed above, the lessee's incremental borrowing rate reflects the rate of interest that a lessee would have to pay, among others, in a similar economic environment. If the contract requires lease payments to be made in a currency other than the functional currency of the lessee (i.e., payments are to be made in a foreign currency) then, the incremental borrowing rate of the lessee should be determined based on a borrowing of a similar amount in that foreign currency.

For a Lessor:

Lessor to use the interest rate implicit in the lease as discussed above.

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8.3.7 Economic Life

'Economic Life' is defined as either

- the period over which an asset is expected to be economically usable by one or more users or
- the number of production or similar units expected to be obtained from an asset by one or more users.

8.3.8 Fair Value

The fair value for the purposes of applying the lessor accounting requirements in Ind AS 116 is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The fair value definition for lessors has been carried forward from Ind AS 17.

Please note that for the purposes of determination of fair value under Ind AS 116, the above stated definition is to be considered, hence Ind AS 113 "Fair Value Measurement" is not applicable for determination of fair value.

8.4 LESSEE ACCOUNTING

8.4.1 Initial Recognition and Measurement

A **'lessee'** is defined as an entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.

At the commencement date, a lessee shall recognise a ROU Asset and a Lease Liability. Ind AS 116 requires lessees to recognise a liability to make lease payments and an asset representing the right to use the underlying asset (i.e., the ROU Asset) during the lease term for ***ALL*** leases (**except** for short-term leases and leases of low-value assets, if they choose to apply such exemptions).

Measuring the lease liability:

At the commencement date, a lessee initially measures the Lease Liability at the **present value of the remaining lease payments to be made over the lease term, discounted using the rate implicit in the lease (or if that rate cannot be readily determined, the lessee's incremental borrowing rate)**. Lease payments used in measuring the lease liability are amounts due to the lessor excluding any payments that a lessee makes before lease commencement. (Refer Section 8.3.3 Lease payments).

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At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Illustration 27: Initial measurement of lease liability

Entity L enters into a lease for 10 years, with a single lease payment payable at the beginning of each year. The initial lease payment is ₹ 100,000. Lease payments will increase by the rate of LIBOR each year. At the date of commencement of the lease, LIBOR is 2 per cent.

Assume that the interest rate implicit in the lease is 5 per cent. How is lease liability initially measured?

Solution:

In the given case, the lease payments depend on a rate (i.e., LIBOR) and hence is included in measuring lease liability. As per Ind AS 116, the lease payments should initially be measured using the rate (i.e. LIBOR) as at the commencement date. LIBOR at that date is 2 per cent; therefore, in measuring the lease liability, it is assumed that each year the payments will increase by 2 per cent, as follows:

Year	Lease Payment	Discount factor @ 5%	PV of lease payments
1	1,00,000	1	100,000
2	1,02,000	0.952	97,102
3	1,04,040	0.907	94,364
4	1,06,121	0.864	91,689
5	1,08,243	0.823	89,084
6	1,10,408	0.784	86,560
7	1,12,616	0.746	84,012

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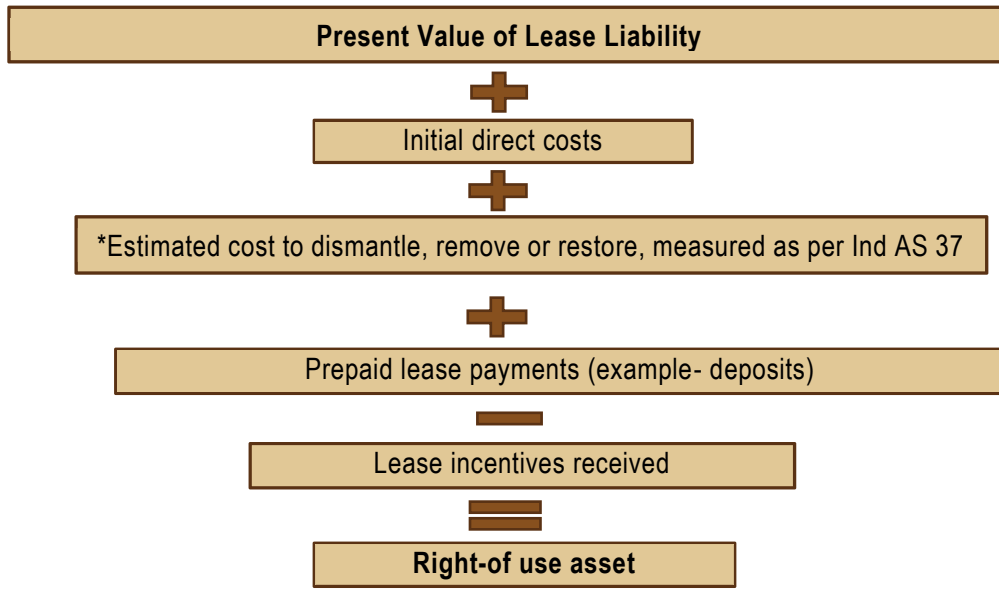
8	1,14,869	0.711	81,672
9	1,17,166	0.677	79,321
10	1,19,509	0.645	77,083
			8,80,887

Therefore, the lease liability is initially measured at ₹ 8,80,887

*****

Measuring the right-of-use asset:

A lessee initially measures the ROU Asset at **COST**, which consists of ***ALL*** of the following:



Journal entry in the books of lessee

ROU Asset	Dr.	Sum total of all below items
To Lease liability	Cr.	PV of outstanding lease payments by lessee using interest rate implicit in lease
To Lessor / Supplier	Cr.	Any lease payment made on or before the commencement date ***less*** lease incentives received
To Bank / Creditor	Cr.	Initial direct costs incurred by lessee
To Provision for dismantling / removing the underlying asset	Cr.	Estimate of costs to be recognised only when lessee incurs an obligation for these costs (Ind AS 37)

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*On initial measurement, a lessee is required to recognise dismantling, removal and restoration costs as part of the ROU Asset. Costs may be incurred at lease commencement or during a particular period as a consequence of having used an underlying asset. Costs that are incurred during a particular period as a consequence of having used the ROU Asset to produce inventories are accounted for under Ind AS 2 *Inventories*. The liability associated with dismantling, removal and restoration costs is recognised and measured in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Illustration 28: Measuring right-of-use asset

Entity Y and Entity Z execute a 12-year lease of a railcar with the following terms on 1 January, 20X1:

- *The lease commencement date is 1 February 20X1.*
- *Entity Y must pay Entity Z the first monthly rental payment of ₹10,000 upon execution of the lease.*
- *Entity Z will pay Entity Y ₹50,000 cash incentive to enter into the lease payable upon lease execution.*

Entity Y incurred ₹1,000 of initial direct costs, which are payable on 1 February 20X1. Entity Y calculated the initial lease liability as the present value of the lease payments discounted using its incremental borrowing rate because the rate implicit in the lease could not be readily determined; the initial lease liability is ₹8,50,000.

How would Lessee Company measure and record this lease?

Solution:

Entity Y would calculate the right-of-use asset as follows: ₹

Initial measurement of lease liability	8,50,000
Lease payments made to Entity Z at or before the commencement date	10,000
Lease incentives received from Entity Z	(50,000)
Initial direct cost	1,000
Initial measurement of right-of-use asset	**8,11,000**

*****

Illustration 29 - Dismantling costs to be included in initial measurement of ROU Asset

Company H leases an aircraft for a period of 5 years. The aircraft must undergo a planned check after every 100,000 flight hours. At the end of the lease, company H must have a check performed

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(or refund the costs to the lessor), irrespective of the actual number of flight hours. What are the lease payments for purposes of calculating ROU asset?

Solution:

In the given case, the legal requirement to perform a check after every 1,00,000 flight hours does not directly lead to an obligation as it depends on future circumstances. However, as the check must be carried out at the end of the lease irrespective of the actual number of flight hours gives rise to an obligation.

As a result, company H has to recognize a provision for the costs of the final check ("present value of the expected cost") at the beginning of the lease term. At the same time, these costs must be included in the cost of the right-of-use (ROU) asset pursuant to para 24 (d) of Ind AS 116.

*****

Comparison with AS 19:

AS 19 is based on dual classification model of operating and finance leases with different classification and measurement guidance for each of them.

- In case of finance lease, asset and liability is recognized at an amount equal to the fair value of the leased asset at the inception of the lease, unless the present value of minimum lease payments is less than the fair value.
- In case of operating lease, rentals payable is charged as an expense in the statement of profit and loss on a straight-line basis over the lease term, even if the payments are not made on that basis, unless another systematic basis is more representative of the time pattern of the user's benefit.

Hence, the accounting for leases in the books of lessee under AS 19 is completely different from that under Ind AS 116. ROU asset is not required to be accounted for under AS 19. Hence, the subsequent measurement, presentation and disclosure of ROU asset is also not relevant from AS 19 perspectives.

8.4.2 Subsequent Measurement

8.4.2.1 Right-of-use assets (ROU Asset)

After the commencement date, the right-of-use asset should be measured using a cost model, unless it applies the revaluation model as specified under Ind AS 16.

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Cost model for right-of-use assets:

To follow the cost model, an entity measures a right-of-use asset at cost:

(a) Less **accumulated depreciation** and accumulated impairment losses (recognised in accordance with Ind AS 36, Impairment of Assets); and

(b) Adjusted for **re-measurements of the lease liability** specified in section 8.4.3

Depreciation for right-of-use assets

ROU Assets measured under the cost model should be depreciated in accordance with the depreciation requirements given in Ind AS 16, subject to the following:

- If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the ROU Asset reflects that the lessee will exercise a purchase option, the ROU Asset should be depreciated from the commencement date to the end of the useful life of the underlying asset;
- otherwise, the right-of-use asset should be depreciated from the commencement date to the earlier of the end of the useful life of the ROU Asset and the end of the lease term.

Where, **'useful life'** is defined as the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Therefore, if the ownership of the underlying asset transfers to the lessee at the end of the lease term, or it is reasonably certain that the lessee will exercise a purchase option, depreciation is based on the useful life of the underlying asset. Otherwise, depreciation is determined by reference to the useful life of the right-of-use asset (provided that is not longer than the lease term).

Revaluation model for right-of-use assets:

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in Ind AS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

However, if right-of-use assets that meet the definition of investment property under Ind AS 40 "Investment Property", then, revaluation model cannot be applied because at present Ind AS 40 "Investment property" does not permit revaluation model and only cost model is allowed for all investment properties.

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8.4.2.2 Lease liability:

A Lease Liability should be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). Consequently, the lease liability is accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment requiring a change in the discount rate has not been triggered). Lease payments reduce the lease liability when paid.

Thus, after the commencement date, a lessee shall measure the lease liability by:

a. increasing the carrying amount to reflect interest on the lease liability;

b. reducing the carrying amount to reflect the lease payments made; and

c. remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments.

8.4.2.3 Expense recognition

Lessees recognise the following items in expense for leases:

- Depreciation of the ROU Asset
- Interest expense on the Lease Liability
- Variable lease payments that are not included in the lease liability (***for e.g.***, variable lease payments that do not depend on an index or rate)
- Impairment of the ROU Asset

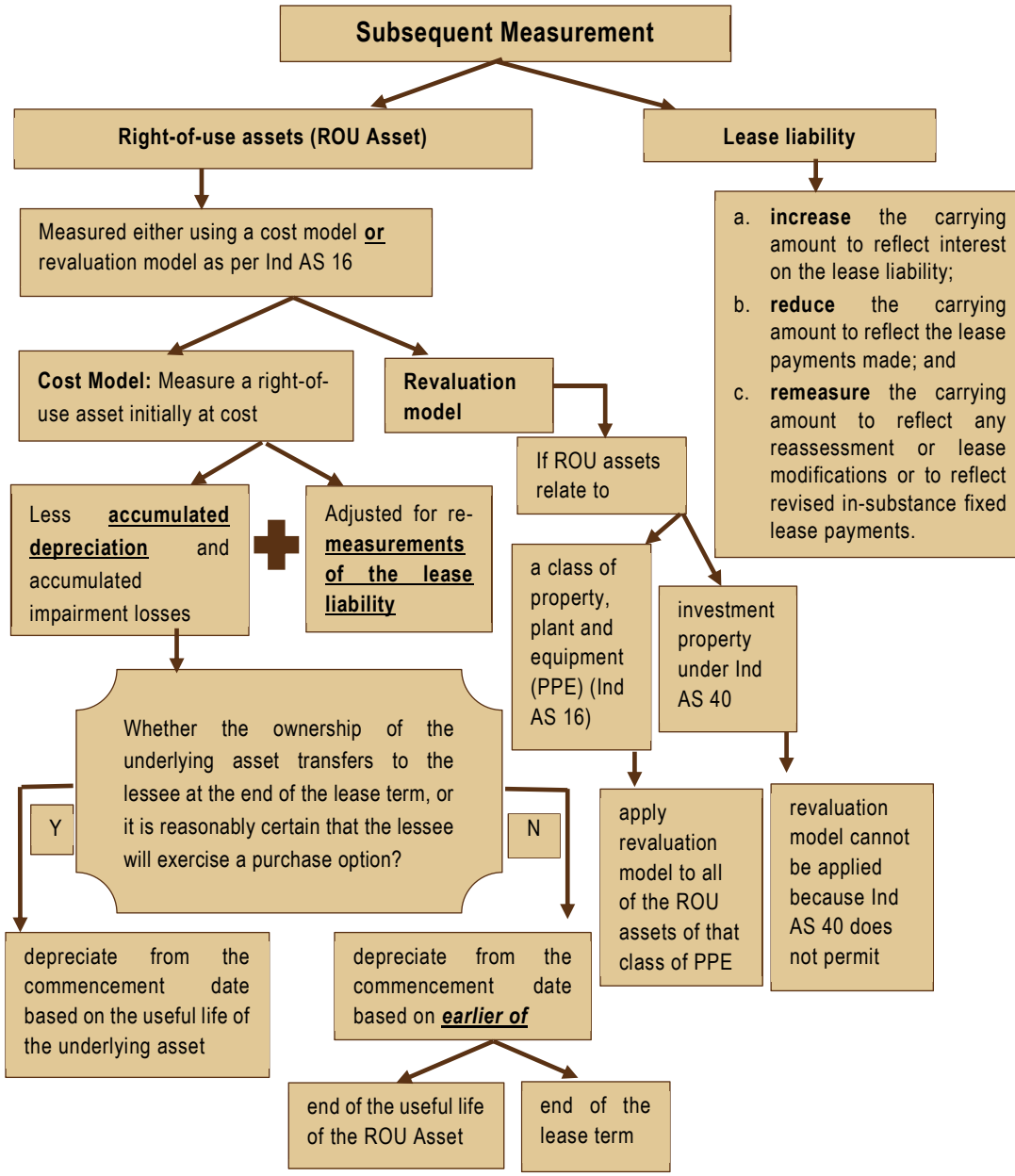
These expenses are further explained below:

Depreciation of the ROU Asset and Interest on the Lease Liability	***Variable lease payments***	***Impairment of the ROU Asset***
After the commencement date, a lessee recognises depreciation of the ROU Asset and separately recognises interest on the lease liability. When a lessee depreciates the ROU Asset on a straight-	After the commencement date, lessees recognise in profit or loss, any variable lease payments **not included** in the measurement of the lease liability in the period in which the event or condition that triggers those payments	Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36, *Impairment of Assets*. If a lessee determines that a ROU Asset is impaired, it recognises an **impairment**

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line basis, the total periodic expense (i.e., the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Interest expense decreases as cash payments are made during the lease term and the lease liability decreases because a constant interest rate is applied to the lease liability. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the ROU Asset, results in a **front-loaded expense recognition pattern**.	occur.	**loss** and measures the ROU Asset at its carrying amount immediately after the impairment. A lessee subsequently depreciates, generally on a straight-line basis, the ROU Asset from the date of the impairment to the earlier of the end of the useful life of the ROU Asset or the end of the lease term. However, the depreciation period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

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Let us have a look at illustration on 'Lessee Accounting':

Illustration 30 - Lessee Accounting

*Entity ABC (lessee) enters into a three-year lease of equipment. Entity ABC agrees to make the following annual payments at the **end** of each year:*

- *₹ 20,000 in year one*

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- *₹ 30,000 in year two*
- *₹ 50,000 in year three.*

For simplicity purposes, there are no other elements to the lease payments (like purchase options, lease incentives from the lessor or initial direct costs). Assumed a discount rate of 12% (which is Entity ABC's incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined). Entity ABC depreciates the ROU Asset on a straight-line basis over the lease term.

How would Entity ABC would account for the said lease under Ind AS 116?

Solution:

At the commencement date, Entity ABC would initially recognise ROU Asset and the corresponding Lease Liability of ₹ **77,364** which is calculated as follows:

Year	*Payments (Cash flows)*	*Discounting Factor @12%*	*Discounted Cash flows / Present Value*
1	20,000	0.8929	17,858
2	30,000	0.7972	23,916
3	50,000	0.7118	35,590
	1,00,000		**77,364**

Then, the next step would be to prepare a schedule for Lease Liability and ROU Asset as follows:

Lease Liability

Year	*Opening balance*	*Interest Expense*	*Payments*	*Closing balance*
1	77,364	9,284	(20,000)	66,648
2	66,648	7,998	(30,000)	44,646
3	44,646	5,354*	(50,000)	-

* Difference of ₹ 4 is due to approximation.

ROU Asset (assuming no lease incentives, no initial direct costs, etc.):

Year	*Opening balance*	*Depreciation*	*Closing balance*
1	77,364	(25,788)	51,576
2	51,576	(25,788)	25,788
3	25,788	(25,788)	-

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At lease commencement, Entity ABC would recognise the Lease Liability and the corresponding ROU Asset as follows:

ROU Asset	Dr.	77,364	
To Lease Liability			77,364
To initially recognise the Lease Liability and the corresponding ROU Asset			

The following journal entries would be recorded in the first year:

Interest Expense	Dr.	9,284	
To Lease Liability			9,284
To record interest expense and accrete the lease liability using the effective interest method (₹ 77,364 x 12%)			
Depreciation Expense	Dr.	25,788	
To ROU Asset			25,788
To record interest expense and accrete the lease liability using the straight-line method (₹ 77,364 / 3 years)			
Lease Liability	Dr.	20,000	
To Cash / Bank			20,000
To record lease payment			

Following is the summary of the said lease contract's accounting (assuming no changes due to reassessment):

Particulars	*Initially*	*Year 1*	*Year 2*	*Year 3*
Cash lease payments		20,000	30,000	50,000
Lease Expense Recognised:				
Interest Expense		9,284	7,998	5,354
Depreciation Expense		25,788	25,788	25,788
Total Periodic Expense		35,072	33,786	31,142
Balance Sheet:				
ROU Asset	77,364	51,576	25,788	-
Lease Liability	(77,364)	(66,648)	(44,646)	-

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Illustration 31 - Subsequent measurement using cost model

Company EFG enters into a property lease with Entity H. The initial term of the lease is 10 years with a 5-year renewal option. The economic life of the property is 40 years and the fair value of the leased property is ₹ 50 Lacs. Company EFG has an option to purchase the property at the end of the lease term for ₹ 30 lacs. The first advance annual payment is ₹ 5 lacs with an increase of 3% every year thereafter. The implicit rate of interest is 9.04%. Entity H gives Company EFG an incentive of ₹ 2 lacs (payable at the beginning of year 2), which is to be used for normal tenant improvement.

Company EFG is reasonably certain to exercise that purchase option. How would EFG measure the right-of-use asset and lease liability over the lease term?

Solution:

As per Ind AS 116, Company EFG would first calculate the lease liability as the present value of the annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using the rate implicit in the lease of approximately 9.04%.

PV of lease payments, less lease incentive (W.N. 1)	₹ 37,39,648
PV of purchase option at end of lease term (W.N. 2)	₹ 12,60,000
Total lease liability	**₹ 49,99,648 or ₹ 50,00,000 (approx.)**

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Company EFG, lease payments made at or before the lease commencement date, or lease incentives received prior to the lease commencement date.

Entity EFG would record the following journal entry on the lease commencement date.

Right-of-use Asset	Dr.	₹ 50,00,000	
To Lease Liability			₹ 50,00,000
To record ROU asset and lease liability at the commencement date.			

Since the purchase option is reasonably certain to be exercised, EFG would amortize the right-of-use asset over the economic life of the underlying asset (40 years). Annual amortization expense would be ₹ 1,25,000 (₹ 50,00,000 / 40 years)

Interest expense on the lease liability would be calculated as shown in the following table. This table includes all expected cash flows during the lease term, including the lease incentive paid by Entity H and Company EFG's purchase option.

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Year	Payment	Principal paid at the beginning of the year	Interest paid	Interest expense	Lease Liability (end of the year
	a	b= a-c	c = (d of pvs. Year)	d = [(e of pvs. year- a) x 9.04%]	e = (e of pvs. Year + d – a)
Commencement					50,00,000
Year 1	5,00,000	5,00,000	-	4,06,800	49,06,800
Year 2	3,15,000*	(91,800)	4,06,800	4,15,099	50,06,899
Year 3	5,30,450	1,15,351	4,15,099	4,04,671	48,81,120
Year 4	5,46,364	1,41,693	4,04,671	3,91,862	47,26,618
Year 5	5,62,754	1,70,892	3,91,862	3,76,413	45,40,277
Year 6	5,79,637	2,03,224	3,76,413	3,58,042	43,18,682
Year 7	5,97,026	2,38,984	3,58,042	3,36,438	40,58,094
Year 8	6,14,937	2,78,499	3,36,438	3,11,261	37,54,418
Year 9	6,33,385	3,22,124	3,11,261	2,82,141	34,03,174
Year 10	6,52,387	3,70,246	2,82,141	2,49,213*	30,00,000
Year 10	30,00,000	27,50,787	2,49,213*	-	-
Total	**85,31,940**	**50,00,000**	**35,31,940**	**35,31,940**	

*(5,00,000 + increased by 3% - lease incentive paid amounting to 2,00,000)

Although the lease was for 10 years, the asset had an economic life of 40 years. When Company EFG exercises its purchase option at the end of the 10-year lease, it would have fully extinguished its lease liability but continue depreciating the asset over the remaining useful life.

Working Notes

1. Calculating PV of lease payments, less lease incentive:

Year	Lease Payment (A)	Present value factor @ 9.04% (B)	Present value of lease payments (A x B = C)
Year 1	5,00,000	1	5,00,000
Year 2	3,15,000	0.92	2,89,800
Year 3	5,30,450	0.84	4,45,578
Year 4	5,46,364	0.77	4,20,700
Year 5	5,62,754	0.71	3,99,555
Year 6	5,79,637	0.65	3,76,764

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Year 7	5,97,026	0.59	3,52,245
Year 8	6,14,937	0.55	3,38,215
Year 9	6,33,385	0.50	3,16,693
Year 10	6,52,387	0.46	3,00,098
Total			**37,39,648**

2. Calculating PV of purchase option at end of lease term:

Year	Payment on purchase option (A)	Present value factor @ 9.04% (B)	Present value of purchase option (A x B = C)
Year 10	30,00,000	0.42	12,60,000
Total			**12,60,000**

The discount rate for year 10 is different in the above calculations because in the earlier one its beginning of year 10 and in the later one its end of the year 10.

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8.4.2.4 Impairment of ROU Assets

Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36 *Impairment of Assets*. Ind AS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit (CGU) of which the asset is a part). The entity has to recognise an impairment loss if the recoverable amount of the CGU is less than the carrying amount of the CGU. After an impairment loss is recognised, the adjusted carrying amount of the ROU Asset would be its new basis for depreciation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined after depreciation, had there been no impairment.

8.4.2.5 Leases denominated in a foreign currency

Lessees apply Ind AS 21 *The Effects of Changes in Foreign Exchange Rates*, to leases denominated in a foreign currency. Lessees remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date, like they do for other monetary liabilities. Any changes to the lease liability due to exchange rate changes are recognised in profit or loss. Because the ROU Asset is a non-monetary asset measured at historical cost, it is not affected by changes in the exchange rate.

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This approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses, but it will be clear to the users of financial statements that the gains or losses result solely from changes in exchange rates.

8.4.3 Remeasurement

Ind AS 116 requires lessees to **REMEASURE LEASE LIABILITIES** upon a change in lease payments on account of **ANY** of the following:

- The reassessment of lease term on account of reasonable certainty to exercise/not exercise of extension and/or termination option
- The reassessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset
- In-substance fixed lease payments
- The amounts expected to be payable under residual value guarantees
- Future lease payments resulting from a change in an index or rate

When to use the 'original' and a 'revised' discount rate?

Revised Discount Rate	*Original Discount Rate*
Lessees use a **revised** discount rate when lease payments are updated for - reassessment of the lease term ***OR*** - a reassessment of a purchase option. The revised discount rate is based on the interest rate implicit in the lease for the **REMAINDER** of the lease term. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate.	Lessees use the **original** discount rate when lease payments are updated for - a change in expected amounts for residual value guarantees ***AND*** - payments dependent on an index or rate, **unless** the rate is a floating interest rate. - the variability of payments is resolved so that they become in-substance fixed payments.

When a lease includes a **market rate adjustment** (a market rent review), the negotiations between the lessee and the lessor may take some time to complete (i.e., the negotiation period). ***For e.g.***, consider a 10-year lease that has a market rate adjustment that applies from the end of year 5. The market rent review negotiations begin during year 5 but are not completed until later in year 6. During year 6, while the negotiation is ongoing, the lessee is required to pay the original contractual lease payments. At the conclusion of the negotiation period (i.e., upon a final determination of the lease payments for year 6 until year 10), the new lease payments apply retrospectively from the beginning of year 6. In this example, the lessee does not adjust the lease

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payments at the beginning of year 6 for the expected increase in rent. Rather, any adjustment is recognised as an adjustment to lease payments when the market rent review is finalised and the change in contractual cash flows takes effect.

A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the ROU Asset. However, if the carrying amount of the ROU Asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee recognises any remaining amount of the remeasurement in profit or loss.

Illustration 32- Remeasurement of a lease with variable lease payments

Entity W entered into a contract for lease of retail store with Entity J in January 1/1/20X1. The initial term of the lease is 5 years with a renewal option of a further 3 years. The annual payments for initial term and renewal term are ₹ 100,000 and ₹ 110,000 respectively. The annual lease payment will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 1/1/20X2 will be based on the CPI available at 31/12/20X1.

Entity W's incremental borrowing rate at the lease inception date and as at 1/1/20X4 is 5% and 6% respectively and the CPI at lease commencement date and as at 1/1/20X4 is 120 and 125 respectively.

At the lease commencement date, Entity W did not have a significant economic incentive to exercise the renewal option. In the first quarter of 20X4, Entity W installed unique lease improvements into the retail store with an estimated five-year economic life. Entity W determined that it will only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

Is Entity W required to remeasure the lease in the first quarter of 20X4?

Solution:

Since Entity W is now reasonably certain that it will exercise its renewal option, it is required to remeasure the lease in the first quarter of 20X4.

The following table summarizes information pertinent to the lease remeasurement.

Remeasured lease term	5 years; 2 years remaining in the initial term plus 3 years in the renewal period
Entity W's incremental borrowing rate On the remeasurement date	6%
CPI available on the remeasurement date	125
Right-of-use asset immediately before the remeasurement	₹ 1,81,840 (Refer note 1)
Lease liability immediately before the remeasurement	₹ 1,95,244 (Refer note 1)

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To remeasure the lease liability, Entity W would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 6%). The following table shows the present value of the future lease payments based on an updated CPI of 125. Since the initial lease payments were based on a CPI of 120, the CPI has increased by 4.167% approx. As a result, Entity W would increase the future lease payments by 4.167%. As shown in the table, the revised lease liability is ₹ 4,91,376.

Year	4	5	6	7	8	Total
Lease payment	1,04,167	1,04,167	1,14,583	1,14,583	1,14,583	5,52,083
Discount @ 6%	1	0.943	0.890	0.840	0.792	
Present value	1,04,167	98,230	1,01,979	96,250	90,750	4,91,376

To calculate the adjustment to the lease liability, Entity W would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	4,91,376
Original lease liability	(1,95,244)
	2,96,132

Entity W would record the following journal entry to adjust the lease liability.

ROU Asset	Dr.	**2,96,132**	
To Lease liability			2,96,132
Being lease liability and ROU asset adjusted on account of remeasurement.			

Working Notes:

1. Calculation of ROU asset before the date of remeasurement

Year beginning	Lease Payment (A)	Present value factor @ 5% (B)	Present value of lease payments (A x B=C)
1	1,00,000	1.000	1,00,000
2	1,00,000	0.952	95,200
3	1,00,000	0.907	90,700
4	1,00,000	0.864	86,400
5	1,00,000	0.823	82,300
Lease liability as at commencement date			**4,54,600**

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2. Calculation of Lease Liability and ROU asset at each year end

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 5%	Closing balance	Initial Value	Depreciation for 5 years	Closing balance
1	4,54,600	1,00,000	17,730	3,72,330	4,54,600	90,920	3,63,680
2	3,72,330	1,00,000	13,617	2,85,947	3,63,680	90,920	2,72,760
3	2,85,947	1,00,000	9,297	1,95,244	2,72,760	90,920	1,81,840
4	1,95,244				1,81,840		

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8.4.4 Lease Modifications

A 'lease modification' is a **change** in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (***for e.g.***, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

The following are examples of lease modifications that may be negotiated after the lease commencement date:

- A lease extension
- Early termination of the lease
- A change in the timing of lease payments
- Leasing additional space in the same building
- Surrendering a part of the underlying asset.

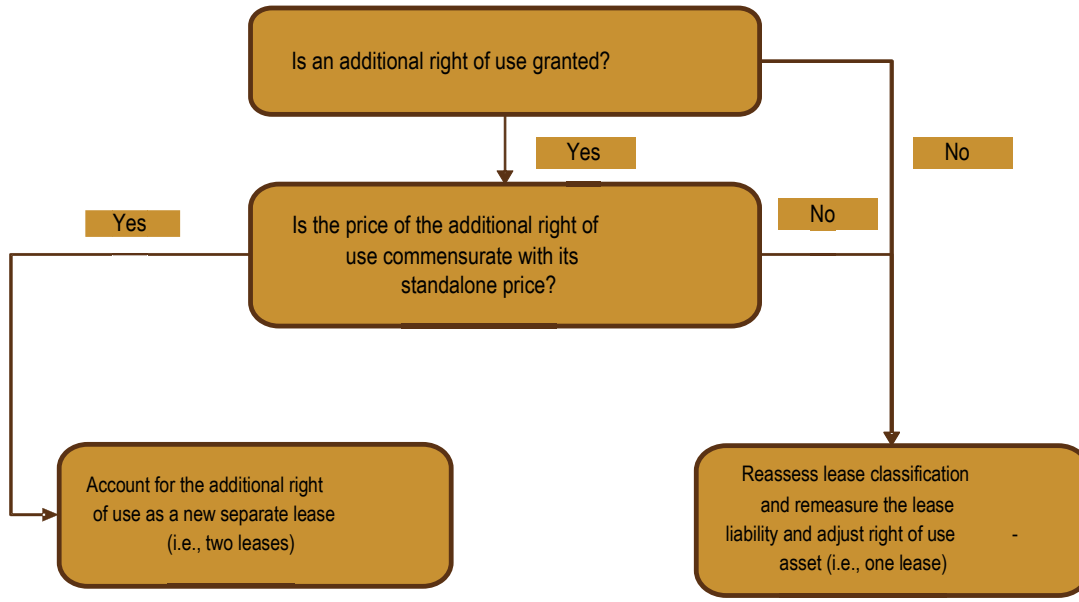
If a lease is modified (as stated above), the modified contract is evaluated to determine whether it is or contains a lease. If a lease continues to exist, lease modification can result in:

- A separate lease OR
- A change in the accounting for the existing lease (i.e., not a separate lease).

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised are **not lease modifications but can result in the remeasurement** of Lease Liabilities and ROU Assets (Remeasurement – as discussed above).

The following diagram demonstrates Lessee's analysis of a change in a lease:

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Let us understand in detail when and how the lease modification will be accounted as a separate lease contract and not as a separate lease contract:

Modification – Separate lease

A lease modification is accounted for as a separate lease if both:

a. The modification increases the scope of the lease by adding the right to use one or more underlying assets; **and**

b. The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessee would follow the previous guidance on the initial recognition and measurement of lease liabilities and right-of-use assets.

Illustration 33 - Modification that is a separate lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

How should the said modification be accounted for?

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Solution:

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this question, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a ROU Asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

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Modification- Not Separate Lease:

If a lease modification fails the test above (e.g. additional right of use granted, but not at a standalone price) or the modification is of any other type (e.g. a decrease in scope from the original contract), the lessee must modify the initially recognised components of the lease contract.

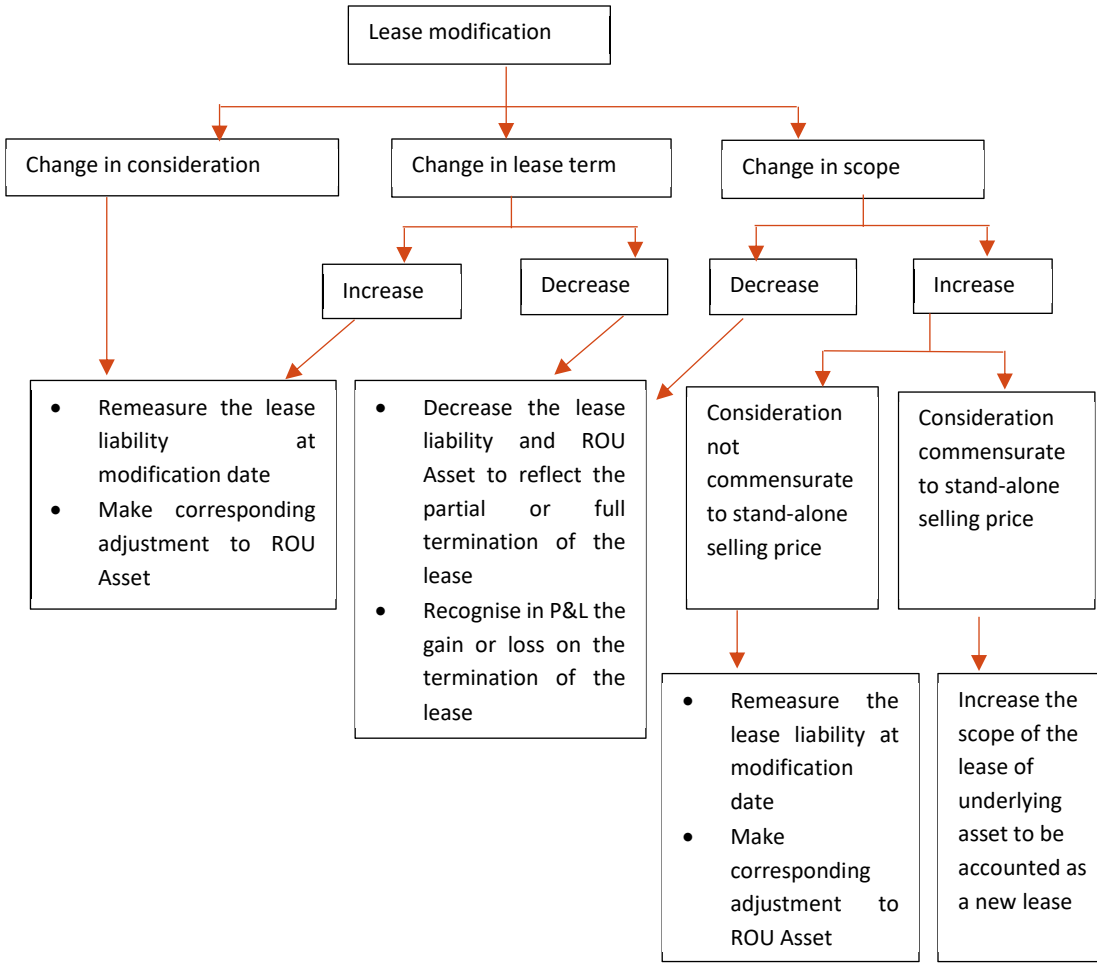
The accounting treatment required for lease modifications that are not accounted for as separate leases is summarised below:

Decrease in scope	1. Remeasure lease liability using revised discount rate*(1) 2. Decrease right-of-use asset (2) i. by its relative scope of lease liability ii. compared to the original lease 3. Difference between (2i) and (2ii) recognised in P&L 4. Make a corresponding adjustment to the ROU asset
All other lease modification	• Remeasure lease liability using revised discount rate* • Remeasure right-of-use asset by same amount

*The implicit rate in the lease is to be used. If it cannot be readily determined, the incremental rate of borrowing is to be used.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.

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In some cases, the lessee and lessor may agree to a modification to the lease contract that starts at a later date (i.e., the terms of the modification take effect at a date later than the date when both parties agreed to the modification). This can be understood with the help of a following example:

A lessee enters into a lease arrangement with a lessor to lease an asset for 10 years. At the beginning of year 8, the lessee and lessor agree to a modification to the contract that will take effect from the beginning of year 9.

Scenario 1 (Increase in scope – Not a Separate Lease)	***Scenario 2 (Increase in scope – Separate Lease)***	***Scenario 3 (Decrease in scope)***
If the modification is an increase in the scope that	If the modification results in a separate lease component,	If the modification is a decrease in the scope, the

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does not result in a separate lease, the lessee will re-allocate the consideration in the modified contract to each of the existing lease and non-lease components and remeasure the lease liability at the date both parties agreed to the modification (the beginning of year 8).	the lessee will allocate the consideration in the modified contract to each of the existing and new lease and non-lease components at the date both parties agreed to the modification (the beginning of year 8). The lessee will remeasure the lease liability for the existing lease components at that date as well. However, recognition of the lease liability and ROU Asset for any new lease component occurs at the commencement date of the new lease component (the beginning of year 9).	lessee will re-allocate the consideration in the modified contract to each existing lease and non-lease component and remeasure the lease liability and ROU Asset at the effective date of the modification (the beginning of year 8).

This can be summarised with the help of the following flow chart:

Following are some more examples for 'lease modification':

Illustration 34 - Modification that increases the scope of the lease by extending the contractual lease term

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by four years. The annual lease payments are unchanged (i.e., ₹ 1,00,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7% p.a.

How should the said modification be accounted for?

Solution:

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on:

(a) An eight-year remaining lease term

(b) Annual payments of ₹ 1,00,000 and

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(c) Lessee's incremental borrowing rate of 7% p.a.

The modified lease liability equals ₹ 5,97,100 (W.N.1). The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is ₹ 3,46,355 (W.N.3). Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (i.e., ₹ 2,50,745) (W.N. 4) as an adjustment to the ROU Asset.

Working Notes:

1. Calculation of modified lease liability:

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A*B=C)
7	100,000	0.935	93,500
8	100,000	0.873	87,300
9	100,000	0.816	81,600
10	100,000	0.763	76,300
11	100,000	0.713	71,300
12	100,000	0.666	66,600
13	100,000	0.623	62,300
14	100,000	0.582	58,200
Modified lease liability			**5,97,100**

2. Calculation of Lease liability as at commencement date:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700

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9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at commencement date			**7,35,900**

3. Calculation of Lease liability immediately before modification date:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090	25,265	100,000	3,46,355
	Lease liability as at modification date			3,46,355

4. Adjustment to ROU asset:

Modified Lease liability	5,97,100
Original Lease liability as at modification date	(3,46,355)
Adjustment to ROU asset	**2,50,745**

The ROU asset will be increased by ₹ 2,50,745 on the date of modification.

*****

Illustration 35 - Modification that decreases the scope of the lease

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments to be made at the end of the year (from Year 6 to Year 10) are ₹ 30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% p.a.

How should the said modification be accounted for in the books of lessee?

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Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 6%	Closing balance	Initial Value	Depreciation	Closing balance
	a	b	c = a x 6%	d = a-b + c	e	f	g
1	3,67,950*	50,000	22,077	3,40,027	3,67,950	36,795	3,31,155
2	3,40,027	50,000	20,402	3,10,429	3,31,155	36,795	2,94,360
3	3,10,429	50,000	18,626	2,79,055	2,94,360	36,795	2,57,565
4	2,79,055	50,000	16,743	2,45,798	2,57,565	36,795	2,20,770
5	2,45,798	50,000	14,748	2,10,546	2,20,770	36,795	1,83,975
6	2,10,546				1,83,975		

*(refer note 1)

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

(a) a five-year remaining lease term,

(b) annual payments of ₹ 30,000 and

(c) Lessee's incremental borrowing rate of 5% p.a.

Year	Lease Payment(A)	Present value factor @ 5% (B)	Present value of lease payments (A x B = C)
6	30,000	0.952	28,560
7	30,000	0.907	27,210
8	30,000	0.864	25,920
9	30,000	0.823	24,690
10	30,000	0.784	23,520
Total			**1,29,900**

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 2,500 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (₹ 1,83,975) is ₹ 91,987.50.

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50% of the pre-modification lease liability (₹ 2,10,546) is ₹ 1,05,273.

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 91,987.50 and the carrying amount of the lease liability by ₹ 1,05,273. Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,05,273 – ₹ 91,987.50 = ₹ 13,285.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Journal Entry

Lease liability	Dr.	₹ 1,05,273	
To ROU Asset			₹ 91,987.50
To Profit and Loss			₹ 13,285.50

Lessee recognises the difference between the remaining lease liability of ₹ 1,05,273 and the modified lease liability of ₹ 1,29,900 (which equals ₹ 24,627) as an adjustment to the ROU Asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Journal Entry

ROU Asset	Dr.	₹ 24,627	
To Lease liability			₹ 24,627

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment(A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	50,000	0.943	47,150
2	50,000	0.890	44,500
3	50,000	0.840	42,000
4	50,000	0.792	39,600
5	50,000	0.747	37,350
6	50,000	0.705	35,250
7	50,000	0.665	33,250
8	50,000	0.627	31,350
9	50,000	0.592	29,600
10	50,000	0.558	27,900
			3,67,950

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Illustration 36 - Modification that is a change in consideration only

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from ₹ 1,00,000 per year to ₹ 95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a. The annual lease payments are payable at the end of each year.

How should the said modification be accounted for?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090			

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

(a) a five-year remaining lease term,

(b) annual payments of ₹ 95,000, and

(c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	95,000	0.935	88,825
2	95,000	0.873	82,935
3	95,000	0.816	77,520
4	95,000	0.763	72,485
5	95,000	0.713	67,735
			3,89,500

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Lessee recognises the difference between the carrying amount of the modified liability (₹ 3,89,500) and the lease liability immediately before the modification (₹ 4,21,090) of ₹ 31,590 as an adjustment to the ROU Asset.

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
4	1,00,000	0.792	79,200
5	1,00,000	0.747	74,700
6	1,00,000	0.705	70,500
7	1,00,000	0.665	66,500
8	1,00,000	0.627	62,700
9	1,00,000	0.592	59,200
10	1,00,000	0.558	55,800
Lease liability as at commencement date			**7,35,900**

*****

Illustration 37 - Modification that both increases and decreases the scope of the lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are ₹1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a.

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to:

(a) include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and

(b) reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is ₹1,50,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract.

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Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

How should the said modification be accounted for?

Solution:

The pre-modification ROU Asset and the pre-modification lease liability in relation to the lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 6%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
1	7,35,900*	44,154	(1,00,000)	6,80,054	7,35,900	(73,590)	6,62,310
2	6,80,054	40,803	(1,00,000)	6,20,857	6,62,310	(73,590)	5,88,720
3	6,20,857	37,251	(1,00,000)	5,58,108	5,88,720	(73,590)	5,15,130
4	5,58,108	33,486	(1,00,000)	4,91,594	5,15,130	(73,590)	4,41,540
5	4,91,594	29,496	(1,00,000)	4,21,090	4,41,540	(73,590)	3,67,950
6	4,21,090				3,67,950		

*Refer Note 4.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of:

(a) A three-year remaining lease term (ie. till 8th year),

(b) Annual payments of ₹ 150,000 and

(c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	1,50,000	0.935	1,40,250
2	1,50,000	0.873	1,30,950
3	1,50,000	0.816	1,22,400
Modified lease liability			**3,93,600**

The modified liability equals ₹ 3,93,600, of which (a) ₹ 1,31,200 relates to the increase of ₹ 50,000 in the annual lease payments from Year 6 to Year 8 and (refer note 1) (b) ₹ 2,62,400 relates to

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the remaining three annual lease payments of ₹ 1,00,000 from Year 6 to Year 8 with reduction of lease term (Refer Note 3).

Decrease in the lease term:

At the effective date of the modification (at the beginning of Year 6), the pre-modification ROU Asset is ₹ 3,67,950. Lessee determines the proportionate decrease in the carrying amount of the ROU Asset based on the remaining ROU Asset for the original 2,000 square metres of office space (i.e., a remaining three-year lease term rather than the original five-year lease term). The remaining ROU Asset for the original 2,000 square metres of office space is ₹ 2,20,770 [i.e., ₹ (3,67,950 / 5) x 3 years].

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is ₹ 4,21,090. The remaining lease liability for the original 2,000 square metres of office space is ₹ 2,67,300 (i.e., present value of three annual lease payments of ₹ 1,00,000, discounted at the original discount rate of 6% p.a.) (refer note 2).

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,47,180 (₹ 3,67,950 – ₹ 2,20,770), and the carrying amount of the lease liability by ₹ 1,53,790 (₹ 4,21,090 – ₹ 2,67,300). Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,53,790 – ₹ 1,47,180 = ₹ 6,610) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease Liability	Dr.	1,53,790	
To ROU Asset			1,47,180
To Gain			6,610

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7% p.a., which is ₹ 4,900 (₹ 2,67,300 – ₹ 2,62,400*), as an adjustment to the ROU Asset.

*(Refer note 3)

Lease Liability	Dr.	4,900	
To ROU Asset			4,900

Increase in the leased space:

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in leased space of ₹ 1,31,200 (i.e., present value of three annual lease payments of ₹ 50,000, discounted at the revised interest rate of 7% p.a.) as an adjustment to the ROU Asset.

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ROU Asset	Dr.	1,31,200	
To Lease Liability			1,31,200

The modified ROU Asset and the modified lease liability in relation to the modified lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 7%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
6	3,93,600	27,552	(1,50,000)	2,71,152	3,47,070**	(1,15,690)	2,31,380
7	2,71,152	18,981	(1,50,000)	1,40,133	2,31,380	(1,15,690)	1,15,690
8	1,40,133	9,867*	(1,50,000)	-	1,15,690	(1,15,690)	-

*Difference is due to approximation; **Refer Note 5

Working Notes:

1. **Calculation of lease liability on increased consideration:**

Year	Lease Payments (A)	Present value @7% (B)	Present value of lease payments (A x B = C)
1	50,000	0.935	46,750
2	50,000	0.873	43,650
3	50,000	0.816	40,800
Modified lease liability			**1,31,200**

2. **Calculation of remaining lease liability for the original contract of 2000 square meters at original discount rate:**

Year	Lease Payments (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
Remaining lease liability			**2,67,300**

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3. **Calculation of remaining lease liability for the original contract of 2000 square meters at revised discount rate:**

Year	Lease Payments (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.935	93,500
2	1,00,000	0.873	87,300
3	1,00,000	0.816	81,600
Remaining lease liability			**2,62,400**

4. **Calculation of Initial value of ROU asset and lease liability:**

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at commencement date			**7,35,900**

5. **Calculation of opening balance of Modified ROU Asset at the beginning of 6th year:**

The remaining ROU Asset for the original 2,000 square metres of office space after decrease in term	2,20,770
Less: Adjustment for increase in interest rate from 6% to 7%	(4,900)
Add: Adjustment for increase in leased space	1,31,200
	3,47,070

*****

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8.4.5 Presentation

ROU Assets and lease liabilities are subject to the same considerations as other assets and liabilities in classifying them as current and non-current in the balance sheet. The following table depicts how lease-related amounts and activities are presented in lessees' financial statements:

Balance Sheet	*Statement of profit and loss*	*Statement of cash flows*
ROU Assets: They are presented either: - Separately from other assets (e.g., owned assets) ***OR*** - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are presented as investment property **Lease Liabilities:** They are presented either: - Separately from other liabilities ***OR*** - Together with other liabilities with disclosure of the balance sheet line items that includes lease liabilities and their amounts	**Depreciation and Interest:** Depreciation on Right of use asset and interest expense accreted on lease liabilities are presented **separately** (i.e., they **CANNOT** be combined). This is because interest expense on the lease liability is a component of **finance costs**	**Principal portion of the lease liability:** - These cash payments are presented within financing activities **Interest portion of the lease liability:** - These cash payments are presented within financing activities **Short-term leases and leases of low-value assets:** - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within operating activities **Variable lease payments not included in the lease liability:** - These are also presented within operating activities **Non-cash activity:** Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)

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8.4.6 Disclosure

Disclosure objective:

The objective of the disclosures is for lessees to disclose information in the notes that, together with the information provided in the balance sheet, statement of profit and loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance, and cash flows of the lessee.

Ind AS 116 requires lessees to present all disclosures in:

— a single note ***OR***

— separate section in the financial statements.

Quantitative Disclosure Requirement		
Balance sheet	***Statement of Profit and Loss***	***Statement of Cash Flows***
– Additions to right-of-use assets. – Carrying value of right-of-use assets at the end of the reporting period by class. – Maturity analysis of lease liabilities separately from other liabilities based on Ind AS 107 requirements.	– Depreciation of assets by class. – Interest expense on lease liabilities. – Short-term leases expensed* – Low-value leases expensed* – Variable lease payments expensed. – Income from subleasing. – Gains or losses arising from sale and leaseback transactions.	– Total cash outflow for leases.

* These disclosures need not include leases with lease terms of one month or less.

All of the above disclosures are required to be presented in tabular format, unless another format is more appropriate. The amounts disclosed include costs that a lessee has included in the carrying amount of another asset during the reporting period.

Other disclosure requirements also include:

- Commitments for short-term leases if the current period expense is dissimilar to future commitments.

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- For right-of-use assets that meet the definition of investment property, the disclosure requirements of Ind AS 40, *Investment property*, with a few exclusions.
- For right-of-use assets where the revaluation model has been applied, the disclosure requirements of Ind AS 16, *Property, plant and equipment.*
- Entities applying the short-term and/or low-value lease exemptions are required to disclose that fact.

Qualitative Disclosure Requirements
– A summary of the nature of the entity's leasing activities; – Potential cash outflows the entity is exposed to that are not included in the measured lease liability, including: – Variable lease payments; – Extension options and termination options; – Residual value guarantees; and – Leases not yet commenced to which the lessee is committed. – Restrictions or covenants imposed by leases; and – Sale and leaseback transaction information.

In providing additional information, lessees are required to consider:

(a) Whether that information is relevant to the users of the financial statements. The additional information (as specified above) is included **ONLY IF** that information is **expected to be relevant** to users of financial statements. For e.g., this is likely to be relevant if it helps those users to understand:

The flexibility provided by leases	*for e.g., a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions*
Restrictions imposed by leases	*for e.g., by requiring the lessee to maintain particular financial ratios*
Sensitivity of reported information to key variables	*for e.g., future variable lease payments*
Deviations from industry practice	*for e.g., unusual or unique lease terms and conditions that affect a lessee's lease portfolio*

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Exposure to other risks arising from leases	

(b) Whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements.

8.4.7 Income tax accounting

For lessees, Ind AS 116 requires recognition of lease related assets and liabilities that are not on the balance sheet under today's accounting (i.e. amounts related to leases that are operating leases under Ind AS 17) and could change the measurement of other lease-related assets and liabilities. These changes affect certain aspects of accounting for income taxes such as the following:

(a) recognition and measurement of deferred tax assets and liabilities; and

(b) assessment of the recoverability of deferred tax assets.

8.5 LESSOR ACCOUNTING

8.5.1 Lease Classification

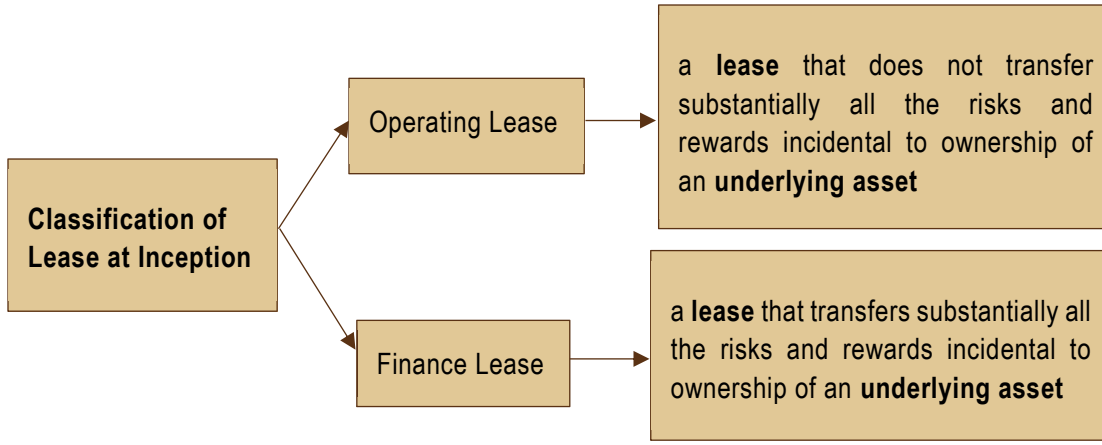
A **'lessor'** is defined as an entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.

At inception, lessors classify all leases as FINANCE LEASE or OPERATING LEASE. Lease classification is very important because it determines how and when a lessor recognizes lease income and what assets are recorded. Classification is based on the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract.

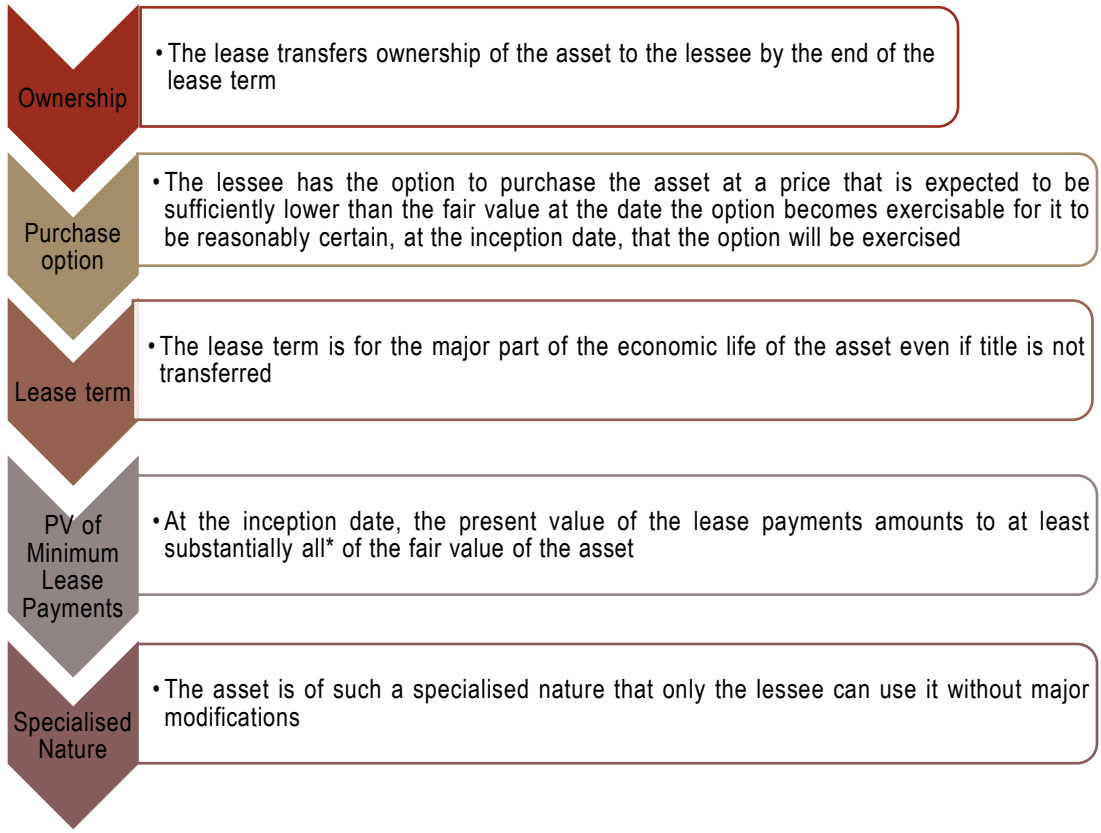
Where, a **'Finance Lease'** is defined as a **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.

Where, an **'Operating Lease'** is defined as a **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.

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Ind AS 116 lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a **FINANCE LEASE**:



*The term "substantially all" is not defined in Ind AS 116.

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Additionally, Ind AS 116 lists the following indicators of situations that, individually or in combination, could also lead to a lease being classified as a **FINANCE LEASE**:

Loss on cancellation	• If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
Risk of fair value of the residual asset	• Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease)
Option to extend lease	• The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

Other considerations that could be made in determining the economic substance of the lease arrangement include the following:

- Are the lease rentals based on a market rate for use of the asset (which would indicate an operating lease) or a financing rate for use of the funds, which would be indicative of a finance lease?
- Is the existence of put and call options a feature of the lease? If so, are they exercisable at a predetermined price or formula (indicating a finance lease) or are they exercisable at the market price at the time the option is exercised (indicating an operating lease)?

Lease classification test for land and buildings:

For a lease that includes both land and buildings elements, the lessor **separately assesses** the classification of each element as a finance lease or an operating lease, **having fact that land normally has an indefinite economic life**.

The lessor allocates lease payments between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case, the entire lease is classified as an operating lease.

For a lease of land and buildings in which the amount for the land element is **immaterial** to the lease, the lessor may treat the land and buildings as a **single unit** for the purpose of lease classification and classify it as a finance lease or an operating lease. In such a case, the lessor regards the economic life of the buildings as the economic life of the **entire** underlying asset.

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Residual value guarantees included in the lease classification test:

In evaluating Ind AS 116's lease classification criteria, lessors are required to include in the 'substantially all' test, **any (i.e., the maximum obligation) residual value guarantees** provided by both lessees and any other third party unrelated to the lessor.

Reassessment of lease classification:

Lessors are required to **reassess** the lease classification only if there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease). Lessors reassess lease classification as at the **effective date of the modification** using the modified conditions at that date. If a lease modification results in a separate new lease, that new lease would be classified in the **same manner** as any new lease.

Key concepts applied by the lessor:

'Gross investment in the lease' is the **SUM** of:

(a) the lease payments receivable by a lessor under a finance lease; ***AND***

(b) any unguaranteed residual value accruing to the lessor.

'**Net investment in the lease'** is the gross investment in the lease discounted at the interest rate implicit in the lease.

'**Unguaranteed residual value'** is that portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

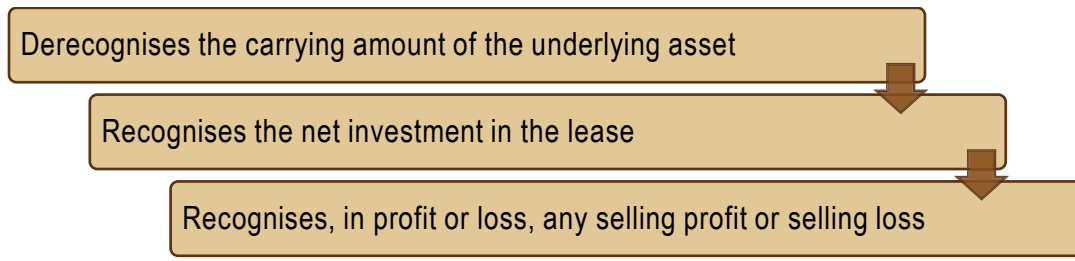
8.5.2 Finance Leases

8.5.2.1 Recognition

At the commencement date, a lessor shall recognise assets held under a finance lease in its balance sheet and present them as receivable at an amount equal to the **net investment in the lease**.

8.5.2.2 Initial Measurement

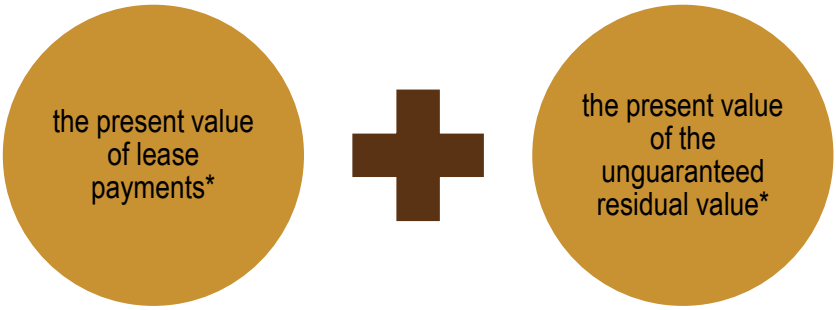
At lease commencement, a lessor accounts for a finance lease, as follows:



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For finance leases (other than those involving manufacturer and dealer lessors), initial direct costs are included in the initial measurement of the finance lease receivable. Initial direct costs are included in the lease and are not added separately to the net investment in lease.

The net investment in the lease is initially measured as the sum of:



*discounted using the interest rate implicit in the lease (i.e., the discount rate).

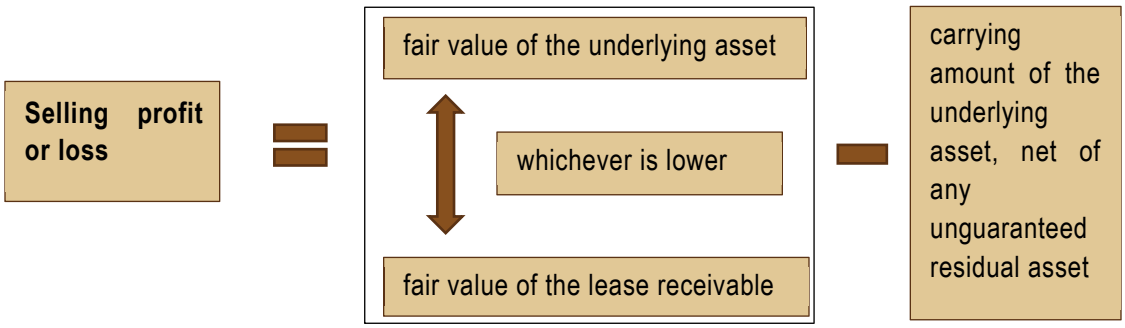
*Lease payments as described in section 8.3.3

Any selling profit or loss is measured as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset, net of any unguaranteed residual asset.

Journal entry for finance lease on initial measurement

Finance lease receivable	Dr.	Net investment
To Underlying asset		Carrying amount

(Balancing figure is profit or loss)

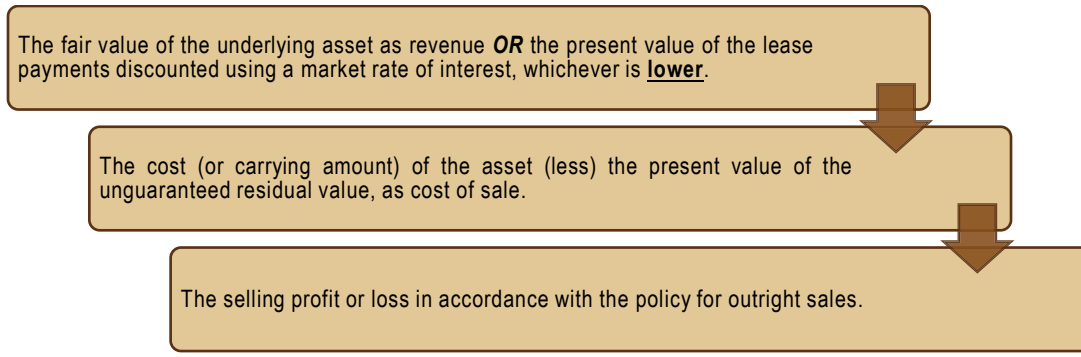


8.5.2.3 Initial Measurement – Manufacturer or Dealer Lessors

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss in accordance with its policy for outright sales to which Ind AS 115 applies.

Therefore, at lease commencement, a manufacturer or dealer lessor recognises the following:

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At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss on a **finance lease**, regardless of whether the lessor transfers the underlying asset as described under Ind AS 115. Costs incurred by a manufacturer or dealer lessor in connection with obtaining a finance lease are recognised as an expense at the commencement date and are **excluded** from the net investment in the lease because they are mainly related to earning the manufacturer or dealer's selling profit.

Accounting for initial direct costs shall be done in the following manner:

By Lessor
Finance Lease: Ind AS 116 requires 'lessors' (*other than manufacturer or dealer lessors*) to include initial direct costs in the initial measurement of their net investments in finance leases and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and they are not added separately. (*Initial direct costs related to finance leases incurred by manufacturer or dealer lessors are expensed at lease commencement*). **Operating Lease:** Ind AS 116 requires lessors to include initial direct costs in the carrying amount of the underlying asset in an operating lease. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income.

8.5.2.4 Subsequent Measurement

After lease commencement, a lessor accounts for a finance lease, as follows:

- Recognises **finance income** (in profit or loss) over the lease term in an amount that produces a constant periodic rate of return on the remaining balance of the net investment in the lease (i.e., using the interest rate implicit in the lease).

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- Income is recognised on the components of the net investment in the lease, which is Interest on the lease receivables.

♦ Reduces the net investment in the lease for lease payments received (net of finance income calculated above)

♦ Separately recognises income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned

♦ Recognises any impairment of the net investment in the lease

Remeasurement of the net investment in the lease:

After lease commencement, the net investment in a lease is **NOT REMEASURED UNLESS** in either of the following situations:

♦ The lease is modified (i.e., a change in the scope of the lease, or the consideration for the lease, that was not part of the original terms and conditions of the lease) and the modified lease is not accounted for as a separate contract

OR

♦ The lease term is revised when there is a change in the non-cancellable period of the lease

(Refer section 8.5.4 Modification of lease)

Summary-Accounting treatment in the books of a lessor

Particulars	Finance lease	Operating lease
Initial measurement		
Balance sheet	• Derecognise the carrying amount of the underlying asset • Recognise the net investment in the lease i.e. a finance lease receivable (equal to the present value of the lease payments to be received)	• Continue to present the underlying asset • Add any initial direct costs incurred in connection with obtaining the lease to the carrying amount of the underlying asset • A **manufacturer or dealer lessor does not recognise any selling profit** on entering into an operating lease because it is not equivalent of a sale

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Statement of Profit and loss	• Recognises, in profit or loss, any **selling profit or selling loss**	
Subsequent measurement		
Balance sheet	• Reduce the net investment in the lease for lease payments received (net of finance income calculated above) • **After** lease commencement, the net investment in a lease is **NOT REMEASURED UNLESS** either: – The lease is modified and the modified lease is not accounted for as a separate contract ***OR*** – The lease term is revised when there is a change in the non-cancellable period of the lease. • Recognise any impairment of the net investment in the lease, if there has been a **reduction in the estimated unguaranteed residual value**	• Calculate depreciation in accordance with Ind AS 16 and Ind AS 38. • Apply Ind AS 36 to determine whether an underlying asset is impaired and to account for any impairment loss identified.
Statement of Profit and loss	• Apportion the amount received between the finance income and reduction in receivable • Finance income will be computed to give a constant periodic rate of return • Separately recognises income from variable lease payments	• Recognise lease income over the lease term, typically on a straight line basis • Depreciation expense to be recognised related to the underlying asset • Recognise variable lease payments that do not depend on an index or rate (e.g.,

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	that are not included in the net investment in the lease in the period in which that income is earned • **Revise the income allocation** over the lease term and recognise immediately any reduction in respect of amounts accrued, if there has been a **reduction in the estimated unguaranteed residual value**	performance- or usage- based payments) **as they are earned**.

Illustration 38 - Lessor accounting for a finance lease → dealer-lessor case

A Dealer-Lessor enters into a 10-year lease of equipment with Lessee. The equipment is not specialised in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- *Lessor receives annual lease payments of ₹ 15,000, payable at the end of the year*
- *Lessor expects the residual value of the equipment to be ₹ 50,000 at the end of the 10-year lease term*
- *Lessee provides a residual value guarantee that protects Lessor from the first ₹ 30,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., ₹ 50,000)*
- *The equipment has an estimated remaining economic life of 15 years, a carrying amount of ₹ 1,00,000 and a fair value of ₹ 1,11,000*
- *The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option to purchase the underlying asset*
- *The interest rate implicit in the lease is 10.078%.*

How should the Lessor account for the same in its books of accounts?

Solution:

Lessor shall classify the lease as a **FINANCE LEASE** because the sum of the present value of lease payments amounts to **substantially all** of the fair value of the underlying asset.

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At lease commencement, Lessor accounts for the finance lease, as follows:

Net investment in the lease	Dr.	₹ 1,11,000[(a)]	
Cost of goods sold	Dr.	₹ 92,340[(b)]	
To Revenue			₹ 1,03,340[(c)]
To Property held for lease			₹ 1,00,000[(d)]

To record the net investment in the finance lease and derecognise the underlying asset.

(a) The net investment in the lease consists of:

(1) the present value of 10 annual payments of ₹ 15,000 plus the guaranteed residual value of ₹ 30,000, both discounted at the interest rate implicit in the lease, which equals ₹ 1,03,340 (i.e., the lease payment) (Refer note 1) ***AND***

(2) the present value of unguaranteed residual asset of ₹ 20,000, which equals ₹ 7,660 (Refer note 2).

Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet.

(b) Cost of goods sold is the carrying amount of the equipment of ₹ 1,00,000 (less) the present value of the unguaranteed residual asset of ₹ 7,660.

(c) Revenue equals the lease receivable.

(d) The carrying amount of the underlying asset.

At lease commencement, Lessor recognizes selling profit of ₹ 11,000 which is calculated as = lease payment of ₹ 1,03,340 – [carrying amount of the asset (₹ 1,00,000) – net of any unguaranteed residual asset (₹ 7,660) ie which equals ₹ 92,340]

Year 1 **Journal entry for a finance lease**

Cash	Dr.	₹ 15,000[(e)]	
To Net investment in the lease			₹ 3,813[(f)]
To Interest income			₹ 11,187[(g)]

(e) Receipt of annual lease payments at the end of the year.

(f) Reduction of the net investment in the lease for lease payments received of ₹ 15,000, net of interest income of ₹ 11,187

(g) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Please refer the computation below:

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The following table summarizes the interest income from this lease and the related amortization of the net investment over the lease term:

Year	*Annual Rental Payment*	*Annual Interest Income (h)*	*Net investment at the end of the year*
Initial net investment	-	-	1,11,000
1	15,000	11,187	1,07,187
2	15,000	10,802	1,02,989
3	15,000	10,379	98,368
4	15,000	9,914	93,282
5	15,000	9,401	87,683
6	15,000	8,837	81,520
7	15,000	8,216	74,736
8	15,000	7,532	67,268
9	15,000	6,779	59,047
10	15,000	5,953	50,000(i)

(h) Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For e.g., Year 1 annual interest income is calculated as ₹ 1,11,000 (initial net investment) x 10.078%.

(i) The estimated residual value of the equipment at the end of the lease term.

Working Notes:

1 Calculation of net investment in lease:

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
1	15,000	0.908	13,620
2	15,000	0.825	12,375
3	15,000	0.750	11,250
4	15,000	0.681	10,215
5	15,000	0.619	9,285

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6	15,000	0.562	8,430
7	15,000	0.511	7,665
8	15,000	0.464	6,960
9	15,000	0.421	6,315
10	15,000	0.383	5,745
10	30,000	0.383	11,480*
			1,03,340

* Figure has been rounded off for equalization of journal entry.

2 Calculation of present value of unguaranteed residual asset

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
10	20,000	0.383	7,660

*****

Impairment of the net investment in the lease:

A lessor shall apply the derecognition and impairment requirements in Ind AS 109 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

8.5.3 Operating Leases

8.5.3.1 Recognition and Measurement

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis ***OR*** another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit derived from the use of the underlying asset is diminished.

Lessors **subsequently** recognise lease payments over the lease term on either a straight-line basis or another systematic and rational basis if that basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. After lease commencement, lessors recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) **as they are earned**.

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A lessor recognises costs, including depreciation, incurred in earning the lease income as an expense.

Ind AS 116 also requires lessors of operating leases to **add** initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset at lease commencement and recognise those costs as an expense over the lease term on the **same basis** as lease income.

The depreciation policy for depreciable underlying assets subject to operating leases must be consistent with the lessor's normal depreciation policy for similar assets. A lessor calculates depreciation in accordance with Ind AS 16 and Ind AS 38. A lessor applies Ind AS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not equivalent of a sale.

8.5.4 Lease Modifications

A '**lease modification**' is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (***for e.g.***, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

8.5.4.1 Finance Lease Modification

Modification- Separate lease:

A lease modification is accounted for as a separate lease if both:

(a) The modification increases the scope of the lease by adding the right to use one or more underlying assets; **and**

(b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessor would follow the existing lessor guidance on initial recognition and measurement.

Modification- Not Separate lease:

If a lease modification fails the test to be considered as separate lease as mentioned above, the lessor follows the following guidance:

When a modification to a finance lease is not a separate lease, the lessor first assesses whether the lease classification would have been different if the modified terms had been effective at the inception date. If the lease would have been classified as an operating lease had the modified terms been effective at the inception date, then the lessor:

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– accounts for the lease modification as a termination of the original lease and the creation of a new lease from the effective date of the modification; and

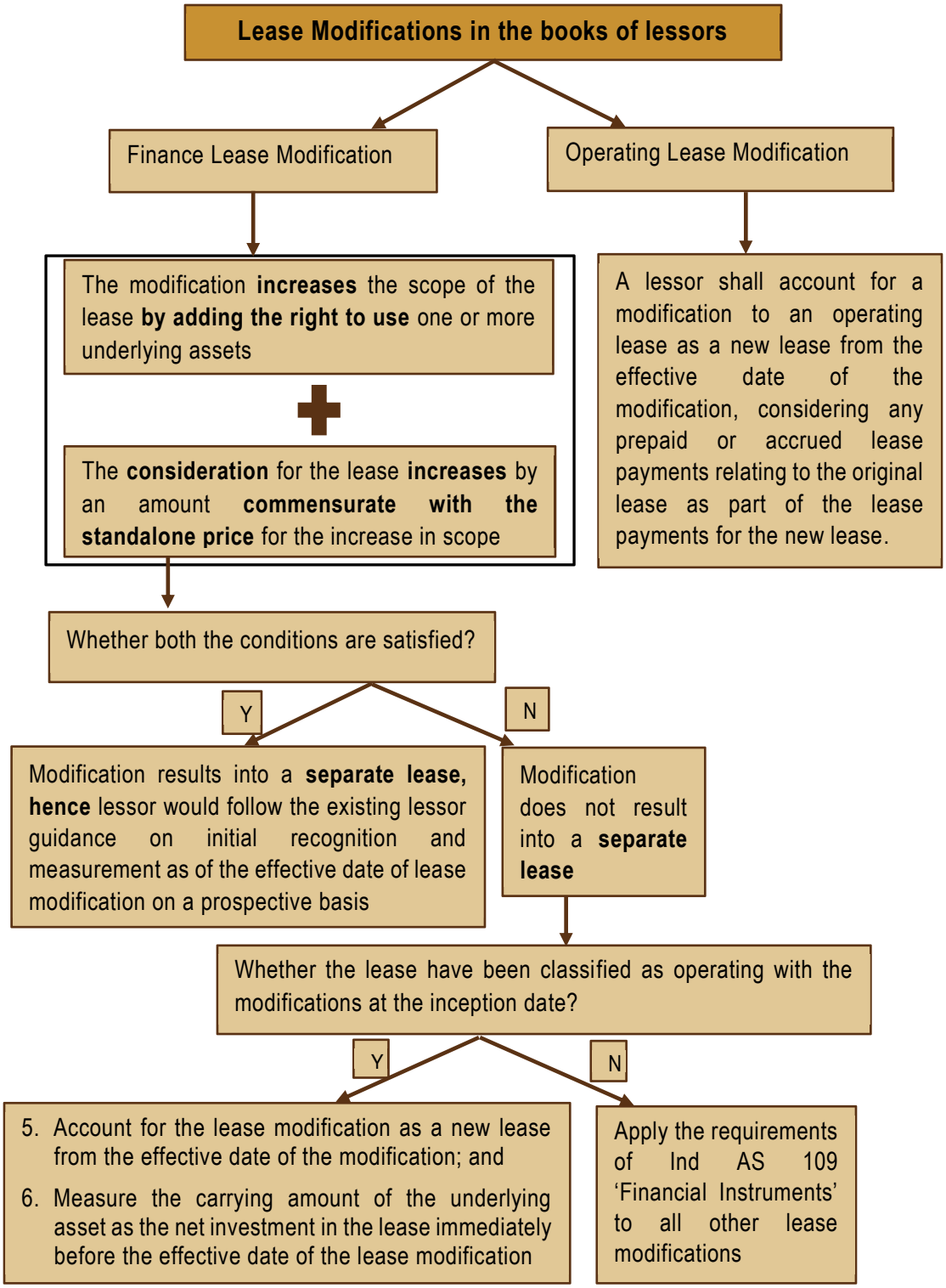
– measures the carrying amount of the underlying asset as the net investment in the original lease immediately before the effective date of the lease modification.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.

8.5.4.2 Operating Lease Modification:

A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

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Illustration 39- Deferral of lease payments not a lease modification

Lessor L leases retail space to Lessee Z and classifies the lease as an operating lease. The lease includes fixed lease payments of ₹ 10,000 per month.

Due to the COVID-19 pandemic, L and Z agree on a rent concession that allows Z to pay no rent in the period from July, 2020 to September, 2020 but to pay rent of 20,000 per month in the period from January 2021 to March 2021. There are no other changes to the lease.

How this will be accounted for by lessor?

Solution:

L determines that the reduction in lease payments in July 2020 to September 2020 and the proportional increase in January 2021 to March 2021 does not result in an overall change in the consideration for the lease.

L does not account for the change as a lease modification. L continues to recognise operating lease income on a straight-line basis, which is representative of the pattern in which Z's benefit from use of the underlying asset is diminished.

Illustration 40 - Unamortised lease incentive: Lease modification

Lessor M enters into a 10-year lease of office space with Lessee K, which commences on 1 April 2015. The rental payments are 15,000 per month, payable in arrears. M classifies the lease as an operating lease. M reimburses K's relocation costs of K of 600,000, which M accounts for as a lease incentive. The lease incentive is recognised as a reduction in rental income over the lease term using the same basis as for the lease income – in this case, on a straight- line basis over 10 years.

On 1 April 2020, during the COVID-19 pandemic, M agrees to waive K's rental payments for May, June and July 2020.

This decrease in consideration is not included in the original terms and conditions of the lease and is therefore a lease modification.

How this will be accounted for by the lessor?

Solution:

M accounts for this modification as a new operating lease from its effective date – i.e. 1 April 2020. M recognises the impact of the waiver on a straight-line basis over the five-year term of the new lease. M also takes into account the carrying amount of the unamortised lease incentive on 1 April 2020 of ₹ 3,00,000. M amortises this balance on a straight-line basis over the five-year term of the new lease.

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Illustration 41 - Modification that is not a separate lease and lease would have been classified as an operating lease

Lessor L enters into an eight-year lease of 40 lorries with Lessee M that commences on 1 January 2018. The lease term approximates the lorries' economic life and no other features indicate that the lease transfer or does not transfer substantially all of the risks and rewards incidental to ownership of the lorries. Assuming that substantially all of the risks and rewards incidental to ownership of the lorries are transferred, L classifies the lease as a finance lease.

During the COVID-19 pandemic, M's business has contracted. In June 2020, L and M amend the contract so that it now terminates on 31 December 2020.

Early termination was not part of the original terms and conditions of the lease and this is therefore a lease modification. The modification does not grant M an additional right to use the underlying assets and therefore cannot be accounted for as a separate lease.

How this will be accounted for by lessor?

Solution:

L determines that, had the modified terms been effective at the inception date, the lease term would not have been for major part of the lorries' economic life. Furthermore, there are no other indicators that the lease would have transferred substantially all the risks and rewards incidental to ownership of the lorries. Therefore, the lease would have been classified as an operating lease.

In June 2020, L accounts for the modified lease as a new operating lease. The lessor L:

a) derecognises the finance lease receivable and recognises the underlying assets in its statement of financial position according to the nature of the underlying asset – i.e. as property, plant and equipment in this case; and

b) measures the aggregate carrying amount of the underlying assets as the amount of the net investment in the lease immediately before the effective date of the lease modification.

Comparison with AS 19:

While the accounting for leases in the books of lessor is similar under AS 19 to that under Ind AS 116, AS 19 does not provide guidance on lease modifications.

8.5.5 Presentation

Lessors have the following presentation requirements under Ind AS 116, depending on the classification of the leases:

Finance Leases	*Operating Leases*
Lessors recognise assets held under a **finance lease** in the balance sheet and present them as a receivable at an amount equal to the net investment in the lease	Lessors are required to present underlying assets subject to **operating leases** according to the

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under Ind AS 116. In addition, the net investment in the lease is subject to the **same considerations** as other assets in classification as current or non-current assets in a balance sheet.	nature of that asset in the balance sheet under Ind AS 116.

8.5.6 Disclosure

The objective of the disclosure requirements for lessors to disclose information in the notes that together with the information provided in the balance sheet, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.

The lessor disclosure requirements in Ind AS 116 are more extensive to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities.

Following are the disclosure requirements under Ind AS 116 for lessors:

Quantitative Disclosure Requirements	
Finance leases	– Selling profit or loss; – Finance income on the net investment; – Income from variable lease payments; – Qualitative and quantitative explanation of changes in the net investment; and – Maturity analysis of lease payments receivable.
Operating leases	– Lease income, separately disclosing variable lease payments; – Disclosure requirements of Ind AS 16 for leased assets, separating leased assets from non-leased assets; – Other applicable disclosure requirements based on the nature of the underlying asset (eg. Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41); and – Maturity analysis of lease payments.

The standard prescribes that the quantitative disclosures should be presented in a tabular format, unless another format is more appropriate to be presented.

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Qualitative Disclosure Requirements
Similar to the lessee disclosure requirements, Ind AS 116 requires a lessor to disclose additional qualitative and quantitative information about its leasing activities in order to provide users with a basis for assessing the leasing's impact on the financial statements. This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including: – Buy-back agreements; – Residual value guarantees; – Variable lease payments for excess use; and – Any other risk management strategies.

8.6 OTHER MATTERS

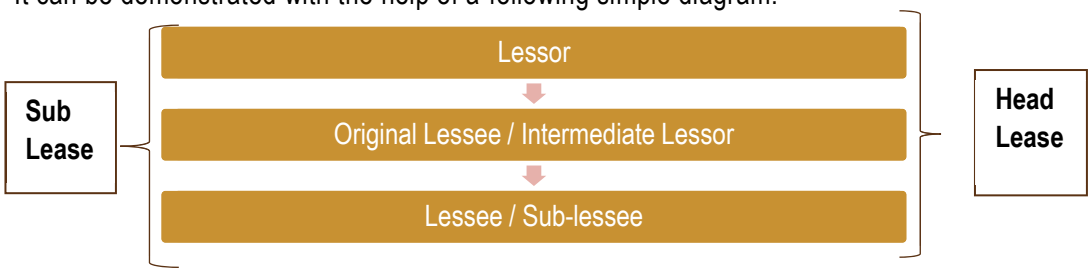
8.6.1 Sub-Leases

8.6.1.1 Recognition and Measurement

A 'Sub-lease' is defined as a transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the original lease ('head lease') between the head lessor and lessee remains in effect.

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect, where, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a 'head lease', the original lessee is often referred to as an 'intermediate lessor' or 'sub-lessor' and the ultimate lessee is often referred to as the 'sub-lessee'.

It can be demonstrated with the help of a following simple diagram:



In some cases, the sublease is a separate lease agreement while, in other cases, a third party assumes the original lease but, the original lessee remains the primary obligor under the original lease.

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Intermediate Lessor Accounting:

Where an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease, i.e., the original lessee generally continues to account for the original lease (the head lease) as a lessee and accounts for the sublease as the lessor (intermediate lessor).

When the head lease is a short-term lease, the sublease is classified as an operating lease. Otherwise, the sublease is classified using the classification criteria (as discussed earlier) BUT, it should be by reference to the 'ROU Asset' in the head lease (and NOT the 'underlying asset' of the head lease). This can be understood better with the help of a following illustration:

Illustration 42 - Classification of a sublease in case of an Intermediate Lessor

Entity ABC (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 40 years. Entity ABC subleases the building for four years.

How should the said sublease be classified by Entity ABC?

Solution:

The sublease is classified with reference to the 'ROU Asset' in the head lease (and **NOT** the 'underlying building' of the head lease). Hence, when assessing the useful life criterion, the sublease term of four years is compared with five-year ROU Asset in the head lease (**NOT** compared with 40-year economic life of the building) and accordingly may result in the sublease being classified as a finance lease.

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The intermediate lessor accounts for the sublease as follows:

If the sublease is classified as a 'Finance Lease'	*If the sublease is classified as an 'Operating Lease'*
The original lessee derecognises the ROU Asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the lessee accounting model. The original lessee (as the intermediate lessor) recognises a net investment in the sublease and evaluates it for impairment.	The original lessee continues to account for the lease liability and ROU asset on the head lease like any other lease. If the total remaining carrying amount of the ROU asset on the head lease exceeds the anticipated sublease income, this may indicate that the ROU asset associated with the head lease is impaired (which is assessed for impairment under Ind AS 36).

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In a sublease, an intermediate lessor may use the discount rate for the head lease (**adjusted for initial direct costs, if any, associated with the sublease**) to measure the net investment in the sublease, if the interest rate implicit in the lease cannot be readily determined.

When contracts are entered into at or near the same time, an intermediate lessor is required to consider the criteria for **combining contracts** (***for e.g.***, when the contracts are negotiated as a package with a single commercial objective, or when the consideration to be paid in one contract depends on the price or performance of the other contract). If the contracts are required to be combined, the intermediate lessor accounts for the head lease and sublease as a **single combined transaction**.

An intermediate lessor who subleases, or expects to sublease an asset, **CANNOT** account for the head lease as a lease of a low-value asset **even when** the required criteria w.r.t. 'leases of low-value assets' (as discussed earlier) are satisfied.

Let us consider some more examples with regards to applying the requirements of Ind AS 116 to an intermediate lessor that enters into a head lease and a sublease of the same underlying asset:

Illustration 43 - Intermediate Lessor – Where the sublease is classified as a 'Finance Lease'

Head lease:

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease:

At the beginning of Year 3, the intermediate lessor subleases the 10,000 square metres of office space for the remaining lease term i.e three years of the head lease to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Solution:

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the three-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as a finance lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease).

When the intermediate lessor **enters into** a sublease, the intermediate lessor:

(i) derecognises the ROU asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;

(ii) recognises any difference between the ROU asset and the net investment in the sublease in profit or loss; ***AND***

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(iii) retains the lease liability relating to the head lease in its balance sheet, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both

- finance income on the sublease ***AND***
- interest expense on the head lease.

*****

Illustration 44 - Intermediate Lessor – Where the sublease is classified as a 'Operating Lease'

Head lease:

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease:

At the commencement of the head lease, the intermediate lessor subleases the 10,000 square metres of office space for two years to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Solution:

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the two-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as an operating lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease and since, it is not satisfied, classified the same as an operating lease).

When the intermediate lessor **enters into** the sublease, the intermediate lessor retains:

- the lease liability ***AND***
- the ROU asset

both relating to the head lease in its balance sheet.

During the term of the sublease, the intermediate lessor:

(a) recognises a depreciation charge for the ROU asset and interest on the lease liability; ***AND***

(b) recognises lease income from the sublease.

Sub-lessee Accounting:

A sub-lessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to Ind AS 116's recognition and measurement provisions).

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8.6.1.2 Presentation

According to paragraph 32 of Ind AS 1, *Presentation of Financial Statements*, an entity **cannot offset** assets and liabilities or income and expenses, **unless** required or permitted by an Ind AS.

Thus, intermediate lessors are **not permitted** to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, **unless** those liabilities and assets meet the requirements in Ind AS 1 for offsetting.

Similarly, intermediate lessors are **not permitted** to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively, **unless** the requirements for offsetting in Ind AS 1 are met.

8.6.1.3 Disclosure

Under Ind AS 116, entities (**including intermediate lessors**) are required to disclose **qualitative** and **quantitative** information which gives a **basis** for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor (refer the disclosures for 'lessors' and 'lessees' already discussed earlier).

8.6.2 Sale and Leaseback Transactions

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee.

Sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing because under Ind AS 116, lessees are required to recognise most leases on the balance sheet (i.e., all leases **except** for leases of low-value assets and short-term leases depending on the lessee's accounting policy election).

Further, both the seller-lessee and the buyer-lessor are required to apply Ind AS 115 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset.

How to determine whether the transfer of an asset is a sale:

As discussed above, when determining whether the transfer of an asset should be accounted for as a sale or purchase, both the seller-lessee and the buyer-lessor shall apply the requirements of Ind AS 115 on when an entity satisfies a performance obligation by transferring **'control'** of an asset. Thus, there are following two possibilities in this scenario:

If Control is passed	*If Control is NOT passed*
If the control of an underlying asset is **passed** to the buyer-lessor, the transaction is accounted for as a **'sale or purchase'** of the asset and a **'lease'**.	If the control of an underlying asset is **NOT passed** to the buyer-lessor, both the seller-lessee and the buyer-lessor account for the transaction as a **'financing transaction'**.

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None of the indicators mentioned under Ind AS 115 individually determine whether the buyer-lessor has obtained control of the underlying asset and thus, both the seller-lessee and the buyer-lessor must consider **all relevant facts and circumstances** to determine whether control has been transferred. Further, **not all of the indicators must be present** to determine that the buyer-lessor has gained control rather, said indicators are the factors that are often present when a customer has obtained control of an asset and the said list is meant to help entities to apply the principle of control.

The existence of a leaseback, **in isolation**, does **NOT preclude a sale** because a lease is different from the sale or purchase of an underlying asset, since a lease does **not transfer 'control'** of the underlying asset. Instead, a lease **transfers the 'right to control'** the use of the underlying asset for the period of the lease.

However, if the seller-lessee has a **'substantive repurchase option'** for the underlying asset (i.e., a right to repurchase the asset), **'NO sale'** has occurred because the buyer-lessor has **NOT** obtained control of the asset.

Accounting Treatment for Sale and Lease back Transaction

Particulars	Seller-lessee	Buyer-lessor
Transfer of asset is a sale	**Apply accounting for sale** • Recognise the cash received • Derecognise the underlying asset **Apply ROU Accounting** • Apply the lessee accounting model to the leaseback asset • Measure the ROU asset at the retained portion of the previous carrying amount • Recognise a gain or loss related to the portion of the assets transferred to the buyer-lessor	• Recognise the underlying asset based on the nature of the asset • Apply the lessor accounting model to leaseback asset
Transfer of asset is not a sale	• Continue to recognise the underlying asset • Account for the transaction as financing transaction • Recognise a financial liability under Ind AS 109 for any	• Do not recognise the underlying asset • Recognise a financial asset under Ind AS 109 for any amount paid to the seller-lessee i.e. account

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	amount received from the buyer-lessor • Decrease the financial liability by the payments made (as and when) less the portion considered as interest expense	for the amount paid as a receivable

Note:

- When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (**with adjustments for any off-market terms**).
- A seller-lessee recognises a lease liability and ROU asset for the leaseback (**subject to the optional exemptions** for short-term leases and leases of low-value assets).

An entity shall make the following adjustments to measure the sale proceeds at fair value if:

- the fair value of the consideration for the sale of an asset does not equal the fair value of the asset ***OR***
- the payments for the lease are not at market rates:
  (a) any **below**-market terms shall be accounted for as a prepayment of lease payments; ***AND***
  (b) any **above**-market terms shall be accounted for as an additional financing provided by the buyer-lessor to the seller-lessee.

The entity shall measure any potential adjustment ('a' or 'b' - as described above) on the basis of the following (whichever is more readily determinable):

(a) the difference between the **fair value** of the consideration for the sale and the **fair value** of the asset; ***OR***

(b) the difference between the **present value** of the contractual payments for the lease and the **present value** of payments for the lease at market rates.

The sale transaction and the resulting lease are **generally interdependent and negotiated as a package**. Consequently, some transactions could be structured with a negotiated sales price that is above or below the asset's fair value and with lease payments for the resulting lease that are above or below the market rates. These off-market terms could mislead / falsify the gain or loss on the sale and the recognition of lease expense and lease income for the lease. Thus, to ensure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are **NEITHER understated NOR overstated**, Ind AS 116 requires **adjustments for any off-market terms** of sale and leaseback transactions, on the **more readily determinable basis** (as discussed above). Thus, the two possibilities of the sale price ***OR*** the present value of

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the lease payments being 'less' or 'greater' than the fair value of the asset ***OR*** present value of the market lease payments, respectively, is discussed in detail:

When sale price or Present Value is LESS	***When sale price or Present Value is GREATER***
Using the more readily determinable basis: When the sale price is **LESS** than the underlying asset's fair value ***OR*** the present value of the lease payments is **LESS** than the present value of the market lease payments, a seller-lessee recognises the difference as an **increase** to the sales price and the initial measurement of the ROU asset as a **'lease prepayment'**.	Using the more readily determinable basis: When the sale price is **GREATER** than the underlying asset's fair value ***OR*** the present value of the lease payments is **GREATER** than the present value of the market lease payments, a seller-lessee recognises the difference as a **reduction** in the sales price and an **'additional financing received'** from the buyer-lessor.
Buyer-lessors are also required to **adjust the purchase price** of the underlying asset for any off-market terms. Such adjustments are recognised as: - **'lease prepayments'** made by the seller-lessee ***OR*** - **'additional financing provided'** to the seller-lessee.	

Let us consider an illustration to understand the accounting for a sale and leaseback transaction:

Illustration 45 - Sale and leaseback transaction

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of ₹ 30,00,000. Immediately before the transaction, the building is carried at a cost of ₹ 15,00,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 20 years, with annual payments of ₹ 2,00,000 payable at the end of each year.

The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in Ind AS 115 'Revenue from Contracts with Customers'.

The fair value of the building at the date of sale is ₹ 27,00,000. Initial direct costs, if any, are to be ignored. The interest rate implicit in the lease is 12% p.a., which is readily determinable by Seller-lessee.

Buyer-lessor classifies the lease of the building as an operating lease.

How should the said transaction be accounted by the Seller-lessee and the Buyer-lessor?

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Solution:

Considering facts of the case, Seller-lessee and buyer-lessor account for the transaction as a sale and leaseback.

Firstly, since the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer - lessor make adjustments to measure the sale proceeds at fair value. Thus, the amount of the excess sale price of ₹ 3,00,000 (as calculated below) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

Sale Price:	30,00,000
Less: Fair Value (at the date of sale):	(27,00,000)
Additional financing provided by Buyer-lessor to Seller-lessee	**3,00,000**

Next step would be to calculate the present value of the annual payments which amounts to ₹ 14,94,000 (calculated considering 20 payments of ₹ 2,00,000 each, discounted at 12% p.a.) of which ₹ 3,00,000 relates to the additional financing (as calculated above) and balance ₹ 11,94,000 relates to the lease — corresponding to 20 annual payments of ₹ 40,164 and ₹ 1,59,836, respectively (refer calculations below).

Proportion of annual lease payments:

Present value of lease payments (as calculated above)	(A)	14,94,000
Additional financing provided (as calculated above)	(B)	3,00,000
Relating to the Additional financing provided	(C) = (E x B / A)	40,160
Relating to the Lease	(D) = (E – C)	1,59,840
Annual payments (at the end of each year)	(E)	2,00,000

Seller-Lessee:

At the commencement date, Seller-lessee measures the ROU asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, calculated as follows:

Carrying Amount	(A)	15,00,000
Fair Value (at the date of sale)	(B)	27,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
ROU Asset	**[(A / B) x C]**	**6,63,333**

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor, calculated as follows:

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Fair Value (at the date of sale)	(A)	27,00,000
Carrying Amount	(B)	15,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
Gain on sale of building	**(D) = (A - B)**	**12,00,000**
Relating to the right to use the building retained by Seller-lessee	(E) = [(D/A) x C]	5,30,667
Relating to the rights transferred to Buyer-lessor	(D - E)	6,69,333

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	Dr.	30,00,000	
ROU Asset	Dr.	6,63,333	
To Building			15,00,000
To Financial Liability			14,94,000
To Gain on rights transferred			6,69,333

Buyer-Lessor:

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	Dr.	27,00,000	
Financial Asset (20 payments of ₹ 40,160 discounted @ 12% p.a.) (approx.)	Dr.	3,00,000	
To Cash			30,00,000

After the commencement date, Buyer-lessor accounts for the lease by treating ₹ 1,59,840 of the annual payments of ₹ 2,00,000 as lease payments. The remaining ₹ 40,160 of annual payments received from Seller-lessee are accounted for as:

(a) payments received to settle the financial asset of ₹ 3,00,000 ***AND***

(b) interest revenue.

*****

Disclosures:

A seller-lessee may be required to provide additional qualitative and quantitative information about its leasing activities that is necessary to meet the disclosure objective in Ind AS 116.

A seller-lessee is also required to disclose any gains and losses arising from sale and leaseback transaction separately from gains and losses on disposals of other assets under Ind AS 116. Thus, additional information relating to sale and leaseback transactions that, depending on the

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circumstances, may be needed to satisfy the disclosure objective in Ind AS 116, could include information that helps users of financial statements to assess, ***for e.g.***:

(a) The lessee's reasons for sale and leaseback transactions and the prevalence of those transactions

(b) Key terms and conditions of individual sale and leaseback transactions

(c) Payments not included in the measurement of lease liabilities

(d) The cash flow effect of sale and leaseback transactions in the reporting period

8.7 TRANSITION APPROACH

An entity shall apply Ind AS 116 for annual reporting periods beginning on or after ***01 April 2019***.

For the purposes of the requirements of this 'Transition' section, the **date of initial application** is the **beginning of the annual reporting period** in which an entity first applies Ind AS 116.

Thus, Ind AS 116's transition provisions are applied at the beginning of the annual reporting period in which the entity first applies Ind AS 116 (i.e., the date of initial application). ***For e.g.***, an entity with a reporting date of 31 March 2020, applies the transition provisions on 01 April 2019.

8.7.1 Definition of a Lease

There is a practical expedient provided which permits lessees and lessors to make an election of not reassessing whether existing contracts contain a lease as defined under Ind AS 116.

Thus, if an entity elects this practical expedient, contracts that do not contain a lease under Ind AS 17 (including those under Appendix C to Ind AS 17, *Determining whether an Arrangement contains a Lease*) are not reassessed either. This practical expedient has been provided because if the entities are required to reassess existing contracts by applying the lease definition guidance in Ind AS 116, probably it would not justify the costs/complexity.

Further, if an entity chooses to apply the practical expedient, it must be applied to ***ALL*** contracts that are ongoing at the date of initial application (i.e., an entity is ***NOT*** permitted to apply the option on a lease-by-lease basis) and that fact shall also be disclosed.

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8.7.2 Transition Options for Lessees

A lessee is required to apply Ind AS 116 to its leases in either of the following ways:

Full Retrospective Approach	*Modified Retrospective Approach*
Retrospectively to each prior reporting period presented, applying Ind AS 8, i.e., an entity applies Ind AS 116 as if it had been applied since the inception of all lease contracts that are presented in the financial statements. If Ind AS 116 is applied at 1 April 2019, this means that, in the 31 March 2020 financial statements, the comparative period to 31 March 2019 must be restated (assuming that this is the only comparative period presented). A restated opening balance sheet at 1 April 2018 will also need to be disclosed as required by Ind AS 1. Hence, the balance sheets for 3 period will be presented: As at 31 March 2020, 31 March 2019 & 1 April 2018.	Retrospectively with cumulative effect of initially applying Ind AS 116 recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of the initial application. Therefore, restatement of comparatives is not required and only Balance Sheets for reporting date and comparative date is required to be presented.

A lessee shall apply the elected transition approach consistently to ***ALL*** leases in which it is lessee.

8.7.3 Modified Retrospective Approach

8.7.3.1 Leases Previously Classified as Operating Leases

When **applying the modified retrospective approach**, a lessee does not restate comparative figures rather, a lessee recognises the cumulative effect of initially applying Ind AS 116 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

For leases previously classified as operating leases under Ind AS 17, a lessee recognises a lease liability measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. A lessee measures the ROU asset on a **lease-by-lease basis**, at either:

— Its carrying amount as if Ind AS 116 had always been applied since the commencement date, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application (Alternative 1)

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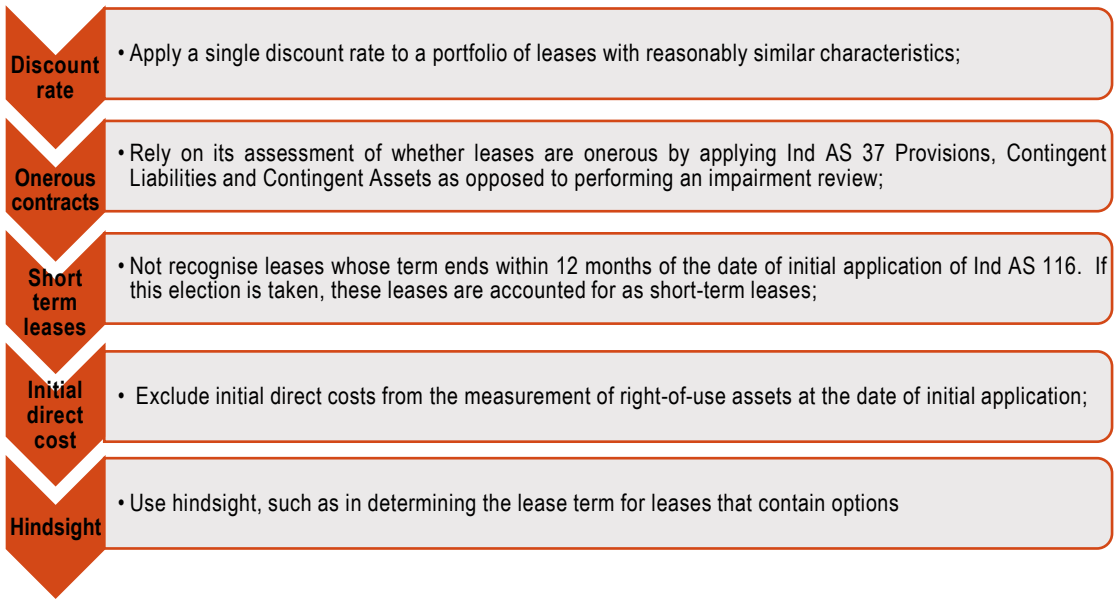
OR

— An amount equal to the lease liability, adjusted for previously recognised prepaid or accrued lease payments (Alternative 2)

A lessee applies Ind AS 36 to ROU assets at the date of initial application, unless the lessee applies the practical expedient for onerous leases (as discussed below).

A lessee is not required to make adjustments on transition for 'leases of low-value assets' (which is one of the recognition exemptions under Ind AS 116 – as discussed earlier).

Additionally, a lessee is also permitted to apply the following practical expedients to leases previously classified as operating leases (when applying modified retrospective approach), on a **lease-by-lease basis**:



Ind AS 116 is silent on as to how a lessee would separate and allocate lease and non-lease components of a contract upon transition when the modified retrospective approach is adopted. So, lessees could allocate the consideration in the contract (determined at lease commencement) to each lease and non-lease component on the basis of the relative stand-alone price of the lease component on that same date unless the lessee elects to use the practical expedient to account for each lease component and any associated non-lease components as a 'single lease component' (as discussed earlier).

8.7.3.2 Leases Previously Classified as Finance Leases

When applying modified retrospective approach, for leases that were classified as finance leases applying Ind AS 17, the carrying amount of the ROU asset and the lease liability at the date of

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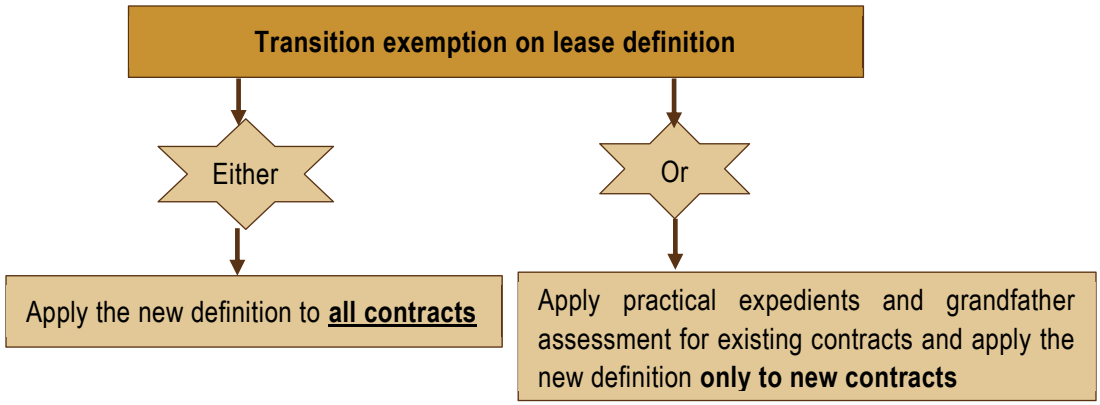
initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying Ind AS 17. For such leases, a lessee shall account for the ROU asset and the lease liability applying Ind AS 116 from the date of initial application. Thus, a lessee will not change its initial carrying amounts for assets and liabilities under finance leases existing at the date of initial application of Ind AS 116.

For leases previously classified as operating leases and finance leases, the below table summarises the application of Modified retrospective approach:

Operating Lease	Lease liability	Measure at the present value of the remaining lease payments, discounted using lessee's incremental borrowing rate at the date of initial application
	Right-of-use asset	Retrospective calculation, using a discount rate based on lessee's incremental borrowing rate at the date of initial application. or Amount of lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments relating to that lease). Lessee can choose one of the alternatives on a lease-by-lease basis.
Finance Lease	Lease liability	Carrying amount of the lease liability immediately before the date of initial application.
	Right-of-use asset	Carrying amount of the lease asset immediately before the date of initial application.
	Application of Ind AS 116	Apply the provisions of this standard to Right of Use asset and lease liability from the date of initial application.

The standard also prescribes certain practical expedients under Modified retrospective approach to leases previously classified as operating leases applying Ind AS 17.

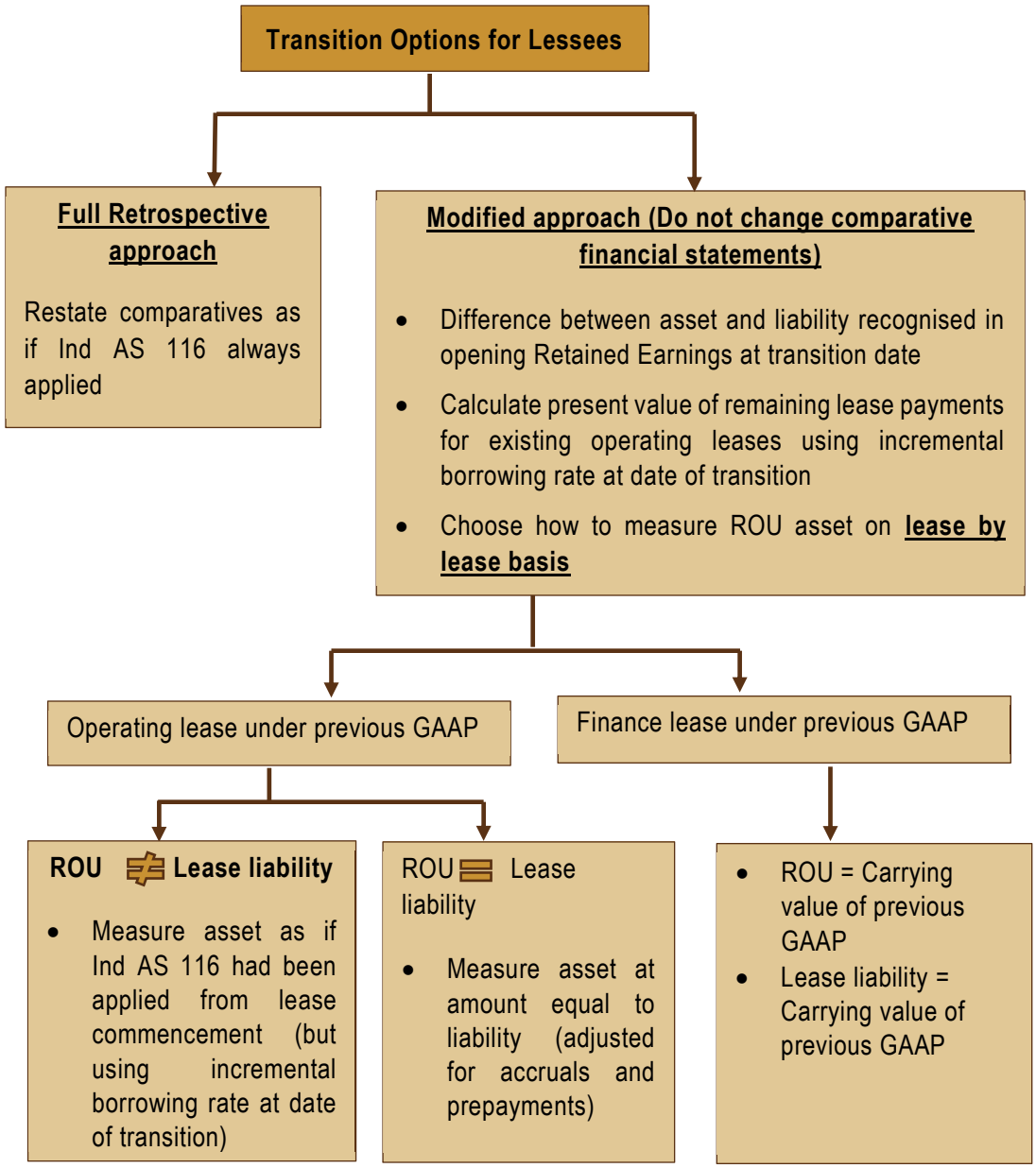
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Practical Expedient

- This exemption must be applied either for all contracts or none **i.e. cherry picking is not permitted**
- This exemption does not mean that previously identified operating leases can remain off-balance sheet for lessee (unless qualify for a recognition exemption). It merely saves the entity the costs and effort of reassessing)
- If the exemption is elected, the new definition of a lease is applied only to contracts entered into or changed on or after initial application
- Disclosure is required if a practical expedient is elected

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Note:

- A lessee applies Ind AS 36 to ROU assets at the date of initial application, unless the lessee applies the practical expedient for onerous leases.
- A lessee is not required to make adjustments on transition for 'leases of low-value assets' (which is one of the recognition exemptions under Ind AS 116)

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Let us consider an illustration to understand the transition approaches in a more precise manner:

Illustration 46 - Transition Approaches

A retailer (lessee) entered into 3-year lease of retail space beginning at 1 April 2017 with three annual lease payments of ₹ 2,00,000 due on 31 March 2018, 2019 and 2020, respectively. The lease is classified as an operating lease under Ind AS 17. The retailer initially applies Ind AS 116 for the first time in the annual period beginning at 1 April 2019. The incremental borrowing rate at the date of the initial application (i.e., 1 April 2019) is 10% p.a. and at the commencement of the lease (i.e., 1 April 2017) was 12% p.a. The ROU asset is subject to straight-line depreciation over the lease term. Assume that no practical expedients are elected, the lessee did not incur initial direct costs, there were no lease incentives and there were no requirements for the lessee to dismantle and remove the underlying asset, restore the site on which it is located or restore the underlying asset to the condition under the terms and conditions of the lease.

What would be the impact for the lessee using all the following transition approaches:

Full Retrospective Approach

Modified Retrospective Approach

- Alternative 1

- Alternative 2

Solution:

Full Retrospective Approach:

Under the full retrospective approach, the lease liability and the ROU asset are measured on the commencement date (i.e., 1 April 2017 in this case) using the incremental borrowing rate **at lease commencement date** (i.e., 12% p.a. in this case). The lease liability is accounted for by the interest method subsequently and the ROU asset is subject to depreciation on the straight-line basis over the lease term of three years. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	*Payments (Cash flows)*	*Present Value Factor @12%*	*Discounted Cash flows / Present Value*
31 Mar 2018	2,00,000	0.8929	1,78,580
31 Mar 2019	2,00,000	0.7972	1,59,440
31 Mar 2020	2,00,000	0.7118	1,42,360
	6,00,000		**4,80,380**

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Lease Liability Schedule:

Year	Opening	Interest Expense @ 12%	Payments	Closing
31 Mar 2018	4,80,380	57,646	(2,00,000)	3,38,026
31 Mar 2019	3,38,026	40,563	(2,00,000)	1,78,589
31 Mar 2020	1,78,589	21,411*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2018	4,80,380	(1,60,126)	3,20,254
31 Mar 2019	3,20,254	(1,60,127)	1,60,127
31 Mar 2020	1,60,127	(1,60,127)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
1 Apr 2017	4,80,380	4,80,380	-	-	-
31 Mar 2018	3,20,254	3,38,026	-	-	-
1 Apr 2018	3,20,254	3,38,026			(17,772)
31 Mar 2019	1,60,127	1,78,589	40,563	1,60,127	-
1 Apr 2019	1,60,127	1,78,589	-	-	-
31 Mar 2020	-	-	21,411	1,60,127	-

Ind AS 116 is applicable for the financial year beginning from 1st April 2019. Hence, 2019-2020 is the first year of adoption and using Full retrospective method the comparative for 2018-2019 needs to be restated and 1st April 2018 (i.e the opening of the comparative) is taken as transition date for adoption of this standard. At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2018 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1st April 2018 (assuming that only the 2018-2019 financial information is included as comparatives).

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ROU Asset	Dr.	3,20,254	
Retained Earnings	Dr.	17,772	
To Lease Liability			3,38,026
To initially recognise the lease-related asset and liability as of 1 April 2018.			

The following journal entries would be recorded during 2018-2019:

Interest expense	Dr.	40,563	
To Lease Liability			40,563
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	21,411	
To Lease Liability			21,411
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

Modified Retrospective Approach (Alternative 1):

Under the modified retrospective approach (Alternative 1), the lease liability is measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 1st April 2019 to 31st March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 01 April 2019** (i.e. 10% p.a. in this case). The ROU asset

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is at its carrying amount as if Ind AS 116 had been applied since the commencement date (i.e., 1st April 2017 in this case) by using incremental borrowing rate as at transition date. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	*Payments (Cash flows)*	*Discounting Factor @10%*	*Discounted Cash flows / Present Value*
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		**1,81,820**

Lease Liability Schedule:

Year	*Opening Balance*	*Interest Expense @ 10%*	*Payments*	*Closing Balance*
31 Mar 2020	1,81,820	18,180	(2,00,000)	-

ROU Asset Schedule:

Year	*Opening Balance*	*Depreciation*	*Closing Balance*
31 Mar 2020	1,65,787***	(1,65,787)	-

***(Refer note no 3)

The following table shows account balances under this method beginning at lease commencement:

Date	*ROU Asset*	*Lease Liability*	*Interest Expense*	*Depreciation Expense*	*Retained Earnings*
1 Apr 2017	4,97,360*	4,97,360**	-	-	-
31 Mar 2018	3,31,574	3,47,096	49,736	1,65,786	-
31 Mar 2019	1,65,787	1,81,806	34,710	1,65,787	(16,019)
1 Apr 2019	1,65,787	1,81,806	-	-	-
31 Mar 2020	-	-	18,194	1,65,787	-

*(Refer note no 1)

**(Refer note no 2)

At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2019 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1st April 2019.

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ROU Asset	Dr.	1,65,787	
Retained Earnings	Dr.	16,019	
To Lease Liability			1,81,806
To initially recognise the lease-related asset and liability as of 1 April 2019.			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	18,194	
To Lease Liability			18,194
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,65,787	
To ROU Asset			1,65,787
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

Note 1:

Calculation of Present value of lease payments as at commencement date i.e. 1st April, 2017

Year	*Payments (Cash flows)*	*Discounting Factor @10%*	*Discounted Cash flows / Present Value*
31 Mar 2018	2,00,000	0.9091	1,81,820
31 Mar 2019	2,00,000	0.8264	1,65,280
31 Mar 2020	2,00,000	0.7513	1,50,260
	6,00,000		**4,97,360**

Lease Liability Schedule:

Year	*Opening*	*Interest Expense @ 10%*	*Payments*	*Closing*
31 Mar 2018	4,97,360	49,736	(2,00,000)	3,47,096
31 Mar 2019	3,47,096	34,710	(2,00,000)	1,81,806
31 Mar 2020	1,81,806	18,194*	(2,00,000)	-

*Difference is due to approximation

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Calculation of ROU asset as at transition date i.e., 1st April, 2019

Year	Opening	Depreciation	Closing
31 Mar 2018	4,97,360	(1,65,786)	3,31,574
31 Mar 2019	3,31,574	(1,65,787)	1,65,787
31 Mar 2020	1,65,787	(1,65,787)	-

Modified Retrospective Approach (Alternative 2):

Under the modified retrospective approach (Alternative 2), the lease liability is also measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 1st April 2019 to 31st March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 1st April 2019** (i.e. 10% p.a. in this case). The carrying amount of the ROU asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items and hence, no impact on retained earnings as on the transition date.

Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Discounting Factor @ 10%	Discounted Cash flows / Present Value
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		**1,81,820**

Lease Liability Schedule:

Year	Opening	Interest Expense	Payments	Closing
31 Mar 2020	1,81,820	18,182	(2,00,000)	-

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2020	1,81,820	(1,81,820)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
1st Apr 2019	1,81,820	1,81,820	-	-	-
31 Mar 2020	-	-	18,182	1,81,820	-

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At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2019 by taking values from the above table and there will be no impact on retained earnings on the transition date being 1st April 2019 since under this alternative, ROU Asset is equal to the Lease Liability.

ROU Asset	Dr.	1,81,820	
To Lease Liability			1,81,820
To initially recognise the lease-related asset and liability as of 1 April 2019.			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	18,182	
To Lease Liability			18,182
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,81,820	
To ROU Asset			1,81,820
To record depreciation expense on the ROU asset.			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

A summary of the lease contract's accounting (assuming there are no changes due to reassessments) is, as follows:

Particulars	***Full Retrospective Approach***	***Modified Retrospective Approach (Alternative 1)***	***Modified Retrospective Approach (Alternative 2)***
Opening balance sheet impact as on 1 April 2019:			
ROU Asset	1,60,126	1,65,787	1,81,820
Lease Liability	1,78,589	1,81,806	1,81,820
Period ended 31 March 2020 activity:			
Cash lease payments	2,00,000	2,00,000	2,00,000

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Lease payments recognised:			
Interest expense	21,411	18,194	18,180
Depreciation expense	1,60,127	1,65,787	1,81,820
Total periodic expense	1,81,538	1,83,981	2,00,002

*****

8.7.4 Disclosure

Disclosure requirements vary in accordance with the Transition Approach opted. The lessee shall disclose the following as required by Ind AS 8 (except that it is impracticable to determine the amount of the adjustment):

Full Retrospective Approach	***Modified Retrospective Approach***
(a) the title of the Ind AS;	(a) the title of the Ind AS;
(b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;	(b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
(c) the nature of the change in accounting policy;	(c) the nature of the change in accounting policy;
(d) when applicable, a description of the transitional provisions;	(d) when applicable, a description of the transitional provisions;
(e) when applicable, the transitional provisions that might have an effect on future periods;	(e) when applicable, the transitional provisions that might have an effect on future periods;
(f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment: (i) for each financial statement line item affected; and (ii) if Ind AS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;	(f) the weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the balance sheet at the date of initial application; and an explanation of any difference between: (i) operating lease commitments disclosed applying Ind AS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing

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	rate at the date of initial application; and (ii) lease liabilities recognised in the balance sheet at the date of initial application.
(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and	(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
(h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.	(h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied. Further, if a lessee uses one or more of the practical expedients (already discussed above), it shall disclose that fact.

8.7.5 Lessors

A lessor is not required to make any adjustments on transition for leases in which it is a lessor and shall account for those leases applying Ind AS 116 from the date of initial application **except** in case of an ***'Intermediate Lessor'*** who shall:

(a) reassess subleases that were classified as operating leases applying Ind AS 17 and are ongoing at the date of initial application, to determine whether each sublease should be classified as an operating lease or a finance lease applying Ind AS 116. The intermediate lessor shall perform this assessment at the date of initial application on the basis of the remaining contractual terms and conditions of the head lease and sublease at that date with reference to the ROU Asset associated with the head lease and not the underlying asset.

(b) for subleases that were classified as operating leases applying Ind AS 17 but, finance leases applying Ind AS 116, account for the sublease as a new finance lease entered into at the date of initial application. Any gain or loss arising on the sublease arrangement is included in the cumulative catch-up adjustment to retained earnings at the date of initial application.

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8.7.6 Sale and Leaseback Transactions before the date of Initial Application

An entity shall not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements under Ind AS 115 to be accounted for as a sale, i.e., a seller-lessee is prohibited from reassessing historical sale and leaseback transactions to determine whether a sale occurred in accordance with Ind AS 115.

Thus, a seller-lessee does not perform any retrospective adjustments to sale and leaseback transactions on transition to Ind AS 116. Instead, the leaseback is accounted for on transition in the following manner, depending on the classification:

Finance Lease	***Operating Lease***
If a sale and leaseback transaction was accounted for as a sale and a **finance lease** applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other finance lease that exists at the date of initial application ***AND*** (b) continue to amortise any gain on sale over the lease term.	If a sale and leaseback transaction was accounted for as a sale and **operating lease** applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other operating lease that exists at the date of initial application; ***AND*** (b) adjust the leaseback ROU asset for any deferred gains or losses that relate to off-market terms recognised in the balance sheet immediately before the date of initial application.

8.7.7 Amounts Previously recognised in respect of Business Combinations

If a lessee previously recognised an asset or a liability applying Ind AS 103 *Business Combinations*, relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination, the lessee shall derecognise that asset or liability and adjust the carrying amount of the ROU asset by a corresponding amount at the date of initial application.

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8.8 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following are the extracts from the financial statements of the listed entity 'InterGlobe Aviation Limited' for the financial year 2021-2022 with respect to 'ROU Assets' and 'Lease Liabilities'.

In the Assets side of the Balance Sheet:

	Note	As at 31 March 2022
I. ASSETS		
Non-current assets		
a. Property, plant and equipment	3.a	8,225.20
b. Right of use assets	4	204,381.48

4. Right of use assets

As at 31 March 2022

Particulars	Aircraft and Engines	Equipment	Leasehold Land	Buildings	Total
Gross value - at cost					
Balance at the beginning of the year	251,021.62	5,387.87	2,944.16	2,316.50	261,670.15
Additions during the year	68,365.07	-	344.13	255.64	68,964.84
Disposals during the year	18,858.35	-	-	153.93	19,012.28
Adjustments during the year *	3,576.74	-	-	(177.70)	3,399.04
Balance at the end of the year	304,105.08	5,387.87	3,288.29	2,240.51	315,021.75
Accumulated depreciation					
Balance at the beginning of the year	80,086.41	849.55	373.28	499.20	81,808.44
Depreciation for the year**	46,647.74	636.38	268.75	291.24	47,844.11
Depreciation on disposals	18,858.35	-	-	153.93	19,012.28
Balance at the end of the year	107,875.80	1,485.93	642.03	636.51	110,640.27
Net carrying value as at 31 March 2022	196,229.28	3,901.94	2,646.26	1,604.00	204,381.48

*Includes adjustment on account of foreign currency loss, arising on re-statement of long-term foreign currency monetary loans used for acquisition of a depreciable capital asset, amounting to Rs. 398.00 (previous year foreign currency gain amounting to Rs. 417.55) and modification on leases amounting to Rs. 3,001.04 (previous year Rs. 1,669.70).

** Depreciation for the year includes Rs. 61.67 (previous year Rs. 167.26) capitalised as part of Capital work-in-progress.

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In the Liabilities side of the Balance Sheet:

LIABILITIES			
Non-current liabilities			
a. Financial liabilities			
(i) Borrowings	17.a	4,161.71	3,816.28
(ia) Lease liabilities	17.b	250,586.59	202,805.34
Current liabilities			
a. Financial liabilities			
(i) Borrowings	17.a	34,805.65	21,239.95
(ia) Lease liabilities	17.b	79,224.42	70,734.97

17.b Lease liabilities

Particulars	As at 31 March 2022		As at 31 March 2021	
	Non-current	Current	Non-current	Current
Lease liabilities*	250,586.59	79,224.42	202,805.34	70,734.97
Total	250,586.59	79,224.42	202,805.34	70,734.97

The Company's leased assets primarily consist of leases for aircraft and engines, equipment, leasehold land and buildings.

Interest expense on lease liabilities for the year is amounting to Rs. 19,627.85 (previous year Rs.16,435.04) (including interest amounting to Rs. 109.45 (previous year Rs. 238.17) capitalised under capital work-in-progress). Refer to Note 26.

Certain lease liabilities amounting to Rs. 13,155.50 (previous year Rs. 16,153.80) are secured against the respective aircraft. Remaining lease liabilities are secured to the extent of letter of credits issued / deposits given to lessors.

The Company has recognised an expense of Rs. 3,116.84 (previous year Rs. 2,804.57) on account of short term leases which represents leased aircraft and engines having a remaining lease term of less than 12 months as on transition date and other short term leases. The portfolio of other short-term leases to which the Company is committed at the end of the reporting period is not materially different from the portfolio of other short term leases for which expense has been recognised during the year.

The Company has several lease contracts that include extension and termination options. The management has included termination options in determination of lease term for contracts having such option. Extension options have not been included in determination of lease term since the management is reasonably certain not to exercise these options. Potential cash flows in relation to such extension options cannot be ascertained since the cash outflow for the extended period will depend on the negotiations with the lessors in the event of exercising the extension options.

Under certain lease arrangements of aircraft and engines, the Company incurs variable payments towards maintenance of the aircraft which are disclosed under "Supplementary rentals and aircraft repair and maintenance (net)".

The Company has entered into sale and leaseback arrangements, for certain aircraft and engines owned and controlled by the Company, to increase its liquidity. The Company has recorded proceeds of Rs. 6,006.43 (previous year Rs. 18,833.68) (net) from the sale and leaseback arrangements as disclosed in the Standalone Cash Flow Statement. The profit (net of loss) on sale and leaseback arrangements is Rs.750.96 (previous year Rs. 12.81) disclosed in Note 23.

Future cash outflows for leases not yet commenced amounts to Rs. 64,435.43 (previous year Rs. 62,343.06).

The maturity analysis of lease liabilities are disclosed in Note 29. Further, information about the Company's exposure to market risks is disclosed in Note 29.

*Includes lease liabilities with related parties amounting to Rs. 5,093.61 (previous year Rs. 5,429.29). Refer to Note 35.

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ACCOUNTING POLICY

Leases

The Company's lease asset classes primarily consist of leases for aircraft and engines, equipment, leasehold land and buildings. The Company assesses at the inception date whether a contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

i) Lease liabilities

At the commencement date, the Company measures the lease liabilities at the present value of the lease payments that are not paid at that date. The lease liabilities include lease payments, payment of penalties for terminating the lease, if the lease term reflects the Company exercising the option to terminate, exercise price of a purchase option, if the company is reasonably certain to exercise that option, less any incentives receivable.

The lease payments are discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the Company uses incremental borrowing rate (IBR). The IBR is the rate of interest that the Company would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right of use assets in a similar economic environment.

After the commencement date, the amount of lease liabilities is increased to reflect the accretion of interest and reduced by the lease payments made. In addition, the carrying amount of lease liabilities is re-measured if there is a lease modification, including modification in the lease term, lease payments or assessment of an option to purchase the underlying asset. The lease liabilities are re-measured by discounting the revised lease payments using a revised discount rate at the effective date of the modification.

ii) Right of use assets

At the commencement date, the right of use assets are measured at cost. The cost includes an amount equal to the lease liabilities plus any lease payments made before the commencement date and any initial direct costs, less any incentives received from equipment manufacturer in terms of the same lease. An estimate of costs to be incurred in respect of redelivery obligation, in accordance with the terms of the lease, is also included in the right of use assets at commencement date.

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After the commencement date, the right of use assets is measured in accordance with the accounting policy for property, plant and equipment i.e. right of use assets are measured at cost, less any accumulated depreciation and impairment losses, if any. Right of use assets are also correspondingly adjusted to reflect any re-measurement impact in the lease liabilities on account of lease modification. The right of use assets are also subject to impairment. Refer to the accounting policies in Note 2.(b) (xiv) Impairment of non-financial assets.

iii) Lease Term

At the commencement date, the Company determines the lease term which represents non-cancellable period of initial lease for which the asset is expected to be used, together with the periods covered by an option to extend or terminate the lease, if the Company is reasonably certain at the commencement date to exercise the extension or termination option.

iv) Other Leases

Lease payments associated with any other leases which falls outside the purview of Ind AS 116, short term leases and leases for which the underlying asset is of low value are charged to Standalone Statement of Profit and Loss on straight line basis over the lease term or another systematic basis which is more representative of the pattern of use of underlying asset.

v) Sale and leaseback transactions

The right of use arising from leaseback is measured at the proportion of previous carrying amount of the asset that relates to right of use retained by the Company. Where sale proceeds (net of maintenance obligation, if any) received are judged to reflect the aircraft's fair value, any gain or loss arising on disposal is recognised in the Standalone Statement of Profit and Loss, to the extent that it relates to the rights that have been transferred. Gains and losses that relate to the rights that have been retained are included in the carrying amount of the right of use assets recognised at commencement of the lease. Where sale proceeds (net of maintenance obligation, if any) received are not at the aircraft's fair value, any below market terms are recognised as a prepayment of lease payments, and above market terms are recognized as additional financing provided by the lessor.

vi) Depreciation

Depreciation on assets held as right of use assets is charged to Standalone Statement of Profit and Loss on a straight-line basis from the commencement date to the earlier of

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the end of the useful life of the right of use assets or the end of the lease term, except for leased aircraft previously classified as finance leases under erstwhile Ind AS where depreciation is charged on useful life of right of use assets.

Depreciation on right of use assets has been charged based on the following period:

Asset Head	***Useful life in years***
Aircraft and engines:	
— *Aircraft and engines components including spare engines*	*1-12*
— *Leased aircraft previously classified as finance lease under erstwhile Ind AS*	*20*
— *Major inspection and overhaul costs (Refer to Note 2(b) (xxi))*	*2-12*
Equipment	*8*
Leasehold land	*15-20*
Buildings	*1-10*

(Source: Annual Report 2021-2022 - 'InterGlobe Aviation Limited')

8.9 KEY DIFFERENCES BETWEEN IND AS 17 AND IND AS 116

The significant differences between Ind AS 17 (Earlier Standard on Leases) and Ind AS 116 (New Standard on Leases) are given below:

Sr. No.	***Particulars***	***Ind AS 17***	***Ind AS 116***
1	Lease Definition	A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the **right to use** an asset for an agreed period of time. Under Appendix C to Ind AS 17 *Determining whether an Arrangement contains a Lease*,	A lease is a contract, or part of a contract, that conveys the **right to control** the use of an asset (the underlying asset) for a period of time in exchange for consideration. To determine if the right to control has been conveyed to the customer, an entity

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		it is not necessary for an arrangement to convey the right to control the use of an asset to be in scope of Ind AS 17.	assesses whether, throughout the period of use, the customer has the right to obtain substantially all of the economic benefits from use of the identified asset and **the right to direct the use** of the identified asset.
2	Short-term lease exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases with a lease term of 12 months or less and without a purchase option. This option is available by **'class of underlying asset'** to which the right of use relates.
3	Leases of low-value assets exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases of low-value assets. Examples of such assets include tablets and personal computers, small items of office furniture and telephones. This option is available on a **'lease-by lease'** basis.
4	Lease Classification	Lessees apply a **dual** recognition and measurement approach for all leases. Lessees classify a lease as a 'finance lease' if it transfers substantially all the risks and rewards incidental to ownership. Otherwise a lease is classified as an 'operating lease'.	Lessees apply a **single** recognition and measurement approach for all leases, with options not to recognize ROU assets and lease liabilities for short-term leases and leases of low-value assets. There is not more classification of leases into operating and finance in case of lessees.

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5	Lease Payments	At the commencement of the lease term, lessees recognize finance leases as assets and liabilities in their balance sheet at amounts equal to: a) the fair value of the leased property ***OR*** b) the present value of the minimum lease payments, whichever is **lower**, each determined at the inception of the lease. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee. No assets and liabilities are recognized for the initial measurement of operating leases, i.e., operating leases only impacted the statement of profit or loss.	At the commencement date, lessees measure the lease liability at the present value of the lease payments to be made over the lease term (except short-term leases and leases of low-value assets). Lease payments include: a) Fixed payments (including in-substance fixed payments), **less** any lease incentives receivable; b) Variable lease payments that depend on an index or a rate, initially measured using the index or rate at the commencement date; c) Amounts expected to be payable by the lessee under residual value guarantees; d) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; e) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease. In addition, the cost of the ROU asset comprises: a) The lease liability (as calculated above); b) Lease payments made at or before the commencement date, **less** any lease incentives received; c) Initial direct costs;

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			d) Asset retirement obligations (unless those costs are incurred to produce inventories).
6	Reassessment of lease liability	Does not apply under Ind AS 17	After the commencement date, lessees are required to remeasure the lease liability when there is a lease modification (i.e., a change in the scope of a lease, ***OR*** the consideration for a lease that was not a part of the original terms and conditions of the lease) that is **NOT** accounted for as a separate contract. Lessees are also required to remeasure lease payments upon a change in **ANY** of the following: - The lease term; - The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset; - The amounts expected to be payable under residual value guarantees; - Future lease payments resulting from a change in an index or rate.
7	Lease income from operating leases	Ind AS 17 contains a **carve out** of not straight-lining the lease escalation, if they are in line with the expected general inflation compensating the lessor for expected inflationary cost.	There is **no such carve out** under Ind AS 116 and thus, a lessor shall recognize lease payments from operating leases as income on either a straight-line basis or another systematic basis.

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8	Lease modifications to an operating lease	Ind AS 17 doesn't mention about this.	Lessors account for a modification to an operating lease as a **new lease** from the effective date of the modification (considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease).
9	Lease modifications which do not result in new separate leases	Ind AS 17 doesn't mention about this.	**Lessees:** a) Allocate the consideration in the modified contract; b) Determine the lease term of the modified lease; c) Remeasure the lease liability by discounting the revised lease payments using a revised discount rate with a corresponding adjustment to ROU asset. Additionally, lessees recognize in profit or loss any gain or loss relating to the partial or full termination of the lease. **Lessors:** If a lease would have been an operating lease, had the modification been in effect at the inception date, lessors in a finance lease would: (i) Account for the modification as a new lease; (ii) Measure the carrying amount of the underlying asset as the net investment in the lease immediately

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			before the effective date of the modification. Otherwise, the modification is accounted for in accordance with Ind AS 109 *Financial Instruments*.
10	Presentation (Lessees) – Balance Sheet	Ind AS 17 doesn't mention about this.	**ROU Assets:** They are presented either: - Separately from other assets (e.g., owned assets) ***OR*** - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are presented as investment property **Lease Liabilities:** They are presented either: - Separately from other liabilities ***OR*** - Together with other liabilities with disclosure of the balance sheet line items that include lease liabilities and their amounts.
11	Presentation (Lessees) – Statement of profit or loss	Operating lease expense is presented as a **single item**.	**Depreciation and Interest:** Lease-related depreciation and lease-related interest expense are presented **separately** (i.e., they **CANNOT** be combined). This is because interest

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			expense on the lease liability is a component of finance costs, which paragraph 82(b) of Ind AS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss.
12	Presentation (Lessees) – Cashflow statement	**For operating leases:** Cash payments are included within **operating activities**.	**Principal portion of the lease liability:** - These cash payments are presented within financing activities **Interest portion of the lease liability:** - These cash payments are presented within financing activities **Short-term leases and leases of low-value assets:** - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within operating activities **Variable lease payments not included in the lease liability:** - These are also presented within operating activities **Non-cash activity:** Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)
13	Disclosures	Quantitative and qualitative disclosures are required but,	**Detailed** disclosures (including the format of disclosure) are

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		generally **fewer** disclosures are required than those under Ind AS 116.	required under Ind AS 116. **Additionally**, qualitative and quantitative information about leasing activities is required in order to meet the disclosure objective.
14	Sale and leaseback transactions – 'Sale'	Ind AS 17 focuses on whether the leaseback is an **operating or finance** lease.	Seller-lessees and buyer-lessors apply the requirements in Ind AS 115 to determine whether a **sale** has occurred in a sale and leaseback transaction.
15	Sale and leaseback transactions – Accounting by seller-lessees	If a sale and leaseback transaction results in a **finance lease**, any excess of sales proceeds over the carrying amount are deferred and amortized over the lease term. If a sale and leaseback transaction results in an **operating lease**, and it is clear that the transaction is established at fair value, any profit or loss is recognized immediately.	The seller-lessee measures the **ROU asset** arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right-of use retained by the seller-lessee and recognizes only the amount of any gain or loss that relates to the rights transferred to the buyer lessor.
16	Sale and leaseback transactions – Transactions NOT at fair value	If a sale and leaseback transaction results in an **operating lease** and the sale price is: - Below fair value: Any profit or loss is recognized immediately except that, if the loss is compensated for by future lease payments at below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected	If the fair value of the consideration for the sale of an asset does **NOT** equal the fair value of the asset ***OR*** if the payments for the lease are not at market rates then, an entity is required to measure the sale proceeds at fair value with an adjustment (as appropriate) either as a prepayment of lease

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		to be used. - Above fair value: The excess over fair value is deferred and amortised over the period for which the asset is expected to be used.	payments (any **below** market terms) ***OR*** additional financing (any **above** market terms).
17	Business combinations – Acquiree is a lessee	Unlike Ind AS 116, there is no exemption under Ind AS 17 for leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of low value (i.e., recognition exemptions). An intangible asset is recognized if the terms of operating lease are favourable relative to market terms and a liability is recognized if terms are unfavourable relative to market terms. An intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms.	The acquirer is not required to recognize ROU assets and lease liabilities for leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of a lower value (i.e., recognition exemptions). The acquirer measures the ROU asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease, relative to market terms.

8.9 KEY DIFFERENCES BETWEEN IND AS 116 AND AS 19

The significant differences between Ind AS 116 and AS 19 are given below:

Sr. No.	Particulars	Ind AS 116	AS 19
1	Lease definition	Under Ind AS 116, the definition of lease is similar to that in AS 19. But, in Ind AS 116, there is substantial	Under Ind AS 116, the definition of lease is similar to that in AS 19. However,

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		change in the guidance of how to apply this definition. The changes primarily relate to the concept of 'control' used in identifying whether a contract contains a lease or not. Ind AS 116 provides detailed guidance on whether an arrangement contains a lease or whether there are non-lease / service components within the arrangement.	guidance part given therein is different.
2	Modifications	Ind AS 116 brings in comprehensive prescription on accounting of modifications in lease contracts. It permits leases, as a practical expedient, not to assess whether the rent concessions that occur as a direct consequence of COVID 19 pandemic and meet specified conditions are lease modifications and instead, to account for those rent concessions as if they were not lease modifications.	No such comprehensive coverage is there
3	Scope	Ind AS 116 has no such scope exclusion	AS 19 excludes leases of land from its scope
4	Definition	Ind AS 116 makes a distinction between 'inception of lease' and 'commencement of lease'	No such distinction has been made in AS 19
5	Classification	Ind AS 116 eliminates the requirement of classification of leases as either operating leases or finance leases for a lessee and instead, introduces a single lessee accounting model which requires lessee to recognise assets and liabilities for all leases unless it applies the recognition exemption (for leases of low value assets or short-term leases)	AS 19 requires a lessee to classify leases as either finance leases or operating leases

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6	Sale & Leaseback transactions	In Ind AS 116, the approach for computation of gain/loss for a completed sale is different. The amount of gain/loss should reflect the amount that relates to the right transferred to the buyer-lessor.	As per AS 19, if a sale and leaseback transaction results in a finance lease, excess, if any, of the sale proceeds over the carrying amount shall be deferred and amortised by the seller-lessee over the lease term in proportion to depreciation of the leased asset.
		Ind AS 116 requires a seller-lessee and a buyer-lessor to use the definition of a sale as per Ind AS 115, *Revenue from Contracts with Customers* to determine whether a sale has occurred in a sale and leaseback transaction. If the transfer of the underlying asset satisfies the requirements of Ind AS 115 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor. If not, then the seller-lessee shall recognise a finance liability and the buyer-lessor will recognise a financial asset to be accounted for as per the requirements of Ind AS 109, *Financial Instruments*.	AS 19 does not contain such specific requirement
7	Treatment of initial direct costs		
	Finance lease – lessor accounting		
	Non-manufacturer/ Non-dealer	Interest rate implicit in the lease is defined in such a way that the initial direct costs included automatically in the finance lease receivable.	Either recognised as expense immediately or allocated against the finance income over the lease term.
	Manufacturer/d	Same as per AS 19.	Recognised as expense

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	ealer		immediately.
	Operating lease- Lessor accounting	Added to the carrying amount of the leased asset and recognised as expense over the lease term on the same basis as lease income.	Either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or recognized as expense in the period in which incurred
8	Initial direct costs	Ind AS 116 contains clearer definition of 'initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. Ind AS 116 define initial direct costs as 'Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.' Further, definition of the term 'interest rate implicit in the lease' has been modified in Ind AS 116.	Different guidance given
9	Presentation	As a consequence of introduction of single lease model for lessees, there are many changes in the presentation in the three components of financial statements *viz.* Balance sheet, Statement of Profit and Loss, Statement of Cash flows.	Different guidance given
10	Disclosure	There are a number of changes in the disclosure relating to qualitative aspects of leasing transactions. For eg. Entities are required to disclose the nature and risks arising from leasing transactions. Also, in case of lessor, there are changes in the disclosure of maturity analysis of leases payments receivable.	Different guidance given

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8.10 MAJOR CHANGES UNDER IND AS 116 FROM IFRS 16

Ind AS 116, like other Ind AS, has been converged from the global standards, i.e., IFRS, which has been made applicable to the Indian entities (based on the net worth criteria) in a phased manner via Ministry of Corporate Affairs Roadmap. While converging from IFRS 16 (which is applicable globally from the reporting periods beginning on or after 1 January 2019), following are the carve outs given under Appendix 1 to Ind AS 116, keeping in mind, the requirements of other converged Ind AS and the economic environment in India:

S. No.	Particulars	IFRS 16	Ind AS 116
1	Subsequent measurement of investment property	Paragraph 34 of IFRS 16 provides that if lessee applies fair value model in IAS 40 to its investment property, it shall apply that fair value model to the ROU assets that meet the definition of investment property.	Paragraph 34 has been **deleted** under Ind AS 116 since Ind AS 40 *Investment Property* does **NOT** allow the use of fair value model. Consequently, reference of the same appearing anywhere under Ind AS 116 has also been **deleted**.
2	Interest portion of lease liability – classification in cash flow statement	Paragraph 50(b) of IFRS 16 requires classifying cash payments for interest portion of lease liability applying requirements of IAS 7 *Statement of Cash Flows*. IAS 7 provides option of treating interest paid as **operating or financing activity**.	Ind AS 7 requires interest paid to be treated as **financing activity only**. Accordingly, paragraph 50(b) has been **modified** under Ind AS 116 to specify that cash payments for interest portion of lease liability will be classified as financing activities applying Ind AS 7.

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TEST YOUR KNOWLEDGE

QUESTIONS

1. A lessee enters into a ten-year contract with a lessor (freight carrier) to transport a specified quantity of goods. Lessor uses rail wagons of a particular specification and has a large pool of similar rail wagons that can be used to fulfil the requirements of the contract. The rail wagons and engines are stored at lessor's premises when they are not being used to transport goods. Costs associated with substituting the rail wagons are minimal for lessor.

   Whether the lessor has substantive substitutions rights and whether the arrangement contains a lease?

2. Customer M enters into a 20-year contract with Energy Supplier S to install, operate and maintain a solar plant for M's energy supply. M designed the solar plant before it was constructed – M hired experts in solar energy to assist in determining the location of the plant and the engineering of the equipment to be used. M has the exclusive right to receive and the obligation to take any energy produced. Whether it can be established that M is having the right to control the use of identified asset?

3. A Customer enters into a ten-year contract with a Company (a ship owner) for the use of an identified ship. The customer decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent the company from sailing the ship into waters at a high risk of piracy or carrying explosive materials. The company operates and maintains the ship and is responsible for safe passage.

   Does the customer have the right to direct how and for what purpose the ship is to be used throughout the period of use and whether the arrangement contains a lease?

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4. A Lessee enters into a ten-year lease contract with a Lessor to use equipment. The contract includes maintenance services (as provided by the lessor). The Lessor obtains its own insurance for the equipment. Annual payments are ₹ 10,000 (₹ 1,000 related to maintenance services and ₹ 500 to insurance costs).

   The Lessee is able to determine that similar maintenance services and insurance costs are offered by third parties for ₹ 2,000 and ₹ 500 a year, respectively. The Lessee is unable to find an observable stand-alone rental amount for similar equipment because none is leased without related maintenance services provided by the lessor.

   How would the Lessee allocate the consideration to the lease component?

5. A Lessee enters into a non-cancellable lease contract with a Lessor to lease a building. Initially, the lease is for five years, and the lessee has the option to extend the lease by another five years at the same rental.

   To determine the lease term, the lessee considers the following factors:

   - Market rentals for a comparable building in the same area are expected to increase by 10% over the ten-year period covered by the lease. At inception of the lease, lease rentals are in accordance with current market rents.
   - The lessee intends to stay in business in the same area for at least 20 years.
   - The location of the building is ideal for relationships with suppliers and customers.

   What should be the lease term for lease accounting under Ind AS 116?

6. A Lessee enters into a lease of a five-year-old machine. The non-cancellable lease term is 15 years. The lessee has the option to extend the lease after the initial 15-year period for optional periods of 12 months each at market rents.

   To determine the lease term, the lessee considers the following factors:

   - The machine is to be used in manufacturing parts for a type of plane that the lessee expects will remain popular with customers until development and testing of an improved model are completed in approximately 15 years.
   - The cost to install the machine in lessee's manufacturing facility is significant.
   - The non-cancellable term of lessee's manufacturing facility lease ends in 15 years, and the lessee has an option to renew that lease for another twelve years.
   - Lessee does not expect to be able to use the machine in its manufacturing process for other types of planes without significant modifications.
   - The total remaining life of the machine is 30 years.

   What should be the lease term for lease accounting under Ind AS 116?

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7. A Company leases a manufacturing facility. The lease payments depend on the number of operating hours of the manufacturing facility, i.e., the lessee has to pay ₹ 2,000 per hour of use. The annual minimum payment is ₹ 2,00,00,000. The expected usage per year is 20,000 hours.

   Whether the said payments be included in the calculation of lease liability under Ind AS 116?

8. Entity X (lessee) entered into a lease agreement ('lease agreement') with Entity Y (lessor) to lease an entire floor of a shopping mall for a period of 9 years. The annual lease rent of ₹ 70,000 is payable at year end. To carry out its operations smoothly, Entity X simultaneously entered into another agreement ('facilities agreement') with Entity Y for using certain other facilities owned by Entity Y such as passenger lifts, DG sets, power supply infrastructure, parking space etc., which are specifically mentioned in the agreement, for annual service charges amounting to ₹ 1,00,000. As per the agreement, the ownership of the facilities shall remain with Entity Y. Lessee's incremental borrowing rate is 10%.

   The facilities agreement clearly specifies that it shall be co-existent and coterminous with 'lease agreement'. The facility agreement shall stand terminated automatically on termination or expiry of 'lease agreement'.

   Entity X has assessed that the stand-alone price of 'lease agreement' is ₹ 1,20,000 per year and stand-alone price of the 'facilities agreement' is ₹ 80,000 per year. Entity X has not elected to apply the practical expedient in paragraph 15 of Ind AS 116 of not to separate non-lease component(s) from lease component(s) and accordingly it separates non-lease components from lease components.

   How will Entity X account for lease liability as at the commencement date?

9. Entity X is an Indian entity whose functional currency is Indian Rupee. It has taken a plant on lease from Entity Y for 5 years to use in its manufacturing process for which it has to pay annual rentals in arrears of USD 10,000 every year. On the commencement date, exchange rate was USD = ₹ 68. The average rate for Year 1 was ₹ 69 and at the end of year 1, the exchange rate was ₹ 70. The incremental borrowing rate of Entity X on commencement of the lease for a USD borrowing was 5% p.a.

   How will entity X measure the right of use (ROU) asset and lease liability initially and at the end of Year 1?

ANSWERS

1. In this case, the rail wagons are stored at lessor's premises, and it has a large pool of similar rail wagons and substitution costs to be incurred are minimal. Thus, the lessor has the practical ability to substitute the asset. If at any point, the same becomes economically

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beneficial for the lessor to substitute the wagons, he can do so and hence, the lessor's substitution rights are substantive, and the arrangement does not contain a lease.

2. In this case, the nature of the solar plant is such that all the decisions about how and for what purpose the asset is used are predetermined because:

– the type of output (i.e. energy) and the production location are predetermined in the agreement; and

– when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because M designed the solar plant and thereby predetermined any decisions about how and for what purpose it is used, M is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give the supplier the right to direct how, and for what purpose the solar plant is used. Hence, M has a right to control the use of asset.

3. The customer has the right to direct the use of the ship because the contractual restrictions are merely protective rights that protect the company's investment in the ship and its personnel. In the scope of its right of use, the customer determines how and for what purpose the ship is used throughout the ten-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport.

The customer has the right to change these decisions throughout the period of use and hence, the contract contains a lease.

4. The observable stand-alone price for maintenance services is ₹ 2,000. There is no observable stand-alone price for the lease. Further, the insurance cost does not transfer a good or service to the lessee and therefore, it is not a separate lease component.

Thus, the Lessee allocates ₹ 8,000 (₹ 10,000 – ₹ 2,000) to the lease component.

5. After considering all the stated factors, the lessee concludes that it has a significant economic incentive to extend the lease.

Thus, for the purpose of lease accounting under Ind AS 116, the lessee uses a lease term of ten years.

6. The lessee notes that the terms for the optional renewal provide no economic incentive and the cost to install is significant. The lessee has no incentive to make significant modifications to the machine after the initial 15-year period. Therefore, the lessee does not expect to have a business purpose for using the machine after the non-cancellable lease term of 15 years.

Thus, the lessee concludes that the lease term consists of 15-year non-cancellable period only.

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7. The said lease contains in-substance fixed payments of ₹ 2,00,00,000 per year, which are included in the initial measurement of the lease liability under Ind AS 116.

However, the additional ₹ 2,00,00,000 that the company expects to pay per year are variable payments that do not depend on an index or rate and, thus, are not included in the initial measurement of the lease liability but, are expensed when the over-use occurs.

8. Entity X identifies that the contract contains lease of premises and non-lease component of facilities availed. As Entity X has not elected to apply the practical expedient as provided in paragraph 15, it will separate the lease and non-lease components and allocate the total consideration of ₹ 1,70,000 to the lease and non-lease components in the ratio of their relative stand-alone selling prices as follows:

Particulars	Stand-alone Prices	% of total Stand-alone Price	Allocation of consideration
	₹		₹
Building rent	1,20,000	60%	1,02,000
Service charge	80,000	40%	68,000
Total	**2,00,000**	**100%**	**1,70,000**

As Entity X's incremental borrowing rate is 10%, it discounts lease payments using this rate and the lease liability at the commencement date is calculated as follows:

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A x B = C)
Year 1	1,02,000	0.909	92,718
Year 2	1,02,000	0.826	84,252
Year 3	1,02,000	0.751	76,602
Year 4	1,02,000	0.683	69,666
Year 5	1,02,000	0.621	63,342
Year 6	1,02,000	0.564	57,528
Year 7	1,02,000	0.513	52,326
Year 8	1,02,000	0.467	47,634
Year 9	1,02,000	0.424	43,248
Lease Liability at commencement date			**5,87,316**

Further, ₹ 68,000 allocated to the non-lease component of facility used will be recognised in profit or loss as and when incurred.

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9. On initial measurement, Entity X will measure the lease liability and ROU asset as under:

Year	Lease Payments (USD)	Present Value factor @ 5%	Present Value of Lease Payment	Conversion rate (spot rate)	INR value
1	10,000	0.952	9,520	68	6,47,360
2	10,000	0.907	9,070	68	6,16,760
3	10,000	0.864	8,640	68	5,87,520
4	10,000	0.823	8,230	68	5,59,640
5	10,000	0.784	7,840	68	5,33,120
Total			**43,300**		**29,44,400**

As per Ind AS 21 *The Effects of Changes in Foreign Exchange Rates*, monetary assets and liabilities are restated at each reporting date at the closing rate and the difference due to foreign exchange movement is recognised in profit and loss whereas non-monetary assets and liabilities carried measured in terms of historical cost in foreign currency are not restated.

Accordingly, the ROU asset in the given case being a non-monetary asset measured in terms of historical cost in foreign currency will not be restated but the lease liability being a monetary liability will be restated at each reporting date with the resultant difference being taken to profit and loss.

At the end of Year 1, the lease liability will be measured in terms of USD as under:

Lease Liability:

Year	Initial Value (USD) (a)	Lease Payment (b)	Interest @ 5% (c) = (a x 5%)	Closing Value (USD) (d = a + c - b)
1	43,300	10,000	2,165	35,465

Interest at the rate of 5% will be accounted for in profit and loss at average rate of ₹ 69 (i.e., USD 2,165 x 69) = ₹ 1,49,385.

Particulars		Dr. (₹)	Cr. (₹)
Interest Expense	Dr.	1,49,385	
To Lease liability			1,49,385

Lease payment would be accounted for at the reporting date exchange rate, i.e. ₹ 70 at the end of year 1

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Particulars		Dr. (₹)	Cr. (₹)
Lease liability	Dr.	7,00,000	
To Cash			7,00,000

As per the guidance above under Ind AS 21, the lease liability will be restated using the reporting date exchange rate i.e., ₹ 70 at the end of Year 1. Accordingly, the lease liability will be measured at ₹ 24,82,550 (35,465 x ₹ 70) with the corresponding impact due to exchange rate movement of ₹ 88,765 (24,82,550 – (29,44,400 + 1,49,385 – 700,000) taken to profit and loss.

At the end of year 1, the ROU asset will be measured as under:

Year	Opening Balance (₹)	Depreciation (₹)	Closing Balance (₹)
1	29,44,400	5,88,880	23,55,520

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NOTES

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CHAPTER 7

OTHER INDIAN ACCOUNTING STANDARDS



UNIT 1:
INDIAN ACCOUNTING STANDARD 41: AGRICULTURE

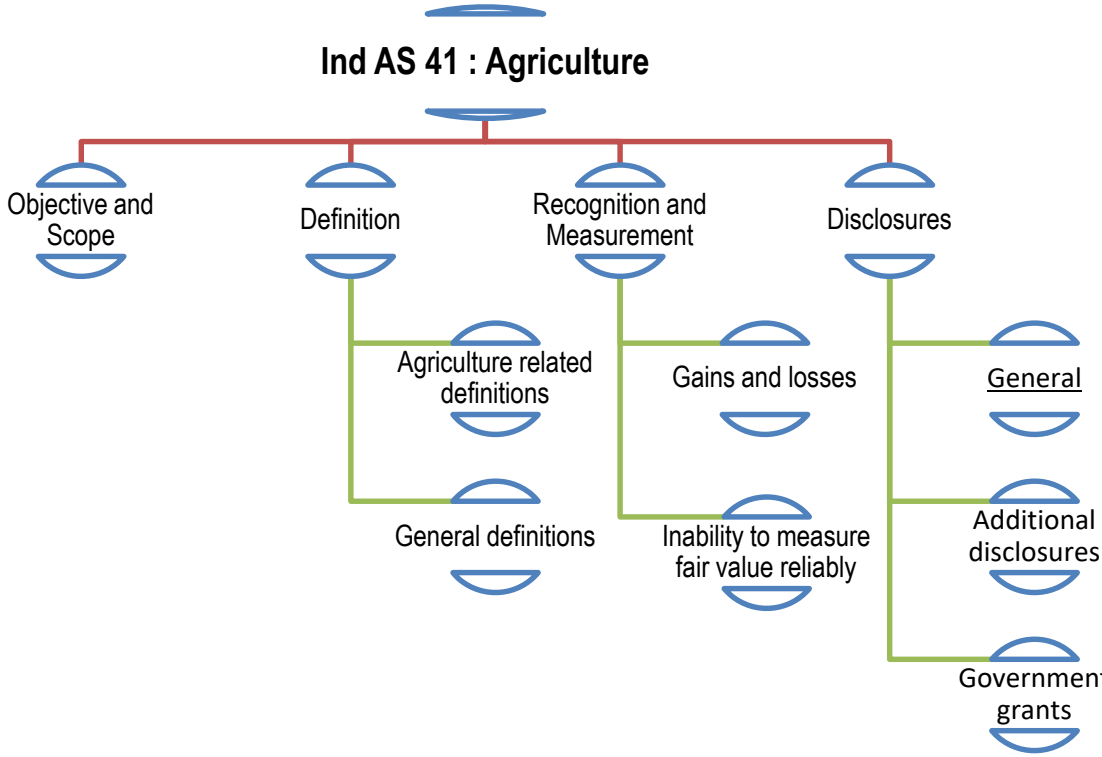
LEARNING OUTCOMES

After studying this unit, you will be able to:

- State the objective and scope of the standard
- Define the terms agricultural activity, agricultural produce, bearer plant, biological asset and biological transformation
- Explain the principles of recognition and measurement
- Compute the gain and loss on initial and subsequent measurement
- Account for the grant relating to a biological asset
- List the various disclosures prescribed in this standard

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UNIT OVERVIEW



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1.1 INTRODUCTION AND OBJECTIVE

Ind AS 41, Agriculture is the first standard that specifically covers the accounting and reporting requirements for the primary sector. Prior to this standard, there were no established guidance on agriculture and allied industry. This Standard introduces a fair value model to agriculture accounting which is a major shift away from the traditional cost model widely applied in primary industry.

Ind AS 41 Agriculture sets out the accounting for agricultural activity, the management of the transformation of biological assets (living plants and animals) into agricultural produce (harvested product of the entity's biological assets). The standard generally requires biological assets to be measured at fair value less costs to sell.

Ind AS 41 addresses following key critical issues:

(a) When should a biological asset or agricultural produce be recognised on the Balance Sheet?

(b) At what value should a recognised biological asset or agricultural produce be measured?

(c) How should the differences in value of a recognised biological asset or agricultural produce be accounted for between two different reporting dates?

(d) What should be the key disclosures?

1.2 SCOPE

1. This Standard shall be applied to account for the following when they **relate to agricultural activity**:

   (a) biological assets;

   (b) agricultural produce at the point of harvest; and

   (c) government grants

2. **Ind AS 41 does not apply to:**

   (a) land related to agricultural activity : for example, the land on which the biological assets grow, regenerate and/or degenerate (Ind AS 16 *Property, Plant and Equipment* and Ind AS 40 *Investment Property*);

   (b) bearer plants related to agricultural activity. Such bearer plants are covered within the scope of Ind AS 16, Property, plant and Equipment and is accounted as per the provisions of that standard. However, this Standard applies to the produce on those bearer plants.

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(c) government grants related to bearer plants (Ind AS 20 *Accounting for Government Grants and Disclosure of Government Assistance*).

(d) intangible assets associated with the agricultural activity, for example licenses and rights are covered under Ind AS 38 *Intangible Assets* and provisions of this standard will be applicable.

(e) right-of-use assets arising from a lease of land related to agricultural activity (Ind AS 116, Leases).

This Standard is applied to agricultural produce, which is the **harvested product** of the entity's biological assets, **only at the point of harvest**. Thereafter, Ind AS 2 or another applicable Standard is applied.

Examples 1 & 2

1. Processing of grapes into wine by a vintner who has grown the grapes. While such processing may be a logical and natural extension of agricultural activity, and the events taking place may bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity in this Standard.
2. Agriculture produces after the point of harvest, for example Wool, meat, fruit, rubber, logs that are processed subsequently are not covered within purview of this standard and Ind AS 2 *Inventories* shall apply.

The table below provides examples of biological assets, agricultural produce, and products that are the result of processing after harvest:

Biological assets	Agricultural produce	Products that are the result of processing after harvest
Sheep	Wool	Yarn, carpet
Trees in a timber plantation	Felled Trees	Logs, lumber
Dairy Cattle	Milk	Cheese
Pigs	Carcass	Sausages, cured hams
Cotton plants	Harvested cotton	Thread, clothing
Sugarcane	Harvested cane	Sugar
Tobacco plants	Picked leaves	Cured tobacco
Tea bushes	Picked leaves	Tea
Grape vines	Picked grapes	Wine
Fruit trees	Picked fruit	Processed fruit
Rubber trees	Harvested latex	Rubber products

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Some plants, for example, tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are within the scope of Ind AS 16, *Property, plant and Equipment*. However, the produce growing on bearer plants, for example, tea leaves, grapes, oil palm fruit and latex, are within the scope of Ind AS 41.

1.3 RELEVANT DEFINITIONS

The following are the key Agriculture-related definitions:

(a) **Agricultural activity** refers to the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

The standard states that 'agricultural activity' covers a wide range of activities, e.g. 'raising livestock, forestry, annual or perennial cropping, cultivating orchards and plantations, floriculture, and aquaculture (including fish farming)'. Nevertheless, these agricultural activities have certain common features:

I. **Capability to change** Living animals and plants are capable of biological transformation;

II. **Management of change** Management facilitates biological transformation by enhancing, or at least stabilising, conditions necessary for the process to take place (for example, nutrient levels, moisture, temperature, fertility, and light). Such management distinguishes agricultural activity from other activities. For example, harvesting from unmanaged sources (such as ocean fishing and deforestation) is not agricultural activity; and

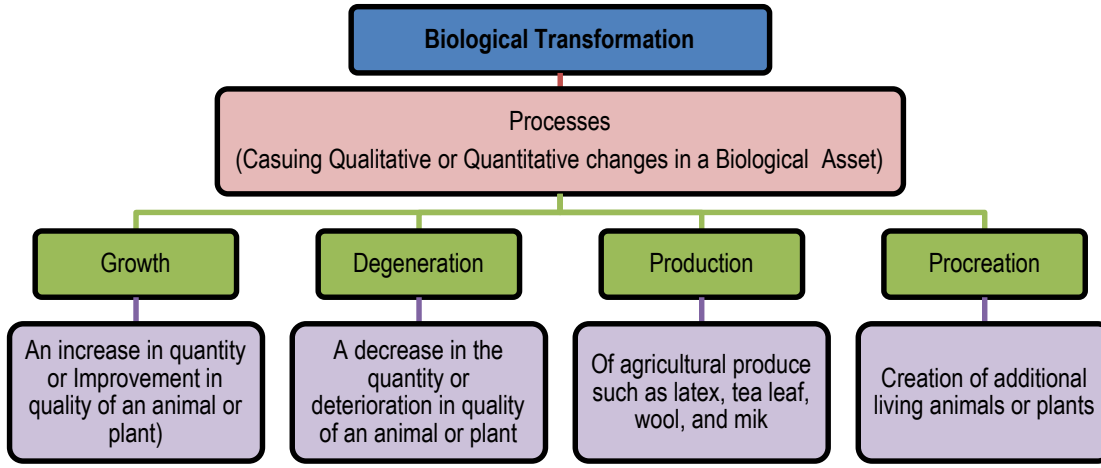
III. **Measurement of change** The change in quality (for example, genetic merit, density, ripeness, fat cover, protein content, and fibre strength) or quantity (for example, progeny, weight, cubic metres, fibre length or diameter, and number of buds) brought about by biological transformation or harvest is measured and monitored as a routine management function.

Ind AS 41 does not deal with the processing of agricultural produce after harvest. The standard makes it clear that, even if the processing is considered 'a logical and natural extension of agricultural activity, and the events taking place bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity'. For example, the process of brewing beer – in which yeast (a fungus) converts sugars into alcohol – would not meet the definition of agricultural activity in the standard. Similarly, cheese production would fall outside the definition of agricultural activity.

(b) **Biological Asset** is defined as a living animal or plant.

(c) **Biological transformation** comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in biological asset.

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(d) **Agricultural produce** is the harvested product of the entity's biological assets.

Ind AS 41 only applies to agricultural produce (i.e. harvested produce) at the point of harvest; not prior or subsequent to harvest. Under Ind AS 41, unharvested agricultural produce is considered to be part of the biological asset from which it will be harvested. Therefore, before harvest, agricultural produce should not be accounted for separately from the biological asset from which it comes. For example, milk is accounted for as part of the dairy cow right up to the moment at which the cow is milked.

Subsequent to harvest, agricultural produce is accounted for under Ind AS 2 or another standard, if applicable. Under Ind AS 2, agricultural produce is initially recognised as inventory at its fair value less costs to sell (measured in accordance with Ind AS 41), which becomes its cost for Ind AS 2 purposes.

(e) **Harvest** is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

(f) **Fair Value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (The definition of Fair value is as given in Ind AS 113, Fair Value Measurement)

(g) **Costs to sell** are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. Therefore, of all the costs that are necessary for a sale to occur, costs to sell include those that would otherwise not arise. Examples of costs to sell could include brokers' and dealers' commissions, levies by regulatory agencies and commodity exchanges, transfer taxes and duties.

(h) **Bearer plant** may be defined as a living plant that:

i. is used in the production or supply of agricultural produce;

ii. is expected to bear produce for more than one period; and

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iii. has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

All of the above criteria need to be met for a plant to be considered a bearer plant.

The definition captures plants that would intuitively be considered to be bearers, for instance, grape vines. Some plants that may appear to be consumable, such as the root systems of perennial plants (e.g. sugar cane, bamboo or asparagus), but due to the perennial nature of their root systems, they are expected to meet the definition of a bearer plant.

Annual crops and other plants that are held solely to be harvested as agricultural produce (e.g. many traditional arable crops such as maize, wheat and soya, as well as trees grown for lumber), are explicitly excluded from the definition of a bearer plant. In addition, plants that have a dual use (i.e. plants cultivated to bear agricultural produce, but for which there is more than remote likelihood that the plant itself will be harvested and sold as agricultural produce, beyond incidental scrap sales) are not bearer plants. This may be the case when, for example, an entity holds rubber trees to sell both the latex as agricultural produce and the trees as lumber.

For example, tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are outside the scope of Ind AS 41 and covered under Ind AS 16.

However, produce growing on bearer plant is a biological asset.

This is important to note here that animals are not covered in the definition of the bearer plants. For example, Sheep, Cows etc are not bearer plants.

Illustration 1

ABC Ltd grows vines, harvests the grapes and produces wine. Which of these activities are in the scope of Ind AS 41?

Solution

The grape vines are bearer plants that continually generate crops of grapes which are covered by Ind AS 16, *Property, Plant and Equipment*.

When the entity harvests the grapes, their biological transformation ceases and they become agricultural produce covered by Ind AS 41, *Agriculture*.

Wine involves a lengthy maturation period. This process is similar to the conversion of raw materials to a finished product rather than biological transformation hence treated as inventory in accordance with Ind AS 2, *Inventories*.

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1.4 RECOGNITION OF ASSETS

Entities are required to recognise a biological asset or agricultural produce when, and only when, all of the following conditions are met:

a) the entity controls the asset as a result of past events;

Control over biological assets or agricultural produce may be evidenced by legal ownership or rights to control, for example legal ownership of cattle and the branding or otherwise marking of the cattle on acquisition, birth, or weaning.

b) it is probable that future economic benefits associated with the asset will flow to the entity; and

Future economic benefits are expected to flow to the enterprise from its ownership or control of the asset. The future benefits are normally assessed by measuring the significant physical attributes.

c) the fair value or cost of the asset can be measured reliably.

1.5 MEASUREMENT

Biological Asset should be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except for the case where the fair value cannot be measured reliably.

There is a presumption that fair value can be measured reliably for a biological asset. In the following cases biological asset should be measured at its cost less any accumulated depreciation and any accumulated impairment losses in accordance with Ind AS 2, Ind AS 16 and Ind AS 36:

- quoted market prices are not available for the biological assets and;
- alternative fair value measurements are determined to be clearly unreliable.

Once the fair value of such a biological asset becomes reliably measurable, an entity shall measure it at its Fair value less costs to sell.

The presumption can be rebutted only on initial recognition. An entity that has previously measured a biological asset at its fair value less costs to sell continues to measure the biological asset at its fair value less costs to sell until disposal.

In all cases, an entity measures agricultural produce at the point of harvest at its fair value less costs to sell. This Standard reflects the view that the fair value of agricultural produce at the point of harvest can always be measured reliably.

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Agricultural produce harvested from an entity's biological assets should be measured at its fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying Ind AS 2 or another applicable Standard.

The fair value measurement of a biological asset or agricultural produce may be facilitated by grouping biological assets or agricultural produce according to significant attributes; for example, by age or quality. An entity selects the attributes corresponding to the attributes used in the market as a basis for pricing.

The fair value less cost to sell of a biological asset can change due to both physical changes and price changes in the market.

Entities often enter into contracts to sell their biological assets or agricultural produce at a future date. Contract prices are not necessarily relevant in measuring fair value, because fair value reflects the current market conditions in which market participant buyers and sellers would enter into a transaction. As a result, the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract.

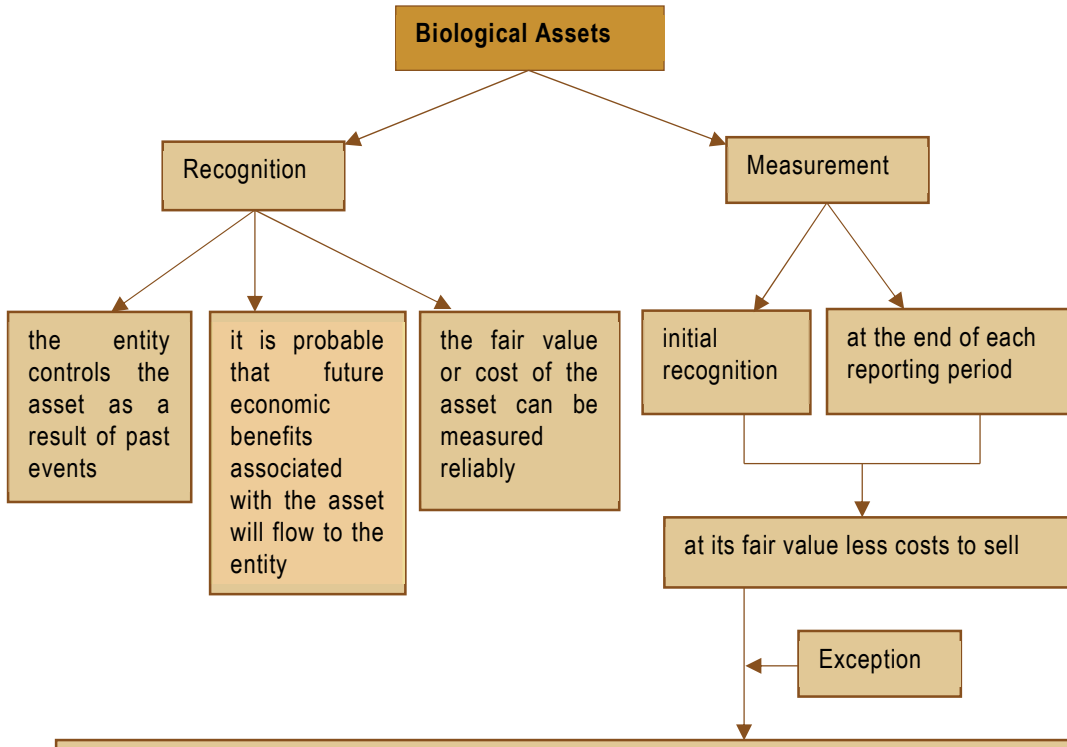
Cost may sometimes approximate fair value, particularly when:

a) little biological transformation has taken place since initial cost incurrence (for example, for fruit tree seedlings planted immediately prior to the end of a reporting period or newly acquired livestock); or

b) the impact of the biological transformation on price is not expected to be material (for example, for the initial growth in a 30-year pine plantation production cycle)

Biological assets are often physically attached to land (for example, trees in a plantation forest). There may be no separate market for biological assets that are attached to the land but an active market may exist for the combined assets, that is, the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to measure the fair value of the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

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Note:

Once a **non-current** biological asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale) as per Ind AS 105, it is presumed that fair value can be measured reliably.

Illustration 2

A farmer owned a dairy herd, of three years old cattle as at 1st April, 20X1 with a fair value of ₹ 13,750 and the number of cattle in the herd was 250.

The fair value of three-year cattle as at 31st March, 20X2 was ₹ 60 per cattle. The fair value of four-year cattle as at 31st March, 20X2 is ₹ 75 per cattle.

Calculate the measurement of group of cattle as at 31st March, 20X2 stating price and physical change separately.

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Solution

Particulars	Amount (₹)
Fair value as at 1st April, 20X1	13,750
Increase due to Price change [250 x {60 - (13,750/250)}]	1,250
Increase due to Physical change [250 x {75-60}]	3,750
Fair value as at 31st March, 20X2	18,750

At the end of reporting period 31st March 20X2

Biological Asset (Cattle A/c)	Dr.	5,000	
To Gain – Change in value (P/L A/c)			5,000

(Being change in value of Cattle recognised at the end of the reporting period)

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Illustration 3

XYZ Ltd., on 1st December, 20X3, purchased 100 sheep from a market for ₹ 5,00,000. The transaction cost of 2% on the market price of the sheep was incurred which was paid by the seller. Sheep's fair value increased from ₹ 500,000 to ₹ 600,000 on 31st March, 20X4. Transaction cost of 2% would have to be incurred by the seller to get the sheep to the relevant market.

Determine the fair value on the date of purchase and the reporting date and pass necessary journal entries thereon.

Solution

The fair value less cost to sell of sheep's on the date of purchase would be ₹ 4,90,000 (5,00,000-10,000). Expense of ₹ 10,000 would be recognised in profit and loss.

On date of Purchase

Biological Asset	Dr.	4,90,000	
Loss on initial recognition	Dr.	10,000	
To Bank			5,00,000

(Being biological asset purchased)

On 31st March, 20X4 sheep would be measured at ₹ 5,88,000 as Biological Asset (6,00,000-12,000) and gain of ₹ 98,000 (5,88,000 - 4,90,000) would be recognised in profit or loss.

At the end of reporting period

Biological Asset	Dr.	98,000	
To Gain – Change in fair value			98,000

(Being change in fair value recognised at the end of reporting period)

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1.6 GAINS AND LOSSES

1) Biological Asset:

A gain or loss arising on initial recognition of a Biological Asset at Fair value less costs to sell and from a change in Fair value less costs to sell of a biological asset shall be included in Profit or Loss for the period in which it arises.

A loss may arise on initial recognition of a biological asset, because cost to sell are deducted in determining fair value less cost to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

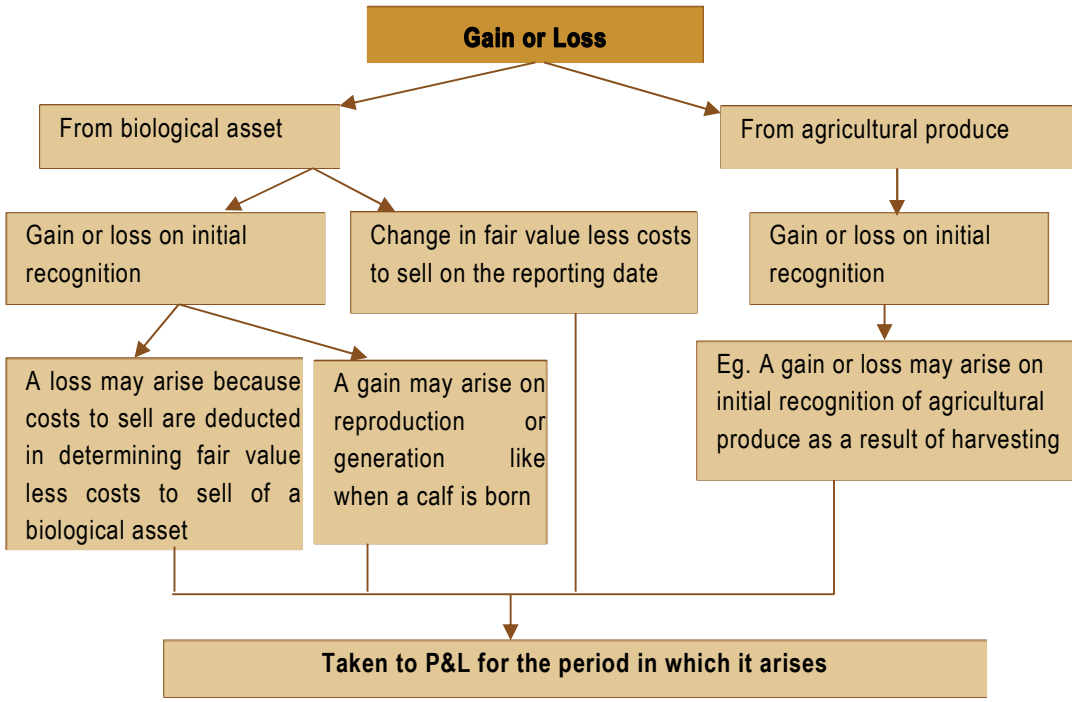
Example 3

During the reporting period 20X1-20X2, an entity is having a cow which has given birth to a calf. The fair value less estimated cost to sell for a calf is ₹ 5,000. The amount of ₹ 5,000 is, therefore, immediately recognised in the Statement of Profit and Loss.

2) Agriculture Produce:

A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in profit or loss for the period in which it arises.

A gain or loss may arise on initial recognition of agricultural produce as a result of harvesting.



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1.7 GOVERNMENT GRANTS

1) Biological Asset measured at fair value less cost to sell:

a) Unconditional Grant:

An unconditional government grant related to a biological asset measured at its fair value less costs to sell shall be recognised in profit or loss when, and only when, the government grant becomes receivable.

b) Conditional Grant:

If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met.

Terms and conditions of government grants vary. For example, a grant may require an entity to farm in a particular location for five years and require the entity to return the entire grant if it farms for a period shorter than five years. In this case, the grant is not recognised in profit or loss until the five years have passed. However, if the terms of the grant allow part of it to be retained according to the time elapsed, the entity recognises that part in profit or loss as time passes.

Example 4

Sun Ltd cultivated a huge plot of land. The government offers a grant of ₹ 10 crore under the condition that the land is being cultivated for 5 years. If the land will be cultivated for a shorter period, the entity is required to return the entire grant.

Therefore, the government grant will be recognised as income only after 5 years of cultivation. The situation would be different if the returning obligation referred to the years of not cultivating the land is with respect to retention of grant for the period till which the entity has cultivated the land. In this case, the amount of ₹ 10 crore would be recognised as income, proportionately with the time period, meaning ₹ 2 crore per annum.

2) Biological Asset measured at its cost:

If a government grant relates to a Biological Asset measured at its cost less any accumulated depreciation and any accumulated impairment losses i.e. (i.e. inability to measure fair value reliably), Ind AS 20 is applied.

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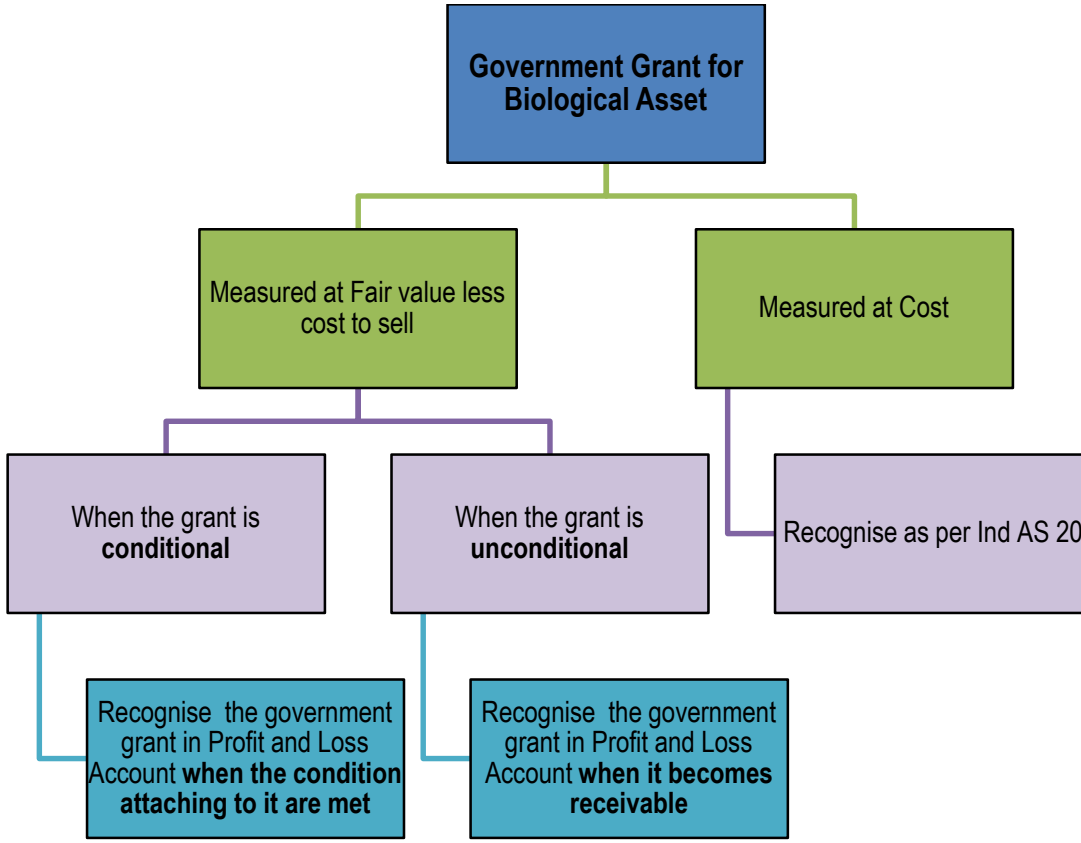


Illustration 4

Agro Foods Ltd. runs a poultry farm business. It has received a government grant from the government for setting up a new poultry unit in a backward area. Agro Foods Ltd used the amount of government grants to buy the first batch of broiler birds, incubators etc. The broiler birds are measured at fair value less costs to sell. However, the incubator machine is measured as per the cost model in Ind AS 16.

As such there are no conditions attached to the release of the government grants pertaining to purchase of poultry birds. However, as regards the investment in incubators and other related plant and machinery items, the government grant contains a condition that the plant and machinery item should be used for a minimum period of 3 years. The useful life of the incubator machine has also been determined to be 3 years in accordance with the management estimate of the time period over which the economic benefits embedded in the incubator machine shall be consumed.

Advise the accounting requirements prescribed in Ind AS 41 Agriculture and Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance in respect of both the government grants?

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Solution

Ind AS 41 requires an unconditional government grant related to a biological asset measured at its fair value less costs to sell to be recognised in profit or loss when, and only when, the government grant becomes receivable. Accordingly, the amount of government grant attributable to the broiler birds which qualify as a biological bird shall be recognized in profit or loss account when the grant becomes receivable.

If a government grant is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity should recognize the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met. This provision of Ind AS 41 is not applicable as we have been informed that there are no conditions attached to the release of the government grant pertaining to broiler birds. In the given case, the grant related to broiler birds has already been received for the purpose of providing immediate financial support to the entity with no future related conditions to be fulfilled. Accordingly, the grant relating to broiler birds is to be recognized in profit and loss in the period in which it is received.

If a government grant relates to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses, the entity applies Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance. The incubator machine does not qualify as a biological asset as it is specifically covered by Ind AS 16 which states that plant and machinery items used to develop or maintain biological assets is covered by Ind AS 16. Therefore, the provisions relating to Government grants contained in Ind AS 41 will not apply to the incubator machine. Therefore, we have to apply directly the provisions contained in IAS 20. Ind AS 20 contains two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to assets are regarded as acceptable alternatives:

- One method recognises the grant as deferred income that is recognized in profit or loss on a systematic basis over the useful life of the asset.
- The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognized in profit or loss over the life of a depreciable asset as a reduced depreciation expense.

Therefore, the grant relating to incubator machine will have to be accounted as a deferred income that is recognized in Profit or loss on a systematic basis over a period of 3 years in line with the condition attached to the grant. Alternatively, the grant may be deducted in determining the carrying amount of the incubator. In such a case the grant is recognised in Profit or Loss over the 3-year useful life of the depreciable incubator machine as a reduced depreciation expense.

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1.8 DISCLOSURE

1) Description of biological assets and activities.

The entity is required to provide a description of each group of biological assets. This disclosure may take the form of a narrative or quantified description. An entity is encouraged to provide a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate.

2) Gains and losses recognised during the period.

An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.

3) Reconciliation of changes in biological assets.

A detailed reconciliation is required of changes in the carrying amount of biological assets between the beginning and the end of the current period, which includes:

a) gain or loss arising from changes in fair value less costs to sell;

b) increases arising from purchases;

c) decreases attributable to sales and biological assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105;

d) decreases due to harvest;

e) increases resulting from business combinations;

f) net exchange differences arising on the translation of financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity; and

g) other changes.

4) Restricted assets, commitments and risk management strategies.

The entity should disclose:

a) the existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities;

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b) the amount of commitments for the development or acquisition of biological assets; and

c) financial risk management strategies related to agricultural activity.

5) Additional disclosures when fair value cannot be measured reliably.

If biological assets within the scope of Ind AS 41 are measured at cost less any accumulated depreciation and any accumulated impairment losses at the end of the period, the following disclosures are required:

a) a description of the biological assets;

b) an explanation of why fair value cannot be measured reliably;

c) the range of estimates within which fair value is highly likely to lie;

d) the depreciation method used;

e) the useful lives or the depreciation rates used; and

f) the gross carrying amount and the accumulated depreciation and impairment losses at the beginning and end of the period.

6) Government grants

The following disclosures are required for government grants relating to agricultural activity:

a) the nature and extent of government grants recognised;

b) unfulfilled conditions and other contingencies attaching to government grants; and

c) significant decreases expected in the level of government grants.

Illustration 5

Moon Ltd prepares financial statements to 31st March, each year. On 1st April 20X1 the company carried out the following transactions:

-- *Purchased a land for ₹ 50 Lakhs.*

-- *Purchased 200 dairy cows (average age at 1st April, 20X1 is 2 years) for ₹ 10 Lakhs.*

-- *Received a grant of ₹ 1 million towards the acquisition of the cows. This grant was non-refundable.*

For the year ending 31st March, 20X2, the company has incurred following costs:

-- *₹ 6 Lakh to maintain the condition of the animals (food and protection).*

-- *₹ 4 Lakh as breeding fee to a local farmer.*

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On 1st October, 20X1, 100 calves were born. There were no other changes in the number of animals during the year ended 31st March, 20X2. As of 31st March, 20X2, Moon Ltd had 3,000 litres of unsold milk in inventory. The milk was sold shortly after the year end at market prices.

Information regarding fair values is as follows:

Item	Fair Value less cost to sell		
	1st April, 20X1	1st October, 20X1	31st March, 20X2
	₹	₹	₹
Land	50 Lakhs	60 Lakhs	70 Lakhs
New born calves (per calf)	1,000	1,100	1,200
Six month old calves (per calf)	1,100	1,200	1,300
Two year old cows (per cow)	5,000	5,100	5,200
Three year old cows (per cow)	5,200	5,300	5,500
Milk (per litre)	20	22	24

Prepare extracts from the Balance Sheet and Statement of Profit and Loss that would be reflected in the financial statements of the entity for the year ended 31st March, 20X2.

Solution

Extract from the Statement of Profit & Loss

	WN	Amount
Income		
Change in fair value of purchased dairy cow	WN 2	1,00,000
Government Grant	WN 3	10,00,000
Change in the fair value of newly born calves	WN 4	1,30,000
Fair Value of Milk	WN 5	72,000
Total Income		13,02,000
Expenses		
Maintenance Costs	WN 2	6,00,000
Breeding Fees	WN 2	4,00,000
Total Expense		(10,00,000)
Net Income		3,02,000

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Extracts from Balance Sheet

Property, Plant and Equipment:		
Land	WN 1	50,00,000
Biological assets other than bearer plants:		
Dairy Cow	WN 2	11,00,000
Calves	WN 4	1,30,000
		62,30,000
Inventory:		
Milk	WN 5	72,000
		72,000

Working Notes:

1. **Land:** The purchase of the land is not covered by Ind AS 41. The relevant standard which would apply to this transaction is Ind AS 16. Under this standard the land would initially be recorded at cost and depreciated over its useful economic life. This would usually be considered to be infinite in the case of land and so no depreciation would be appropriate. Under Cost Model no recognition would be made for post-acquisition changes in the value of land. The allowed alternative treatment under Revaluation Model would permit the land to be revalued to market value with the revaluation surplus taken to the other comprehensive income. We have followed the Cost Model.

2. **Dairy Cows:** Under the 'fair value model' laid down in Ind AS 41 the mature cows would be recognised in the Balance Sheet at 31st March, 20X2 at the fair value of 200 x ₹ 5,500 = ₹ 11,00,000.

   Increase in price change 200 x (5,200-5,000) = 40,000

   Increase in physical change 200 x (5,500-5,200) = 60,000

   The total difference between the fair value of matured herd and its initial cost (₹ 11,00,000 – ₹ 10,00,000 = a gain of ₹ 1,00,000) would be recognised in the profit and loss along with the maintenance costs and breeding fee of ₹ 6,00,000 and ₹ 4,00,000 respectively.

3. **Grant:** Grant relating to agricultural activity is not subject to the normal requirement of Ind AS 20. Under Ind AS 41 such grants are credited to income as soon as they are unconditionally receivable rather than being recognised over the useful economic life of the herd. Therefore, ₹ 10,00,000 would be credited to income of the company.

4. **Calves:** They are a biological asset, and the fair value model is applied. The breeding fees

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are charged to income and an asset of 100 x ₹ 1,300 = ₹ 1,30,000 recognised in the Balance Sheet and credited to Profit and Loss.

5. **Milk:** This is agricultural produce and initially recognised on the same basis as biological assets. Thus the milk would be valued at 3,000 x ₹ 24 = ₹ 72,000. This is regarded as 'cost' for the future application of Ind AS 2 to the unsold milk.

*****

1.9 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Avanti Feeds Limited' for the financial year 2021-2022 with respect to 'Biological assets', and its accounting policy.

Balance Sheet as at 31st March, 2022

(All amounts in Lakhs in Indian Rupees, unless otherwise stated)

Particulars	Note No.	As at 31st March, 2022	As at 31st March, 2021
ASSETS			
Non-current Assets			
Property, Plant and Equipment	3	14,622.48	15,586.59
Capital work-in-progress	3	2,312.85	12.26
Intangible assets	4	7.15	11.27
Right-of-use Assets	5(a)	177.95	132.05
Financial assets			
Investments	6(a)	20,702.54	19,703.81
Loans	7(a)	60.81	72.97
Other financial assets	8	645.08	570.88
Non-current tax assets (net)	20(b)	1,642.37	1,589.54
Other non-current assets	9 (a)	779.52	2.94
Total Non-current Assets		**40,950.75**	**37,682.31**
Current Assets			
Inventories	10 (a)	71,467.25	31,333.73
Biological Assets	**10 (b)**	**84.14**	**66.25**

10 b) Biological Assets

Particulars	As at 31st March, 2022	As at 31st March, 2021
Biological Assets (Refer note below)	**84.14**	**66.25**
Note:		
Brood stock	51.93	66.25
Post Larval	32.21	-
	84.14	66.25

Reconciliation of changes in the carrying amount of biological assets:

Particulars	As at 31st March, 2022	As at 31st March, 2021
As at beginning of the year	66.25	-
Increase due to purchase/production/physical change	742.00	1,182.44
Decrease due to Physical change/sales	724.11	1,116.19
Net change in the Fair value less estimated cost to sell	**84.14**	**66.25**

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ACCOUNTING POLICY

Biological Assets

The Company recognises biological assets only when, the Company controls the assets as a result of past events, it is probable that future economic benefits associated with such assets will flow to the Company. Biological assets of the Company are in the nature of Consumable Biological Assets. It is bifurcated into Brood Stock, (the Parents) and harvested species which undergo biological transformation under different stages as nauplius, Zoea, Mysis and Post Larvae. The Company sells the biological assets harvested from brood stock at nauplius and Post Larvae Stages. The Brood Stock has a maximum useful life of 6 months for laying eggs, and thereafter these are destroyed.

The valuation of the Brood stock biological assets are determined on the following basis:

Brood stock are used for captive consumption or to support farmers, it cannot be sold before the end of its useful life and as such, there is no active market. Other references to market prices such as market prices for similar assets are also not available due to the uniqueness of the breed. Valuation based on a discounted cash flow method is considered to be unreliable given the uncertainty with respect to mortality rates and production. Consequently, brood stock and Shrimp seed (Different stages) are measured at cost, less depreciation and impairment losses.

The transmission phase from nauplius to Zoea and Mysis are not considered as significant transformation of biological asset and hence Zoea and Mysis are not valued as per Ind AS 41.

The Company recognises other biological assets at the fair value or cost of the assets that can be measured reliably. Expenditure incurred on biological assets are measured on initial recognition and at the end of each reporting period at its fair value less costs to sell. The gain or loss arising from a change in fair value less costs to sell the biological assets are included in Statement of Profit and Loss for the period in which it arises.

Management estimates the fair value less costs to sell of biological assets, taking into account the most reliable evidence available at each reporting date. The future realization of these biological assets may be affected by their survival rate, age and / or other market - driven changes that may reduce the future economic benefits associated with such assets. The fair value is arrived at based on the observable market prices of biological assets adjusted for cost to sells, as applicable.

(Source: Annual Report 2021-2022 – Avanti Feeds Limited')

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. Entity A purchased cattle at an auction on 30th June 20X1

Purchase price at 30th June 20X1	₹ 1,00,000
Costs of transporting the cattle back to the entity's farm	₹ 1,000
Sales price of the cattle at 31st March, 20X2	₹ 1,10,000

The company would have to incur similar transportation costs if it were to sell the cattle at auction, in addition to an auctioneer's fee of 2% of sales price. The auctioneer charges 2% of the selling price, from both, the buyer as well as the seller.

Calculate the amount at which cattle is to be recognised in books on initial recognition and at year end 31st March, 20X2. Show corresponding journal entries.

2. XY Ltd. is a farming entity where cows are milked on a daily basis. Milk is kept in cold storage immediately after milking and sold to retail distributors on a weekly basis. On 1st April 20X1, XY Ltd. had a herd of 500 cows which were all three years old.

During the year, some of the cows became sick and on 30th September 20X1, 20 cows died. On 1st October 20X1, XY Ltd. purchased 20 replacement cows from the market for ₹ 21,000 each. These 20 cows were all one-year old when they were purchased.

On 31st March 20X2, XY Ltd. had 1,000 litres of milk in cold storage which had not been sold to retail distributors. The market price of milk at 31st March 20X2 was ₹ 20 per litre. When selling the milk to distributors, XY Ltd. incurs selling costs of ₹ 1 per litre. These amounts did not change during March 20X2 and are not expected to change during April 20X2.

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Information relating to fair value and costs to sell is given below:

Date	Fair value of a dairy cow (aged)				Costs to sell a cow
	1 year	1.5 years	3 years	4 years	
1st April 20X1	20,000	22,000	27,000	25,000	1,000
1st October 20X1	21,000	23,000	28,000	26,000	1,000
31st March 20X2	21,500	23,500	29,000	26,500	1,100

The fair value of a 3.5 years old cow on 1st October 20X1 is ₹ 27,000.

Pass necessary journal entries of above transactions with respect to cows in the financial statements of XY Ltd. for the year ended 31st March, 20X2? Also show the amount lying in inventory if any.

3. Company X purchased 100 goats at an auction for ₹ 1,00,000 on 30th September 20X1. Subsequent transportation costs were ₹ 1,000 that is similar to the cost X would have to incur to sell the goat at the auction. Additionally, there would be a 2% selling fee on the market price of the goat to be incurred by the seller.

   On 31st March 20X2, the market value of the goat in the most relevant market increases to ₹ 1,10,000. Transportation costs of ₹ 1,000 would have to be incurred by the seller to get the goat to the relevant market. An auctioneer's fee of 2% on the market price of the goat would be payable by the seller.

   On 1st June 20X2, X sold 18 goats for ₹ 20,000 and incurred transportation charges of ₹ 150. In addition, there was a 2% auctioneer's fee on the market price of the goat paid by the seller.

   On 15th September 20X2, the fair value of the remaining goat was ₹ 82,820. 42 goats were slaughtered on that day, with a total slaughter cost of ₹ 4,200. The total market price of the carcasses on that day was ₹ 48,300, and the expected transportation cost to sell the carcasses is ₹ 420. No other costs are expected.

   On 30th September 20X2, the market price of the remaining 40 goat was ₹ 44,800. The expected transportation cost is ₹ 400. Also, there would be a 2% auctioneer's fee on the market price of the goat payable by the seller.

   Pass Journal entries for the initial and subsequent measurement for all above transactions. Interim reporting periods are of 30th September and 31 March and the company determines the fair values on these dates for reporting.

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4. On 1st November, 20X1, C Agro Ltd. purchased 100 goats of special breed from a market for ₹ 10,00,000 with a transaction cost of 2%. Goats fair value decreased from ₹ 10,00,000 to ₹ 9,00,000 as on 31st March, 20X2.

   Determine the fair value on the date of purchase and as on financial year ended 31st March, 20X2 under both the cases viz-

   (i) the transaction costs are borne by the seller and

   (ii) the transaction costs are incurred by the seller and purchaser both

   Also pass journal entries under both the situations on both dates.

5. Analyse whether the following activities fall within the scope of Ind AS 41 with proper reasoning:

   - Managing animal-related recreational activities like Zoo
   - Fishing in the ocean
   - Fish farming
   - Development of living organisms such as cells, bacteria and viruses
   - Growing of plants to be used in the production of drugs
   - Purchase of 25 dogs for security purpose of the company's premises.

Answers

1. Initial recognition of cattle

	₹
Fair value less costs to sell (₹ 1,00,000 – ₹ 1,000 - ₹ 2,000)	97,000
Cash outflow (₹ 1,00,000 + ₹ 1,000 + ₹ 2,000)	1,03,000
Loss on initial recognition	6,000
Cattle Measurement at year end	
Fair value less costs to sell (₹ 1,10,000 – 1,000 – (2% x 1,10,000))	1,06,800

At 31st March, 20X2, the cattle is measured at ₹ 1,06,800 i.e. fair value less cost to sell (transportation ₹ 1,000 and the estimated auctioneer's fee of ₹ 2,200). The estimated transportation costs of getting the cattle to the auction of ₹ 1,000 are deducted from the sales price in determining fair value.

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Journal Entries on 30th June, 20X1

(All figures in ₹)

Biological Asset (Cattle A/c)	Dr.	97,000	
Loss on initial recognition	Dr.	6,000	
To Bank (Purchase and cost of transportation on purchase paid by buyer)			1,03,000
(Being biological asset purchased)			

Journal Entries on 31st March, 20X2

(All figures in ₹)

Biological Asset (Cattle A/c)	Dr.	9,800	
To Gain on remeasurement (P/L A/c)			9,800
(Subsequent measurement of cattle at fair value less costs to sell)			

2. Journal Entries on

(All figures in ₹)

30th September 20X1	Loss (on death of 20 cows) (W.N.)	Dr.	5,20,000	
	To Biological asset			5,20,000
	(Loss booked on death of 20 cows)			
1st October 20X1	Biological Asset (purchase of 20 new cows) (W.N.)	Dr.	4,00,000	
	Loss on initial recognition (of 20 new cows)	Dr.	20,000	
	To Bank			4,20,000
	(Initial recognition of 20 new purchased cows at fair value less costs to sell)			
1st October 20X1	Loss on remeasurement of old cows	Dr.	2,88,000	
	To Biological asset [(1,30,00,000 – 5,20,000) – 1,21,92,000]			2,88,000
	(Subsequent measurement of cows at fair value less costs to sell)			

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	Biological Asset (4,48,000 – 4,00,000)	Dr.	48,000	
	To Gain on remeasurement of new cows			48,000
	(Subsequent measurement of cows at fair value less costs to sell)			

Inventory (Milk) as at 31st March, 20X2 = ₹ 19,000 [1,000 x (20 – 1)].

Working Note:

Calculation of Biological asset at various dates

Date	Number	Age	Fair Value (₹)	Cost to Sell (₹)	Net (₹)	Biological asset (₹)
1st April 20X1	500	3 years	27,000	1,000	26,000	1,30,00,000
30th September 20X1	(20)	3.5 years	27,000	1,000	26,000	(5,20,000)
1st October 20X1	20	1 year	21,000	1,000	20,000	4,00,000
						1,28,80,000
31st March 20X2	480	4 years	26,500	1,100	25,400	1,21,92,000
	20	1.5 years	23,500	1,100	22,400	4,48,000
						1,26,40,000

3. Value of goat at initial recognition (30th September 20X1) **(All figures are in ₹)**

Biological asset (goat)	Dr.	97,000*	
Loss on initial recognition	Dr.	4,000	
To Bank (Purchase and cost of transportation on purchase paid by buyer)			1,01,000
(Initial recognition of goat at fair value less costs to sell)			

*Fair value of goat = 1,00,000 – 1,000 – 2,000 (2% of 1,00,000) = 97,000

Subsequent measurement at 31st March 20X2 **(All figures are in ₹)**

Biological Assets (Goat)	Dr.	9,800	
To Gain on Sale (Profit & Loss)			9,800
(Subsequent measurement of Goat at fair value less costs to sell (1,06,800** – 97,000))			

** Fair value of goat = 1,10,0000 – 1,000 – 2,200 (2% of 1,10,000) = 1,06,800

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Sale of goat on 1st June 20X2 **(All figures are in ₹)**

Biological Assets (Goats)	Dr.	226	
To Gain on Sale (Profit & Loss)			226
(Subsequent re-measurement of 18 goats at fair value less costs to sell just prior to the point at which they are sold [19,450 - {(1,06,800/100) x 18}])			
Cost to Sales (20,000 – 400 {i.e. 2% of 20,000} – 150)	Dr.	19,450	
To Biological Assets (Goats)			19,450
(Recording a cost of sales figure separately with a corresponding reduction in the value of the biological assets)			
Bank	Dr.	19,450	
Selling expenses (150 + 400)	Dr.	550	
To Revenue			20,000
(Recognition of revenue from sale of goat)			

Transfer of Goat to Inventory on 15th September 20X2 **(All figures are in ₹)**

Inventory (48,300 - 420)	Dr.	47,880	
Loss on remeasurement	Dr.	1,176	
To Biological Asset (Goats)			44,856#
To Bank (Slaughtering cost)			4,200
(Transfer of goat to inventory)			

#Note: 44,856 is calculated as the proportion of goat sold using the fair value [(1,06,800+ 226 – 19,450) x 42/82]

Subsequent measurement of goat at 30th September 20X2 **(All figures are in ₹)**

Biological Asset (Goats)	Dr.	784	
To Gain on remeasurement			784
(Subsequent measurement of goat at fair value less costs to sell [43,504## – {(1,06,800 + 226 – 19,450) – 44,856}]			

##Fair value of goat = 44,800 – 400 – 896 (2% of 44,800) = 43,504.

4. As per para 12 of Ind AS 41, a biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell. Therefore, regardless of who bears the transaction costs, the transaction costs of 2% are the costs to sell the goats on 1st November 20X1, and therefore, the goats should be measured at their fair value less costs to sell on initial recognition date, i.e., ₹ 9,80,000.

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Journal Entry

As on 1st November 20X1:

(h) Where transaction costs are borne by the seller:

Biological assets (Goats) A/c	Dr.	9,80,000	
Loss on purchase of biological assets (Goats) A/c	Dr.	20,000	
To Bank A/c			10,00,000

(ii) Where transaction costs are borne by the seller and buyer both:

Biological assets (Goats) A/c	Dr.	9,80,000	
Loss on purchase of biological asset (Goats) A/c	Dr.	40,000	
To Bank A/c			10,20,000

As on 31st March 20X2 – under both the scenarios:

Loss on fair valuation of biological assets A/c	Dr.	98,000	
To Biological assets (Goats) A/c			98,000

[9,80,000 - (9,00,000 - 18,000)]

5.

Activity	Whether in the scope of Ind AS 41?	Remarks
Managing animal-related recreational activities like Zoo	No	Since the primary purpose is to show the animals to public for recreational purposes, there is no management of biological transformation but simply control of the number of animals. Hence it will not fall in the purview of considered in the definition of agricultural activity.
Fishing in the ocean	No	Fishing in ocean is harvesting biological assets from unmanaged sources. There is no management of biological transformation since fish grow naturally in the ocean. Hence, it will not

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		fall in the scope of the definition of agricultural activity.
Fish farming	Yes	Managing the growth of fish and then harvest for sale is agricultural activity within the scope of Ind AS 41 since there is management of biological transformation of biological assets for sale or additional biological assets.
Development of living organisms such as cells, bacteria viruses	Analysis required	The development of living organisms for research purposes does not qualify as agricultural activity, as those organisms are not being developed for sale, or for conversion into agricultural produce or into additional biological assets. Hence, development of such organisms for the said purposes does not fall under the scope of Ind AS 41. However, if the organisms are being developed for sale or use in dairy products, the activity will be considered as agricultural activity under the scope of Ind AS 41.
Growing of plants to be used in the production of drugs	Yes	If an entity grows plants for using it in production of drugs, the activity will be agricultural activity. Hence it will come under the scope of Ind AS 41.
Purchase of 25 dogs for security purposes of the company's premises	No	Ind AS 41 is applied to account for the biological assets when they relate to agricultural activity. Guard dogs for security purposes do not qualify as agricultural activity, since they are not being kept for sale, or for conversion into agricultural produce or into additional biological assets. Hence, they are outside the scope of Ind AS 41.

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UNIT 2 :
INDIAN ACCOUNTING STANDARD 20: ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

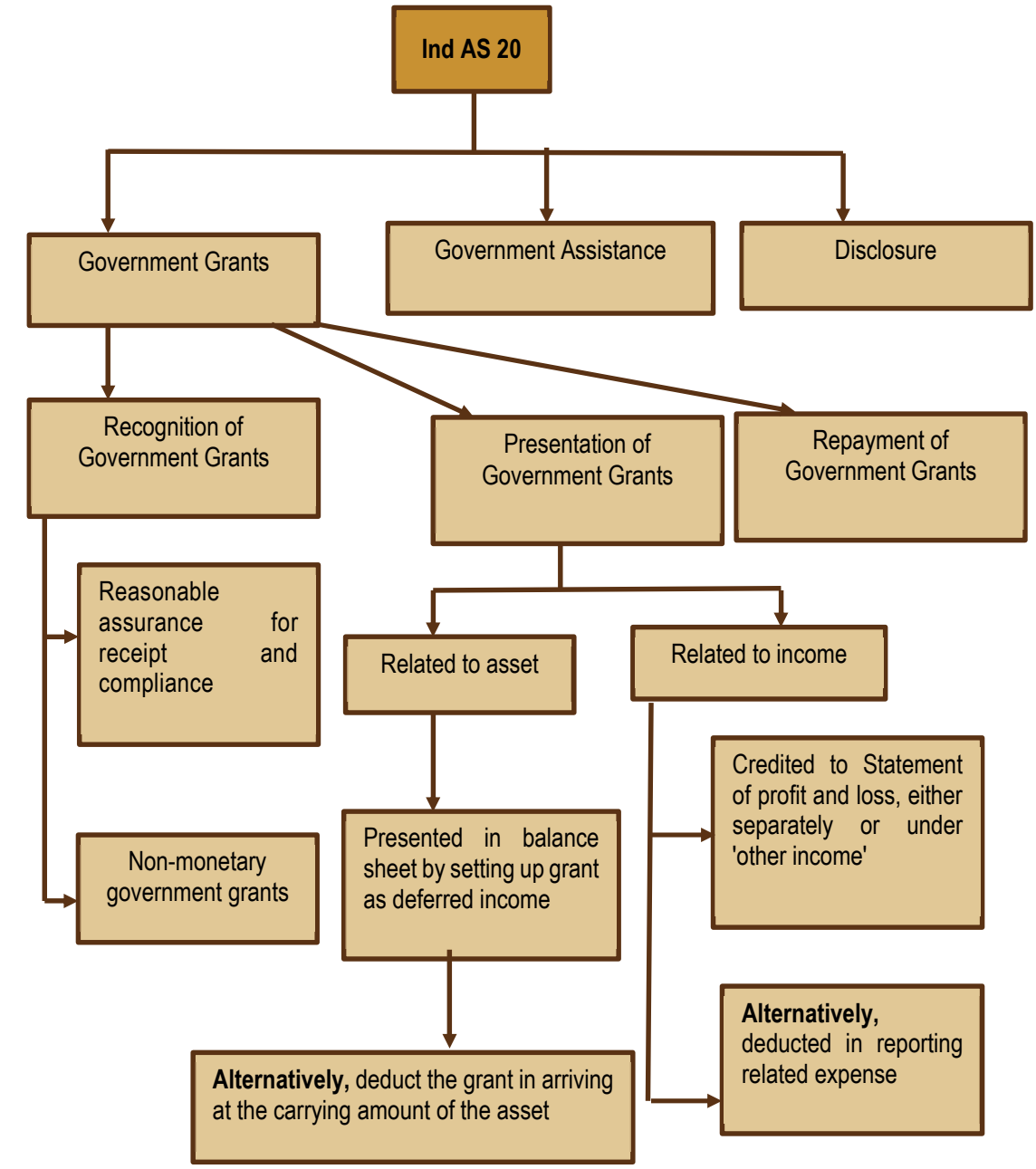
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Interpret the principles for recognition of government grant including non-monetary grants
- Recommend presentation requirements of grants related to assets and income
- Account for repayment of government grants

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UNIT OVERVIEW



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2.1 INTRODUCTION

The government gives grants to entities for various purposes including for industrial, geographic and social development, to facilitate the flow of foreign investments, to promote entrepreneurship, as subsidies to reduce the prices of goods and services offered by these entities.

The grant could be in different forms, e.g., monetary or non-monetary government grants.

Government grants may be significant for an entity and require appropriate treatment in the books of accounts and disclosures in the financial statements to facilitate comparison with other entities and with prior periods. Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* provides guidance on this.

2.2 SCOPE

2.2.1 Applicability

Ind AS 20 should be applied for:

(a) accounting and disclosure of government grants; and

(b) disclosure of other forms of government assistance.

2.2.2 Non-applicability

Ind AS 20 does not deal with:

(a) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature;

(b) government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability;

Examples of such benefits are income tax holidays, investment tax credits, accelerated depreciation.

(c) government participation in the ownership of the entity;

(d) government grants that will be covered by Ind AS 41, *Agriculture*.

2.3 DEFINITIONS

The following definitions are relevant for the purpose of understanding of Ind AS 20:

1. ***Government*** refers to government, government agencies and similar bodies whether local, national or international.

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2. ***Government assistance*** is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government assistance for the purpose of Ind AS 20 does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government assistance does not include the provision of infrastructure by improvement to the general transport and communication network and the supply of improved facilities such as irrigation or water reticulation which is available on an ongoing indeterminate basis for the benefit of an entire local community.

Government assistance takes many forms varying both in the nature of the assistance given and in the conditions which are usually attached to it. The purpose of the assistance may be to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided.

The receipt of government assistance by an entity may be significant for the preparation of the financial statements for two reasons:

- Firstly, if resources have been transferred, an appropriate method of accounting for the transfer must be found.
- Secondly, it is desirable to give an indication of the extent to which the entity has benefited from such assistance during the reporting period. This facilitates comparison of an entity's financial statements with those of prior periods and with those of other entities.

Examples 1-4 : Government assistance

1. Free technical assistance or marketing advice and the provision of guarantees are forms of government assistance to which no value could reasonably be assigned.
2. An example of transactions with government which cannot be distinguished from the normal trading transactions of the entity is a government procurement policy that is responsible for a portion of the entity's sales. The existence of the benefit might be unquestioned but any attempt to segregate the trading activities from government assistance could well be arbitrary.
3. **Assistance in the form of priority bidding status:** The government specifies that entities below a certain size are to be given priority in bidding for a particular type of government contract by mandating a minimum number of such entities to obtain bidding status. Although the entities will benefit from the quota, the value cannot be identified, and the effects of the assistance cannot be segregated from the trading activities of the entities.

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4. **Assistance in the form of credit facilities at market rates:** Three governments that amongst themselves own over 50% of the shares in an airline, participate in granting it a revolving credit facility at a market rate of interest. This is not a government grant as a loan is provided at market rate of interest which any private market participant might have accepted. However, it is government assistance as the benefit cannot be distinguished from normal trading activities of the airline.

The significance of the benefit in the above examples may be such that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading.

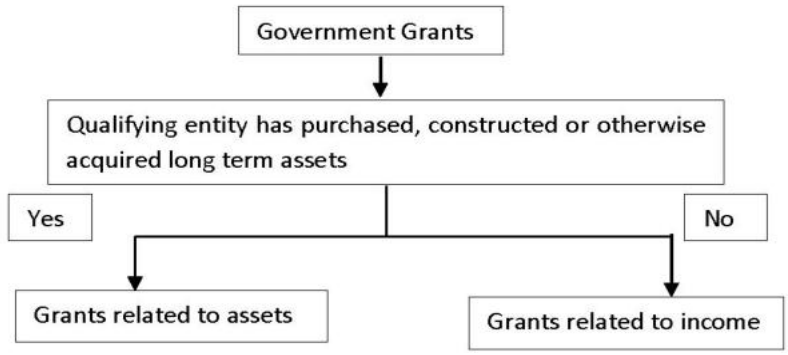
3. ***Government grants*** are assistance by the government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

4. ***Grants related to assets*** are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

5. ***Grants related to income*** are government grants other than those related to assets.

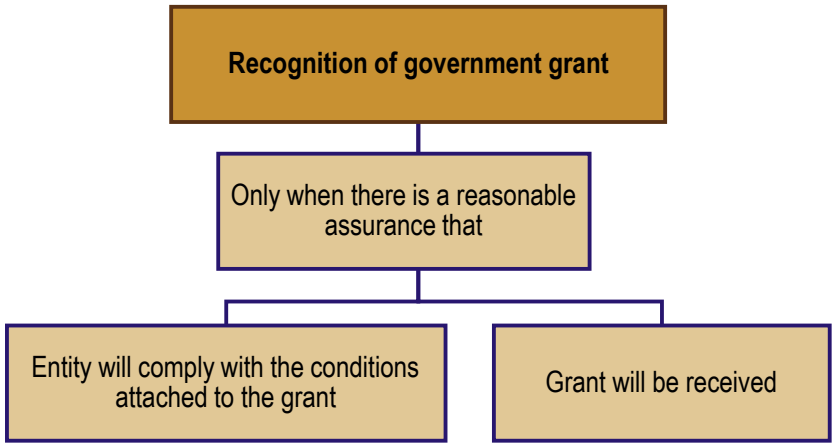


6. ***Forgivable loans*** are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

7. **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (Ind AS 113, *Fair Value Measurement*).

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2.4 RECOGNITION OF GOVERNMENT GRANTS



Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received.

A government grant is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

Illustration 1

Government gives a grant of ₹ 10,00,000 for past research of H1N1 vaccine to A Pharmaceuticals Limited. There is no condition attached to the grant.

Examine how this government grant be recognised in the books of A Pharmaceuticals Limited.

Solution

The entire grant should be recognised immediately in the statement of profit and loss.

*****

Illustration 2

Government gives a grant of ₹ 10,00,000 for research and development of H1N1 vaccine to A Pharmaceuticals Limited even though similar vaccines are available in the market but are expensive. The entity has to ensure by developing a manufacturing process over a period of

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2 years that the costs come down by at least 40%.

Examine how this government grant be recognised assuming that A Pharmaceuticals Limited has reasonable assurance that the conditions attached to the grant will be complied with.

Solution

The entire grant should be recognised immediately as deferred income and charged to profit or loss over a period of two years.

*****

Illustration 3

A village of artisans in a district got devastated because of an earthquake. A Limited was operating in that district and was providing employment to the artisans. The government gave a grant of ₹ 10,00,000 to A Limited so that 100 artisans are rehabilitated over a period of 3 years. Government releases ₹ 2,00,000.

Examine how this government grant be recognised.

Solution

A Limited will recognise ₹ 10,00,000 as government grant and set it up as a deferred income and will recognise it in its profit or loss over the period of three years as per the principles enunciated in Ind AS 20.

Once a government grant is recognised, any related contingent liability or contingent asset is treated in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets.*

The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government or in the form of a non-monetary asset.

*****

2.4.1 Forgivable loan

A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

2.4.2 Loans at less than market rate of interest

The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan should be recognised and measured in accordance with Ind AS 109, *Financial Instruments*. The benefit of the below-market rate of interest should be measured as the difference between the initial carrying value of the loan determined in accordance with

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Ind AS 109 and the proceeds received. The benefit is accounted for in accordance with Ind AS 20. The entity should consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

Illustration 4

A Limited received from the government a loan of ₹ 50,00,000 @ 5% payable after 5 years in a bullet payment. The prevailing market rate of interest is 12%. Interest is payable regularly at the end of each year.

Calculate the amount of government grant and pass necessary journal entry. Also examine how the Government grant be recognised.

Solution

The fair value of the loan is calculated at ₹ 37,38,328 (refer Working Note).

Year	Opening Balance	Interest calculated @ 12%	Interest paid @ 5% on ₹ 50,00,000 + principal paid	Closing Balance
(a)	(b)	(c) = (b) x 12%	(d)	(e) =(b) + (c) – (d)
1	37,38,328	4,48,600	2,50,000	39,36,928
2	39,36,928	4,72,431	2,50,000	41,59,359
3	41,59,359	4,99,123	2,50,000	44,08,482
4	44,08,482	5,29,018	2,50,000	46,87,500
5	46,87,500	5,62,500	52,50,000	Nil

A Limited will recognise ₹ 12,61,672 (₹ 50,00,000 – ₹ 37,38,328) as the government grant and will make the following entry on receipt of loan:

Bank Account	Dr.	50,00,000	
To Deferred Income			12,61,672
To Loan Account			37,38,328

₹ 12,61,672 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognise as expenses the related costs for which the grant is intended to compensate. (see Illustration 5 in this regard).

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Working Note:

Particulars	Amount (₹)	Discounting factor	Present value taking 12% as the discount rate (₹)
Interest @ 5% for Year 1 on loan amount of ₹ 50 lakhs	2,50,000	0.893	2,23,214
Interest @ 5% for Year 2 on loan amount of ₹ 50 lakhs	2,50,000	0.797	1,99,298
Interest @ 5% for Year 3 on loan amount of ₹ 50 lakhs	2,50,000	0.712	1,77,945
Interest @ 5% for Year 4 on loan amount of ₹ 50 lakhs	2,50,000	0.636	1,58,880
Interest @ 5% for Year 5 on loan amount of ₹ 50 lakhs	2,50,000	0.567	1,41,857
Loan	50,00,000	0.567	28,37,134
Present value of loan at the beginning of Year 1			**37,38,328**

The above present value above has been computed on full scale basis.

*****

2.5 ACCOUNTING OF GOVERNMENT GRANT

There are two approaches to the accounting of government grant: 'capital approach' or 'income approach'. Under capital approach, a grant is recognised outside profit or loss, i.e., grant is credited directly to equity whereas under the income approach grant is recognised in profit or loss over one or more periods.

The Standard rejects the capital approach and prescribes only the income approach despite the following arguments in favour of capital approach:

(a) government grants are a financing device and should be dealt with as such in the balance sheet rather than be recognised in profit or loss to offset the items of expense that they finance. Since no repayment is expected, such grants should be recognised outside profit or loss.

(b) it is inappropriate to recognise government grants in profit or loss, because they are not earned but represent an incentive provided by government without related costs.

The income approach has been prescribed because of the following arguments in its favour:

(a) because government grants are receipts from a source other than shareholders, they should not be recognised directly in equity but should be recognised in profit or loss in appropriate periods.

(b) government grants are rarely gratuitous. The entity earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be recognised in

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profit or loss over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

(c) since income and other taxes are expenses, it is logical to deal also with government grants, which are an extension of fiscal policies, in profit or loss.

Principle:

Thus, government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

In most cases the periods over which an entity recognises the costs or expenses related to a government grant are readily ascertainable. Thus grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.

Illustration 5

Continuing with the facts given in the Illustration 4, state how the grant will be recognized in the statement of profit or loss assuming:

(a) the loan is an immediate relief measure to rescue the enterprise

(b) the loan is a subsidy for staff training expenses, incurred equally, for a period of 4 years

(c) the loan is to finance a depreciable asset.

Solution

₹ 12,61,672 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

Assuming (a), the loan is an immediate relief measure to rescue the enterprise - ₹ 12,61,672 will be recognised in profit or loss immediately.

Assuming (b), the loan is a subsidy for staff training expenses, incurred equally, for a period of 4 years, ₹ 12,61,672 will be recognised in profit or loss over a period of 4 years.

Assuming (c), the loan is to finance a depreciable asset - ₹ 12,61,672 will be recognised in profit or loss on the same basis as depreciation.

*****

2.5.1 Whether receipts basis permissible

Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (Ind AS 1, *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received.

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2.5.2 Grants related to non-depreciable assets

Grants related to non-depreciable assets may also require the fulfilment of certain obligations and would then be recognised in profit or loss over the periods that bear the cost of meeting the obligations.

Example 5

A grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognise the grant in profit or loss over the life of the building.

2.5.3 Conditional Grants received as part of a package of financial or fiscal aids

In such cases, care is needed in identifying the conditions giving rise to costs and expenses which determine the periods over which the grant will be earned. It may be appropriate to allocate part of a grant on one basis and part on another.

2.5.4 Grant for expenses or losses already incurred and grant as an immediate financial support

A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs should be recognised in profit or loss of the period in which it becomes receivable.

In some circumstances, a government grant may be awarded for the purpose of giving immediate financial support to an entity rather than as an incentive to undertake specific expenditures. Such grants may be confined to a particular entity and may not be available to a whole class of beneficiaries. These circumstances may warrant recognising a grant in profit or loss of the period in which the entity qualifies to receive it, with appropriate disclosures to ensure that its effect is clearly understood.

A government grant may become receivable by an entity as compensation for expenses or losses incurred in a previous period. Such a grant is recognised in profit or loss of the period in which it becomes receivable, with disclosure to ensure that its effect is clearly understood.

2.5.5 Non-monetary government grants

A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. In these circumstances the fair value of the non-monetary asset is assessed and both grant and asset are accounted for at that fair value. Alternatively, an entity may measure both asset and grant at nominal value.

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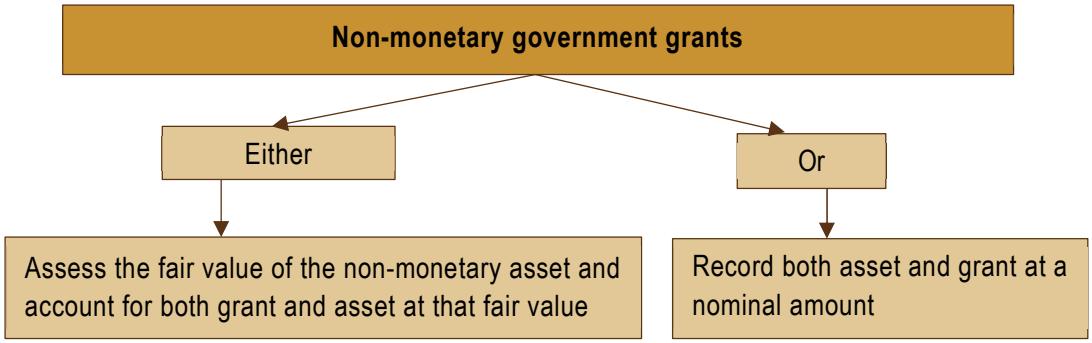


Illustration 6

A Limited wants to establish a manufacturing unit in a backward area and requires 5 acres of land. The government provides the land on a leasehold basis at a nominal value of ₹ 10,000 per acre. The fair value of the land is ₹ 100,000 per acre.

Calculate the amount of the government grant to be recognized by an entity.

Solution

A limited will recognise the land at fair value of ₹ 5,00,000 and ₹ 450,000 [(₹ 100,000 – ₹ 10,000) x 5)] as government grant. This government grant should be presented in the balance sheet by setting up the grant as deferred income.

Alternatively, the land may be recognised by A Ltd. at nominal value of ₹ 50,000 (₹ 10,000 x 5).

*****

2.5.6 Government Assistance – No Specific relation to Operating Activities

In some countries government assistance to entities may be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the entity.

Examples of such assistance are transfers of resources by governments to entities which:

(a) operate in a particular industry;

(b) continue operating in recently privatised industries; or

(c) start or continue to run their business in underdeveloped areas.

The issue is whether such government assistance is a 'government grant' within the scope of Ind AS 20 and, therefore, should be accounted for in accordance with Ind AS 20.

In this regard, Appendix A to Ind AS 20 provides that government assistance to entities meets the definition of government grants in Ind AS 20, even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or

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industry sectors. Such grants should therefore not be credited directly to shareholders' interests and should be recognised in profit or loss on a systematic basis.

2.6 PRESENTATION OF GRANTS RELATED TO ASSETS

2.6.1 Presentation in the Balance Sheet

Government grants related to assets should be presented in the balance sheet by setting up the grant as deferred income. The non-monetary grants at fair value should be presented in a similar manner.

Alternatively, it can be presented in the balance sheet by deducting the grant in arriving at the carrying amount of the asset.

The grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset.

The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognised in profit or loss over the life of a depreciable asset as a reduced depreciation expense.

Illustration 7

A Limited establishes solar panels to supply solar electricity to its manufacturing plant. The cost of solar panels is ₹ 1,00,00,000 with a useful life of 10 years. The depreciation is provided on straight line method basis. The government gives ₹ 50,00,000 as a subsidy.

Examine how the Government grant be realized.

Solution

A Limited will set up ₹ 50,00,000 as deferred income and will credit ₹ 5,00,000 equally to its statement of profit and loss over next 10 years.

Alternatively, A Ltd. may deduct ₹ 50,00,000 from the cost of solar panel of ₹ 1,00,00,000.

*****

2.6.2 Disclosure in the statement of cash flows

The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and in order to show the gross investment in assets, such movements are disclosed as separate items in the statement of cash flows. This presentation is done irrespective of the fact that the grant is deducted or not from the related asset, for the purpose of presentation in the balance sheet.

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Illustration 8

Continuing with the facts given in Illustration 7 above, state how the same will be disclosed in the Statement of cash flows.

Solution

A Limited will show ₹ 1,00,00,000 being acquisition of solar panels as outflow in investing activities. The receipt of ₹ 50,00,000 from government will be shown as inflow under investing activities.

*****

2.7 PRESENTATION OF GRANTS RELATED TO INCOME

Two methods are prescribed for presentation of grants related to income. The grant could be

(a) (first method) presented as a credit in the statement of profit and loss, either separately or under a general heading such as 'Other income'; or

(b) (second method) deducted in reporting the related expense.

The first method lays it foundation on the base:

(a) that it is inappropriate to net income and expense items and

(b) that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant.

It is argued for the second method:

(a) that the expenses might well not have been incurred by the entity if the grant had not been available; and

(b) thus, presentation of the expense without offsetting the grant may therefore be misleading.

Both methods are regarded as acceptable for the presentation of grants related to income. Disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense which is required to be separately disclosed is usually appropriate.

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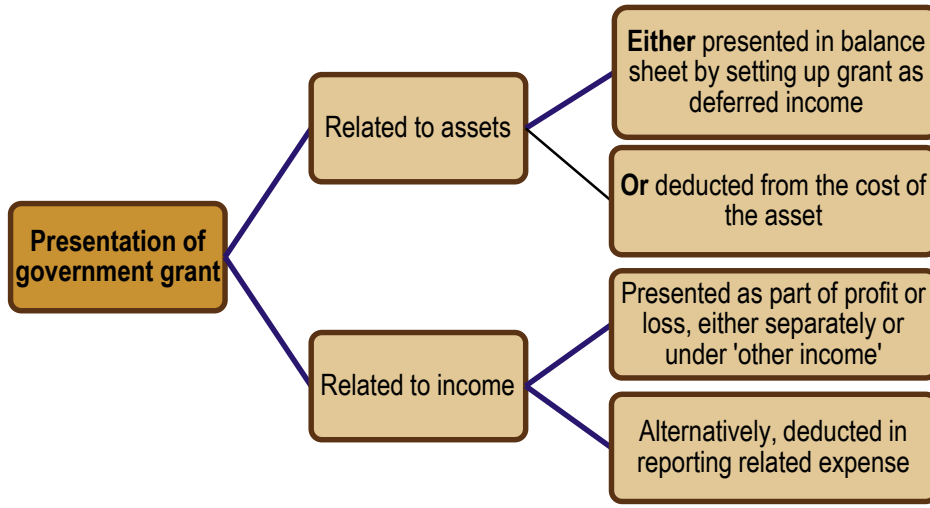


Illustration 9

A Ltd. received a government grant of ₹ 10,00,000 to defray expenses for environmental protection. Expected environmental costs to be incurred is ₹ 3,00,000 per annum for the next 5 years.

Determine the presentation of such grant related to income in the financial statements of A Ltd.?

Solution

As per paragraph 29 of Ind AS 20, grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense.

In accordance with the above, presentation of grants related to income under both the methods are as follows:

Method 1: Credit in the statement of profit and loss

The entity can recognise the grant as income on a straight line basis i.e., ₹ 2,00,000 per year in the statement of profit and loss either separately or under the head "Other Income".

The supporters of this method consider it inappropriate to present income and expense items on a net basis and that 'separation of the grant from the expense facilitates comparison with other expenses not affected by a grant'.

Method 2: As a deduction in reporting the related expense

Since the grant relates to environmental expenses incurred/to be incurred by the entity, it can present the grant by reducing the grant amount every year from the related expense i.e., environmental expense of ₹ 1,00,000 (i.e., net expense ₹ 3,00,000 – ₹ 2,00,000).

The supporters of this method are of the view that 'the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting

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the grant may therefore be misleading'.

The Standard regards both the methods as acceptable for the presentation of grants related to income. However, method 2 may be more appropriate when the company can relate the grant to a specific expenditure.

The Standard also provides that disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense which is required to be separately disclosed is usually appropriate.

*****

2.8 REPAYMENT OF GOVERNMENT GRANTS

An entity may have to repay the government grant including in cases where conditions related to the grant are not fulfilled by it.

A government grant that becomes repayable should be accounted for as a change in accounting estimate and be treated in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

Repayment of a grant related to income

The following steps should be followed in repayment of a grant related to income:

(a) The repayment should be applied first against any unamortised deferred credit recognised in respect of the grant.

(b) To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment should be recognised immediately in profit or loss.

The repayment of a grant related to an asset should be recognised either by reducing the deferred income balance by the amount repayable or by increasing the carrying amount of the asset.

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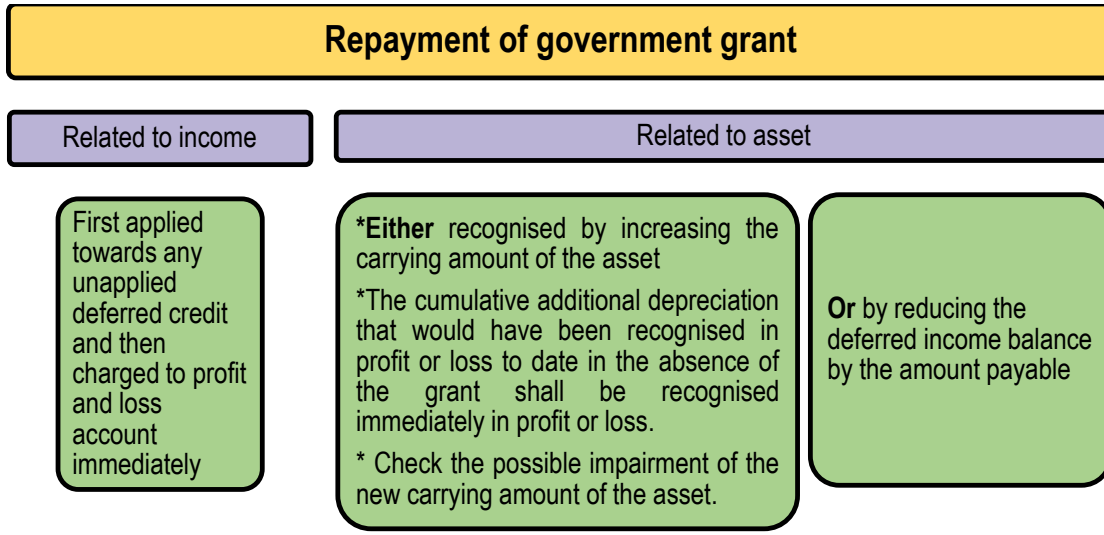


Illustration 10

A Ltd. has received a grant of ₹ 10,00,00,000 in the year 20X1-20X2 from local government in the form of subsidy for selling goods at lower price to lower income group population in a particular area for two years. A Ltd. had accounted for the grant as income in the year 20X1-20X2. While accounting for the grant in the year 20X1-20X2, A Ltd. was reasonably assured that all the conditions attached to the grant will be complied with. However, in the year 20X5-20X6, it was found that A Ltd. has not complied with the above condition and therefore notice of refund of grant has been served to it. A Ltd. has contested but lost in court in 20X5-20X6 and now grant is fully repayable. The accounting done in previous years was not incorrect and was not an error as per Ind AS 8.

Analyse how should A Ltd. reflect repayable grant in its financial statements ending 20X5-20X6?

Solution

Paragraph 32 of Ind AS 20, states that a government grant that becomes repayable shall be accounted for as a change in accounting estimate (see Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors).

Repayment of a grant related to income shall be applied first against any unamortised deferred credit recognised in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment shall be recognised immediately in profit or loss.

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The following journal entries should be passed:

S. No.	Particulars	Nature of Account		Amount (₹ in crores)
(i)	Repayment of Government Grant To Grant repayable (Being recognition of repayment of grant in statement of profit or loss)	Expense (P/L) Balance sheet (Liability)	Dr.	10 10
(ii)	Grant repayable To Bank (Being grant refunded)	Balance sheet (Liability) Balance sheet (Asset)	Dr.	10 10

Assuming that no deferred credit balance exists in the year 20X5-20X6, therefore repayment recognised in P&L.

*****

2.9 DISCLOSURE

The following should be disclosed:

(a) the accounting policy adopted for government grants;

(b) the methods of presentation adopted for government grants in the financial statements;

(c) the nature and extent of government grants recognised in the financial statements;

(d) an indication of other forms of government assistance from which the entity has directly benefited. At times, the significance of the benefit of government assistance may be such that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading; and

(e) unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.

*****

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2.10 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Hindustan Unilever Limited' for the financial year 2021-2022 with respect to 'Government Grants'.

Government grants:

The Company has received approval under the Production Linked Incentive Scheme of the Government of India for specific product categories. Incentive under the scheme is subject to meeting certain committed investments and defined incremental sales threshold. Such grants are recognised as other operating revenue when there is a reasonable assurance that the Company will comply with all necessary conditions attached to that.

Income from such grants is recognised on a systematic basis over the periods to which they relate.

	Year ended 31st March, 2022	Year ended 31st March, 2021
Sale of products	50,336	45,311
Other operating revenue*		
Income from services rendered	281	225
Commission income on consignment sales	315	264
Government grants (GST budgetary support and Production linked incentives) #	140	108
Others (including scrap sales, rentals, etc)	121	88
Total	**51,193**	**45,996**

Previous period figures have been re-classified from Others for better presentation

(Source: Annual Report 2021-2022 – Hindustan Unilever Limited)

2.11 SIGNIFICANT DIFFERENCES BETWEEN IND AS 20 AND AS 12

S. No.	Particulars	Ind AS 20	AS 12
1.	Monetary grants related to non-depreciable assets	Taken to the statement of profit and loss assuming that all grants have conditions attached to it. Specifically prohibits recognition of grants directly in the shareholders' funds	Credited as capital reserve which is part of shareholder's funds. If such grant requires fulfilment of certain obligations, credit the grant amount to income over the same period over which the cost of meeting such obligations is charged to income.
2.	Non-monetary	Accounted for at fair value	• Accounted for on the basis

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	government grant given at a concessional rate	or at nominal value	of their acquisition cost • Non-monetary assets given free of cost are recorded at a nominal value
3.	Grants in the nature of promoter's contribution	Ind AS 20 does not recognise government grants of the nature of promoters' contribution. As stated at (1) above, Ind AS 20 is based on the principle that all government grants would normally have certain obligations attached to them and it, accordingly, requires all grants to be recognised as income over the periods which bear the cost of meeting the obligation.	To be credited to capital reserve and to be treated as part of shareholders' funds
4.	Loan received from the government at below-market rate of interest	Measured in accordance with Ind AS 109 (which requires all loans to be recognised at fair value, thus requiring interest to be imputed to loans with a below-market rate of interest)	AS 12 does not deal with such cases
5.	Government assistance not falling within the definition of government grants	Requires an indication of other forms of government assistance from which the entity has directly benefited and should be disclosed in the financial statements	Does not deal with such government assistance

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. ABC Ltd. has received the following grants from the Government of Delhi for its newly started pharmaceutical business:

   - ₹ 20 lakhs received for immediate start-up of business without any further condition.
   - ₹ 50 lakhs received for research and development of drugs required for the treatment of cardiovascular diseases with following conditions:
     - that drugs should be available to the public at 20% cheaper from current market price; and
     - the drugs should be in accordance with quality prescribed by the World Health Organisation [WHO].
   - Two acres of land (fair Value: ₹ 10 Lakhs) received for set up of plant.
   - ₹ 2 lakhs received for purchase of machinery of ₹ 10 lakhs. Useful life of machinery is 5 years. Depreciation on this machinery is to be charged on straight-line basis.

   Recommend how should ABC Ltd. recognise the government grants in its books of accounts.

2. A Limited received from the government a loan of ₹1,00,00,000 @ 5% payable after 5 years in a bulleted payment. The prevailing market rate of interest is 12%. Interest is payable regularly at the end of each year.

   Calculate the amount of government grant and pass necessary journal entry. Also examine how the government grant be recognised. Also state how the grant will be recognized in the statement of profit or loss assuming that the loan is to finance a depreciable asset.

3. MNC Ltd. has received grant in the nature of exemption of custom duty on capital goods with certain conditions related to export of goods under Export Promotion Capital Goods (EPCG) scheme of Government of India.

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State whether the same is a government grant under Ind AS 20, Government Grants and Disclosure of Government Assistance? If yes, then how the same is to be accounted for if it is

(a) A grant related to asset; or

(b) A grant related to income.

4. ABC Ltd is a government company and is a first-time adopter of Ind AS. As per the previous GAAP, the contributions received by ABC Ltd. from the government (which holds 100% shareholding in ABC Ltd.) which is in the nature of promoters' contribution have been recognised in capital reserve and treated as part of shareholders' funds in accordance with the provisions of AS 12, Accounting for Government Grants.

State whether the accounting treatment of the grants in the nature of promoters' contribution as per AS 12 is also permitted under Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance.

5. Rainbow Limited carries out various projects for which it has either received government financial assistance or is in the process of receiving the same. The company has received two grants of ₹ 1,00,000 each, relating to the following ongoing research and development projects:

(i) The first grant relates to the "Clean river project" which involves research into the effect of various chemicals waste from the industrial area in Madhya Pradesh. However, no major steps have been completed by Rainbow limited to commence this research as at 31st March, 20X2.

(ii) The second grant relates to the commercial development of a new equipment that can be used to manufacture eco-friendly substitutes for existing plastic products. Rainbow Limited is confident about the technical feasibility and financial viability of this new technology which will be available for sale in the market by April 20X3.

In September 20X1, due to the floods near one of its factories, the entire production was lost and Rainbow Limited had to shut down the factory for a period of 3 months. The State Government announced a compensation package for all the manufacturing entities affected due to the floods. As per the scheme, Rainbow Limited is entitled to a compensation based on the average of previous three months' sales figure prior to the floods, for which the company is required to submit an application form on or before 30th June, 20X2 with necessary figures. The financial statements of Rainbow Limited for the year ended 31st March 20X2 are to be adopted on 31st May, 20X2, by which date the claim form would not have been filed with the State Government.

Suggest the accounting treatment of, if any, for the two grants received and the flood-related compensation in the books of accounts of Rainbow Limited as at 31st March, 20X2.

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6. An entity opens a new factory and receives a government grant of ₹ 15,000 in respect of capital equipment costing ₹ 1,00,000. It depreciates all plant and machinery at 20% per annum on straight-line basis.

   Show the statement of profit and loss and balance sheet extracts in respect of the grant for first year under both the methods as per Ind AS 20.

7. A company receives a cash grant of ₹ 30,000 on 31st March 20X1. The grant is towards the cost of training young apprentices. Training programme is expected to last for 18 months starting from 1st April 20X1. Actual costs of the training incurred in 20X1-20X2 was ₹ 50,000 and in 20X2-20X3 ₹ 25,000.

   State, how this grant should be accounted for.

8. Entity A is awarded a government grant of ₹ 60,000 receivable over three years (₹ 40,000 in year 1 and ₹ 10,000 in each of years 2 and 3), contingent on creating 10 new jobs and maintaining them for three years. The employees are recruited at a total cost of ₹ 30,000, and the wage bill for the first year is ₹ 1,00,000, rising by ₹ 10,000 in each of the subsequent years.

   Calculate the grant income and deferred income to be accounted for in the books for the years 1, 2 and 3 under the following two situations:

   (a) There is reasonable assurance that the entity will comply with the conditions attaching to them and the grant will be received

   (b) There is no reasonable assurance that the grant will be received.

Answers

1. ABC Ltd. should recognise the grants in the following manner:

- ₹ 20 lakhs have been received for immediate start-up of business. This should be recognised in Statement of Profit and Loss immediately as there are no further conditions attached to the grant.
- ₹ 50 lakhs should be recognised in profit or loss on a systematic basis over the periods which the entity recognises as expense the related costs for which the grants are intended to compensate provided that there is reasonable assurance that ABC Ltd. will comply with the conditions attached to the grant.
- Land should be recognised at fair value of ₹ 10 lakhs and government grant should be presented in the balance sheet by setting up the grant as deferred income. Alternatively, deduct the amount of grant from the cost of the asset. In the given case, the land is granted at no cost. It will be presented in the books at nominal value.

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- ₹ 2 lakhs should be recognised as deferred income and will be transferred to profit and loss over the useful life of the asset. In this case, ₹ 40,000 [₹ 2 lakhs/5] should be credited to profit and loss each year over a period of 5 years. Alternatively, ₹ 2,00,000 will be deducted from the cost of the asset and depreciation will be charged at reduced amount of ₹ 8,00,000 (₹ 10,00,000 – ₹ 2,00,000) every year.

2. The fair value of the loan is calculated at ₹ 74,76,656 (refer Working Note).

Year	Opening Balance	Interest calculated @ 12%	Interest paid @ 5% on ₹ 1,00,00,000 + principal paid	Closing Balance
(a)	(b)	(c) = (b) x 12%	(d)	(e) =(b) + (c) – (d)
1	74,76,656	8,97,200	5,00,000	78,73,856
2	78,73,856	9,44,862	5,00,000	83,18,718
3	83,18,718	9,98,246	5,00,000	88,16,964
4	88,16,964	10,58,036	5,00,000	93,75,000
5	93,75,000	11,25,000	1,05,00,000	Nil

A Limited will recognise ₹ 25,23,344 (₹ 1,00,00,000 – ₹ 74,76,656) as the government grant and will make the following entry on receipt of loan:

Bank Account	Dr.	1,00,00,000	
To Deferred Income			25,23,344
To Loan Account			74,76,656

₹ 25,23,344 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

If the loan is to finance a depreciable asset. ₹ 25,23,344 will be recognised in profit or loss on the same basis as depreciation.

Working Note:

Particulars	Rs.	Discounting factor@ 12%	Present value taking 12% as the discount rate (Rs.)
Interest @ 5% for Year 1 on loan amount of ₹ 1 crore	5,00,000	0.893	4,46,429
Interest @ 5% for Year 2 on loan amount of ₹ 1 crore	5,00,000	0.798	3,98,597

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Interest @ 5% for Year 3 on loan amount of ₹ 1 crore	5,00,000	0.712	3,55,890
Interest @ 5% for Year 4 on loan amount of ₹ 1 crore	5,00,000	0.636	3,17,759
Interest @ 5% for Year 5 on loan amount of ₹ 1 crore	5,00,000	0.567	2,83,713
Loan	1,00,00,000	0.567	56,74,269
Present value of loan at the beginning of Year 1			**74,76,656**

The above present value above has been computed on full scale basis.

3. Paragraph 3 of Ind AS 20 states that Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

In accordance with the above, in the given case exemption of custom duty under EPCG scheme is a government grant and should be accounted for as per the provisions of Ind AS 20.

Ind AS 20 defines grant related to assets and grants related to income as follows:

"Grants related to asset are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held. Grants related to income are government grants other than those related to assets."

Presentation

It is pertinent to note that the classification of the grant as related to asset or income will require exercise of judgement and careful examination of the facts, objective and conditions attached to the scheme of the government. Care is also required to ascertain the purpose of the grant and the costs for which the grant is intended to compensate. Based on the evaluation of facts, if it is ascertained that the grant is an asset related grant then the same shall be presented as per paragraphs 24 and 26 of Ind AS 20 which has been stated below:

Presentation of grants related to assets

As per para 24, government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet by setting up the grant as deferred income.

As per para 26, the grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset.

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If it is determined that the grant is related to income then the same shall be presented as follows:

Presentation of grants related to income

As per para 29, grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense.

It may be further noted that as per paragraph 12 of Ind AS 20, government grants shall be accounted as follows:

As per para 12, government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

In the given case, if based on the terms and conditions of the scheme, the grant received is to compensate the import cost of assets subject to an export obligation as prescribed in the EPCG Scheme; recognition of grant in the statement of profit and loss should be linked to fulfilment of associated export obligations.

However, if the grant received is to compensate the import cost of the asset and based on the examination of the terms and conditions of the grant, if it can be reasonably concluded that conditions relating to export of goods are subsidiary conditions, then it is appropriate to recognise such grant in profit or loss over the life of the underlying asset.

4. Paragraph 2 of Ind AS 20, "Accounting for Government Grants and Disclosure of Government Assistance" inter alia states that the Standard does not deal with government participation in the ownership of the entity.

Since ABC Ltd. is a government company, it implies that government has 100% shareholding in the entity. Accordingly, as per Ind AS 20, the entity needs to determine whether the payment is provided as a shareholder contribution or as a government. Equity contributions will be recorded in equity while grants will be shown in the Statement of Profit and Loss.

Where it is concluded that the contributions are in the nature of government grant, the entity shall apply the principles of Ind AS 20 retrospectively as specified in Ind AS 101 'First Time Adoption of Ind AS'. Ind AS 20 requires all grants to be recognised as income on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. Unlike AS 12, Ind AS 20 requires the grant to be classified as either a capital or an income grant and does not permit recognition of government grants in the nature of promoter's contribution directly to shareholders' funds.

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5. Accounting treatment for:

1. First Grant

The first grant for 'Clear River Project' involving research into effects of various chemicals waste from the industrial area in Madhya Pradesh, seems to be unconditional as no details regarding its refund has been mentioned. Even though the research has not been started nor any major steps have been completed by Rainbow Limited to commence the research, yet the grant will be recognised immediately in profit or loss for the year ended 31st March, 20X2.

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

2. Second Grant

The second grant related to commercial development of a new equipment is a grant related to depreciable asset. As per the information given in the question, the equipment will be available for sale in the market from April, 20X3. Hence, by that time, grant relates to the construction of an asset and should be initially recognised as deferred income.

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

The entity should recognise a liability in its balance sheets as at 31st March, 20X2 and 31st March, 20X3. Once the equipment starts getting used in the manufacturing process, the deferred grant income of ₹ 100,000 should be recognised over the asset's useful life to compensate for depreciation costs.

Alternatively, as per Ind AS 20, Rainbow Limited would also be permitted to offset the deferred income of ₹ 100,000 against the cost of the equipment as at 1st April, 20X3.

3. For flood related compensation

Rainbow Limited will be able to submit an application form only after 31st May, 20X2 ie in the year 20X2-20X3. Although flood happened in September, 20X1 and loss was incurred due to flood in the year 20X1-20X2, the entity should recognise the income from the government grant in the year when the application form related to it is submitted and approved by the government for compensation.

Since, in the year 20X1-20X2, the application form could not be submitted due to adoption of financials with respect to sales figure before flood occurred, Rainbow Limited should not recognise the grant income as it has not become receivable as at 31st March,20X2.

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6. (a) When grant is treated as deferred income

Statement of profit and loss – An extract

	₹
Depreciation (₹ 1,00,000 x 20%)	(20,000)
Government grant credit (W.N.1)	3,000

Balance Sheet - An extract

		₹
Non-current assets		
Property, plant and equipment	1,00,000	
Less: Accumulated depreciation	(1,00,000 x 20%) (20,000)	80,000
		XXXX
Non-current liabilities		
Government grant	[12,000 – 3,000 (current liability)]	9,000
Current liabilities		
Government grant	(15,000 x 20%)	3,000
		XXXX

Working Note:

1. Government grant deferred income account

	₹		₹
To Profit or loss (15,000 × 20%)	3,000	By Grant cash received	15,000
To Balance c/f	12,000		
	15,000		15,000

(b) When grant is deducted from cost of the asset

Statement of profit and loss – An extract

	₹
Depreciation [(₹ 1,00,000 – 15,000) x 20%]	(17,000)

Balance Sheet – An extract

		₹
Non-current assets		
Property, plant and equipment	(1,00,000-15,000) 85,000	
Less: Accumulated depreciation	(17,000)	68,000

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7. As at 31st March 20X1 the grant would be recognised as a liability (deferred income) and presented in the balance sheet as a split between current and non-current amounts.

₹ 20,000 [(12 months / 18 months) x 30,000] is current which would be recognised in the statement of profit and loss for the year ended 31st March, 20X2. The balance amount of ₹ 10,000 will be shown as non-current.

At the end of year 20X1-20X2, there would be a current balance of 10,000 (being the non-current balance at the end of year 20X1-20X1 reclassified as current) in the balance sheet. This would be recognised in profit in the year 20X2-20X3.

Extracts from the financial statements are as follows:

Balance Sheet (extracts)

	31 March 20X1	31 March 20X2	31 March 20X3
Current liabilities			
Deferred income	20,000	10,000	-
Non-current liabilities			
Deferred income	10,000	-	-

Statement of profit and loss (extracts)

	31 March 20X2	31 March 20X3
Method 1		
Other Income - Government grant received	20,000	10,000
Training costs	(50,000)	(25,000)
Method 2		
Training costs (50,000 – 20,000)	30,000	
Training costs (25,000 – 10,000)		15,000

8. (a) When there is reasonable assurance

The grant of ₹ 60,000 should be recognised at the beginning of the first year as receivable and will be compensated for the related costs over three years.

The initial journal entry would be:

Grant Receivable Ac	Dr. ₹ 60,000	
To Deferred Income A/c		₹ 60,000

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Calculation of grant income and deferred income:

Year	Labour Cost	Grant Income	Computation of Grant Income	Deferred Income at the end of the year	Computation of deferred income at the end of the year
	₹	₹		₹	
1	1,30,000	21,667	60,000 x (130/360)	38,333	(60,000 – 21,667)
2	1,10,000	18,333	60,000 x (110/360)	20,000	(38,333 – 18,333)
3	1,20,000	20,000	60,000 x (120/360)	-	(20,000 – 20,000)
	3,60,000	60,000			

Therefore, grant income to be recognised in the Statement of Profit and Loss for the years 1, 2 and 3 would be ₹ 21,667, ₹ 18,333 and ₹ 20,000 respectively.

The amount of grant that has not yet been credited to the statement of profit and loss i.e. deferred income is to be shown in the balance sheet. Hence deferred income balance as at end of year 1, 2 and 3 are ₹ 38,333, ₹ 20,000 and Nil respectively.

(b) When reasonable assurance is not there

The grant of ₹ 60,000 should be recognised over three years to compensate for the related costs.

The journal entry on receipt of grant at year 1 would be:

Grant Receivable Ac Dr. ₹ 40,000

To Deferred Income A/c ₹ 40,000

Calculation of Grant Income and Deferred Income:

Year	Labour Cost	Grant Income	Computation of Grant Income	Deferred Income at the end of the year	Computation of deferred income at the end of the year
	₹	₹		₹	
1	1,30,000	21,667	60,000 x (130/360)	18,333	(40,000 – 21,667)
2	1,10,000	18,333	60,000 x (110/360)	10,000	(50,000 – 21,667 – 18,333)
3	1,20,000	20,000	60,000 x (120/360)	-	(60,000 – 21,667 – 18,333 – 20,000)
	3,60,000	60,000			

Therefore, Grant income to be recognised in the statement of Profit and Loss for the years 1, 2 and 3 would be ₹ 21,667, ₹ 18,333 and ₹ 20,000 respectively.

Amount of grant that has not yet been credited to the statement of profit and loss i.e; deferred income is to be shown in the balance sheet. Hence, deferred income balance as at the end of year 1, 2 and 3 are ₹ 18,333, ₹ 10,000 and Nil respectively.

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UNIT 3 :
INDIAN ACCOUNTING STANDARD 102 : SHARE-BASED PAYMENT

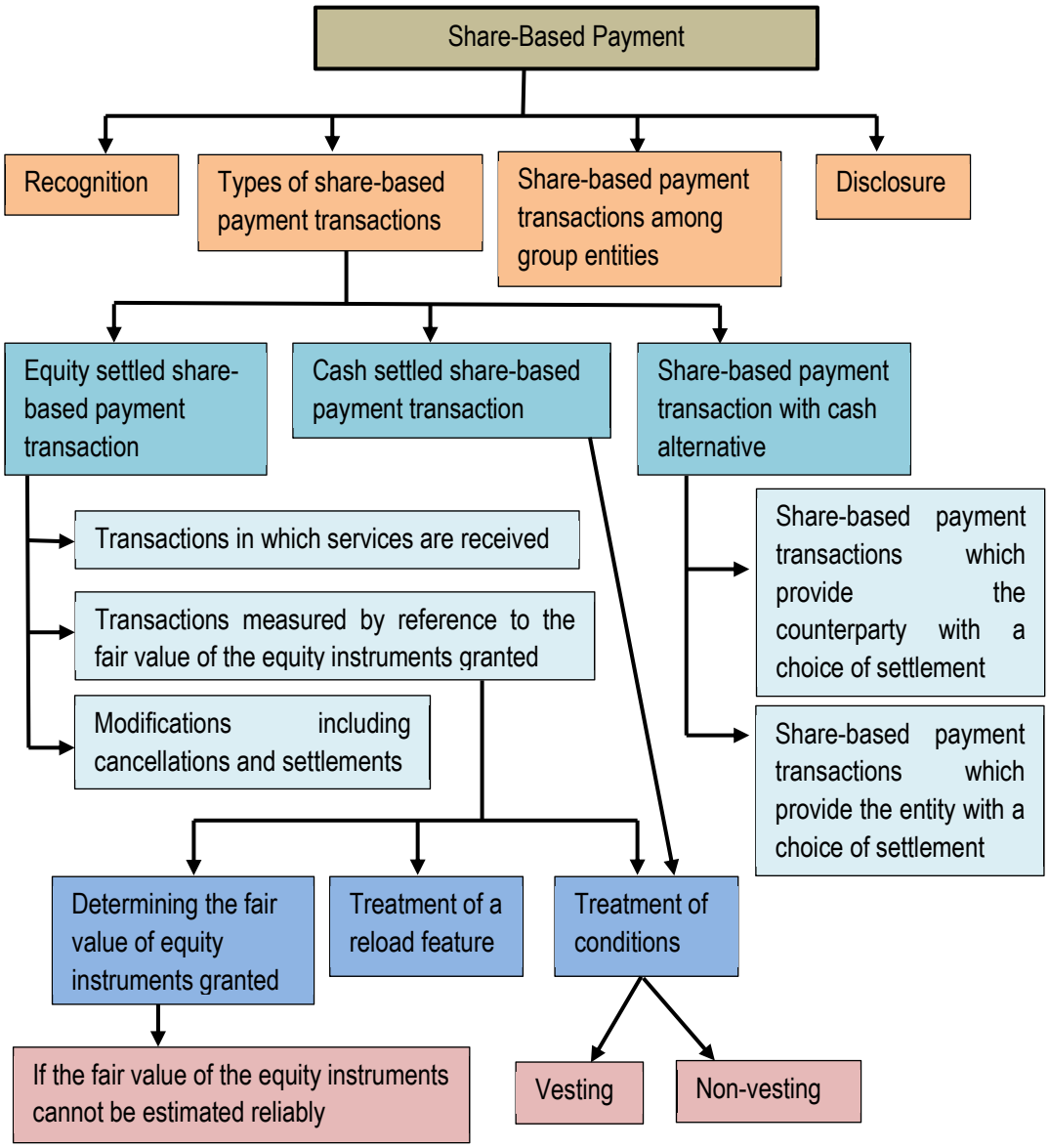
LEARNING OUTCOMES

After studying this unit, you would be able to:

- Examine the transactions as share-based payment transactions
- Study the various types of share-based payments
- Recognize and measure the share-based payment transactions in the books
- Deal with the accounting issues in case of various vesting conditions attached with the share-based payment transactions
- Determine the fair value of share-based payment transactions
- Identify the accounting treatment for modification, cancellation and settlements of such transactions
- Make necessary and significant disclosures with respect to share-based payment transactions in the financial statements.

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UNIT OVERVIEW



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3.1 INTRODUCTION



As the name suggests, it is a payment based on price or value of shares. Entities often grant shares or share options to employees or other parties. Share plans and share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.

In India, accounting of share-based payment transactions is done in accordance with SEBI guidelines and Guidance Note on Accounting for Employee Share-Based Payments or on the basis of Ind AS 102 "Share-Based Payment". The corporate entities following Ind AS would not account for share-based payment based on Guidance Note. The Companies Act, 2013 also discusses about it under section 62.

Under Section 62 (1) (b) of the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

3.2 DEFINITION

Some of the terms used in Ind AS 102 are as follows:

a. **Cash-settled share-based payment transaction:** A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.

b. **Employees and others providing similar services:** Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, i.e. those people having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.

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c. **Equity instrument:** A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

d. **Equity instrument granted:** The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

e. **Equity-settled share-based payment transaction:** A share-based payment transaction in which the entity

(a) receives goods or services as consideration for its own equity instruments (including shares or share options), or

(b) receives goods or services but has no obligation to settle the transaction with the supplier.

f. **Fair value:** The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

g. **Grant date :** The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At the grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

h. **Intrinsic value:** The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a share option with an exercise price of ₹ 15, on a share with a fair value of ₹ 20, has an intrinsic value of ₹ 5.

i. **Market condition:** A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities.

j. **Measurement date:** The date at which the fair value of the equity instruments granted is measured for the purposes of this Ind AS. For transactions with employees and others

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providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

k. **Performance condition:** A vesting condition that requires:

(a) the counterparty to complete a specified period of service (ie a service condition); the service requirement can be explicit or implicit; and

(b) specified performance target(s) to be met while the counterparty is rendering the service required in (a).

The period of achieving the performance target(s):

(a) shall not extend beyond the end of the service period; and

(b) may start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

A performance target is defined by reference to:

(a) the entity's own operations (or activities) or the operations or activities of another entity in the same group (i.e. a non-market condition); or

(b) the price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group (including shares and share options) (ie a market condition).

A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

l. **Reload feature:** A feature that provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price.

m. **Reload option**: A new share option granted when a share is used to satisfy the exercise price of a previous share option.

n. **Service condition**: A vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. A service condition does not require a performance target to be met.

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o. **Share option:** A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

p. **Vest:** To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.

q. **Vesting condition:** A condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.

r. **Vesting period:** The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

3.2.1 Share-based payment arrangement

It is an agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive -

(a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, Or

(b) **equity instruments** (including shares or **share options**) of the entity or another group entity,

provided the specified **vesting conditions**, if any, are met.

3.2.2 Share-Based Payment Transaction

It is a transaction in which the entity -

(a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

Analysis of share-based payment (SBP)

1. Share-based payment should be formed with an **agreement** between an entity & a party (includes employees) which essentially means that a communication of the terms and conditions should be in place in order to have share-based payment.

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Example 1

A management committee of an entity has initiated a plan to provide some stock options to its employees but there are some terms which are yet to be finalized and the plan is not yet communicated to the employee. Since, there is no formal communication stating the terms or conditions of the agreement, it will not attract Ind AS 102 provisions. The standard will be attracted when there will be a binding arrangement.

2. Share-based payments should be made for goods/ services and should be with an external person e.g. supplier including employee.

Examples 2 & 3

2. Goods/services have been received by an entity for which it has issued its own equity shares to the counterparty (who has supplied the goods) at discount/ premium. The value of the goods received has been paid by using its own equity shares but if the fair value of the goods received are more / less than the value of share issued by an entity, then some un-identified goods / services will be received / or have been received. Hence, Ind AS 102 will still be applicable for such unidentified goods/ services.

3. An entity issuing its own shares to a charity without any consideration will be covered under Ind AS 102. This is a share-based payment arrangement, covered under Ind AS 102 (not a share-based payment transaction).

3. Goods/services that are being received by an entity should be from a supplier which will include an employee of the entity. The goods/services received from a counterparty who act in the capacity of shareholder will not be covered under Ind AS 102.

Example 4

Service Maintenance Agreement has been entered by an entity with one of the supplier, outside the entity which requires to pay for these services by issuing equity shares of the entity. Such an agreement will be covered under Ind AS 102.

4. A transaction with an employee (or other party) in his/her capacity as a holder of equity instruments of the entity is not a share-based payment transaction.

Example 5

An entity issued right shares to all its shareholders which include employees of the company. Since the employees who have received such shares are acting in the capacity of shareholders and not as employees, this transaction will **not** be covered under Ind AS 102.

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5. For receiving goods / services, an entity needs to settle the transaction either by issuing its own equity shares / or group entity's shares (which is called as "equity settled") or by paying cash amount equivalent against such shares (which is called as "cash settled") or a combination of these two where settlement option rests either with an entity or with the counterparty.

6. Equity instruments, which means a residual interest in asset & liability of the company will include –

   a) Ordinary shares

   b) Redeemable preference shares

   c) Written call option or warrants over such ordinary shares.

7. Share-based payment transaction may be settled by an entity through its own equity shares or one of group's entity shares which means that a parent of the reporting entity might issue shares on behalf of its subsidiary for providing goods/services to its subsidiary and the same transaction will be covered under Ind AS 102.

Example 6

1. A parent issues share options to the employee of its subsidiary company or a subsidiary company issues share options to its employees based on the price of equity shares of its parent company or the subsidiary company respectively. Both the plans will be covered under Ind AS 102.

2. An entity issues certain benefits to its employees by taking a reference of earnings of next year. Since the benefit is **not** based on share price of the entity, hence this transaction will not be covered under Ind AS 102. However, it may be treated as employee benefits under Ind AS 19.

8. Vesting conditions means the criteria which is to be fulfilled (if it is required as per the share-based agreement) in order to get such Shared based payment.

Example 7

A stock option has been issued by an entity to its employees those who remain in service for next 4 years. Those who leave before 4 years will not get the share-based payments. Staying with the organization for 4 years is a vesting condition in order to get the shared based payment.

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3.3 SCOPE

3.3.1 What is covered within Ind AS 102?

Based on the analysis of the definitions, the scope of the standard are as follows:



- Covers settlement in equity or in cash or alternative settlement option i.e. to issue shares or by paying cash.
- Even if an entity is not able to identify all goods/ services that are being received by settling the transaction, either by issuing its own equity / group's equity or by paying a cash value equivalent to the equity prices, still it will be covered under Ind AS 102.
- Un-identified goods/ services that are being received will be covered in the standard.
- Share-based payment can be settled by another group entity or by using equity shares of group's entity.
- Employee of a company, working as a service provider to an entity and receiving share-based payments (e.g. stock options, warrants etc.) will be covered under this standard.
- Goods will include inventories, consumables, property, plant & equipment and other non-financial items.

Examples 8 - 11

8. An entity grants 10 shares to its employees who will remain in service for next 2 years - this will be covered within the standard as equity settled share-based payment.
9. An entity grants ₹ 1,000 to each employee which is same as the current equity price. This will not be covered under Ind AS 102 as the amount of ₹ 1,000 is fixed now and it will be paid to the employees even if the market rate of its share goes up/down from the current level.
10. An entity received services from a party who is acting as shareholder will not be covered under the standard. However, an employee who received additional payment from the entity for providing services other than its normal employment will be covered under this standard.

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11. An entity has agreed to provide bonus to its employees purely based on the share price of the entity. Since the benefit is with reference to the share price of the entity, hence it will be covered under Ind AS 102.

3.3.2 What is not covered in Ind AS 102?

Transactions with shareholders as a whole, i.e., when the shareholders act solely in their capacity as shareholders.

Example 12

If an entity grants all holders of a particular class of its equity instruments the right to acquire additional equity instruments of the entity at a price that is less than the fair value of those equity instruments, and an employee receives such a right because he/she is a holder of equity instruments of that particular class, the granting or exercise of that right is not subject to the requirements of Ind AS 102.

- Entity shall not apply this standard to transactions in which the entity acquires goods as part of net assets acquired in business combinations as defined by Ind AS 103 'Business Combinations', or contribution for Joint ventures as per Ind AS 111 'Joint Arrangements'.

Examples 13 and 14

13. An entity has issued equity instruments in exchange for control of the acquiree is not within the scope of this standard. However, if the equity instruments are being issued to acquiree's employees in their capacity as employee, then it will be covered under Ind AS 102.

14. An entity buys a business from an individual to whom equity instruments are being issued. The individual will be working as an employee in the combined new entity. The instruments that are being issued as part of business purchase consideration under Ind AS 103 'Business Combination' will not be covered under Ind AS 102. However, if the equity instrument is being issued in the capacity of accepting employment in a new company, then it will be covered within Ind AS 102.

- Financial instruments issued to buy/sell non-financial items which can be settled at net will be outside Ind AS 102.

Example 15

Contracts for purchase and sale of goods/ services which are entered for settling in net amounts/ or keep it for speculation purposes will be covered under Ind AS 109- Financial Instruments and hence will not be covered under Ind AS 102.

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3.4 RECOGNITION

An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.



Analysis of recognition of SBP (Share-based payments)

- All such goods / services which are being received in share-based payment will be recognized when such goods are received or services are obtained.
- An entity would recognize an expense or an asset if the goods and/or services received meet the criteria for recognition as an asset.
- A corresponding increase in equity for equity settled transactions or in liabilities for cash-settled transactions would be recognized.
- The recognition will depend on vesting conditions, if any (in certain cases there will not be any vesting condition). It means, if there are certain conditions either service related or performance related which needs to be completed in order to be eligible for such share-based payments, then recognition will be based on the best estimate of the expected vesting value of such share-based payments.

Examples 16 and 17

16. An entity purchases some inventory from a supplier for which the entity will issue 100 shares as payment. The fair value of the inventory was ₹ 15,000. On purchase of inventory, the transaction will be recorded by a debit to the inventory and a credit to equity with an amount of ₹ 15,000 i.e. taking fair value of goods / services so transacted (except in case of transactions with an employee). However, if the fair value of goods / services is not reliably measurable, then fair value of shares can be considered.

17. An entity has given 100 stock options to each of its 1,000 employees for those who will remain in service for next 4 years. The grant date was 1st January, 20X1. The condition to remain in service shows that the stock option has been given for the

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services to be provided in the next 4 years; hence at the end of each year, the entity will estimate the expected number of employees who will remain in service and accordingly will recognize the cost over 4 years.

Timing	• Goods: when received • Services: When obtained
Recognition (debit entry)	• Expenses • Asset (if goods/services qualify as asset)
Recognition (credit entry)	• Increase in equity (for equity—settled SBP) • Liability (for cash—settled SBP)

3.5 TYPES OF SHARE-BASED PAYMENTS

3.5.1 Equity Settled- Share-Based Payments



For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

Analysis of the Equity Settled Share-based payments

- As per Ind AS 102, all goods or services which are received by an entity should be fair valued in order to arrive at the transaction price to recognize the share-based payment.
- In the absence of reliable information to arrive at the fair value of goods & services received, the fair value of equity instrument issued will be used.
- In the case of EMPLOYEES, it is required by the standard to use fair value of equity granted because it is practically not possible to identify the fair value of the services rendered by the employees.

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- In the case of awards to non-employees, there is a rebuttable presumption that the fair value of goods/services received from any external supplier can be estimated. However, if this is not feasible, then an indirect reference can be used by taking fair value of instruments issued.
- There might be some cases where the transaction is other than with employee, where goods / services received are less than the fair value of equity share issued then some un-identified goods / services are recognized by taking a difference between fair value of equity instruments issued and fair value of goods / services received.

Examples 18 and 19

18. An entity has agreed to issue 100 shares to each of its 500 employees if they remain in service for the next 3 years. In this case 3 years is a service period, on completion of which shares will be issued by the entity. Since this is a share-based payment plan with employees of the entity, the fair value of equity instruments issued will be used for calculating transaction value of the share-based payments.

19. An entity agreed to issue 100 shares to a supplier to provide some consultancy services for next 2 years. There is a similar contract in the market which has a value of ₹ 20,000. The similar value of the contract will be used as fair value of this share-based payment transaction unless there is no reliable fair value is available.

Measurement principle for equity—settled awards:

Counterparty	Measurement basis	Measurement date	Recognition date
Employee	Fair value of equity instruments awarded	Grant date	Date goods or services received
Non-employee	Fair value of goods or services received	Date goods or services received	Date goods or services received

Illustration 1-Equity Settled Shared Based Payment- Service conditions

ABC Limited granted to its employees, share options with a fair value of ₹ 5,00,000 on 1st April, 20X0, if they remain in the organization upto 31st March, 20X3. The exercise price if the share option is NIL. On 31st March, 20X1, ABC Limited expects only 91% of the employees to remain in the employment. On 31st March, 20X2, company expects only 89% of the employees to remain in the employment. However, only 82% of the employees remained in the organization at the end of March, 20X3 and all of them exercised their options. Share options will be settled in 5,000 shares of ₹ 100 each.

Pass the Journal entries?

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Solution

Period	Proportion	Fair value	To be vested	Cumulative expenses	Expenses
	a	b	c	d= b x c x a	e = d-previous period d
Period 1	1/3	5,00,000	91%	1,51,667	1,51,667
Period 2	2/3	5,00,000	89%	2,96,667	1,45,000
Period 3	3/3	5,00,000	82%	4,10,000	1,13,333
					4,10,000

Journal Entries

31st March, 20X1			
Employee benefits expenses (transferred to P/L)	Dr.	1,51,667	
To Share-based payment reserve (equity)			1,51,667
(1/3 of expected vested equity instruments value)			
31st March, 20X2			
Employee benefits expenses (transferred to P/L)	Dr.	1,45,000	
To Share-based payment reserve (equity)			1,45,000
(2/3 of expected vested equity instruments value)			
31st March, 20X3			
Employee benefits expenses (transferred to P/L)	Dr.	1,13,333	
To Share-based payment reserve (equity)			1,13,333
(Final vested equity instruments value)			
Share-based payment reserve (equity)	Dr.	4,10,000	
To Share Capital/ Securities Premium			4,10,000
(re-allocated and issued shares)			

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3.5.2 Cash Settled- Share-Based Payments

For cash-settled share-based payment transactions, the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognized in profit or loss for the period.

Analysis of the Cash Settled Share-Based Payments

- It is a plan where entity issues rights to its employees/ suppliers where employees/ suppliers will be entitled for a cash payment in future based on equity share prices of the entity / or equity prices of the Group (group means parent company of the entity). In some cases, right to increase in equity prices is also provided which is known as Share Appreciation Rights (SAR).
- The goods/ services received against share-based payment plan to be settled in cash are measured at fair value of the liability and the liability continues to re-measured at every reporting date until it is actually paid off.
- There could be vesting conditions attached to the share-based payment plans e.g. to remain in service for next 3 years etc. The recognition of such share-based payment plans should be done by recognizing fair value of the liability at the time of goods/ services received and not at the date of grant. The liability so recognized will be fair valued at each reporting date and difference in fair value will be charged to profit or loss for the period.
- There could be some cases where no vesting period / condition is required to be fulfilled, in those cases, cash settled share-based payment can be recognized in full at initial recognition itself.

Examples 20 and 21



20. An entity issued share appreciation rights to its existing employees who remains in service for next 3 years and the benefit will then be settled in cash of an equivalent amount of share price.
21. Management of an entity decides to issue bonus amount to certain key employees for their past services based on share price of the entity. The amount equivalent to the shares will be recognized immediately as cost of employees because there are no conditions which are to be vested upon.

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Illustration 2 - Cash Settled Shared-Based Payment - Service conditions

XYZ issued 10,000 Share Appreciation Rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹ 95. SAR can be exercised any time upto 31st March, 20X3. At the end of period on 31st March, 20X1 it is expected that 95% of total employees will exercise the option, 92% of total employees will exercise the option at the end of next year and finally 89% were exercised at the end of the 3rd year. Fair values at the end of each period have been given below:

Fair value of SAR		₹
31st March, 20X1		*112*
31st March, 20X2		*109*
31st March, 20X3		*114*

Pass the Journal entries?

Solution

Period	Fair value a	To be vested b	Cumulative c= a x b x 10,000	Expense d= c-prev. period c
Start	95	100%	9,50,000	9,50,000
Period 1	112	95%	10,64,000	1,14,000
Period 2	109	92%	10,02,800	(61,200)
Period 3	114	89%	10,14,600	11,800
				10,14,600

Journal Entries

1st April, 20X0			
Employee benefits expenses (transfer to P/L)	Dr.	9,50,000	
To Share-based payment liability			9,50,000
(Fair value of the SAR recognized)			
31st March, 20X1			
Employee benefits expenses (transfer to P/L)	Dr.	1,14,000	
To Share-based payment liability			1,14,000
(Fair value of the SAR re-measured)			

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31st March, 20X2			
Share-based payment liability	Dr.	61,200	
To Employee benefits expenses (transfer to P/L)			61,200
(Fair value of the SAR re-measured & reversed)			
31st March, 20X3			
Employee benefits expenses (transfer to P/L)	Dr.	11,800	
To Share-based payment liability			11,800
(Fair value of the SAR recognized)			
Share-based payment liability	Dr.	10,14,600	
To Cash			10,14,600
(Settlement of SAR)			

*****

3.5.3 Share-Based Payment Transactions with Cash Alternatives

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the entity shall account for that transaction, or the components of that transaction, as a cash settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

Analysis of Share-Based Payment Transactions with Cash Alternatives

- The choice either to settle in cash or equity may be with the entity or its counterparty which will define the way of recognizing such alternatives either equity-settled or cash-settled. The choice to select the cash or equity alternatives can be segregated in two parts –

  a) When Counterparty has a choice of settlement

  - When counterparty has a choice of settlement for such share-based payments, then this will be treated as compound instrument which has debt and equity components.
  - When such alternatives are given in case of transactions with parties other than employees where fair value of goods / services is measured directly then the difference between fair value of such goods/ services and the fair value of debt

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component, at the date when the goods or services are received, will be considered to be the value of equity component.

- For other transactions, including transactions with employees, a separate fair value of compound financial instruments will be calculated and accordingly the values of goods/services received will be accounted. To apply this requirement, the entity shall first measure the fair value of the debt component, and then measure the fair value of the equity component — taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument. The fair value of the compound financial instrument is the sum of the fair values of the two components. However, share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cash settled share appreciation rights. In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. Conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component usually will be greater than zero, in which case the fair value of the compound financial instrument will be greater than the fair value of the debt component.
- The entity shall account separately for the goods or services received or acquired in respect of each component of the compound financial instrument. For the debt component, the entity shall recognise the goods or services acquired, and a liability to pay for those goods or services, as the counterparty supplies goods or renders service, in accordance with the requirements applying to cash-settled share-based payment transactions. For the equity component (if any), the entity shall recognise the goods or services received, and an increase in equity, as the counterparty supplies goods or renders service, in accordance with the requirements applying to equity-settled share-based payment transactions.
- At the date of settlement, the entity shall remeasure the liability to its fair value. If the entity issues equity instruments on settlement rather than paying cash, the liability shall be transferred direct to equity, as the consideration for the equity instruments issued.
- If the entity pays in cash on settlement rather than issuing equity instruments, that payment shall be applied to settle the liability in full. Any equity component previously recognised shall remain within equity. By electing to receive cash on settlement, the counterparty forfeited the right to receive equity instruments.

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However, this requirement does not preclude the entity from recognising a transfer within equity, i.e. a transfer from one component of equity to another.

Example 22

An entity issues stock options to its employees which can be claimed either in cash or equity instrument of an entity. Employees need to be in service for next 2 years. Entity needs to find fair value component of equity to be settled and fair value of cash amount to be settled. Each balance sheet date, these values need to be updated. Upon the exercising of the option, if it is in equity then fair value liability will be transferred to the equity in full.

b) *When the entity has a choice of settlement*

If the entity can choose the settlement method then the whole award would be treated as either cash-settled or equity-settled, depending on-

- Whether entity has a present obligation to settle in cash in which case accounting of award would be as a liability. The assumption to consider present obligation to settle in cash would be in those cases when there is no commercial substance to issue equity (e.g. restriction to issue new share capital etc.) or there is past practice or stated policy to settle such type of arrangement in cash only or entity has generally settled in cash whenever counterparty asks for cash settlement.
- There is no such obligation to pay in cash then equity settled accounting treatment would be required.

In case, equity settled accounting has been done but the settlement is required to be done in cash then it would be accounted for as repurchase of an equity interest.

Upon settlement, if the entity elects the settlement alternative with the higher fair value, as at the date of settlement, the entity shall recognise an additional expense for the excess value given, i.e. the difference between the cash paid and the fair value of the equity instruments that would otherwise have been issued, or the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Examples 23 and 24

23. An entity issues stock options to its employees which provide entity an option to settle either in cash or by entity's own shares. As per the past practice of the entity, these kind of stock options have been settled in cash only, hence the entity will create a liability assuming present obligation to settle the options in cash.

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24. An entity has issued certain stock options to its employees where it has right to settle these options either in cash or by its own equity. Based on the past practices, the entity assumed the settlement will be done in equity only and accordingly the fair value of such options at grant date was credited to equity (based on expected vesting rights). However, the options were actually settled in cash, hence all such equity portion will be debited to the extent it was credited as re-purchasing the equity shares, and the portion above the equity portion so debited will be transferred to Profit and Loss of the period.

Illustration 3 - Share-based payment with cash alternative

On 1st January, 20X1, ABC limited gives options to its key management personnel (employees) to take either cash equivalent to 1,000 shares or 1,500 shares. The minimum service requirement is 2 years and shares being taken must be kept for 3 years.

Fair values of the shares are as follows:	₹
Share alternative fair value (with restrictions)	*102*
Grant date fair value on 1st January, 20X1	*113*
Fair value on 31st December, 20X1	*120*
Fair Value on 31st December, 20X2	*132*

The employees exercise their cash option at the end of 20X2.

Pass the journal entries.

Solution

	1st January, 20X1 ₹	31st December, 20X1 ₹	31st December, 20X2 ₹
Equity alternative (1,500 x 102)	1,53,000		
Cash alternative (1,000 x 113)	1,13,000		
Equity option (1,53,000 – 1,13,000)	40,000		
Cash option (cumulative) (using period end fair value		(1,000x120 x ½) 60,000	1,32,000
Equity option (cumulative)		(40,000 x ½) 20,000	40,000

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Expense for the period			
Equity option		20,000	20,000
Cash Option		60,000	72,000
Total		80,000	92,000

Journal Entries

31st December, 20X1			₹
Employee benefits expenses (transfer to P/L)	Dr.	80,000	
To Share-based payment reserve (equity)*			20,000
To Share-based payment liability			60,000
(Recognition of Equity option and cash settlement option)			
31st December, 20X2			
Employee benefits expenses (transfer to P/L)	Dr.	92,000	
To Share-based payment reserve (equity)*			20,000
To Share-based payment liability			72,000
(Recognition of Equity option and cash settlement option)			
Share-based payment liability	Dr.	1,32,000	
To Bank/ Cash			1,32,000
(Settlement in cash)			
Share-based payment reserve (equity)	Dr.	40,000	
To Retained Earnings			40,000

*The equity component recognized (₹ 40,000) shall remain within equity. By electing to receive cash on settlement, the employees forfeited the right to receive equity instruments.

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Illustration 4-Share-based payment - Purchase of goods

Indian Inc. issued 995 shares in exchange for purchase of an office building. The title was transferred in the name of Indian Inc. on February, 20X1 and shares were issued. Fair value of the office building was ₹2,00,000 and face value of each share of Indian Inc was ₹100.

Pass the journal entries?

Solution

1st February, 20X1			**₹**
Office Building	Dr.	2,00,000	
To Share capital (995 x 100)			99,500
To Securities premium (balance)			1,00,500
(Recognition of equity option and cash settlement option)			

*****

Illustration 5-Share-based payment - Services

Reliance limited hired a maintenance company for its oil fields. The services will be settled by issuing 1,000 shares of Reliance. Period for which the service is to be provided is 1st April, 20X1 to 1st July, 20X1 and fair value of the service was estimated using market value of similar contracts for ₹1,00,000. Nominal value per share is ₹10.

Record the transactions in a Journal?

Solution

Fair value of services	1,00,000
Number of months	3
Monthly expense	33,333.33

30th April, 20X1			**₹**
Repair & Maintenance	Dr.	33,333.33	
To Share-based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			
31st May, 20X1			
Repair & Maintenance	Dr.	33,333.33	
To Share-based payment reserve (equity)			33,333.33

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(Recognition of Equity settled SBP using fair value of services rendered)			
30th June, 20X1			
Repair & Maintenance	Dr.	33,333.33	
To Share-based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			
1st July, 20X1			
Share-based payment reserve (equity)	Dr.	1,00,000	
To Equity Shares (1000 x 10)			10,0000
To Securities premium (balancing figure)			90,000
(Recognition of Equity settled SBP using fair value of services rendered)			

*****

Illustration 6 - Share-based payment - Cash & equity alternatives

Tata Industries issued share-based option to one of its key management personal which can be exercised either in cash or equity and it has following features:

Option I		***Period***	***₹***
No of cash settled shares			*74,000*
Service condition		*3 years*	
Option II			
No of equity settled shares of face value of ₹ 100 each			*90,000*
Conditions:			
Service		*3 years*	
Restriction to sell		*2 years*	
Fair values			
Equity price with a restriction of sale for 2 years			*115*
Fair value at grant date			*135*
Fair value	*20X0*		*138*
	20X1		*140*
	20X2		*147*

Pass the Journal entries?

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Solution

Fair value of Equity option components:		
Fair value of a share with restrictive clause		₹ 115
Number of shares		90,000
Fair value (90,000 x 115)	A	₹ 1,03,50,000
Fair value of a share at the date of grant		₹ 135
Number of cash settled shares		74,000
Fair value (74,000 x 135)	B	₹ 99,90,000
Fair value of equity component in compound instrument (A-B)		₹ 3,60,000

Journal Entries

31/12/20X0			₹
Employee benefit expenses (Transfer to P/L)	Dr.	35,24,000	
To Share-based payment reserve (equity) (3,60,000/3)			1,20,000
To Share-based payment liability (138 x 74,000) / 3			34,04,000
(Recognition of equity option and cash settlement option)			
31/12/20X1			
Employee benefits expenses (Transfer to P/L)	Dr.	36,22,667	
To Share-based payment reserve (equity) (3,60,000/3)			1,20,000
To Share-based payment liability (140 x 74,000) 2/3 -34,04,000			35,02,667
(Recognition of equity option and cash settlement option)			
31/12/20X2			
Employee benefits expenses (Transfer to P/L)	Dr.	40,91,333	
To Share-based payment reserve (equity) (3,60,000/3)			1,20,000
To Share-based payment liability (147 x 74,000) 3/3 - (34,04,000 + 35,02,667)			39,71,333
(Recognition of equity option and cash settlement option)			

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Upon cash alternative chosen			
Share-based payment liability (147 x 74,000)	Dr.	1,08,78,000	
To Bank/ Cash			1,08,78,000
(Being settlement made in cash)			
Share-based payment reserve (equity)	Dr.	3,60,000	
To Retained Earnings			3,60,000
(Being transfer of equity from one account to another one)			
Upon equity alternative chosen			
Share-based payment liability	Dr.	1,08,78,000	
To Share Capital			90,00,000
To Securities Premium			18,78,000
(Being settlement made in equity)			
Share-based payment reserve (equity)	Dr.	3,60,000	
To Securities Premium			3,60,000
(Being transfer of equity from one account to another one)			

*****

Example 25-Share-based payment arrangements with cash alternatives

An entity grants an employee the right to choose either 2,000 shares, ie, a right to a cash payment equal to the value of 2,000 shares, or 2,400 shares. The grant is conditional upon the completion of three years' service. If the employee chooses the share alternative, the shares must be held for three years after vesting date.

At the grant date, the entity's share price is ₹ 50 per share. At the end of years 1, 2 and 3, the share price is ₹ 52, ₹ 55 and ₹ 60 respectively. The entity does not expect to pay dividends in the next three years. After taking into account the effects of the post-vesting transfer restrictions, the entity estimates that the grant date fair value of the share alternative is ₹ 48 per share.

At the end of year 3, the employee chooses:

Scenario 1: The cash alternative

Scenario 2: The equity alternative

Application of requirements

The fair value of the equity alternative is ₹ 1,15,200 (2,400 shares x ₹ 48). The fair value of

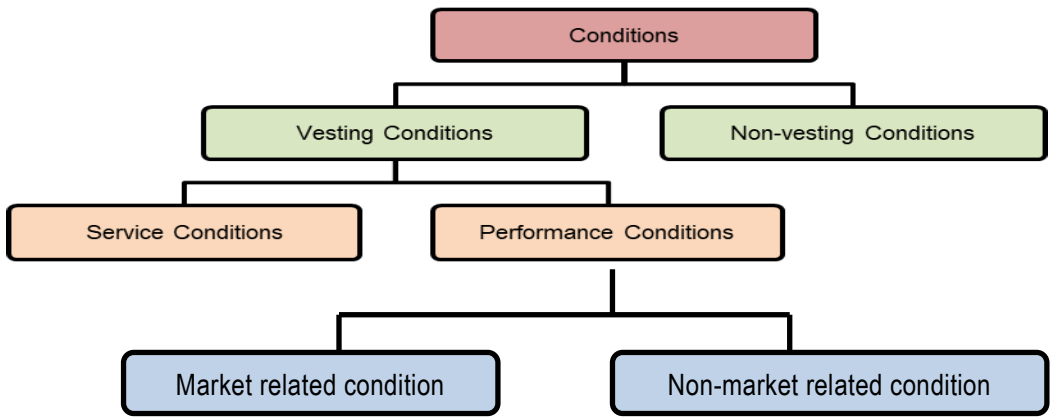
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the cash alternative is ₹ 1,00,000 (2,000 shares x ₹ 50). Therefore, the fair value of the equity component of the compound instrument is ₹ 15,200 (₹ 1,15,200 - ₹ 1,00,000).

The entity recognizes the following amounts:

Year	Computation	Expense (₹)	Equity (₹)	Liability (₹)
1	Liability component: (2,000 x ₹ 52 x 1/3)	34,667		34,667
	Equity component: (₹ 15,200 x 1/3)	5,067	5,067	
2	Liability component: (2,000 x ₹ 55 x 2/3) — ₹ 34,666	38,666		38,666
	Equity component: (₹ 15,200 x 1/3)	5,067	5,067	
3	Liability component: (2,000 x ₹ 60) — ₹ 73,333	46,667		46,667
	Equity component: (₹ 15,200 x 1/3)	5,066	5,066	
End Year 3	Scenario 1: cash of ₹ 1,20,000 paid			(1,20,000)
	Scenario 1 totals	**1,35,200**	**15,200**	**0**
	Scenario 2: 2,400 shares issued		1,20,000	(1,20,000)
	Scenario 2 totals	**1,35,200**	**1,35,200**	

3.6 DETERMINING TYPES OF CONDITIONS



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3.6.1 Vesting conditions

Share-based payment awards generally vest upon meeting specified conditions, such as service conditions (time-based) or performance conditions (eg. achieving a specified EBITDA target). These conditions affect the timing of when the expense is recognized, and in some cases, the measurement of expense. In addition, if a condition is not met, whether or not the entity may reverse previously recognized compensation expense depends on the nature of the condition that was not met. Hence classification of a condition is an important step in accounting of share-based payments.

Following are the classification of various conditions and their accounting requirements.

a) Service condition

When share-based payment is dependent upon the minimum term to be served in order to be eligible for employees share-based payment, it is called service condition.

Examples 26 & 27

26. An entity has issued 100 shares each to its 1,000 employees under share-based payment if they remain in the organization for next 3 years. This would be considered to be a service condition; 3 years being the period over which the employee would be required to be in service as a condition.

27. If an employee remains in service for at least three years from the grant date of the award, the employee can exercise the options at any time between three and ten years from the grant date of the award. The fair value of the award at the grant date, ignoring the effect of vesting condition, is ₹ 6,00,000.

    For this award, the vesting period is three years, the exercise period is seven years, and the life of the option is ten years. The requirement to remain employed is a (vesting) service condition. The entity recognizes an expense of ₹ 2,00,000 per year for three years, with a corresponding increase in equity.

    If the employee leaves at the end of year two, the entity reverses the cumulative expense previously recognized. However, if the employee does not exercise options after the vesting period, expense previously recognized cannot be reversed.

    Consider an alternate scenario. The employee was given an unconditional right to exercise the option at any time between the grant date and ten years from the grant date of the award. For this award, the vesting period is nil, the exercise period and the life of the option are ten years. The entity recognizes an expense of ₹ 6,00,000 immediately, with a corresponding increase in equity. Subsequently, the entity cannot

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reverse this expense even if the employee does not exercise its options. This is because they are vested from day 1.

b) Performance condition

If an employee is granted share options conditional upon the achievement of a performance condition and remaining in the entity's employment until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition.

Performance condition may be

a. Market-related; or

b. Non-market related.

a. Market related condition

In order to be eligible for share-based payment, when one of the conditions is to achieve target price/ value of the share by an entity, it is called as market-related performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted and shall not be subsequently revised.

Example 28

An entity issues stock options to its employees who will serve the organization for next 2 years and till the time the share price reaches to ₹ 100. The target price to reach ₹ 100 is one of the market-related condition.

b. Non-market related condition

When the parameter is not market driven but linked with some internal performance/ operations or activities of the entity, it will be considered as non-market related conditions. Non- market related conditions do not have any impact on market price of the shares of the entity issuing such share-based payments. If the performance condition is not a market condition, the entity shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

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Example 29

An entity issued some stock options to employees with a condition that they have to remain in the organisation for next 2 years and EBITA of the entity should rise to ₹ 10 million. Here, the EBITA target is non-market related condition.

3.6.2 Non-vesting conditions

Such conditions which do not have any impact on eligibility to have share-based payments. It has not been specifically defined by the standard. However, one can understand this as conditions which are other than vesting conditions.

Examples 30 & 31

30. An entity issued some stock options to its employees wherein they are required to serve minimum period of next 2 years and from the end of 2nd year there will further be waiting time till next 1 year within which the entity should achieve revenue of ₹ 100 million. However, if an employee leaves the entity after the end of 2nd year then the employee will not lose the entitlement to get such share-based payments. Hence the condition of achieving revenue target is non-vesting condition.

31. An entity grants share options to a director on the condition that the director does not compete with the reporting entity for a period of at least three years. The fair value of the award at the date of the grant, including the effect of non - compete clause is ₹ 15 million. The 'non-compete' clause is a non-vesting condition because the entity does not receive any services. On the grant date, the entity immediately recognizes a cost of ₹ 15 million because director is not providing any future services. The entity cannot reverse the expense recognised, even if the director goes to work for a competitor and loses the share options.

3.7 DETERMINING IMPACT OF CONDITIONS ON SHARE BASED VALUATION

Once we understood the conditions attached with any share-based payment, next question arises that about the implication of the conditions on accounting / measurement of such share-based payments and why it is crucial to segregate them.

a. A grant of equity instruments might be conditional upon satisfying specified vesting conditions. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the entity's employment for a specified period of time. There might be performance conditions that must be satisfied, such as the entity

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achieving a specified growth in profit or a specified increase in the entity's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, eg the counterparty fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements mentioned below in point c.

b. To apply the requirements mentioned in abovementioned point (a), the entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements mentioned below in point c.

c. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity shall recognize the goods or services received from a counterparty who satisfies all other vesting conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied.

d. Similarly, an entity shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.,

Treatment of a reload feature

For options with a reload feature, the reload feature shall not be taken into account when estimating the fair value of options granted at the measurement date. Instead, a reload option shall be accounted for as a new option grant, if and when a reload option is subsequently granted.

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Below mentioned table summarizes the impact of various conditions –

Conditions	To include in fair value of SBP (refer note-1)	To include expected equity shares which meet conditions (refer note-2)
Service condition	No	Yes
Performance condition - Market related	Yes	No
Performance condition - Non-market related	No	Yes
Non-vesting condition	Yes	No

Note 1 Share-based payment will be measured at fair value on initial recognition which will include the effect of these conditions. Equity settled share-based payment will be measured at fair value on grant date with no subsequent measurement, whereas cash settled share-based payment shall be re-measured at each reporting date till its settlement in full.

Note 2 These conditions will have no impact on fair valuation of share-based payments. However, they will be considered while estimating the expected number of equity shares at the end of each period for recognition of the share-based payment.

Summary of recognising expense for an award with multiple conditions:

Scenario	Service condition met?	Market condition met?	Non-market performance condition met?	Ind AS 102 expense?
1	Yes	Yes	Yes	Yes
2	Yes	No	Yes	Yes
3	Yes	Yes	No	No
4	Yes	No	No	No
5	No	Yes	Yes	No
6	No	No	Yes	No
7	No	Yes	No	No
8	No	No	No	No

Example 32

An entity issued 100 shares each to its 1,000 employees under share-based payment upon the condition to serve the organization for at least next 2-years subject to the below scenarios:

1) EBIDTA of the entity shall be ₹ 10 million in next 2 years.

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2) Share price of the entity shall be ₹ 150 in next 2 years.

3) Employees are required to serve additional 4 months from the end of 2 years but will have no impact on vesting rights at the end of 2nd year.

Since 2 years to remain in service is a 'service related condition', it will be considered in the calculation of expected number of shares which will satisfy the conditions attached.

1) **EBIDTA** is one of the performance conditions which is non-market related, hence will be considered while making an estimation of number of shares which will satisfy the condition attached.

2) **Share price target** is one of the market related conditions and hence it will be considered in the measurement of fair value at initial recognition (equity & cash settled) and at subsequent dates (in case of cash settled).

3) **Additional 4-months** requirement does not have any impact on eligibility to get share-based payment. Therefore, it is a non -vesting condition and will be considered in fair value of the share-based payment.

Illustration 7 - Equity Settled – Non-market conditions

Ankita Holding Inc. grants 100 shares to each of its 500 employees on 1st January, 20X1. The employees should remain in service during the vesting period. The shares will vest at the end of the

First year if the company's earnings increase by 12%;

Second year if the company's earnings increase by more than 20% over the two-year period;

Third year if the entity's earnings increase by more than 22% over the three-year period.

The fair value per share at the grant date is ₹ 122. In 20X1, earnings increased by 10%, and 29 employees left the organisation. The company expects that the shares will vest at the end of the year 20X2. The company also expects that additional 31 employees will leave the organisation in the year 20X2 and that 440 employees will receive their shares at the end of the year 20X2. At the end of 20X2, company's earnings increased by 18%. Therefore, the shares did not vest. Only 29 employees left the organization during 20X2. Company believes that additional 23 employees will leave in 20X3 and earnings will further increase so that the performance target will be achieved in 20X3. At the end of the year 20X3, only 21 employees have left the organization. Assume that the company's earnings increased to desired level and the performance target has been met.

Determine the expense for each year and pass appropriate journal entries?

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Solution

Since the earnings of the entity is non-market related, hence it will not be considered in fair value calculation of the shares given. However, the same will be considered while calculating number of shares to be vested.

Workings:

	20X1	20X2	20X3
Total employees	500	500	500
Employees left (Actual)	(29)	(58)	(79)
Employees expected to leave in the next year	(31)	(23)	-
Year end – No of employees	440	419	421
Shares per employee	100	100	100
Fair value of share at grant date	122	122	122
Vesting period	1/2	2/3	3/3
Expenses-20X1 (Note 1)	26,84,000		
Expenses-20X2 (Note 2)		7,23,867	
Expenses-20X3 (Note 3)			17,28,333

Note 1:

Expense for 20X1 = Number of employees x Shares per employee x Fair value of share x Proportionate vesting period

= 440 x 100 x 122 X ½ = 26,84,000

Note 2:

Expense for 20X2 = (Number of employees x Shares per employee x Fair value of share x Proportionate vesting period) – Expense recognized in year 20X1

= (419 x 100 x 122 x 2/3) – 26,84,000 = 7,23,867

Note 3:

Expense for 20X3 = (No of employees x Shares per employee x Fair value of share x Proportionate vesting period) – Expense recognized in year 20X1 and 20X2

= (421 x 100 x 122 x 3/3) – (26,84,000 + 7,23,867) = 17,28,333.

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Journal Entries

31st December, 20X1			
Employee benefits expenses (transfer to P/L)	Dr.	26,84,000	
To Share-based payment reserve (equity)			26,84,000
(Equity settled shared-based payment expected vesting amount)			
31st December, 20X2			
Employee benefits expenses (transfer to P/L)	Dr.	7,23,867	
To Share-based payment reserve (equity)			7,23,867
(Equity settled shared based payment expected vesting amount)			
31st December, 20X3			
Employee benefits expenses (transfer to P/L)	Dr.	17,28,333	
To Share-based payment reserve (equity)			17,28,333
(Equity settled shared-based payment expected vesting amount)			
Share-based payment reserve (equity)	Dr.	51,36,200	
To Share Capital / Securities Premium			51,36,200
(Share capital Issued)			

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Illustration 8 - Equity Settled – Non market conditions (Reversals)

ACC limited granted 10,000 share options to one of its managers. In order to get the options, the manager has to work for next 3 years in the organization and reduce the cost of production by 10% over the next 3 years.

Fair value of the option at grant date was ₹ *95*

Cost reduction achieved-

Year 1	*12%*	*Achieved*
Year 2	*8%*	*Not expected to vest in future*
Year 3	*10%*	*Achieved*

How the expenses would be recorded?

Solution

It is a non-market related condition. Hence the target to achieve cost reduction would be taken while estimating the number of options to be vested.

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Year	Options	Fair value		FV of the options vested
Year 1	10,000	95	1/3	3,16,667
Year 2	10,000	95	0	(3,16,667)
Year 3	10,000	95	3/3	9,50,000

The condition to achieve 10% cost reduction each was not fulfilled in the year 2 and there was no expectation to vest this non-market condition in future as well and hence earlier expense amount was reversed in year 2. Since in the year 3 the non-market condition was again met, hence all such expense will be charged to Profit and Loss.

*****

Illustration 9 - Equity Settled – Market based conditions

Apple Limited has granted 10,000 share options to one of its directors for which he must work for next 3 years and the price of the share should increase by 20% over next 3 years.

The share price has moved as per below details -

Year 1	*22%*
Year 2	*19%*
Year 3	*25%*

At the grant date, the fair value of the option was ₹120.

How should we recognize the transaction?

Solution

The share price movement is a market-based vesting condition hence its expectations are taken into consideration while calculating the fair value of the option.

Even if the required market condition as required is not fulfilled, there is no requirement to reverse the expense previously booked.

Irrespective of the outcome of the market prices (as it is already taken care of in the fair value of the option), each period an amount of (120 x 10,000)/3 = ₹ 4,00,000 will be charged to profit and loss.

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3.8 GRANT DATE

Definition of Grant date

"The date at which the entity and another party (including an employee) **agrees** to a share-based payment arrangement, being when the entity and the counterparty have a **shared understanding** of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an **approval process** (for example, by shareholders), grant date is the date when that approval is obtained".

Analysis of the definition of the Grant date

- It is crucial to determine grant date correctly for determination of fair value of share-based payment and its accounting.
- There must be an agreement between the employee/ supplier and the entity with clear communication of the terms and conditions of such share-based payment. The date of such agreement will be considered as grant date.
- If the agreement is subject to the approval of appropriate authorities, then the grant date will be the date of approval.

Example 33

Entity initiated a share-based payment agreement in its board meeting and directed the supervisors to communicate the agreement to the employee. Consider the following scenarios to arrive at grant date:

1) Employees have not yet given his/her consent either implicitly or explicitly. However, entity has taken approval of the agreement in its General Meeting.

2) Employees have agreed to the terms implicitly/ explicitly. However, the approval process is under finalization.

3) Certain terms have not been specifically mentioned since they are based on some subjective conditions in future.

Now,

1. Even when the approval has been acquired, no consent has been given by an employee/ counterparty; therefore, grant date cannot be determined.

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2. Even when the employee/ counterparty has agreed to the terms but approval process is still not complete, hence the grant date should be the date when approvals are complete.

3. Terms/ conditions mentioned in the agreement must be objectively defined and should not be based on subjective outcome. Mutual understanding is crucial which essentially means that all terms/ clauses and calculation related to the equity prices must be clear and objectively defined.

3.9 SUBSEQUENT MEASUREMENT

3.9.1 Equity settled Share-Based Payment

The entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested.

Equity will be credited by an additional amount (adjusted with re-estimation of expected vesting equity shares at each reporting period) and there will not be any change in the value credited to the equity.

Example 34

An entity issued 100 shares each to its 2,000 employees subject to service condition of next 3 years. Grant date fair value of the shares is ₹ 200 each. There is an expectation that employee will remain in service at the rate 95% at end of 1st year, however the expectation got revised at the end of 2nd year to 92% and again got revised to 88% at the end of the 3rd year.

Year end	% Vest	Expense (current period)	Cumulative expenses
First	95%	2,000 x 100 x 200 x 95% x 1/3 = 1,26,66,667	1,26,66,667
Second	92%	2,000 x 100 x 200 x 92% x 2/3 – 1,26,66,667 = 1,18,66,667	2,45,33,333
Third	88%	2,000 x 100 x 200 x 88% x 3/3 – 2,45,33,333 = 1,06,66,667	3,52,00,000

3.9.2 Cash-settled share-based payment

After the initial recognition of a liability to settle SBP in cash, at the end of each subsequent period the liability would be fair valued till the time it is settled.

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Example 35

An entity issued 100 shares each to its 20 employees subject to service condition of next 3 years. The settlement is to be made in cash. Grant date fair value of the shares is ₹ 200 each. However, the fair value as at end of 1st year, 2nd year & 3rd year were ₹ 180, ₹ 190, ₹ 220 respectively.

Year end	Vest	Expense (current period)	Cumulative expenses
First	1/3	20 x 100 x 180 x 1/3 = 1,20,000	1,20,000
Second	2/3	20 x 100 x 190 x 2/3 – 1,20,000= 1,33,333	2,53,333
Third	3/3	20 x 100 x 220 x 3/3 – 2,53,333 =1,86,667	4,40,000

3.10 MODIFICATION, CANCELLATION AND SETTLEMENTS

An entity might modify the terms and conditions on which the equity instruments were granted. For example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options.

Analysis of the requirement of Modification, Cancellation and Settlements

- An entity shall recognize, as a minimum, the services measured at the grant date fair value unless vesting conditions are not fulfilled. If an entity modifies as award, it must recognize, at a minimum, cost of the original award as if the award was not modified. If modification increases fair value of the award, the entity must recognize that additional cost. The additional cost is spread over the period from the modification date until the vesting of modified options, which may differ from the vesting date of original award. Whether a modification increases or decreases the fair value of an award is determined at the modification date. If an entity modifies a vested option, it recognizes any additional fair value given on the modification date itself.
- This requirement is applicable irrespective of any modification of terms, cancellation or early settlement, if any.
- If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

  a. the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

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b. any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, ie as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

c. if new equity instruments are granted to the employee and on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 of Ind AS 102 and the guidance in Appendix B of Ind AS 102. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (b) above. If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for those new equity instruments as a new grant of equity instruments.

- If an entity or counterparty can choose whether to meet a non-vesting condition, the entity shall treat the entity's or counterparty's failure to meet that non-vesting condition during the vesting period as a cancellation.
- If an entity repurchases vested equity instruments, the payment made to the employee shall be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments repurchased, measured at the repurchase date. Any such excess shall be recognised as an expense.

Illustration 10 – Modifications – Equity-settled share-based payment

Marathon Inc. issued 150 share options to each of its 1,000 employees subject to the service condition of 3 years. Fair value of the option given was calculated at ₹ 129. Below are the details and activities related to the SBP plan-

Year 1: *35 employees left and further 60 employees are expected to leave*

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Share options re-priced (as MV of shares has fallen) as the FV fell to ₹ 50.

After the re-pricing they are now worth ₹ 80, hence expense is expected to increase by ₹ 30.

Year 2: *30 employees left and further 36 employees are expected to leave*

Year 3: *39 employees left*

How the modification/ re-pricing will be accounted?

Solution

The re-pricing was done at the end of year 1, and hence the increased expense would be spread over next 2 years equally.

Total increased value due to modification is	**₹ 30**		**(1/2 weight each years)**
	Year 1	**Year 2**	**Year 3**
Number of employees	1,000	1,000	1,000
Employee left	(35)	(65)	104
Expected to leave	(60)	(36)	___
Net employees	905	899	896
Options per employee	150	150	150
Fair value of the option	129	129	129
Period weight	1/3	2/3	3/3
Modification		30	30
Expense (original)	58,37,250	57,59,850	57,40,500
Modification	Nil	20,22,750	20,09,250
		(899x150x30x1/2)	(896x150x30x2/2)- 20,22,750)

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Illustration 11 - Cancellation- Equity Settled Share-based payment

Anara Fertilisers Limited issued 2000 share options to its 10 directors for an exercise price of ₹ 100. The directors are required to stay with the company for next 3 years.

Fair value of the option estimated *₹ 130*

Expected number of directors to vest the option *8*

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During the year 2, there was a crisis in the company and Management decided to cancel the scheme immediately. It was estimated further as below-

Fair value of option at the time of cancellation was ₹ *90*

Market price of the share at the cancellation date was ₹ *99*

There was a compensation which was paid to directors and only 9 directors were currently in employment. At the time of cancellation of such scheme, it was agreed to pay an amount of ₹ *95 per option to each of 9 directors.*

Suggest how the cancellation will be recorded.

Solution

	Year 1	Year 2	
A)			
Expected directors to vest	8	9	
Fair value of option	130	130	
Number of options	2,000	2,000	
Total	20,80,000	23,40,000	
Expense weightage	1/3		Full, as it is cancelled
Expense for the year	6,93,333	16,46,667	Remaining amount since cancelled

B) Cancellation compensation	
Number of directors	9
Amount agreed to pay	95
Number of options / director	2,000
Compensation amount (9 x 95 x 2,000) Also refer working notes 1 and 2	17,10,000

Working Notes:

1. Amount to be deducted from Equity

Number of directors	9
Fair value of option (at the date of cancellation)	90
Number of options / director	2,000
Total	16,20,000

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2. Amount transferred to Profit and Loss

Total cancellation compensation	17,10,000
Less: To deduct from Equity	(16,20,000)
Balance transferred to Profit and Loss	90,000

*****

3.11 FAIR VALUE CALCULATION

All the share-based payment plans are recognized referring fair value at grant date and it is crucial to understand how the fair value is arrived and the specific guidance available in the standard.

Fair value which is required to be used is not just a quoted price of any security. There are some market related conditions and / or non-vesting conditions that would be considered in the determination of fair value. Hence to determine such fair value, one has to use valuation techniques. However, there is nothing specific which has been defined by the standard. Black-scholes pricing model and Binomial pricing model are being used widely and are also generally accepted.

Standard specify minimum inputs to be used while calculating the fair value.

All option pricing models take into account, as a minimum, the following factors:

(a) the exercise price of the option;

(b) the life of the option;

(c) the current price of the underlying shares;

(d) the expected volatility of the share price;

(e) the dividends expected on the shares (if appropriate); and

(f) the risk-free interest rate for the life of the option.

Exercise price, current price and life of the option are observable inputs and relatively easy to understand and value can be easily identified. However, other inputs which are required to be used as minimum can be detailed out as below:

1. **Expected early exercise:** If a share-based payment has service / performance conditions attached, then there is an underlying presumption that the share-based payment plan will vest and it is usually expected to settle / exercise when the current market price crosses exercise price of the plan. Some senior level employees normally tend to exercise options

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later than lower-level employees. Since all expected exercise will not happen at the same time and it is difficult to establish a linear function for such behavior, hence Binomial model is generally used in such situations. Alternatively, expected early exercise could be modelled in a similar option pricing model that uses contractual life as an input.

2. **Expected volatility:** Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. Volatility is typically expressed in annualised terms that are comparable regardless of the time period used in the calculation, for example, daily, weekly or monthly price observations.

3. **Expected dividend:** Whether expected dividend should be taken into account when measuring the fair value of shares or options granted depends on whether the counterparty is entitled to dividend or dividend equivalents.

Example 36

If employees were granted options and are entitled to dividend on the underlying shares or dividend equivalents (which might be paid in cash or applied to reduce the exercise price) between grant date and exercise date, the options granted should be valued as if no dividend will be paid on the underlying shares, i.e. the input for expected dividend should be zero.

4. **Risk-free interest rate:** The risk-free interest rate is the implied yield currently available on zero-coupon government issues of the country in whose currency the exercise price is expressed, with a remaining term equal to the expected term of the option being valued (based on the option's remaining contractual life and taking into account the effects of expected early exercise). It may be necessary to use an appropriate substitute, if no such government issues exist or circumstances indicate that the implied yield on zero-coupon government issues is not representative of the risk-free interest rate (for example, in high inflation economies). Also, an appropriate substitute should be used if market participants would typically determine the risk-free interest rate by using that substitute, rather than the implied yield of zero-coupon government issues, when estimating the fair value of an option with a life equal to the expected term of the option being valued.

3.12 GROUP SHARE-BASED PAYMENT PLAN

In practice, we have come across many cases where one member of the group (typically, the parent) has obligation to settle a share-based payment transaction in which services are

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provided to another member of the group (typically a subsidiary). For example, within a multinational group, shares in the listed parent entity may be granted to the employees of various subsidiary entities located around the world. In some other cases, a listed subsidiary may have obligation to settle a share-based payment transaction in which services are provided to another member of the group (including the parent). These transactions are within the scope of Ind AS 102 for the entity receiving the services. This is despite the fact that it is not a direct party to the arrangement between its group entity and its employee.

For share-based payment transactions among group entities, in its separate or individual financial statements, the entity receiving the goods or services shall measure the goods or services received as either an equity-settled or a cash-settled share-based payment transaction by assessing:

(a) the nature of the awards granted, and

(b) its own rights and obligations.

The amount recognised by the entity receiving the goods or services may differ from the amount recognised by the consolidated group or by another group entity settling the share-based payment transaction.

The entity receiving the goods or services shall measure the goods or services received as an equity-settled share-based payment transaction when:

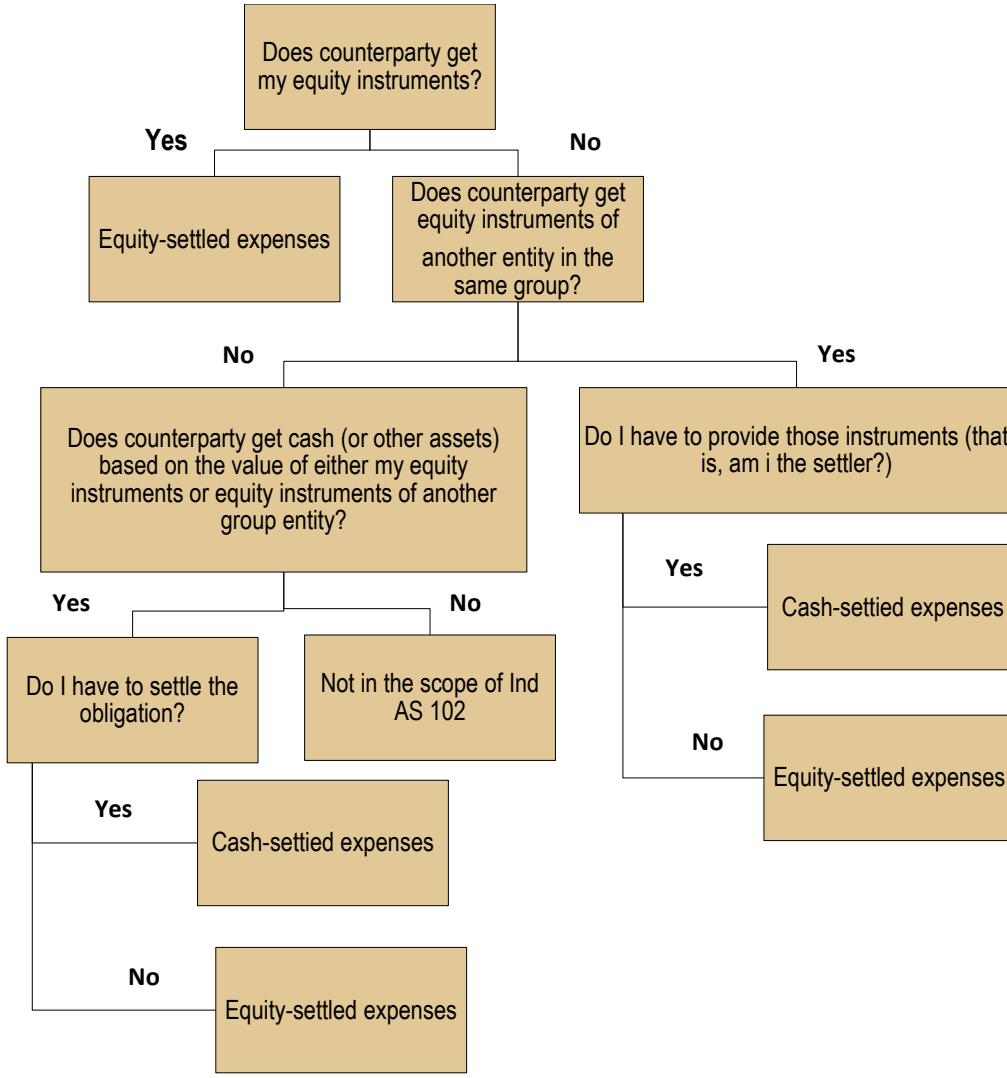
(a) the awards granted are its own equity instruments, or

(b) the entity has no obligation to settle the share-based payment transaction.

The entity shall subsequently remeasure such an equity-settled share-based payment transaction only for changes in non-market vesting conditions. In all other circumstances, the entity receiving the goods or services shall measure the goods or services received as a cash-settled share-based payment transaction.

The entity settling a share-based payment transaction when another entity in the group receives the goods or services shall recognise the transaction as an equity-settled share-based payment transaction only if it is settled in the entity's own equity instruments. Otherwise, the transaction shall be recognised as a cash-settled share-based payment transaction.

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Let's understand the basis of determination of the classification of share-based payment transactions in both separate financial statements and consolidated financial statements in various scenarios:

1. Parent issues its own shares for the share-based payment plan issued by its subsidiary

Since the subsidiary company do not have any obligation to settle the services/ goods which are being issued against the plan, hence it will be treated as equity-settled share-based payment (for subsidiary).

- Parent would debit these shares as "Investment in Subsidiary" and credit its equity.

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- Subsidiary will treat this as equity-settled share-based payment plan and will debit its expenses (employee related cost) and credit the capital contribution from the Parent.

2. Subsidiary provides rights to its employees to get equity instruments of its parent

Subsidiary will account for this arrangement as cash-settled share-based payment plan since it has an obligation to settle the same in other than its own equity shares.

- Parent would consider the payment/ settlement which is being made by its subsidiary as credit to "Dividend Income" and debit to Expenses (employee related cost).
- Subsidiary would debit its retained earnings as "Dividend distribution" and credit Equity (being share issued).

3. Parent settles the transaction by paying cash value for share-based payment plan issued by its subsidiary

Irrespective of the cash which is settled either based on Parent's equity or Subsidiary's equity, it will be treated as equity-settled share-based payment plan in case of separate financial statements of subsidiary because the subsidiary does not have any obligation to settle the payments.

Illustration 12

A parent grants 200 share options to each of 100 employees of its subsidiary, conditional upon the completion of two years' service with the subsidiary. The fair value of the share options on grant date is ₹ 30 each. At grant date, the subsidiary estimates that 80 percent of the employees will complete the two-year service period. This estimate does not change during the vesting period. At the end of the vesting period, 81 employees complete the required two years of service. The parent does not require the subsidiary to pay for the shares needed to settle the grant of share options.

Pass the necessary journal entries for giving effect to the above arrangement.

Solution

As required by paragraph B53 of the Ind AS 102, over the two-year vesting period, the subsidiary measures the services received from the employees in accordance, the requirements applicable to equity-settled share-based payment transactions as given in paragraph 43B. Thus, the subsidiary measures the services received from the employees on the basis of the fair value of the share options at grant date. An increase in equity is recognised as a contribution from the parent in the separate or individual financial statements of the subsidiary.

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The journal entries recorded by the subsidiary for each of the two years are as follows:

Year 1		₹	₹
Remuneration expense (Transfer to P/L) (200 x 100 employees x Rs. 30 x 80% x ½)	Dr.	2,40,000	
To Equity (Contribution from the parent)			2,40,000
Year 2			
Remuneration expense (Transfer to P/L) [(200 x 81 employees x Rs. 30) – 2,40,000]	Dr.	2,46,000	
To Equity (Contribution from the parent)			2,46,000

3.13 DISCLOSURE

Standard requires an entity to disclose the following-

- Type and scope of agreement existing during the reporting period.
- Describing general terms & conditions of each type of share-based payment plans.
- The number of weighted average price of share option as outstanding with a movement of granted, vested, expired, exercised, cancelled and closing balance of share-based payment plans.
- The average share price of exercised options.
- The range of exercise prices and weighted average remaining contractual life of options outstanding at the end of reporting period.
- The valuation method used to estimate the fair value of the awards.
- The impact on Statement of Profit and Loss and Balance Sheet for such share-based payments.

3.14 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Bharti Airtel Limited' for the financial year 2021-2022 with respect to 'Share-based payment' and its accounting policy thereon.

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25.1 Share-based payment plans

The following table provides an overview of all existing share option plans of the Company:

Scheme	Plan	Vesting period (years)	Contractual term (years)
Equity settled Plans			
Scheme I	2006 Plan	1 - 5	7
Scheme 2005	Long Term Incentive (LTI) Plan	1 - 3	7

The stock options vesting are subject to service and certain performance conditions mainly pertaining to certain financial parameters.

The movement in the number of stock options and the related weighted average exercise prices are as follows:

	For the year ended			
	March 31, 2022		March 31, 2021	
	Number of share options ('000)	Weighted average exercise price (₹)	Number of share options ('000)	Weighted average exercise price (₹)
2006 Plan				
Outstanding at beginning of year	113	5.00	30	5.00
Granted	-	-	93	5.00
Exercised	(113)	5.00	(10)	5.00
Outstanding at end of year	-	-	113	5.00
Exercisable at end of year	-	-	20	5.00
LTI Plan				
Outstanding at beginning of year	3,048	5.00	3,195	5.00
Granted	1,956	5.00	1,176	5.00
Exercised	(1,297)	5.00	(1,077)	5.00
Forfeited / expired	(484)	5.00	(246)	5.00
Outstanding at end of year	3,223	5.00	3,048	5.00
Exercisable at end of year	904	5.00	603	5.00

The details of weighted average remaining contractual life, weighted average fair value and weighted average share price for the options are as follows:

	March 31, 2022	March 31, 2021
Weighted average		
Remaining contractual life for the options outstanding as of (years)	0.4 to 6.4	1.4 to 6.7
Fair value for the options granted during the year ended (₹)	347.7 to 595.1	347.7 to 548.7
Share price for the options exercised during the year ended (₹)	581.7 to 716.6	483.3 to 590.2

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The fair value of options is measured using Black-Scholes valuation model. The key inputs used in the measurement of the grant date fair valuation of equity settled plans is given in the table below:

	For the year ended March 31, 2022	For the year ended March 31, 2021
Risk free interest rates	5.5% to 5.8%	5.1% to 5.8%
Expected life	48 to 60 months	48 to 78 months
Volatility	32.8%	32.7%
Dividend yield	0.3%	0.4%
Exercise price (₹)	5	5
Share price on the date of grant (₹)	607.80	560.60

The expected life of the stock options is based on the Company's expectations and is not necessarily indicative of exercise patterns that may actually occur. The expected volatility reflects the assumption that the historical volatility over a period similar to the expected life of the options is indicative of future trends, which may not necessarily be the actual outcome. Further, the expected volatility is based on the weighted average volatility of the comparable benchmark companies.

ACCOUNTING POLICY

Share-based payments

The Company operates equity-settled and cash-settled employee share-based compensation plans, under which the Company receives services from employees as consideration for stock options either towards shares of the Company or cash settled units.

In case of equity-settled awards, the fair value of stock options (at grant date) is recognised as an expense in the Statement of Profit and Loss within employee benefits as employee share-based payment expenses over the vesting period, with a corresponding increase in share-based payment reserve (a component of equity).

However, in case of cash-settled awards, the credit is recognised as a liability within other non-financial liabilities over the vesting period. Subsequently, at each reporting period, until the liability is settled, and at the date of settlement, liability is re-measured at fair value through Statement of Profit and Loss.

The total amount so expensed is determined by reference to the grant date fair value of the stock options granted, which includes the impact of any market performance conditions and non-vesting conditions but excludes the impact of any service and non-market performance vesting conditions. However, the non-market performance vesting

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and service conditions are considered in the assumption as to the number of options that are expected to vest. The forfeitures are estimated at the time of grant and reduce the said expense rateably over the vesting period.

The expense so determined is recognised over the requisite vesting period, which is the period over which all of the specified vesting conditions are to be satisfied. As at each reporting date, the Company revises its estimates of the number of options that are expected to vest, if required.

It recognises the impact of any revision to original estimates in the period of change. Accordingly, no expense is recognised for awards that do not ultimately vest, except for which vesting is conditional upon a market performance / non-vesting condition. These are treated as vested irrespective of whether or not the market / non-vesting condition is satisfied, provided that service conditions and all other non-market performance are satisfied.

Where the terms of an award are modified, in addition to the expense pertaining to the original award, an incremental expense is recognised for any modification that results in additional fair value or is otherwise beneficial to the employee as measured at the date of modification.

Where an equity-settled award is cancelled (including due to non-vesting conditions not being met), it is treated as if it is vested thereon, and any un-recognised expense for the award is recognised immediately. In case of cancellation of cash-settled award, change in the value of the liability, if any, is recognised in Statement of Profit and Loss.

(Source: Annual Report 2021-2022 – Bharti Airtel Limited)

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. An entity issued 100 shares each to its 1,000 employees subject to service condition of next 2 years. Grant date fair value of the share is ₹ 195 each. There is an expectation 97% of the employees will remain in service at the end of 1st year. However, at the end of 2nd year the expected employees to remain in service would be 91% of the total employees. Calculate the expense for years 1 & 2?

2. An entity issued 50 shares each to its 170 employees subject to service condition of next 2 years. The settlement is to be made in cash. Grant date fair value of the share is ₹ 85 each, however, the fair value as at end of 1st year, 2nd year were ₹ 80 & ₹ 90 respectively. Calculate the expense for years 1 and 2

3. Company P is a holding company for company B. A group share-based payment is being organized in which Parent issues its own equity-shares for the employees of company B. The details are as below –

Number of employees of company B	**100**
Grant date fair value of share	₹ 87
Number of shares to each employee granted	25
Vesting conditions	Immediately

Pass the journal entry in the books of company P & company B?

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4. An entity P issues share-based payment plan to its employees based on the below details:

Number of employees	100
Fair value at grant date	₹ 25
Market condition	Share price to reach at ₹ 30
Service condition	To remain in service until market condition is fulfilled
Expected completion of market condition	4 years

Define expenses related to such share-based payment plan in each year subject to the below scenarios-

a) Market condition if fulfilled in year 3, or

b) Market condition is fulfilled in year 5.

5. Entity X grants 10 shares each to its 1,000 employees on the conditions as mentioned below-

- To remain in service & entity's profit after tax (PAT) shall reach to ₹ 100 million.
- It is expected that PAT should reach to ₹ 100 million by the end of 3 years.
- Fair value at grant date is ₹ 100.
- Employees expected for vesting right by 1st year 97%, then it revises to 95% by 2nd year and finally to 93% by 3rd year.

Calculate the expenses for next 3 years in respect of share-based payment?

6. At 1st January, 20X0, Ambani Limited grants its CEO an option to take either cash amount equivalent to 800 shares or 990 shares. The minimum service requirement is 2 years. There is a condition to keep the shares for 3 years if shares are opted.

Fair values of the shares	₹
Share alternative fair value (with restrictions)	212
Grant date fair value on 1st January, 20X0	213
Fair value on 31st December, 20X0	220
Fair value on 31st December, 20X1	232

The key management personnel exercises his cash option at the end of 20X2.

Pass the journal entries.

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7. MINDA issued 11,000 share appreciation rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹ 100. SAR can be exercised any time until 31st March, 20X3. It is expected that out of the total employees, 94% at the end of the period on 31st March, 20X1, 91% at the end of next year will exercise the option. Finally, when these were vested i.e. at the end of the 3rd year, only 85% of the total employees exercised the option.

Fair value of SAR	₹
31st March, 20X1	132
31st March, 20X2	139
31st March, 20X3	141

Pass the Journal entries?

8. P Ltd. granted 400 stock appreciation rights (SAR) each to 75 employees on 1st April 20X1 with a fair value ₹ 200. The terms of the award require the employee to provide service for four years in order to earn the award. The fair value of each SAR at each reporting date is as follows:

31st March 20X2	₹ 210
31st March 20X3	₹ 220
31st March 20X4	₹ 215
31st March 20X5	₹ 218

What would be the difference if at the end of the second year of service (i.e. at 31st March 20X3), P Ltd. modifies the terms of the award to require only three years of service?

9. QA Ltd. had on 1st April, 20X1 granted 1,000 share options each to 2,000 employees. The options are due to vest on 31st March, 20X4 provided the employee remains in employment till 31st March, 20X4.

On 1st April, 20X1, the Directors of Company estimated that 1,800 employees would qualify for the option on 31st March, 20X4. This estimate was amended to 1,850 employees on 31st March, 20X2 and further amended to 1,840 employees on 31st March, 20X3.

On 1st April, 20X1, the fair value of an option was ₹ 1.20. The fair value increased to ₹ 1.30 as on 31st March, 20X2 but due to challenging business conditions, the fair value declined thereafter. In September, 20X2, when the fair value of an option was ₹ 0.90, the Directors repriced the option and this caused the fair value to increase to ₹ 1.05. Trading

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conditions improved in the second half of the year and by 31st March, 20X3 the fair value of an option was ₹ 1.25. QA Ltd. decided that additional cost incurred due to repricing of the options on 30th September, 20X2 should be spread over the remaining vesting period from 30th September, 20X2 to 31st March, 20X4.

Suggest the suitable accounting treatment for these transaction as on 31st March, 20X3.

10. A parent, Company P, grants 30 shares to 100 employees each of its subsidiary, Company S, on condition that the employees remain employed by Company S for three years. Assume that at the outset, and at the end of Years 1 and 2, it is expected that all the employees will remain employed for all the three years. At the end of Year 3, none of the employees has left. The fair value of the shares on grant date is ₹ 5 per share. Company S agrees to reimburse Company P over the term of the arrangement for 75 percent of the final expense recognised by Company S.

What would be the accounting treatment in the books of Company P and Company S?

11. An entity which follows its financial year as per the calendar year grants 1,000 share appreciation rights (SARs) to each of its 40 management employees as on 1st January 20X5. SARs provide the employees with the right to receive (at the date when the rights are exercised) cash equal to the appreciation in the entity's share price since the grant date. All of the rights vest on 31st December 20X6; and they can be exercised during 20X7 and 20X8. Management estimates that, at grant date, the fair value of each SAR is ₹ 11; and it estimates that overall 10% of the employees will leave during the two-year period. The fair values of the SARs at each year end are shown below:

Year	Fair value at year end
31 December 20X5	12
31 December 20X6	8
31 December 20X7	13
31 December 20X8	12

10% of employees left before the end of 20X6. On 31st December 20X7 (when the intrinsic value of each SAR was ₹ 10), six employees exercised their options; and the remaining 30 employees exercised their options at the end of 20X8 (when the intrinsic value of each SAR was equal to the fair value of ₹ 12).

How much expense and liability is to be recognized at the end of each year? Pass the Journal entries.

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Answers

1.

Year end	% Vest	Expense (current period)
FIRST	97%	100 x 1,000 x 195 x 97% x 1/2 = 94,57,500
SECOND	91%	100 x 1,000 x 195 x 91% x 2/2 – 94,57,500= 82,87,500

2.

Year end	Vest	Expense (current period)
FIRST	1/2	50 x 170 x 80 x 1/2 = 3,40,000
SECOND	2/2	50 x 170 x 90 x 2/2 – 3,40,000 = 4,25,000

- Liability will be re-measured at each reporting date.
- Fair value at the end of the year will be used.

3. **Books of Company P**

Investment in Company B Dr. ₹ 2,17,500

To Equity Capital / Securities Premium (Issue of Shares) ₹ 2,17,500

Books of Company B

Expense Dr. ₹ 2,17,500

To Capital contribution from Parent P ₹ 2,17,500

4. Market conditions are required to be considered while calculating fair value at the grant date. However, service conditions will be considered as per the expected vesting right to be exercised by the employees and would be re-estimated during vesting period. However, if the market-related condition is fulfilled before it is expected then all remaining expenses would immediately be charged off. If market-related condition takes longer than the expected period, then original expected period will be followed.

a) Market condition is fulfilled in year 3:

Year 1	2,500/4 = 625
Year 2	2,500/4 = 625
Year 3	2,500-625-625=1,250
Year 4	NIL

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b) Market condition is fulfilled in year 5:

Year 1	2,500/4 = 625
Year 2	2,500/4 = 625
Year 3	2,500/4 = 625
Year 4	2,500/4 = 625
Year 5	NIL

5. Entity's PAT is one of the non-market related conditions and hence would be included while making an expectation of vesting shares and there is no requirement to make any changes in the non-market condition whether this is fulfilled or not because it has already been considered in the expectation of vesting rights at the end of each year.

Year -1	1,000 x 10 x 100 x 97% x1/3 = 3,23,333
Year-2	1,000 x 10 x 100 x 95% x 2/3 - 3,23,333 = 3,10,000
Year -3	1,000 x 10 x 100 x 93% x 3/3 - 6,33,333 = 2,96,667

6.

	1st January, 20X0	31st December, 20X0	31st December, 20X1
Equity alternative (990 x 212)	2,09,880		
Cash alternative (800 x 213)	1,70,400		
Equity option (2,09,880 – 1,70,400)	39,480		
Cash Option (cumulative) (using period end fair value)		88,000	1,85,600
Equity Option (cumulative)		19,740	39,480
Expense for the period			
Equity option		19,740	19,740
Cash Option		88,000	97,600
Total		1,07,740	1,17,340

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Journal Entries

31st December, 20X0			₹
Employee benefits expenses	Dr.	1,07,740	
To Share-based payment reserve (equity)			19,740
To Share-based payment liability			88,000
(Recognition of Equity option and cash settlement option)			
31st December, 20X1			
Employee benefits expenses	Dr.	1,17,340	
To Share-based payment reserve (equity)			19,740
To Share-based payment liability			97,600
(Recognition of Equity option and cash settlement option)			
Share-based payment liability	Dr.	1,85,600	
To Bank/ Cash			1,85,600
(Settlement in cash)			

7.

Period	Fair value	To be vested	Cumulative	Expense
Start	100	100%	11,00,000	11,00,000
Period 1	132	94%	13,64,880	2,64,880
Period 2	139	91%	13,91,390	26,510
Period 3	141	85%	13,18,350	(73,040)
				13,18,350

Journal Entries

1st April, 20X0			
Employee benefits expenses	Dr.	11,00,000	
To Share-based payment liability			11,00,000
(Fair value of the SAR recognised)			
31st March, 20X1			
Employee benefits expenses	Dr.	2,64,880	

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To Share-based payment liability			2,64,880
(Fair value of the SAR re-measured)			
31st March, 20X2			
Employee benefits expenses	Dr.	26,510	
To Share-based payment liability			26,510
(Fair value of the SAR re-measured)			
31st March, 20X3			
Share-based payment liability	Dr.	73,040	
To Employee benefits expenses			73,040
(Fair value of the SAR reversed)			
Share-based payment liability	Dr.	13,18,350	
To Cash			13,18,350
(Settlement of SAR)			

8. Journal entries in the books of P Ltd (without modification of service period of stock appreciation rights) **(₹ in lakhs)**

Date	Particulars		Debit	Credit
31.03.20X2	Profit and Loss account	Dr.	15.75	
	To Liability against SARs			15.75
	(Being expenses liability for stock appreciation rights recognised)			
31.03.20X3	Profit and Loss account	Dr.	17.25	
	To Liability for SARs			17.25
	(Being expenses liability for stock appreciation rights recognised)			
31.03.20X4	Profit and Loss account	Dr.	15.38	
	To Liability for SARs			15.38
	(Being expenses liability for stock appreciation rights recognised)			
31.03.20X5	Profit and Loss account	Dr.	17.02	
	To Liability for SARs			17.02
	(Being expenses liability for stock appreciation rights recognised)			

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Journal entries in the books of P Ltd (with modification of service period of stock appreciation rights) **(₹ in lakhs)**

Date	Particulars	Debit	Credit
31.03.20X2	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	15.75	15.75
31.03.20X3	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	28.25	28.25
31.03.20X4	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	20.50	20.50

Working Notes:

Calculation of expenses for issue of stock appreciation rights without modification of service period

For the year ended 31st March 20X2

= ₹ 210 x 400 awards x 75 employees x 1 year /4 years of service

= ₹ 15,75,000

For the year ended 31st March 20X3

= ₹ 220 x 400 awards x 75 employees x 2 years /4 years of service - ₹ 15,75,000 previous recognised

= ₹ 33,00,000 - ₹ 15,75,000 = ₹ 17,25,000

For the year ended 31st March 20X4

= ₹ 215 x 400 awards x 75 employees x 3 years/4 years of service - ₹ 33,00,000 previously recognised

= ₹ 48,37,500 - ₹ 33,00,000 = ₹ 15,37,500

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For the year ended 31st March, 20X5

= ₹ 218 x 400 awards x 75 employees x 4 years / 4 years of service – ₹ 48,37,500 previously recognised

= ₹ 65,40,000 – ₹ 48,37,500 = ₹ 17,02,500

Calculation of expenses for issue of stock appreciation rights with modification of service period

For the year ended 31st March 20X2

= ₹ 210 x 400 awards x 75 employees x 1 year / 4 years of service = ₹ 15,75,000

For the year ended 31st March 20X3

= ₹ 220 x 400 awards x 75 employees x 2 years / 3 years of service - ₹ 15,75,000 previous recognised

= ₹ 44,00,000 - ₹ 15,75,000 = ₹ 28,25,000

For the year ended 31st March 20X4

= ₹ 215 x 400 awards x 75 employees x 3 years/ 3 years of service - ₹ 44,00,000 previous recognised

= ₹ 64,50,000 - ₹ 44,00,000 = ₹ 20,50,000.

9. Paragraph 27 of Ind AS 102 requires the entity to recognise the effects of repricing that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

If the repricing increases the fair value of the equity instruments granted paragraph B43(a) of Appendix B requires the entity to include the incremental fair value granted (ie the difference between the fair value of the repriced equity instrument and that of the original equity instrument, both estimated as at the date of the modification) in the measurement of the amount recognised for services received as consideration for the equity instruments granted.

If the repricing occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the repricing date until the date when the repriced equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.

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Accordingly, the amounts recognised in years 1 and 2 are as follows:

Year	Calculation	Compensation expense for period	Cumulative compensation expense
		₹	₹
1	[1,850 employees x 1,000 options x ₹ 1.20] x $^1/_3$	7,40,000	7,40,000
2	(1,840 employees x 1,000 options x [(₹ 1.20 x $^2/_3$) + {(₹ 1.05 - 0.90) x 0.5/1.5}] – 7,40,000	8,24,000	15,64,000

Note: Year 3 calculations have not been provided as it was not required in the question.

10. Company S expects to recognise an expense totalling ₹ 15,000 (30 shares x 100 employees x ₹ 5 per share) and, therefore, expects the total reimbursement to be ₹ 11,250 (₹ 15,000 x 75%). Company S therefore reimburses Company P ₹ 3,750 (₹ 11,250 x 1/3) each year.

Accounting by Company S

In each of Years 1 to 3, Company S recognises an expense in profit or loss, the cash paid to Company P, and the balance of the capital contribution it has received from Company P.

Journal Entry		₹	
Employee benefits expenses	Dr.	5,000	
To Cash/Bank			3,750
To Equity (Contribution from the parent)			1,250
(To recognise the share-based payment expense and partial reimbursement to parent)			

Accounting by Company P

In each of Years 1 to 3, Company P recognises an increase in equity for the instruments being granted, the cash reimbursed by Company S, and the balance as investment for the capital contribution it has made to Company S.

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Journal Entry		₹	₹
Investment in Company S	Dr.	1,250	
Cash/Bank	Dr.	3,750	
To Equity			5,000
(To recognise the grant of equity instruments to employees of subsidiary less partial reimbursement from subsidiary)			

11. The amount recognized as an expense in each year and as a liability at each year-end) is as follows:

Year	*Expense* ₹	*Liability* ₹	Calculation of Liability
31 December 20X5	2,16,000	2,16,000	= 36 x 1,000 x 12 x ½
31 December 20X6	72,000	2,88,000	= 36 x 1,000 x 8
31 December 20X7	1,62,000*	3,90,000	= 30 x 1,000 x 13
31 December 20X8	(30,000)**	0	Liability extinguished

* Expense comprises an increase in the liability of ₹ 102,000 and cash paid to those exercising their SARs of ₹ 60,000 (6 x 1,000 x 10).

** Difference of opening liability (₹ 3,90,000) and actual liability paid [₹ 3,60,000 (30 x 1,000 x 12)] is recognised to Profit and loss ie ₹ 30,000.

Journal Entries

31 December 20X5			
Employee benefits expenses	Dr.	2,16,000	
To Share-based payment liability			2,16,000
(Fair value of the SAR recognized)			
31 December 20X6			
Employee benefits expenses	Dr.	72,000	
To Share-based payment liability			72,000
(Fair value of the SAR re-measured)			

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31 December 20X7			
Employee benefits expenses	Dr.	1,62,000	
To Share-based payment liability			1,62,000
(Fair value of the SAR recognized)			
Share-based payment liability	Dr.	60,000	
To Cash			60,000
(Settlement of SAR)			
31 December 20X8			
Share-based payment liability	Dr.	30,000	
To Employee benefits expenses			30,000
(Fair value of the SAR recognized)			
Share-based payment liability	Dr.	3,60,000	
To Cash			3,60,000
(Settlement of SAR)			

Note: Last two entries can be combined.

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NOTES

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CHAPTER 8

IND AS ON LIABILITIES OF THE FINANCIAL STATEMENTS



UNIT 1: INDIAN ACCOUNTING STANDARD 19: EMPLOYEE BENEFITS

LEARNING OUTCOMES

After studying this unit, you will be able to:

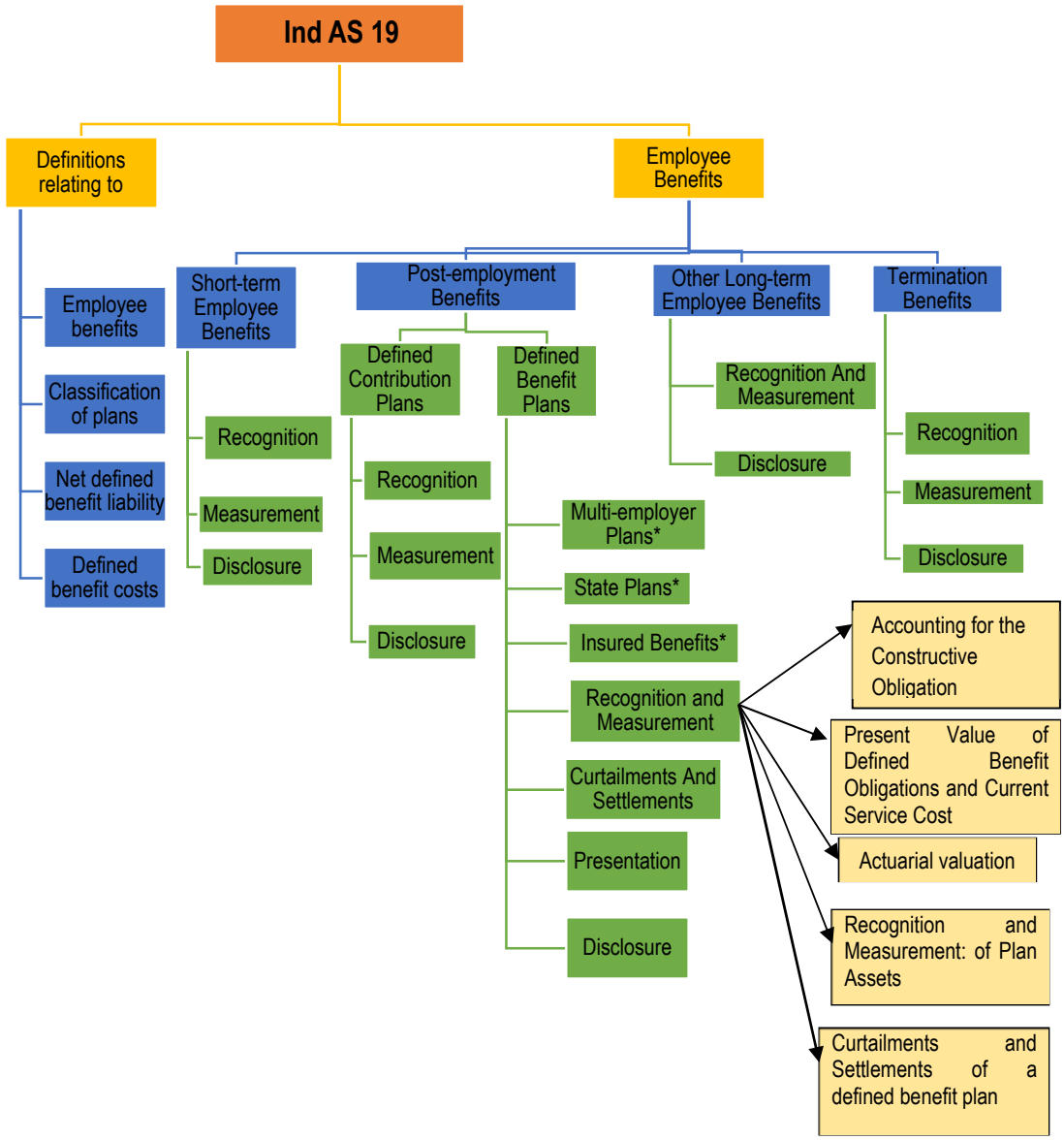
- State the objective and scope of Ind AS 19
- Define the terms relating to employee benefits, classification of plans, net defined benefit liability (asset) and defined benefit cost
- Examine the four categories of employee benefits (short-term, post-employment, other long- term and termination benefits)
- Recognise and measure all short term employee benefits, short term paid absences and account for profit sharing and bonus plans
- Distinguish between defined contribution plans and defined benefit plans
- Account for multiemployer plans, state plans and insured benefits
- Recognise and measure defined benefit plans that share risks between entities under common control
- Recognise, measure and disclose defined contribution plans
- Account for the constructive obligation plans under defined benefit plan

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- Apply actuarial valuations in recognition and measurement of defined benefit plans
- Remeasure the net defined benefit liability (asset) using the current fair value of plan assets and current actuarial assumptions
- Determine past service cost, or a gain or loss on settlement,
- Recognise the components of defined benefit cost
- Present and disclose employee benefits in the financial statements as per Ind AS 19

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UNIT OVERVIEW



***Note:** These plans may also be considered as Defined Contribution Plans.

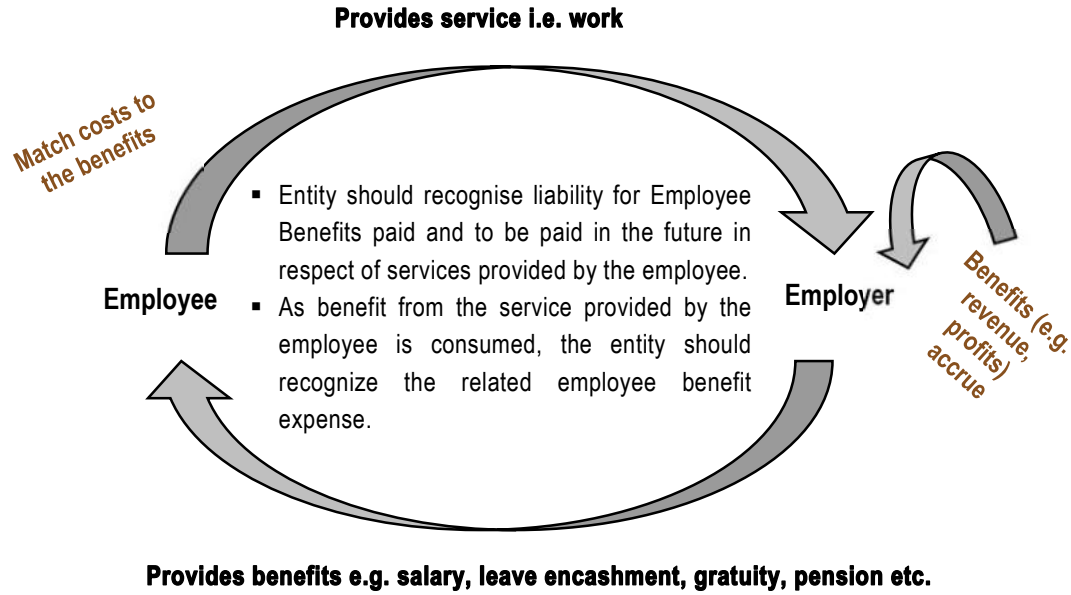
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1.1 OBJECTIVE OF IND AS 19

- The objective of this standard is to prescribe the accounting and disclosure for employee benefits.
- Ind AS 19 requires an entity to recognise:
  (a) a liability for the services received from an employee; and
  (b) an expense for consumption of economic benefits arising from the service provided by an employee in exchange for employee benefits.

Financial statements are prepared on the accrual basis of accounting. Under this basis, the **effects** of transactions and other events are recognised **when they occur** (and not when cash or its equivalent is received or paid) and they are **recorded** in the accounting records and reported in the financial statements of the **periods to which they relate**. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.

When employees provide services to their employer during a period, their services lead to generation of benefits (revenues or profits or increased efficiency), directly or indirectly, for their employers for that period. The underlying assumption of accrual requires that for the benefit earned in a particular period, the costs incurred in earning that benefit need to be recognised entirely. Adherence to this requirement of the framework is what is addressed by Ind AS 19.



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1.2 SCOPE

The concept of 'Employee Benefits' has evolved over the years to encompass more than just the salaries, wages and social welfare contributions. The companies of today – established or start-ups – provide a host of benefits to its employees including, but not limited to, Employees' Stock Option Plans, jubilee bonuses, long-term disability benefits etc. In fact, companies like Google even provide unusual benefits such as 'death benefits', which involve paying the deceased's spouse or domestic partner 50% of their salary for 10 years after death of the employee.

- This Standard shall be applied by an employer in **accounting for all employee benefits** except those to which Ind AS 102, *Share-based Payment*, is applicable (e.g. Employees Stock Option Plans).
- This Standard does not deal with reporting by employee benefit plans.
- Employee benefits to which this Standard applies include those provided
  - under formal plans/agreements between an entity and its individual employees/group of employees/their representatives,
  - as required by law or as required by any type of industry arrangements whereby an entity is required to contribute to any nation/state/industry or other multi-employer plans; or
  - by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits.

    Example of a constructive obligation - Where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

1.3 EMPLOYEE BENEFITS

Employee benefits include:

(i) short employee benefits,

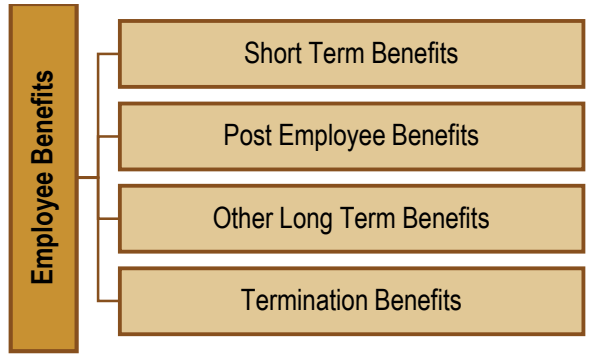
(ii) post-employment benefits,

(iii) other long term employee benefits and

(iv) termination benefits.

All these categories have different characteristics and hence the Standard has specified separate accounting requirements for each such category.

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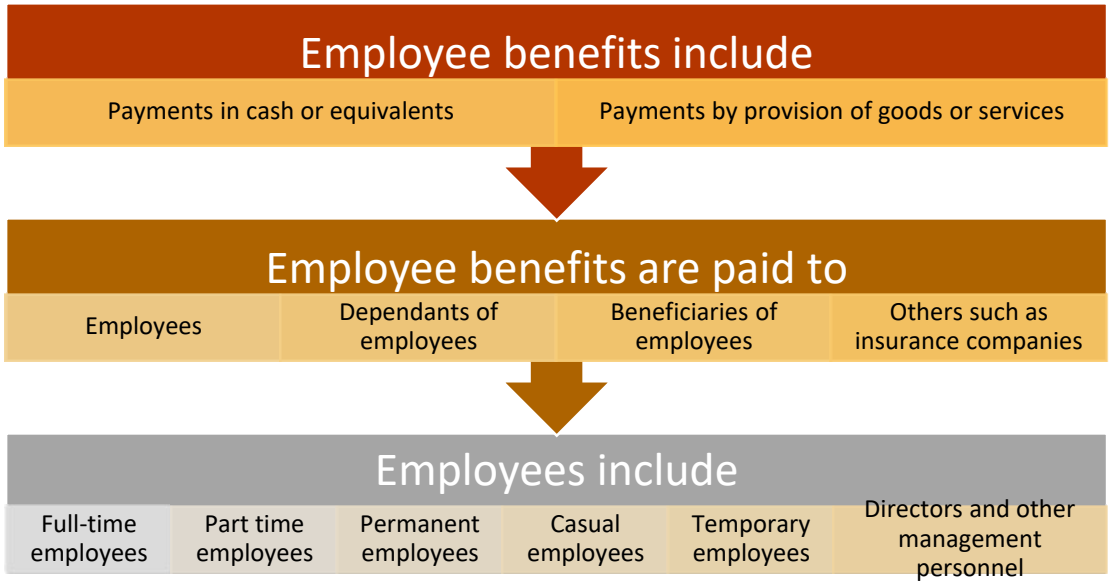


- Employee benefits include benefits provided either to
  - employees; or
  - their dependants; or
  - their beneficiaries.
- Employee benefits may be settled by payments (or the provision of goods or services) made either directly
  - directly to the employees; or
  - to their spouses; or
  - to their children; or
  - to their other dependants; or
  - others, such as insurance companies.
- An employee may provide services to an entity on a
  - full-time; or
  - part-time; or
  - permanent; or
  - casual; or
  - temporary

  basis.

Note: For the purpose of this Standard, employees include directors and other management personnel.

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1.4 DEFINITIONS

1.4.1 Definitions of employee benefits

1. ***Employee Benefits:*** All forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

2. ***Short-term Employee Benefits:*** Employee benefits (other than termination benefits) that are expected to be settled wholly **before twelve months** after the end of the annual reporting period in which the employees render the related service.

   Example : Wages, salaries, social security contributions (PF / ESI), paid annual leave / sick leave.

3. ***Post-employment Benefits:*** Employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

   Example : Pensions, lumpsum payments on retirement.

4. ***Other long-term employee benefits*** are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

   Example : Long-term paid absences such as long-service leave or sabbatical leave, jubilee or other long-service benefits.

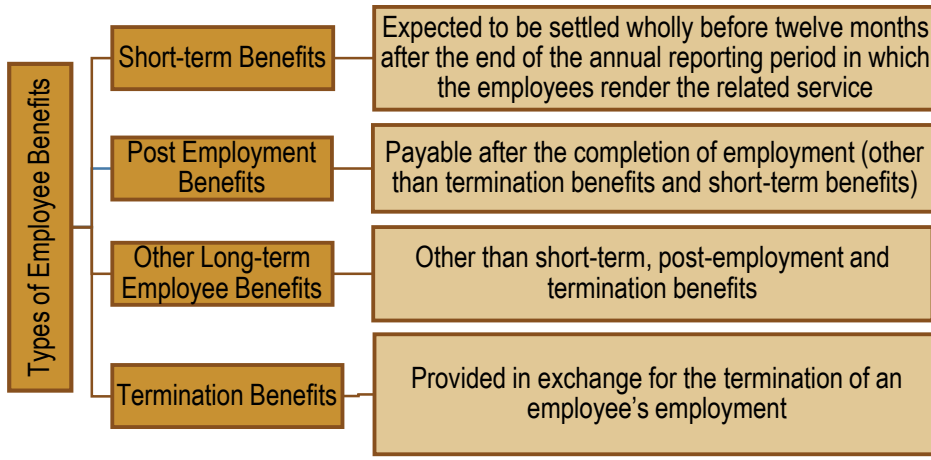
5. ***Termination benefits*** are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

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(a) an entity's decision to terminate an employee's employment before the normal retirement date; or

(b) an employee's decision to accept an offer of benefits in exchange for the termination of employment.

Example : VRS compensation or Retrenchment compensation



1.4.2 Definitions relating to classification of plans

1. ***Post-employment Benefit Plans:*** These plans are **formal** or **informal** arrangements under which an entity provides post-employment benefits for one or more employees.

   Under these plans, the benefits are given to the employees after employment, like gratuity, pension, provident fund etc.

Note: Defined contribution plans and defined benefit plans are two categories of post-employment benefits plans.

2. ***Defined Contribution Plans:*** They are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a Fund) and will have **no** legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

   In these plans, the contribution is defined i.e. contribution is fixed and known to the entity.

Example : Provident Fund contribution by the employer to the Employees' Provident Fund Organisation under Ministry of Labour & Employment, Government of India.

3. ***Defined Benefit Plans:*** Post-employment benefit plans other than defined contribution plans.

Example: Gratuity.

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4. ***Multi-employer Plans:*** Defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

   (a) pool the assets contributed by various entities that are not under common control; and

   (b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees.

1.4.3 Definitions relating to the net defined benefit liability (asset)

1. ***Net defined benefit liability (asset)***: The deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

2. ***Deficit or surplus:***

   (a) the present value of the defined benefit obligation ***less***

   (b) the fair value of plan assets (if any).

3. ***Asset ceiling***: The present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

4. ***Present value of a defined benefit obligation:*** Present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

5. ***Plan assets*** comprise:

   (a) assets held by a long-term employee benefit fund; and

   (b) qualifying insurance policies.

6. ***Assets held by a long-term employee benefit fund:*** Assets (other than non-transferable financial instruments issued by the reporting entity) that:

   (a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

   (b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

      (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

      (ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

7. ***Qualifying Insurance Policy:*** Insurance policy issued by an insurer that is not a related party (as defined in Ind AS 24, *Related Party Disclosures*) of the reporting entity, if the proceeds of the policy:

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(a) can be used only to pay or fund employee benefits under a defined benefit plan; and

(b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

(i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

8. ***Fair Value:*** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Ind AS 113, Fair Value Measurement.)

1.4.4 Definitions relating to defined benefit cost

1. ***Service cost*** comprises:

(a) *Current service cost*, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period;

(b) *Past service cost,* which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and

(c) any gain or loss on settlement.

2. ***Net interest on the net defined benefit liability (asset):*** The change during the period in the net defined benefit liability (asset) that arises from the passage of time.

3. ***Remeasurements of the net defined benefit liability (asset)*** comprise:

(a) actuarial gains and losses;

(b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

4. ***Actuarial gains and losses*** are changes in the present value of the defined benefit obligation resulting from:

(a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and

(b) the effects of changes in actuarial assumptions.

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5. ***Return on plan assets:*** Interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets,

   Less:

   (a) any costs of managing plan assets; and

   (b) any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation.

6. ***Settlement:*** A transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

1.5 SHORT-TERM EMPLOYEE BENEFITS

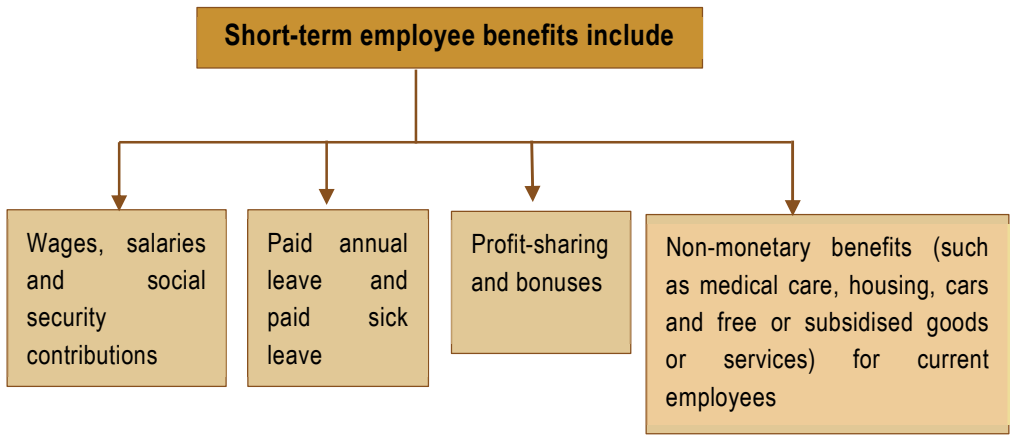
- Short-term employee benefits include items expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services.
- It includes

  (a) wages, salaries and social security contributions;

  (b) paid annual leave and paid sick leave;

  (c) profit-sharing and bonuses; and

  (d) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.



- Reclassification of a short-term employee benefit is not required if the entity's expectations of the timing of settlement of such benefits change temporarily.

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- Reclassification may be considered-
  - if the characteristics of the benefit change (such as a change from a non-accumulating benefit to an accumulating benefit) or
  - if a change in expectations of the timing of settlement is not temporary.

1.5.1 Recognition and measurement of short-term benefits

Accounting for short term benefits has two characteristics:

(a) short-term benefits are measured on an undiscounted basis; and

(b) they don't involve any actuarial valuation for their measurement.

The undiscounted amount of short-term employee benefits expected to be paid in exchange for that service shall be recognised:

(a) as a liability (accrued expense), after deducting any amount already paid.

If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and

(b) as an expense, if it doesn't form part of the cost of an asset as per any other Ind AS (e.g. Ind AS 2, *Inventories* or Ind AS 16 *Property, Plant and Equipment*).

Note: Recognition of short-term employee benefit is in the form of either paid expenses or profit sharing or bonus plans.

1.5.2 Short-term paid absences

An employer may compensate an employee for absence for various reasons including holidays, sickness and short-term disability, maternity or paternity, jury service and military service. Entitlement to paid absences (i.e. compensated balances) fall into two categories and are recognized as follows:

(a) **Accumulating** paid absences - recognized when the employees render service that increases their entitlement to future paid absences; and

(b) **Non-accumulating** paid absences - recognized when the absences occur.

1.5.2.1 Accumulating paid absences

- These are the absences that are carried forward and can be used in future periods if the employee is not able to use them in current reporting period of the employer. They can be either:
  - (i) **Vesting:** In this case, employees are **entitled to a cash-payment** for the unutilised entitlement at the time of leaving the entity; and
  - (ii) **Non-vesting:** In this case, employees are **not entitled to a cash payment** for unused entitlement on leaving.

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- This obligation exists and is recognized, even if the paid (compensated) absences are non-vesting. However, in case an employee leaves the entity before they use an accumulated non-vesting entitlement, it will affect the measurement of this obligation.
- An entity shall measure the expected cost of accumulating paid (compensated) absences as the **additional amount that the entity expects to pay as a result of the unused entitlement** that has accumulated at the end of the reporting period.

Illustration 1: Vested Accumulating Benefits

Mr. Rajan is working for Infotech Ltd. Consider the following particulars:

Annual salary of Mr. Rajan = ₹ 30,00,000

Total working days in 20X0-20X1 = 300 days

Leaves allowed in 20X0-20X1 as per company policy = 10 days

Leaves utilized by Mr. Rajan in 20X0-20X1 = 8 days

The unutilized leaves are settled by way of payment and accordingly, carry forward of such leaves to the subsequent period is not allowed.

Compute the total employee benefit expense for Infotech Ltd. in respect of 20X0-20X1.

Solution

Mr Rajan is entitled to a salary of ₹ 30,00,000 for 300 total working days.

Thus, per day salary works out to ₹ 30,00,000 ÷ 300 days = ₹ 10,000 per day

In the year 20X0-20X1, Mr. Rajan availed 8 out of 10 leaves allowed by the company.

Accordingly, leaves unutilized = 10 – 8 = 2 days

In line with the company policy, Infotech Ltd. will pay Mr. Rajan for the unutilized leave.

Thus, total expense for 20X0-20X1 = ₹ 30,00,000 + (2 days unutilized leaves x ₹ 10,000 per day) = ₹ 30,20,000.

*****

Illustration 2: Non-Vested Accumulating Benefits

Mr. Niranjan is working for Infotech Ltd. Consider the following particulars:

	Year 20X0-20X1	Year 20X1-20X2
Annual salary	*₹ 30,00,000*	*₹ 30,00,000*
No. of working days during the year	*300 days*	*300 days*
Leave allowed	*10 days*	*10 days*
Leave taken	*7 days*	*13 days*
Leave unutilized carried forward to next year	*3 days*	*NIL*

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Based on past experience, Infotech Ltd. assumes that Mr. Niranjan will avail the unutilized leaves of 3 days of 20X0-20X1 in 20X1-20X2.

Infotech Ltd. contends that it will record ₹ 30,00,000 as employee benefits expense in each of the years 20X0-20X1 and 20X1-20X2, stating that the leaves will, in any case, be utilized by 20X1-20X2.

Comment on the accounting treatment proposed to be followed by Infotech Ltd. Also pass journal entries for both the years.

Solution

Particulars	Year 20X0-20X1	Year 20X1-20X2
Annual Salary	₹ 30,00,000	₹ 30,00,000
No. of working days (A)	300 days	300 days
Leaves Allowed	10 days	10 days
Leaves Taken (B)	7 days	13 days
Therefore, number of days worked (A – B)	293 days	287 days
Expense proposed to be recognized by Infotech Ltd.	₹ 30,00,000	₹ 30,00,000

Based on the evaluation above, Mr. Niranjan has worked for 6 days more (293 days – 287 days) in 20X0-20X1 as compared to 20X1-20X2.

Since he has worked more in 20X0-20X1 as compared to 20X1-20X2, the accrual concept requires that the expenditure to be recognized in 20X0-20X1 should be more as compared to 20X1-20X2.

Thus, if Infotech Ltd. recognizes the same expenditure of ₹ 30,00,000 for each year, it would be in violation of the accrual concept.

The expenditure to be recognized will be as under:

Particulars	Year 20X0-20X1	Year 20X1-20X2
Annual salary (A)	₹ 30,00,000	₹ 30,00,000
No. of working days (B)	300 days	300 days
Salary cost per day (A ÷ B)	₹ 10,000 per day	₹ 10,000 per day
No. of days worked (from above)	293 days	287 days
Expense to be recognised: **In 20X0-20X1:** ₹ 30,00,000 + [₹ 10,000 per day x 3 days (leaves unutilized expected to be utilized subsequently)]	₹ 30,30,000	
In 20X1-20X2: ₹ 30,00,000 – [₹ 10,000 per day – 3 days (excess leave utilized in 20X1-20X2)]		₹ 29,70,000

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Journal Entry for 20X0-20X1

Employee Benefits Expense Account	Dr.	30,30,000	
To Bank Account			30,00,000
To Provision for Leave Encashment			30,000

Journal Entry for 20X1-20X2

Employee Benefits Expense Account	Dr.	29,70,000	
Provision for Leave Encashment Account	Dr.	30,000	
To Bank Account			30,00,000

*****

Illustration 3: Non-Vested Accumulating Benefits

Assume same information as in Illustration 2.

Based on past experience, Infotech Ltd. assumes that Mr. Niranjan will avail the unutilized leaves of 2 days of 20X0-20X1 subsequently.

However, in 20X1-20X2, Mr. Niranjan availed in actual all 3 days of brought forward leave.

Compute the expense to be recognised in 20X0-20X1 and 20X1-20X2. Also pass journal entries for both the years.

Solution

The expenditure to be recognized will be as under:

Particulars	Year 20X0-20X1	Year 20X1-20X2
Annual salary (A)	₹ 30,00,000	₹ 30,00,000
No. of working days (B)	300 days	300 days
Salary cost per day (A ÷ B)	₹ 10,000 per day	₹ 10,000 per day
No. of days worked (from above)	293 days	287 days
Expense to be recognised: **In 20X0-20X1:** ₹ 30,00,000 + [₹ 10,000 per day x 2 days (leaves unutilized expected to be utilized subsequently)]	₹ 30,20,000	
In 20X1-20X2: ₹ 30,00,000 – [₹ 10,000 per day x 3 days (excess leave utilized in 20X1-20X2)] + ₹ 10,000 (additional expense due to change in accounting estimate)		₹ 29,80,000

The additional ₹ 10,000 booked as an expense in 20X1-20X2 represents a change in accounting estimate (i.e. as against the entity's estimation that 2 days of unutilized leave

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would be utilized subsequently, actually 3 days were utilized subsequently), for which a prospective effect needs to be given, in line with Para 36 of Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Journal Entry for 20X0-20X1

Employee Benefits Expense Account	Dr.	30,20,000	
To Bank Account			30,00,000
To Provision for Leave Encashment			20,000

Journal Entry for 20X1-20X2

Employee Benefits Expense Account	Dr.	29,80,000	
Provision for Leave Encashment Account	Dr.	20,000	
To Bank Account			30,00,000

*****

Illustration 4:

Sunderam Pvt. Ltd. has a headcount of 100 employees in 20X0-20X1. As per the employee policy, the employees are entitled to:

- *30 casual leaves out of which 10 casual leaves may be carried forward to the next year; and*
- *10 sick leaves out of which 2 sick leaves may be carried forward as paid leave.*

At 31st March, 20X1, the average unused entitlement is 5 days per employee for casual leaves and 1 day per employee for sick leave. On an average, it is found that the number of such employees who would be claiming casual leaves would be 30 and 10 employees who would claim sick leaves.

Compute the liability to be recognised in respect of sick leaves and casual leaves by the entity at the end of the financial year 20X0-20X1.

Solution

Type of leave (A)	Leave Entitlement (B)	Leaves c/f permissible (C)	Average leaves Unutilized (D)	No. of Employees (E)	Liability (F = D x E)
Casual Leave	30 days	10 days	5 days	30	150 days salary
Sick Leave	10 days	2 days	1 days	10	10 days salary

The entity will recognise liability in the books equal to 150 (30 x 5) days of paid casual leaves and 10 (10 x 1) days of paid sick leaves.

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Illustration 5

An entity has 100 employees, who are each entitled to ten working days of paid sick leave for each year. Unused sick leave may be carried forward for one financial year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis).

At 31st March 20X1, the average unused entitlement is two days per employee. Based on past experience, the management expects that only 20% of the employees will use 1 day from their carried forward leave. Salary per day is ₹ 2,500.

Compute the expenses in respect of the short-term compensated absences, if they are assumed to be (a) vested short-term compensated absences, and (b) non-vested short-term compensated absences.

Solution

Vested short-term compensated absences:

Employee Benefit Expense = 100 Employees x 2 Days x ₹ 2,500 = ₹ 5,00,000

Non-vested short-term compensated absences:

Employee Benefit Expense = 100 Employees x 20% x 1 Day x ₹ 2,500 = ₹ 50,000

*****

Illustration 6

Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates observed during past 10 years represents 6% per annum. Acer Ltd. provides the following benefits to all its employees:

Paid vacation - 10 days per year regardless of date of hiring. Compensation for paid vacation is 100% of employee's salary and unused vacation can be carried forward for 1 year. As of 31st March, 20X1, unused vacation carried forward was 3 days per employee, average salary was ₹ 15,000 per day and accrued expense for unused vacation in 20X0-20X1 was ` 65,00,000. During 20X1-20X2, employees took 9 days of vacation in average. Salary increases in 20X1-20X2 was 10%.

Analyse how would Acer Ltd. recognize liabilities and expenses for these benefits as of 31st March, 20X2. Pass the journal entry to show the accounting treatment.

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Solution

Paid Vacation:

Step 1: Calculation of Unused Vacation in man-days as on 31st March, 20X2:

A. No. of Employees in service for the whole year (94%):

Particulars	Man-days
Unused vacation as on 31st March, 20X1	3 days per employee
Entitlement to vacation for 20X1-20X2	10 days per employee
Average vacation availed in 20X1-20X2	(9) days per employee
Unused vacation as on 31st March, 20X2 (being unused leaves of 20X1-20X2 on FIFO basis)	**4 days per employee**
Total Unused vacation as on 31st March, 20X2 - (A) (350 employees x 94% x 4 days per employee)	**1,316 man-days**

B. Newcomers (6%):

Particulars	Man-days
Entitlement to vacation for 20X1-20X2	10 days per employee
Average vacation availed in 20X1-20X2	(9) days per employee
Unused vacation as on 31st March, 20X2 (being unused leaves of 20X1-20X2 on FIFO basis)	**1 day per employee**
Total Unused vacation as on 31st March, 20X2 - (B) (350 employees x 6% x 1 day per employee)	**21 man-days**
Total unused vacation as on 31st March, 20X2 (A + B)	1,337 man-days

Step 2: Calculation of average salary per day:

Particulars	Amount (₹)
Average salary per day as on 31st March, 20X1	15,000
Salary increase in 20X1-20X2	10%
Average salary per day as on 31st March, 20X2	**16,500**

Step 3: Calculation of provision for unused paid vacation:

Particulars	Amount (₹)
Calculation of provision for unused paid vacation 20X1-20X2: (1,337 man-days x ₹ 16,500)	2,20,60,500
Provision for unused paid vacation 20X0-20X1	65,00,000

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Step 4: Accounting treatment

Provision for 20X1-20X2

Employee Benefits Expenses A/c	Dr.	2,20,60,500	
To Provision for Leave Encashment			2,20,60,500

Settlement of Liability of 20X0-20X1

Provision for Leave Encashment A/c	Dr.	65,00,000	
To Cash / Bank			65,00,000

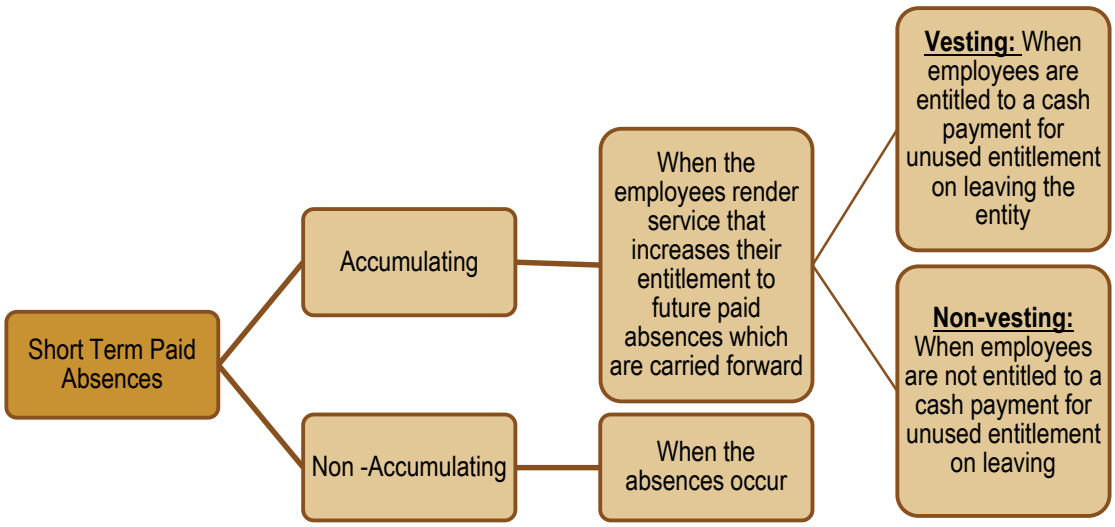
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1.5.2.2 Non-accumulating paid absences:

- These are the absences that do not carry forward and they will lapse if the current period's entitlement is not used in full by the employee; and
- They do not entitle employees to a cash payment for unused entitlement on leaving the entity.

Example: Sick pay (to the extent that unused past entitlement does not increase future entitlement).

- An entity shall recognise no liability or expense until the time of the absence because the employee service does not increase the amount of the benefit.



1.5.3 Profit-sharing and bonus plans

- Expected costs of profit-sharing and bonus plans shall be recognised when and only when:

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(a) the entity has a present legal or constructive obligation to make such payments as a result of past events; and

(b) a reliable estimate of the obligation can be made by the entity.

- A present obligation exists when, and only when, an entity has no realistic alternative but to make the payments in lieu of profits and bonuses to its employees.
- Under some profit-sharing plans, employees receive a share of the profit only if they remain with the entity for a specified period. Such plans create a constructive obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such constructive obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.
- An entity may have no legal obligation to pay a bonus. Nevertheless, in some cases, an entity has a practice of paying bonuses. In such cases, the entity has a constructive obligation because the entity has no realistic alternative but to pay the bonus. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.
- An entity can make a reliable estimate of its legal or constructive obligation under a profit-sharing or bonus plan when, and only when:

(a) the formal terms of the plan contain a formula for determining the amount of the benefit;

(b) the entity determines the amounts to be paid before the financial statements are approved for issue; or

(c) past practice gives clear evidence of the amount of the entity's constructive obligation.

- An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the entity's owners. **Hence**, **an entity recognises the cost of profit-sharing and bonus plans not as a distribution of profit but as an expense**.

Illustration 7

Laxmi Mills is a profit-making entity and has reported profit of ` 200 crore in the financial year 20X1-20X2. According to its profit–sharing plan, it distributes and pays 5% as its portion of profit to its employees if they complete 1 year with the organisation.

Under this plan, an entity is under an obligation to pay if the employees complete a specified period with the organisation. Laxmi Mills has estimated that due to staff turnover in the organisation, the estimated pay-out would be around 4.5%.

Compute the liability and expense of the company under this plan.

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Solution

The company shall recognize a liability and an expense of an amount of ₹ 9 crores for the financial year 20X1-20X2 (i.e. 4.5% of ₹ 200 crores).

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Illustration 8

Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates as observed during past 10 years represents 6% per annum. Acer provides the following benefits to all its employees:

Annual bonus - during past 10 years.

Acer paid bonus to all employees who were in service during the entire financial year. Bonus was paid in June following the financial year-end. Amount of bonus for 20X1-20X2 paid in June 20X2 represented ₹ 1,25,000 per employee. Acer Ltd. used to increase amount of bonus based on official inflation rate which is 8.5% for 20X2-20X3, although there was no legal obligation to increase the bonus by such inflation rate.

Determine how would Acer Ltd. recognize liabilities and expenses for these employee benefits as on 31st March, 20X3. Pass the journal entry to show the accounting treatment.

Solution

Particulars	**Amount (₹)**
Bonus paid for 20X1-20X2	1,25,000 per employee
Bonus for 20X2-20X3 - increased by inflation of 8.5%: [1,25,000 x (100% + 8.5%)]	1,35,625 per employee
No. of employees in staff during the whole year [350 x (100-6%)]	329 employees
Provision for Bonus for 20X2-20X3	**4,46,20,625**

Accounting Treatment:

Provision for Bonus for 20X2-20X3

Employee Benefits Expenses A/c	Dr.	4,46,20,625	
To Provision for Bonus 20X2-20X3			4,46,20,625

Note:

It is given that the company is under no legal obligation to increase the bonus by the official inflation rate. However, the company has been increasing the bonus by the inflation rate over the past years. This has given rise to a constructive obligation for Acer Ltd. Informal practices, such as these, give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits. Accordingly, provision is made for the amount considering the inflation rate.

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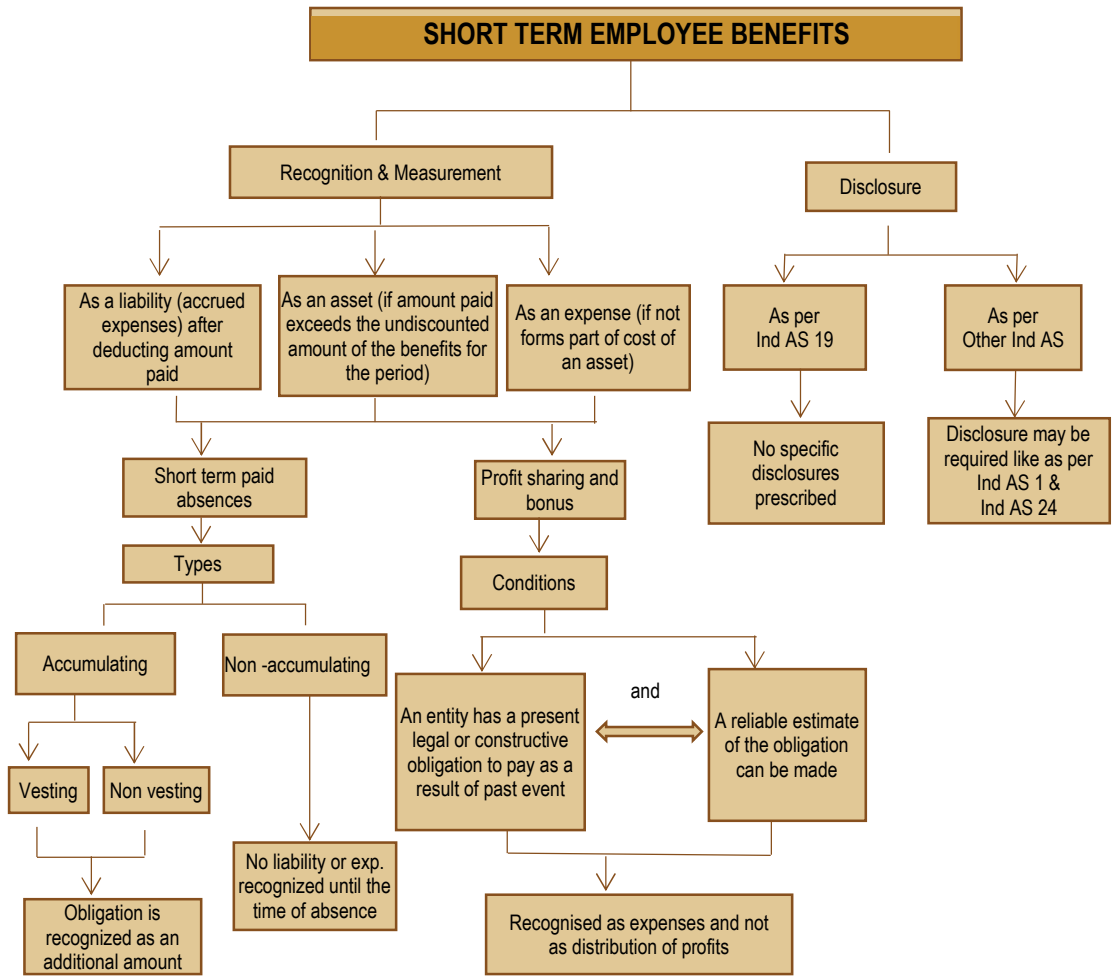
- If profit-sharing and bonus payments are **not settled wholly before the twelve months after the end of the reporting period** in which the employees render the related service, those payments are **considered as other long –term employee benefits**.

1.5.4 Disclosure

- This Standard does not require specific disclosures about short-term employee benefits.
- However, other Ind AS may require disclosures.

Examples:

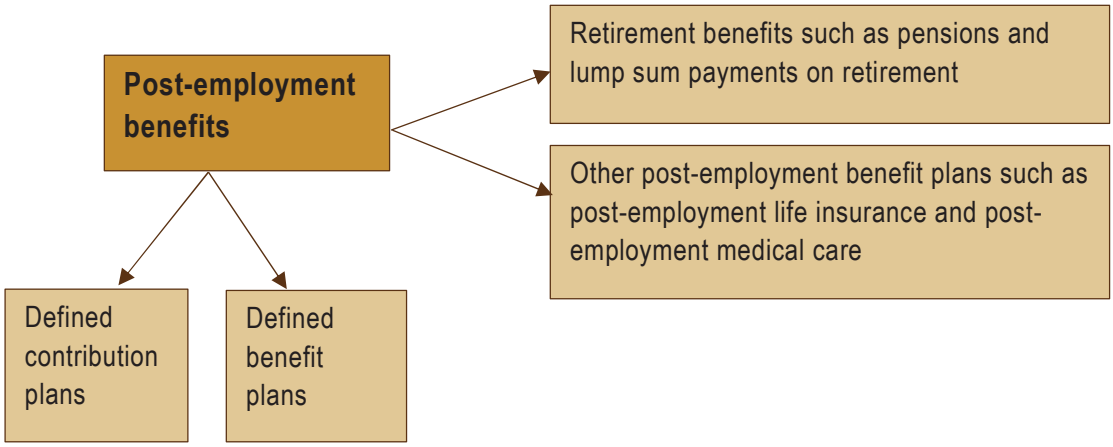
- Ind AS 24 requires disclosures about employee benefits for key management personnel.
- Ind AS 1, Presentation of Financial Statements, requires disclosure of employee benefits expense.



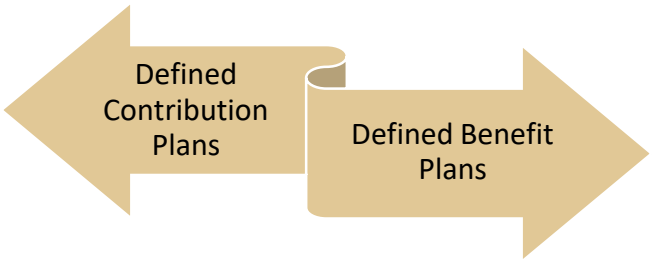
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1.6 POST-EMPLOYMENT BENEFITS

- Post-employment benefits include:
  - (a) Retirement benefits such as pensions and lump sum payments on retirement; and
  - (b) Other post-employment benefit such as post-employment life insurance and post-employment medical care.
- Depending upon the economic substance of the plan which is derived from its principal terms and conditions, post-employment benefit plans are classified as
  - (i) **either** defined contribution plans
  - (ii) **or** defined benefit plans.



1.6.1 Classification of post-employment Benefit Plans into Defined Contribution Plan vs Defined Benefit Plans



1.6.1.1 Under defined contribution plans

(a) The entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund.

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(b) Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions.

(c) As a result of this, actuarial risk (which means that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall, in substance on the employee (and not on the entity like in defined benefit plan).

Exception:

There are cases where an entity's obligation is not limited to the amount that it agrees to contribute to the fund as the entity has a legal or constructive obligation. Examples of such cases are listed below:

(a) a plan benefit formula that is not linked solely to the amount of contributions and requires the entity to provide further contributions if assets are insufficient to meet the benefits in the plan benefit formula;

(b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or

(c) informal practices that give rise to a constructive obligation.

For example, a constructive obligation may arise where an entity has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

1.6.1.2 Under defined benefit plans

(a) The entity's obligation is to provide the agreed benefits to current and former employees; and

(b) Actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity (and not on the employee like in the case of defined contribution plan).

(c) Thus, if actuarial or investment experience are worse than expected, the entity's obligation may be increased.

The above differences can be summarized as follows:

S. No.	Particulars	Defined Contribution Plans	Defined Benefit Plans
1.	*Entity's obligation*	The entity's legal or constructive obligation **is limited to the amount** that it agrees to contribute to the fund.	The entity's obligation is to **provide the agreed benefits** to current and former employees.

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2.	*Risk bearer*	Actuarial risk and investment risk **fall on the employee** and not on the entity.	Actuarial risk and investment risk **fall on the entity** and not on the employee.
3.	*Change in the obligation*	Generally, no change in the contribution of an entity is made except in certain cases.	If actuarial or investment experience are worse than expected, **the entity's obligation may be increased** for providing to the employees.
4.	*Determination of the amount of post-employment benefit*	The amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity and employee as well.	Pre-determined / Agreed post-employment benefits are received by the employee.

Illustration 9

A company pays each employee a lump-sum one-time benefit upon retirement. This benefit is computed based on the employee's years in service in the company and the final salary prior to retirement. To cover its liabilities from this remuneration, the company contributes 3% of annual gross salaries to the fund.

Comment whether this obligation represent a defined contribution plan or a defined benefit plan and why?

Solution

Defined benefit plan

Reason: Although the Company pays contributions to the fund to cover its liabilities, amount of remuneration is determined in advance and Company will have to carry the risk in case the fund's assets are not sufficient to cover remuneration in full.

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Illustration 10

In accordance with applicable legislation, company contributes 12% and employees 12% of annual gross salaries to the provident and pension fund. Upon retirement, the employees will get the accumulated balance that is calculated based on employee's years of service and his average salary for past 15 years before retirement. The pension will be paid out of the state fund assets and the company has no further obligation except to make contributions.

Analyse whether this obligation represent a defined contribution plan or a defined benefit plan.

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Solution

Defined contribution plan

Reason: Although employee's pension is determined in advance by the formula (and thus employees neither carry actuarial nor investment risks), Company's liability is limited to contributions to the fund. In this case, as pension will be paid out of the state fund, it is a state fund which carries all the risks.

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1.6.2 Multi-employer plans

- An entity shall classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any constructive obligation that goes beyond the formal terms).
- In the case of a multi-employer defined benefit plan, normally
  - The amount of contributions is decided keeping in mind the amount of benefits that an entity is required to pay in the same period and
  - The future benefits that an entity gets during the current period will be paid out of future contributions.
  - Employers have no realistic means of withdrawing from the plan without paying a contribution for the benefits earned.
  - Employees' benefits are determined by the length of their service in the entity as a future amount which is required to be paid to them. Such a plan would create actuarial risk to the entity (i.e. if the ultimate cost of benefits already earned at the end of the reporting period is more than expected, the entity will have to either increase its contributions or to persuade employees to accept a reduction in benefits).
- In case the multi-employer plan is a defined benefit plan, an entity shall:

  (a) account for its proportionate share of the

  (i) defined benefit obligation;

  (ii) plan assets; and

  (iii) cost associated with the plan

  in the same way as for any other defined benefit plan; and

  (b) disclose the information required.
- When sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, an entity shall:

  (a) account for the plan as if it were a defined contribution plan;

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(b) disclose:

(i) the fact that the plan is a defined benefit plan;

(ii) the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan; and

(iii) the expected contributions to the plan for the next annual reporting period; and

(c) to the extent that a surplus or deficit in the plan may affect the amount of future contributions, disclose:

(i) available information about that surplus or deficit;

(ii) the basis used to determine that surplus or deficit; and

(iii) the implications, if any, for the entity.

❖ The reasons that an entity is not able to term its plan as a defined benefit plan and has to account for a plan as multi-employer defined contribution plan, this may occur if:

➢ the entity does not have access to sufficient information about the plan to satisfy the requirements of this Standard; or

➢ the plan exposes the entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan.

❖ There may be a contractual agreement between the multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants (or the deficit funded). A participant in a multi-employer plan with such an agreement that accounts for the plan as a defined contribution plan shall recognise

➢ the asset or liability that arises from the contractual agreement and

➢ the resulting income or expense in profit or loss.

❖ In determining when to recognise, and how to measure, a liability relating to the wind-up of a multi-employer defined benefit plan, or the entity's withdrawal from a multi-employer defined benefit plan, an entity shall apply Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Example 1

Paras Pvt. Ltd. does not have sufficient information about a defined benefit plan and thus accounts for the plan as if it were defined contribution plan.

In the plan, there is a contractual agreement between Paras Pvt. Ltd. and its participants to share the deficit amongst all. The funding valuation shows a deficit of ₹ 500 million in the plan. The plan has agreed under contract a schedule of contributions with the participating employers in the plan that will eliminate the deficit over the next 10 years. The entity's total contributions

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under the contract are ₹ 30 million.

As per Ind AS 19, Paras Pvt. Ltd. should recognise a liability for the contributions adjusted for the time value of money and an equal expense in profit or loss.

1.6.3 Group administration plans

- A group administration plan is merely an aggregation of single employer plans combined to allow participating employers to pool their assets for investment purposes and reduce investment management and administration costs.
- The claims of different employers are segregated for the sole benefit of their own employees. In other words, the individual identities of the employees and their entities are preserved, unlike in case of multi-employer plans wherein the identity of the employees and the entities are lost in the common pool.
- Group administration plans pose no particular accounting problems because information is readily available to treat them in the same way as any other single employer plan. This is because such plans do not expose the participating entities to actuarial risks associated with the current and former employees of other entities.
- An entity should classify a group administration plan as a defined contribution plan or a defined benefit plan in accordance with the terms of the plan (including any constructive obligation that goes beyond the formal terms)

1.6.4 Defined benefit plans that share risks between entities under common control

- Defined benefit plans that share risks between entities under common control, for example, a parent and its subsidiaries, are not multi-employer plans.
- An entity who is participating in such a plan shall obtain information about the plan as a whole on the basis of assumptions that it applies to the plan as a whole.
- The entity shall, in its separate or individual financial statements, recognise the net defined benefit cost it charged, if there is a contractual agreement or stated policy for charging the net defined benefit cost for the whole plan to individual group entities.
- In case there is no such agreement or policy, the net defined benefit cost shall be recognised in the separate or individual financial statements of the group entity that is legally the sponsoring employer for the plan.
- The other group entities shall, in their separate or individual financial statements, recognise a cost equal to their contribution payable for the period.
- Participation in such kind of plan is a related party transaction for each individual group entity. Therefore, following **disclosures** are required by an entity in its separate or

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individual financial statements:

(a) the contractual agreement or stated policy according to which net defined benefit cost has been charged by the individual entity or the fact that there is no such policy.

(b) the policy for determining the contribution to be paid by the entity.

(c) if the entity accounts for an allocation of the net defined benefit cost, then disclosure has to be made for information about the whole plan.

(d) if the entity accounts for the contribution payable for the period, the information about the plan also needs to be disclosed for the plan as a whole.

1.6.5 State plans

- A state plan is accounted for in the same way as a multi-employer plan.
- State plans are normally established by legislation to cover all entities (or all entities in a particular category, for example, a specific industry) and are operated by national or local government or by another body (for example, an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting entity.
- Some plans established by an entity provide both compulsory benefits, as a substitute for benefits that would otherwise be covered under a state plan, and additional voluntary benefits. Such plans are not state plans.
- State plans are characterised as defined benefit or defined contribution, depending on the entity's obligation under the plan.
- Many state plans are funded on a pay-as-you- go basis which implies that contributions are set at a level that is expected to be sufficient to pay the required benefits falling due in the same period. In such kind of a case, future benefits earned during the current period will be paid out of future contributions.
- In most of the state plans, the entity has no legal or constructive obligation to pay those future benefits as its only obligation as an entity is to pay the contributions as they fall due and in case the entity does not employ members of the state plan, it will have no obligation to pay the benefits earned by its own employees in previous years. For this reason, state plans are normally defined contribution plans.

1.6.6 Insured benefits

- An entity normally pays insurance premiums for funding a post-employment benefit plan. The entity shall treat such a plan as a defined contribution plan.
- The entity shall treat the plan as a defined benefit plan in case an entity has (either directly, or indirectly through the plan) retained a legal or constructive obligation, either to pay:

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(a) the employee benefits directly when they fall due; or

(b) further amounts if the insurer does not pay all future employee benefits which are relating to employee service in the current and prior periods.

- Where an entity is funding a post-employment benefit obligation and contributes to an insurance policy under which the entity retains a legal or constructive obligation, in this case the payment of the premiums does not amount to a defined contribution arrangement. This can be either directly or indirectly through the plan, through the mechanism for setting future premiums or through a related party relationship with the insurer. Hence the entity shall:

  (a) account for a qualifying insurance policy as a plan asset; and

  (b) recognise other insurance policies as reimbursement rights.

- The entity has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits where an insurance policy is in the name of a specified plan participant or a group of plan participants and the entity does not have any legal or constructive obligation to cover any loss on the policy.

- The payment of fixed premiums under such kind of arrangement is a settlement of the employee benefit obligation rather than an investment to meet the obligation. Therefore, an entity treats such payments as contributions to a defined contribution plan.

1.7 ACCOUNTING FOR DEFINED CONTRIBUTION PLANS

- The reporting entity's obligation for each period is determined by the amounts to be contributed for that period.

- No actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss.

- The obligations are measured on an undiscounted basis.

Exception:

Discounting is done where the obligation falls due after twelve months after the end of the annual reporting period in which the employees render the related service.

1.7.1 Recognition and measurement

When an employee has rendered service to an entity during a period, the entity shall **recognise the contribution payable** to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid.

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In case the amount of contribution already paid under a defined contribution plan exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, a reduction in future payments or a cash refund; and

(b) as an expense if not included in the cost of an asset as per other Ind AS (for example, according to Ind AS 2 and Ind AS 16).

Where contributions to a defined contribution plan do not fall due wholly before twelve months after the end of the annual reporting period in which the employees render the related service, the contributions shall be discounted using the discount rate as specified in this Standard.

1.7.2 Disclosure

- An entity shall disclose the amount recognised as an expense for defined contribution plans.
- An entity shall disclose information about contributions to defined contribution plans for key management personnel where required as per Ind AS 24.

Illustration 11

Acer Ltd. provides lump-sum remuneration upon retirement to its employees. Remuneration is paid out of the fund to which Acer Ltd. contributes 12% of annual gross salaries. Contributions are made twice a year i.e. in November of the related financial year and in June after the financial year-end. Total annual gross salaries for 20X0-X1 amounted to ₹ 50 crores. Contribution made by Acer Ltd. in November 20X0 was ` 2.8 crores. Remuneration depends on the number of employee's service and amount of cash in the fund at retirement date (Acer Ltd. has no further obligations except for contributions).

How should this transaction appear in the financial statements of Acer Ltd. as of 31st March 20X1?

Solution

1. Calculation of accrual for contributions in 20X0-20X1:

Annual gross salaries in 20X0-20X1:	₹	50.00 crores
Amount of total contributions for 20X0-20X1 (12%):	₹	6.00 crores
Contributions already made in November 20X0:	₹	2.80 crores
Accrual (₹ 6 crores - ₹ 2.8 crores)	₹	3.20 crores

2. Accounting Treatment:

Employee Benefits Expenses Account	Dr.	6.00 crores	
To Bank Account			2.80 crores
To Contribution Payable			3.20 crores

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The contribution of ₹ 6 crores will be debited to the statement profit and loss. The contribution payable of ₹ 3.20 crores will appear as a liability as at 31st March, 20X1.

*****

1.8 ACCOUNTING FOR DEFINED BENEFIT PLANS

Accounting for defined benefit plans is complex because -

- actuarial assumptions are required to measure the obligation and the expense;
- there is a possibility of actuarial gains and losses;
- the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

Illustration 12

Dinkar Ltd., a large IT company, accounts for gratuity on payment basis, and supports such accounting policy by making the following disclosure in the Financial Statements:

"Due to high labour turnover, a large degree of uncertainty is involved in estimating the liability of gratuity. Accordingly, the management opines that as the estimates of the uncertainty would confuse the readers by complicating the financial statements, such liability would be recorded on payment basis."

The management opines that by making the above disclosures, the company is complying with the requirements of all the Ind AS, as a disclosure to the effect of the above is given. The management is also willing to specifically highlight the above aspect by making it conspicuous in the financial statements.

Is the contention of management correct as per the provisions of Ind AS?

Solution

Gratuity represents a payment being made to an employee upon retirement / resignation from the organization. The amount is determined in accordance with the provisions of the Gratuity Act, 1972, which applies to Dinkar Ltd. Since the amount is determined pursuant to a formula laid down under the statue, the gratuity payable represents a Defined Benefit Plan that is to be paid to the employees, with the actuarial risk and investment risk both belonging to the employer. Thus, Dinkar Ltd. must comply with Ind AS 19 and provide for the gratuity on an annual basis.

In estimating the liability for gratuity, there would be several assumptions involved such as

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mortality rate, staff attrition rate, salary at the time of retirement / resignation, discount rate etc., all of which have to be considered by Dinkar Ltd. The complexity involved in this exercise does not provide Dinkar Ltd. with an excuse to avoid accrual accounting.

Dinkar Ltd. has stated that it would be willing to make a disclosure to the effect of the departure from Ind AS 8 requirements. In terms of Para 19 of Ind AS 1, departure is permitted in **extremely rare** circumstances wherein the management concludes that compliance with an Ind AS requirement would be so **misleading** that it would **conflict** with the objective of the Financial Statements set out in the Framework.

In the given case, compliance with Ind AS would not be a conflict, as the compliance with Ind AS 19 would ensure that the accrual assumption laid down in the Framework is complied with. Further, a disclosure cannot be a remedy for non-compliance. Therefore, the company have to state that the Ind AS have not been complied with by the company in the preparation and presentation of its Financial Statements.

Hence, the company will have to suitably modify the financial statements considering the materiality and pervasiveness of the non-compliance.

*****

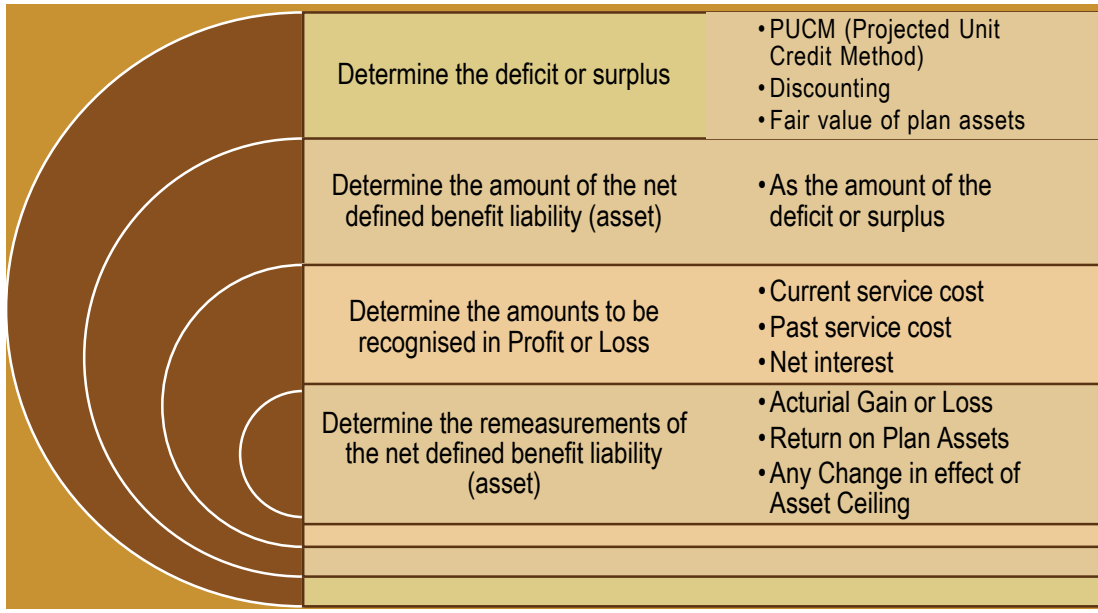
1.8.1 Recognition and measurement

- Defined benefit plans can be:
  - Unfunded; or
  - Wholly or partly funded

  by contributions by an entity, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting entity and from which the employee benefits are paid.
- The payment of funded benefits when they fall due depends on
  - the financial position and the investment performance of the fund; and
  - an entity's ability (and willingness) to make good any shortfall in the fund's assets.
- Therefore, the entity, in substance, underwrites the actuarial and investment risks associated with the plan.
- Hence the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period.

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1.8.1.1 Steps involved in accounting by an entity for defined benefit plans



Step I: Determining the Deficit or Surplus

This involves:

(a) using actuarial techniques, the projected unit credit method, to make a reliable estimate of the amount of benefit that employees have earned in return for their service in the current and prior periods.

This requires an entity to -

(i) determine how much benefit is attributable to the current and prior periods and

(ii) make estimates (actuarial assumptions) about

- demographic variables (such as employee turnover and mortality); and
- financial variables (such as future increases in salaries and medical costs)

that will influence the cost of the benefit;

(b) discounting that benefit in order to determine the present value of the defined benefit obligation; and the current service cost

(c) deducting the fair value of any plan assets from the present value of the defined benefit obligation.

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Step II: Determining the amount of the net defined benefit liability (asset)

Determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in step I above, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

Step III: Determining amounts to be recognised in profit or loss:

(i) current service cost.

(ii) any past service cost and gain or loss on settlement.

(iii) net interest on the net defined benefit liability (asset).

Step IV: Determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:

(i) actuarial gains and losses;

(ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(iii) any change in the effect of the asset ceiling, **excluding** amounts included in net interest on the net defined benefit liability (asset).

In case an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.

An entity shall determine the net defined benefit liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

1.8.2 Accounting for the constructive obligation

- Accounting for any constructive obligation will also be done by an entity that arises from the entity's informal practices.
- Constructive obligation arises due to informal practices where the entity has no realistic alternative but to pay employee benefits.

  Example - Where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees
- The formal terms of a defined benefit plan may permit an entity to terminate its obligation under the plan. Nevertheless, it is usually difficult for an entity to terminate its obligation under a plan (without payment) if employees are to be retained.
- Hence accounting for post-employment benefits assumes that an entity which is currently promising such benefits will continue to do so over the remaining working lives of employees, in the absence of evidence to the contrary.

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1.8.3 Balance sheet

- An entity shall recognise the net defined benefit liability (asset) in the balance sheet.
- When an entity has a surplus in a defined benefit plan, it shall measure the net defined benefit asset **at the lower of:**

  (a) the surplus in the defined benefit plan; and

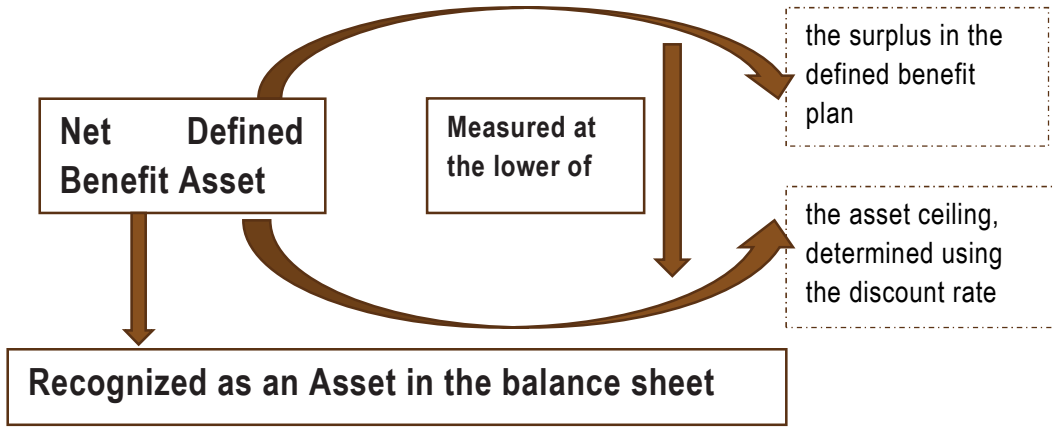
  (b) the asset ceiling, determined using the discount rate.

- A net defined benefit asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are arisen. An entity recognises a net defined benefit asset in such cases because:

  (a) the entity controls a resource, which is the ability to use the surplus to generate future benefits;

  (b) that control is a result of past events (contributions paid by the entity and service rendered by the employee); and

  (c) future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit. The asset ceiling is the present value of those future benefits.



Comparison with recognition of Deferred Tax Asset under Ind AS 12 *Income Taxes*:

As per para 24 of Ind AS 12 *Income Taxes*, a deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is **probable** that taxable profit will be available against which the deductible temporary difference can be utilised.

The principle of taxable profit being available for future utilization of deductible temporary difference is essential under Ind AS 12 in order to recognise Deferred Tax Assets. However, in Ind AS 19, no such principle of establishing probability is required as the Plan

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Assets represent actual investments which are held by the entity (albeit through a separate trust specially formed).

Illustration 13

How will the following information be presented in the Balance Sheet of Udyog Ltd.?

Particulars	***₹ in lakhs***
PV of Defined Benefit Obligations	*3,500*
Fair Value of Plan Assets	*3,332*

Solution

Particulars	**₹ in lakhs**
PV of Defined Benefit Obligations	3,500
Less: Fair Value of Plan Assets	(3,332)
Deficit, to be treated as Net Defined Benefit Liability under Non-current Liabilities as Provisions in the Balance Sheet	**168**

*****

Illustration 14

How will the following information be presented in the Balance Sheet of Udyog Ltd.?

Particulars	***₹ in lakhs***
PV of defined benefit obligations	*2,750*
Fair value of plan assets	*2,975*
Asset ceiling	*175*

Solution

Particulars	**₹ in lakhs**
PV of defined benefit obligations	2,750
Less: Fair value of plan assets	(2,975)
Surplus, to be treated as net defined benefit asset	**225**
Asset ceiling as per Ind AS 19	175
Least of above is surplus to be treated as net defined benefit asset under non-current assets in the Balance Sheet	**175**

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1.9 RECOGNITION AND MEASUREMENT: PRESENT VALUE OF DEFINED BENEFIT OBLIGATIONS AND CURRENT SERVICE COST

The cost of a defined benefit plan is influenced by many variables, such as

- final salaries;
- employee turnover and mortality;
- employee contributions; and
- medical cost trends.

Hence the ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time.

In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary to:

(a) apply an actuarial valuation method;

(b) attribute benefit to periods of service; and

(c) make actuarial assumptions.

1.9.1 Actuarial valuation method

❖ Projected Unit Credit Method (PUCM) is used by an entity to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

❖ The Projected Unit Credit Method (which is also sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) perceives each period of service as which gives rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.

Illustration 15

AJ Ltd is engaged in the business of trading of chemicals having a net worth of ₹ 150 crores. The company's profitability is good and hence the company has introduced various benefits for its employees to keep them motivated and to ensure that they stay with the organization. The company is an associate of RJ Ltd which is listed on Bombay Stock Exchange in India.

The company initially did not have any HR function but over the last 2 years, the management set up that function and now HR department takes care of all the benefits

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related to the employees and how they can be structured in a manner beneficial to both the employees and the objectives of the company.

One of the employee benefits involves a lump sum payment to employee on termination of service and that is equal to 1 per cent of final salary for each year of service. Consider the salary in year 1 is ₹ 10,000 and is assumed to increase at 7 per cent (compound) each year.

Taking a discount rate at 10 per cent per year, you are required to compute

(a) benefits attributed (year on year) and

(b) the obligation in respect of this benefit (year on year)

For an employee who is expected to leave at the end of year 5

Following assumptions may be taken to solve this:

- *There are no changes in actuarial assumptions.*
- *No additional adjustments are needed to reflect the probability that the employee may leave the entity at an earlier or later date.*

Solution

a. Computation of benefit attributed to prior years and current year:

Amount in ₹

Year	1	2	3	4	5
Benefit attributed to:					
- Prior years	-	131	262	393	524
- Current year (Refer W.N.1)	131	131	131	131	131
Total (i.e. current and prior years)	**131**	**262**	**393**	**524**	**655**

b. Computation of the obligation for an employee who is expected to leave at the end of year 5 (taking discount rate of 10% p.a.) Amount in ₹

Year	1	2	3	4	5
Opening obligation (A)	-	89	196	324	475
Interest at 10% (B = A X 10%)	-	9	20	32	47
Current service cost (C) (Refer WN 2)	89	98	108	119	131
Closing obligation D = (A+B+C)	**89**	**196**	**324**	**475**	**653**

Figures have been rounded off in the above table.

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Working Notes:

1. A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service. The salary in year 1 is ₹ 10,000 and is assumed to increase at 7 per cent (compound) each year.

   The year on year salary would be as follows: Amount in ₹

Year	1	2	3	4	5
Salary	10,000	10,700 (10,000 x 107%)	11,449 (10,700 x 107%)	12,250 (11,449 x 107%)	13,108 (12,250 x 107%)

   Accordingly, for the purpose of above-mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

2. Computation of current service cost: Amount in ₹

Year	1	2	3	4	5
1% salary at the end of year 5	-	-	-	-	131
PV factor at the end of each year to be considered at 10% p.a. **(E)**	0.683	0.751	0.826	0.909	1.000
PV at the end of each year	89 (131 x E)	98 (131 x E)	108 (131 x E)	119 (131 x E)	131 (131 x E)

   Accordingly, for the purpose of above-mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

*****

- An entity discounts the whole of a post-employment benefit obligation, even if part of the obligation is expected to be settled before twelve months after the reporting period.

1.9.2 Attributing benefit to periods of service

- An entity shall attribute benefit to periods of service under the plan's benefit formula, in determining the present value of its defined benefit obligations and the related current service cost, and, where applicable, past service cost.
- However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis from:

  (a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service) until

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(b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

- The Projected Unit Credit Method requires an entity to attribute benefit to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations).

  An entity will attribute benefit to periods in which the obligation to provide post-employment benefits arises as employees render services in return for post-employment benefits which an entity expects to pay in future reporting periods.

- These kind of actuarial techniques allow an entity to measure that obligation with sufficient reliability to justify recognition of a liability.

Example 2

A defined benefit plan provides a lump-sum benefit of ₹ 200 payable on retirement for each year of service. A benefit of ₹ 200 is attributed to each year. The current service cost is the present value of ₹ 200. The present value of the defined benefit obligation is the present value of ₹ 200, multiplied by the number of years of service up to the end of the reporting period.

If the benefit is payable immediately when the employee leaves the entity, the current service cost and the present value of the defined benefit obligation reflect the date at which the employee is expected to leave. Thus, because of the effect of discounting, they are less than the amounts that would be determined if the employee left at the end of the reporting period.

- Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (***in other words they are not vested***).

- Employee service given the vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. An entity considers the probability that some employees may not satisfy any vesting requirements in measuring its defined benefit obligation.

- Although, certain post-employment benefits, for example, post- employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs.

  The probability that the specified event will occur affects the measurement of the obligation but does not determine whether the obligation exists.

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Illustration 16

A plan pays a benefit of ₹ 150 for each year of service. The benefits vest after ten years of service. Compute the benefit to be attributed each year?

Solution

1. A benefit of ₹ 150 is attributed to each year.
2. In each of the first ten years, the current service cost and the present value of the obligation reflect the probability that the employee may not complete ten years of service. This is because the benefits vest at a future date (i.e. after ten years of service).

*****

Illustration 17

A plan pays a benefit of ₹ 150 for each year of service, excluding service before the age of 25. The benefits vest immediately. Compute the benefit to be attributed each year?

Solution

1. No benefit is attributed to the service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional).
2. A benefit of ₹ 150 is attributed to each subsequent year. There is no requirement to reflect any probability of completion as the benefits vest immediately.

*****

❖ The obligation increases till the date when further service by the employee will lead to no material amount of further benefits. Therefore, all benefit is attributed to periods ending on or before that date. Benefit is attributed to individual accounting periods under the plan's benefit formula.

However, in case an employee renders service in later years which will lead to a materially higher level of benefit than in earlier years, an entity will attribute benefit on a straight-line basis until the date when further service by the employee will lead to no material amount of further benefits. That is because the employee's service throughout the entire period will ultimately lead to benefit at that higher level.

Example 3

A plan pays a lump-sum retirement benefit of ₹ 4,000 to all employees who are still employed at the age of 55 after twenty years of service, or who are still employed at the age of 65, regardless of their length of service.

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Category of Employee	Description	Benefit attributed per year
Employees who join before the age of 35	▪ These employees will be in service for 20 years at the age of 55. Accordingly, the service leads to benefits at the age of 35 and are conditional of further service. ▪ However, service beyond the age of 55 leads to no material amount of further benefits (i.e. benefit will still be the same).	▪ For these employees, the entity attributes benefit of ₹ 200 (₹ 4,000 divided by 20 years) each year from the age of 35 to the age of 55. ▪ The current service cost and the present value of the obligation should reflect the probability of an employee not completing the necessary service period.
Employees who join after the age of 35	▪ These employees will not be in service for 20 years at the age of 55 and must wait till the age of 65, regardless of the years of service. ▪ The service leads to benefits at the beginning of employment and service beyond age 65 leads to no material amount of further benefits.	▪ For these employees, the entity attributes benefit of ₹ 4,000 ÷ (65 years – whatever age when employment started may be 40, 45, 50...) to each year of service from the start until the age of 65. ▪ The current service cost and the present value of the obligation should reflect the probability of an employee not completing the necessary service period.

Illustration 18

Amra Pvt. Ltd. has a plan for its employees where it has decided to pay a lump-sum benefit of ₹ 2,000 that will vest after ten years of service. However, that plan will provide no further benefit for subsequent service.

Compute the benefit attributed for 10 years of service and for the period of service after 10 years?

Solution

1. In this case, as per the company's plan, a benefit of ₹ 200 (₹ 2,000 ÷ 10 years) is attributed to each of the first 10 years.
2. The current service cost in each of the first ten years reflects the probability that the employee may not complete ten years of service. This is because the benefits vest at a future date (i.e. after ten years of service).

No benefit is attributed to subsequent years.

*****

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Illustration 19

Sanat Pvt. Ltd. has a plan for the employees where employees are entitled to a benefit of 5% of final salary for each year of service before the age of 55.

Compute the benefit attributed up to 55 years and after 55?

Solution

Benefit of 5% of estimated final salary is attributed to each year up to the age of 55. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that age.

*****

Illustration 20

A post-employment medical plan reimburses 40 percent of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50 per cent of those costs if the employee leaves after twenty or more years of service.

Determine how will the benefit be attributed to the years of service.

Solution

1. Under the Plan's Benefit Formula, the entity should attribute 4% of the present value of the expected medical costs (40% ÷ 10 years) to each of the first ten years, and 1% (10% ÷ 10 years) to each of the second ten years.
2. For employees expected to leave within 10 years, no benefit is attributed.
3. The Current Service Cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits.

*****

Illustration 21

A post-employment medical plan reimburses 10 percent of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50 per cent of those costs if the employee leaves after twenty or more years of service.

Determine how will the benefit be attributed to the years of service.

Solution

1. Service in later years will lead to a materially higher level of benefit than in earlier year. So, for employees expected to leave after 20 or more years, the entity should attribute benefit on a straight-line basis under Para 71. Service beyond 20 years will lead to no material amount of further benefits. So, the benefit attributed to each of the first 20 years will be 2.5% of the Present Value of the Expected Medical Costs (50% ÷ 20 years).
2. For employees expected to leave between 10 and 20 years, the benefit attributed to each

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of the first 10 years is 1% (10% ÷ 10 years) of the Present Value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

3. For employees expected to leave within ten years, no benefit is attributed.

4. The Current Service Cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits.

*****

Illustration 22

AKJ Ltd is a listed company engaged in the business of manufacturing of electronic equipment. The company has various branch offices spread out across India and has 1,000 employees.

As per the statutory requirements, gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than five years -

(a) on his superannuation, or

(b) on his retirement or resignation, or

(c) on his death or disablement due to accident or disease.

The completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement.

The amount payable is determined by a formula linked to number of years of service and last drawn salary. The amount payable to an employee shall not exceed ₹ 10,00,000.

Compute the amount of employee benefit, if any, attributed to each year of service.

Solution

The amount of gratuity would be attributed to each year of service and calculated as follows:

Number of employees not likely to fulfil the eligibility criteria will be ignored.

Other employees will be grouped according to period of service they are expected to render taking into account:

- mortality rate,
- disablement and
- resignation after 5 years.

Gratuity payable will be calculated in accordance with the formula prescribed in the governing statute based on the period of service and the salary at the time of termination of employment, assuming promotion, salary increases etc.

For those employees for whom the amount payable as per the formula does not exceed ₹ 10,00,000, over the expected period of service, the amount payable will be divided by the

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expected period of service and the resulting amount will be attributed to each year of the expected period of service, including the period before the stipulated period of 5 years.

In case of the remaining employees, the amount as per the formula exceeds ₹ 10,00,000 over the expected period of service of 10 years (say), and the amount of the threshold of ₹ 10,00,000 is reached at the end of 8 years (assumed) i.e. ₹ 1,25,000 (₹ 10,00,000 ÷ 8 years) is attributed to each of the first 8 years. In this case, no benefit is attributed to subsequent two years. This is because service beyond 8 years will lead to no material amount of further benefits.

*****

1.9.3 Actuarial assumptions

- Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits.
- Actuarial assumptions shall be unbiased and mutually compatible.
- Actuarial assumptions are unbiased if they are neither imprudent nor excessively conservative.
- Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, salary increment rate and discount rates.

  For example, all assumptions which depend on a particular inflation level (such as assumptions about interest rates and salary and benefit increases) in any given future period assume the same inflation level in that period.
- Actuarial assumptions comprise:

  (a) **demographic assumptions** about the future characteristics of current and former employees (and their dependants) who are eligible for benefits. Demographic assumptions deal with matters such as:

  (i) mortality, both during and after employment;

  (ii) rates of employee turnover, disability and early retirement;

  (iii) the proportion of plan members with dependants who will be eligible for benefits;

  (iv) the proportion of plan members who will select each form of payment option available under the plan terms; and

  (v) claim rates under medical plans; and

  (b) **financial assumptions,** dealing with items such as:

  (i) the discount rate;

  (ii) future salary and benefit levels;

  (iii) in the case of medical benefits, future medical costs, including claim handling costs (i.e. the costs that will be incurred in processing and resolving claims, including legal and adjuster's fees); and

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(iv) taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service.

- An entity determines discount rate and other financial assumptions in nominal (stated) terms unless estimates in real (inflation-adjusted) terms are more reliable. For example, in a hyperinflationary economy, or where the benefit is index-linked and there is a deep market in index-linked bonds of the same currency and term.
- Financial assumptions are based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled.

1.9.3.1 Actuarial assumptions: mortality and discount rate

1. Mortality Assumptions

Entity is required to determine its mortality assumptions by reference to its best estimate of the mortality of plan members both during and after employment.

In order to estimate the ultimate cost of the benefit an entity shall takes into consideration the expected changes in mortality, for example by modifying standard mortality tables with estimates of mortality improvements.

2. Discount Rate Assumptions

- The rate which is used to discount post-employment benefit obligations (both funded and unfunded) is **determined by reference to market yields on government bonds** at the end of the reporting period.
- **Subsidiaries, associates, joint ventures and branches domiciled outside India** shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate **determined by reference to market yields** at the end of the reporting period **on high quality corporate bonds**.
- In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries **where there is no deep market in such bonds, the market yields** (at the end of the reporting period) **on government bonds** of that country **shall be used**.
- The currency and term of the government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations as the pay-outs will happen in same currency only.
- The discount rate reflects the estimated timing of benefit payments/time value of money and not the actuarial or investment risk. This also does not reflect entity-specific credit risk borne by the entity's creditors.
- Thus, practically speaking, it is achieved by an entity by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payments and the currency in which the benefits are to be paid.

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- Where there is no deep market in government bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments, an entity uses current market rates of the appropriate term to discount shorter-term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve.
- **Interest cost is computed by multiplying the discount rate as determined at the start of the period by the present value of the defined benefit obligation** throughout that period and taking account of any material changes in the obligation.

1.9.3.2 Actuarial assumptions: salaries, benefits and medical costs

- Defined benefit obligations shall be measured on a basis that reflects:

  (a) the benefits set out in the terms of the plan (or resulting from any constructive obligation that goes beyond those terms) at the end of the reporting period;

  (b) estimated future salary increases;

  (a) the effect of any limit on the employer's share of the cost of the future benefits;

  (b) contributions from employees or third parties that reduce the ultimate cost to the entity of those benefits; and

  (e) estimated future changes in the level of any state benefits that affect the benefits payable under a defined benefit plan, if, and only if, either:

    (i) those changes were enacted before the end of the reporting period; or

    (ii) historical data, or other reliable evidence, indicates that those state benefits will change in some predictable manner, for example, in line with future changes in general price levels or general salary levels.

- Estimates of future salary increases are calculated after taking account inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.
- The formal terms of the plan (or a constructive obligation that goes beyond those terms) require an entity to consider change in benefits for future periods; the measurement of the obligation reflects those changes at the end of the reporting period will impact actuarial gains and losses.

  For examples when:

  (a) entity has a history of increasing benefits, for example, to mitigate the effects of inflation, and there is no indication that this practice will change in the future;

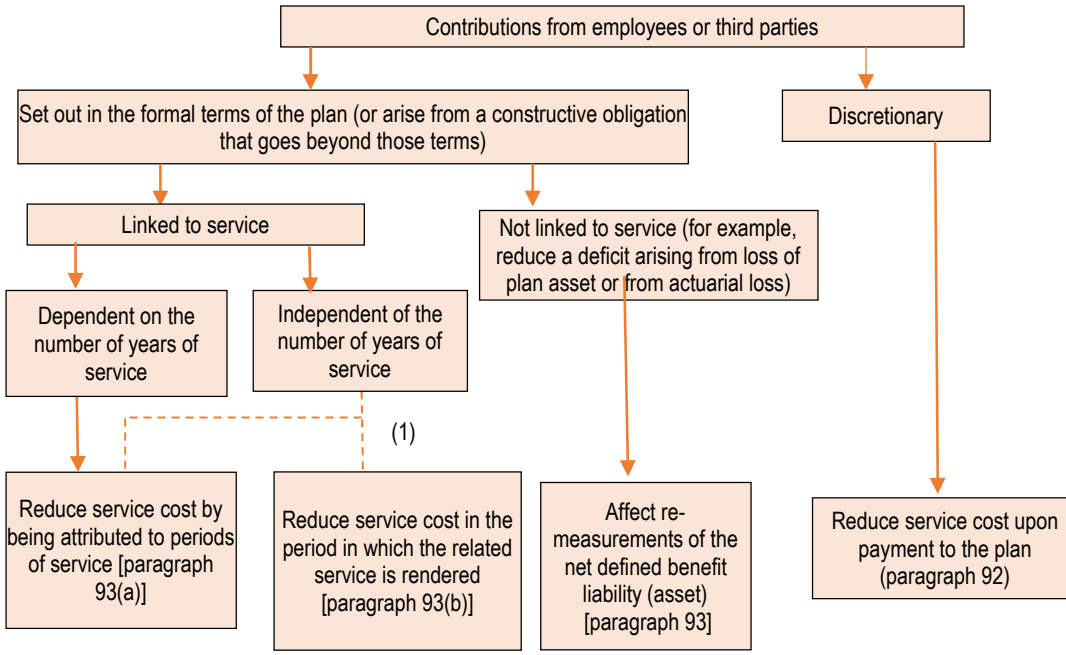
  (b) the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants; or

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(c) benefits vary in response to a performance target or other criteria. For example, the terms of the plan may state that it will pay reduced benefits or require additional contributions from employees if the plan assets are insufficient. The measurement of the obligation reflects the best estimate of the effect of the performance target or other criteria.

- Further, future benefit changes that are not set out in formal terms of the plan (or a constructive obligation) at the end of the reporting period; will result in impacting past service cost and current service cost for the period after change to the extent of such change in benefits for the service.
- Some post-employment benefits are linked to variables such as the level of state retirement benefits or state medical care. The measurement of such benefits reflects expected changes in such variables, based on past history and other reliable evidence.
- Assumptions about medical costs shall take into account estimated future changes in the cost of medical services, resulting from both inflation and specific changes in medical costs.
- Post-employment medical benefits measurement requires assumptions about the level and frequency of future claims and the cost of meeting those claims. Future medical costs are estimated on the basis of historical data about the entity's own experience and in case some more data is required to analyse the data, this data is gathered as historical data from other entities, insurance companies, medical providers or other sources. Estimates of future medical costs would consider the effect of technological advances, changes in health care utilisation or delivery patterns and changes in the health status of plan participants.
- The level and frequency of claims is particularly sensitive to the age, health status and sex of employees (and their dependants) and may be sensitive to other factors such as geographical location. Hence, this historical data is adjusted to the extent that the demographic mix of the population which differs from that of the population used as a basis for the historical data. Also it requires an adjustment where there is reliable evidence that historical trends will not continue.
- Some post-employment health care plans also require employees to contribute to the medical costs covered by the plan and thus estimates of future medical costs also take in account of any such contributions which are based on the terms of the plan at the end of the reporting period (or based on any constructive obligation that goes beyond those terms). Changes in those employee contributions result in past service cost or, where applicable, curtailments. The cost of meeting claims may be reduced by benefits from state or other medical providers.

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(1) This dotted arrow means that an entity is permitted to choose either accounting.

1.9.3.3 Past service cost and gains and losses on settlement

- When determining past service cost, or a gain or loss on settlement, an entity shall remeasure the net defined benefit liability (asset) using the current fair value of plan assets and current actuarial assumptions (including current market interest rates and other current market prices) reflecting:
  - the benefits offered under the plan and the plan assets before the plan amendment, curtailment or settlement; and
  - the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement.
- An entity need not distinguish between past service cost resulting from a plan amendment, past service cost resulting from a curtailment and a gain or loss on settlement if these transactions occur together. In some cases, a plan amendment occurs before a settlement, such as when an entity changes the benefits under the plan and settles the amended benefits later. In those cases, an entity recognises past service cost before any gain or loss on settlement.
- When a plan amendment, curtailment or settlement occurs, an entity shall recognise and measure any past service cost, or a gain or loss on settlement. In doing so, an entity shall not consider the effect of the asset ceiling. An entity shall then determine the effect of the asset ceiling after the plan amendment, curtailment or settlement and shall recognise any change in that effect.

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- A settlement occurs together with a plan amendment and curtailment if a plan is terminated with the result that the obligation is settled and the plan ceases to exist. However, the termination of a plan is not a settlement if the plan is replaced by a new plan that offers benefits that are, in substance, the same.

1.9.3.3.1 Past service cost

- Change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment is known as past service cost.
- An entity shall recognise past service cost as an expense at the earlier of the following dates:
  (a) when the plan amendment or curtailment occurs; and
  (b) when the entity recognises related restructuring costs (refer Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets) or termination benefits.
- Plan amendment happens when an entity introduces, or withdraws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan.
- Curtailment arises when an entity significantly reduces the number of employees covered by a plan. A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan.
- Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases).
- In case, an entity reduces benefits payable under an existing defined benefit plan and, at the same time, increases other benefits payable under the plan for the same employees, the entity treats the change as a single net change.
- Past service cost excludes the following:
  (a) the effect of differences between actual and previously assumed salary increases on the obligation to pay benefits for service in prior years (there is no past service cost because actuarial assumptions allow for projected salaries);
  (b) underestimates and overestimates of discretionary pension increases when an entity has a constructive obligation to grant such increases (there is no past service cost because actuarial assumptions allow for such increases);
  (c) estimates of benefit improvements that result from actuarial gains/ return on plan assets that have been recognised in the financial statements if the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants, even if the benefit increase has not yet been formally awarded (there is no past service cost because the resulting increase in the obligation is an actuarial loss); and

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(d) the increase in vested benefits when, in the absence of new or improved benefits, employees complete vesting requirements (there is no past service cost because the entity recognised the estimated cost of benefits as current service cost as the service was rendered).

1.9.3.3.2 Gains and losses on settlement

- A settlement occurs when an entity enters into a transaction that eliminates all further legal or constructive obligation for part or all of the benefits provided under a defined benefit plan (other than a payment of benefits to, or on behalf of, employees in accordance with the terms of the plan and included in the actuarial assumptions).

  For example, a one-off transfer of significant employer obligations under the plan to an insurance company through the purchase of an insurance policy is a settlement; a lump sum cash payment, under the terms of the plan, to plan participants in exchange for their rights to receive specified post-employment benefits is not.

- The gain or loss on a settlement is the difference between:

  (a) the present value of the defined benefit obligation being settled, as determined on the date of settlement; and

  (b) the settlement price, including any plan assets transferred and any payments made directly by the entity in connection with the settlement.

- Gain or loss on the settlement of a defined benefit plan is recognised by the entity when the settlement occurs.

1.10 RECOGNITION AND MEASUREMENT: PLAN ASSETS

1.10.1 Fair value of plan assets

- The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus.
- Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.
- Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

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1.10.2 Reimbursements

- An entity will recognise its right to reimbursement as a separate asset when, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation. The assets are measured at fair value by the entity and in all other respects, an entity shall treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.
- Sometimes, an entity is able to look to another party, such as an insurer, to pay part or all of the expenditure required to settle a defined benefit obligation, there an entity accounts for qualifying insurance policies in the same way as for all other plan assets. When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset.
- Further, when an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. In such a scenario, an entity recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability (asset) and in all other respects, the entity treats that asset in the same way as plan assets.
- If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, the fair value of the reimbursement right is deemed to be the present value of the related obligation.

1.11 COMPONENTS OF DEFINED BENEFIT COST

- An entity is required to recognise the components of defined benefit cost, except to the extent that another Ind AS (refer Ind AS 2 and Ind AS 16) requires or permits their inclusion in the cost of an asset, as follows:

  (a) service cost in profit or loss;

  (b) net interest on the net defined benefit liability (asset) in profit or loss; and

  (c) remeasurements of the net defined benefit liability (asset) in other comprehensive income.
- Remeasurements of the net defined benefit liability (asset) recognised in other comprehensive income shall not be reclassified to profit or loss in a subsequent period. However, the entity may transfer those amounts recognised in other comprehensive income within equity.

Current service cost

- An entity shall determine current service cost using actuarial assumptions determined at

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the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), as discussed above, it shall determine current service cost for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using the actuarial assumptions used to remeasure the net defined benefit liability (asset) in accordance with paragraph 99(b) of Ind AS 19 (i.e. reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement).

1.11.1 Net interest on the net defined benefit liability (asset)

- An entity shall determine net interest on the net defined benefit liability (asset) by multiplying the net defined benefit liability (asset) by the discount rate specified for post-employment benefit obligation.
- To determine net interest in accordance with paragraph mentioned above, an entity shall use the net defined benefit liability (asset) and the discount rate determined at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine net interest for the remainder of the annual reporting period after considering the benefits offered under the plan and the plan asset after the plan amendment, curtailment or settlement using:

  (a) the net defined benefit liability (asset) ; and

  (b) the discount rate used to remeasure the net defined benefit liability (asset).

  Further, in applying this paragraph, the entity shall also take into account any changes in the net defined benefit liability (asset) during the period resulting from contributions or benefit payments.
- Net interest on the net defined benefit liability (asset) can be viewed as comprising interest income on plan assets, interest cost on the defined benefit obligation and interest on the effect of the asset ceiling.
- Interest income on plan assets is a component of the return on plan assets and is determined by multiplying the fair value of the plan assets by the discount rate specified for post-employment benefit obligation. An entity shall determine the fair value of the plan assets at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine interest income for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using the plan assets used to remeasure the net defined benefit liability (asset) reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement). Further, in applying this paragraph, the entity shall also consider any changes in the plan assets held during the period resulting from contributions or benefit payments.

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- The difference between the interest income on plan assets and the return on plan assets is included in the remeasurement of the net defined benefit liability (asset).
- Interest on the effect of the asset ceiling is part of the total change in the effect of the asset ceiling and is determined by multiplying the effect of the asset ceiling by the discount rate. An entity shall determine the effect of the asset ceiling at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine interest on the effect of the asset ceiling for the remainder of the annual reporting period after the plan amendment, curtailment or settlement considering any change in the effect of the asset ceiling. The difference between interest on the effect of the asset ceiling and the total change in the effect of the asset ceiling is included in the remeasurement of the net defined benefit liability (asset).

1.11.2 Remeasurements of the net defined benefit liability (asset)

- Remeasurements of the net defined benefit liability (asset) comprise:
  (a) actuarial gains and losses;
  (b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and
  (c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).
- Actuarial gains and losses occur from increases or decreases in the present value of the defined benefit obligation because of changes in actuarial assumptions and experience adjustments. Following are the few causes of actuarial gains and losses:
  (a) unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs;
  (b) the effect of changes to assumptions concerning benefit payment options;
  (c) the effect of changes in estimates of future employee turnover, early retirement, or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs; and
  (d) the effect of changes in the discount rate.
- Actuarial gains and losses does not include changes in the present value of the defined benefit obligation because of the introduction, amendment, curtailment or settlement of the defined benefit plan, or changes to the benefits payable under the defined benefit plan. Rather such changes shall result in past service cost or gains or losses on settlement.
- In measuring the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial

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assumptions used to measure the defined benefit obligation. Other administration costs are not deducted from the return on plan assets.

Illustration 23

Pratap Ltd. belongs to the ship-building industry. The company reviewed an Actuarial Valuation for the first time for its pension scheme which revealed a surplus of ₹ 60 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 20 lakhs instead of ₹ 50 lakhs. The average remaining life of the employees is estimated to be 6 years.

Advise the Company in line with Ind AS 19.

Solution

1. **Recognition:** As per Ind AS 19, any Actuarial Gains and Losses should be recognized as a re-measurement of the Net Defined Benefit Liability / (Asset) in "Other Comprehensive Income".

2. **Measurement and Presentation:** In the given case, the amount of surplus from Pension Scheme of ₹ 60 lakhs is an Actuarial Gain and should be recognized as a "re-measurement" in "Other Comprehensive Income", and not to be adjusted from the amount of annual contribution in future years.

3. **Disclosure:** The change relating to Actuarial Valuation for the Pension Scheme requires disclosure under Ind AS 8. Disclosures required by Ind AS 19 should also be made in the financial statements.

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Illustration 24

RKA Private Ltd is an old company established in 19XX. The company started with a very small capital base and today it is one of the leading companies in India in its industry. The company has an annual turnover of ₹ 11,000 crores and planning to get listed in the next year.

The company has a large employee base. The company provided a defined benefit plan to its employees. Following is the information relating to the balances of the fund's assets and liabilities as at 1st April, 20X1 and 31st March, 20X2. *₹ in lacs*

Particulars	*1st April, 20X1*	*31st March, 20X2*
Present value of benefit obligation	*1,400*	*1,580*
Fair value of plan assets	*1,140*	*1,275*

For the financial year ended 31st March, 20X2, service cost was ₹ 55 lacs. The company made a contribution of an amount of ₹ 111 lacs to the plan. No benefits were paid during the year.

Consider a discount rate of 8%.

You are required to -

(a) Compute the balance(s) of the company to be included its balance sheet as on

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31st March, 20X2 and amounts to be recognized in the statement of profit and loss and other comprehensive income for the year ended 31st March, 20X2.

(b) Provide the journal entries in respect of amount(s) to be recognized.

Solution

(a) Extract of the Balance Sheet of RKA Private Ltd as at 31st March, 20X2

	₹ in lacs
Closing net defined liability (1,580 – 1,275) lacs	305

Extract of the Statement of Profit or Loss of RKA Private Ltd for the year ended 31st March, 20X2

Particulars	₹ in lacs
Service cost	55
Net interest ***(Refer W.N.1)***	21
Profit or loss	**76**
Other comprehensive income:	
Remeasurements ***(Refer W.N.2)***	80
Total	**156**

(b) Journal entries in the books of RKA Private Ltd

Particulars		₹ in lacs	₹ in lacs
Profit & Loss	Dr.	76	
Other comprehensive income	Dr.	80	
To Cash (Contribution)			111
To Net defined benefit liability ***(Refer WN 3)***			45

Working Notes:

1. Computation of Net interest taken to the Statement of Profit or Loss

= Discount rate x Opening net defined benefit liability

= 8% x (1,400 – 1,140) lacs

= 8% x 260 lacs = 21 lacs (Rounded off to nearest lacs)

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2. Computation of Remeasurements

Defined Benefit Obligation Account

Particulars	₹ in lacs	Particulars	₹ in lacs
To Balance c/d (given) (closing balance)	1,580	By Balance b/d (given) (opening balance)	1,400
		By Current Service Cost (given)	55
		By Interest on Opening Liability (1,400 x 8%)	112
		By Actuarial loss **(bal. figure)**	13
	1,580		**1,580**

OR

Statement to calculate Actuarial gain or loss on defined benefit liability:

Particulars	₹ in lacs
Opening balance of liability	1,400
Current service cost	55
Interest on opening liability (1,400 x 8%)	112
Actuarial loss (Bal. fig)	13
Closing balance of liability	**1,580**

Plan Assets Account

Particulars	₹ in lacs	Particulars	₹ in lacs
To Balance b/d (given) (opening balance)	1,140	By Balance c/d (given) (closing balance)	1,275
To Bank Account (contribution for the year)	111		
To Surplus / Actual Return (bal. figure)	24		
	1,275		**1,275**

OR

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Statement to calculate Actual return on plan assets:

Particulars	₹ in lacs
Opening balance of asset	1,140
Cash contribution	111
Actual return (Bal. fig)	24
Closing balance of asset	**1,275**

Net interest on opening balance of plan asset = ₹ 91 lacs (i.e. ₹ 1,140 lacs x 8%) (Rounded off to nearest lacs)

Hence there is a decrease in plan assets due to remeasurement for which computation is as follows:

Actual Return – Net interest on opening plan asset

= ₹ 24 lacs – ₹ 91 lacs = ₹ 67 lacs.

Net remeasurement would be computed as follows:

Actuarial loss on liability + Loss on return = ₹ 13 lacs + ₹ 67 lacs = ₹ 80 lacs.

3. **Computation of increase/ decrease in net defined benefit liability:**

Particulars	₹ in lacs
Opening net liability (₹ 1,400 lacs – ₹ 1,140 lacs)	260
Closing net liability ₹ 1,580 lacs – ₹ 1,275 lacs)	305
Increase in liability	**45**

*****

1.12 PRESENTATION

1.12.1 Offset

- An asset relating to one plan will be offset against a liability relating to another plan when, and only when, the entity:
  - (a) has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and
  - (b) there is an intention either to settle the obligations on a net basis, or to realise the surplus in one plan and settle its obligation under the other plan simultaneously.
- The offsetting criteria are similar to those established for financial instruments in Ind AS 32, Financial Instruments: Presentation.

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1.12.2 Current / Non-current distinction

This Standard does not specify whether an entity should distinguish current and non-current portions of assets and liabilities arising from post-employment benefits.

1.12.3 Components of defined benefit costs

This Standard does not specify how an entity should present current service cost and net interest cost on net defined liability (asset). An entity presents those components in accordance with Ind AS 1 Presentation of Financial Statements.

1.13 DISCLOSURE

An entity shall disclose information that enables users of financial statements to evaluate the nature of its defined benefit plans and the financial effects of changes in those plans during the period.

1.13.1 General

- An entity shall disclose information that:
  - (a) explains the characteristics of its defined benefit plans and risks associated with them;
  - (b) identifies and explains the amounts in its financial statements arising from its defined benefit plans; and
  - (c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.
- If the disclosures provided in accordance with Ind AS 19 and other Ind AS are insufficient to meet the required objectives, additional information necessary to meet those objectives should be disclosed. For example, an entity might present an analysis of the present value of the defined benefit obligation that distinguishes the nature, characteristics and risks of the obligation. Such a disclosure could distinguish:
  - (a) between amounts owing to active members, deferred members, and pensioners;
  - (b) between vested benefits and accrued but not vested benefits; and
  - (c) between conditional benefits, amounts attributable to future salary increases and other benefits.

1.13.2 Characteristics of defined benefit plans and risks associated with them

An entity shall disclose:

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(a) information about the characteristics of its defined benefit plans, including:

(i) the nature of the benefits provided by the plan (e.g. final salary defined benefit plan or contribution-based plan with guarantee);

(ii) a description of the regulatory framework in which the plan operates (e.g. the level of any minimum funding requirements, and any effect of the regulatory framework on the plan, such as the asset ceiling); and

(iii) a description of any other entity's responsibilities for the governance of the plan (e.g. responsibilities of trustees or of board members of the plan).

(b) a description of the risks to which the plan exposes the entity, focused on any unusual, entity specific or plan-specific risks, and of any significant concentrations of risk. For example, if plan assets are invested primarily in one class of investments (e.g. property), the plan may expose the entity to a concentration of property market risk; and

(c) a description of any plan amendments, curtailments and settlements.

1.13.3 Explanation of amounts in the financial statements

❖ An entity shall provide a reconciliation from the opening balance to the closing balance for each of the following, if applicable:

(a) the net defined benefit liability (asset), showing separate reconciliations for:

(i) plan assets;

(ii) the present value of the defined benefit obligation; and

(iii) the effect of the asset ceiling; and

(b) any reimbursement rights. An entity shall also describe the relationship between any reimbursement right and the related obligation.

❖ Each reconciliation listed above shall show each of the following, if applicable:

(a) current service cost;

(b) interest income or expense;

(c) remeasurements of the net defined benefit liability (asset), showing separately:

(i) the return on plan assets, excluding amounts included in interest in interest income or expense;

(ii) actuarial gains and losses arising from changes in demographic assumptions;

(iii) actuarial gains and losses arising from changes in financial assumptions; and

(iv) changes in the effect of limiting a net defined benefit asset to the asset ceiling, excluding amounts included in interest income or expense. An entity shall also

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disclose how it determined the maximum economic benefit available, i.e. whether those benefits would be in the form of refunds, reductions in future contributions or a combination of both;

(d) past service cost and gains and losses arising from settlements. If permitted by the Standard (i.e., entity need not distinguish between past service cost resulting from a plan amendment), past service cost and gains and losses arising from settlements need not be distinguished if they occur together;

(e) the effect of changes in foreign exchange rates;

(f) contributions to the plan, showing separately those by the employer and by plan participants;

(g) payments from the plan, showing separately the amount paid in respect of any settlements; and

(h) the effects of business combinations and disposals.

❖ The fair value of the plan assets shall be disaggregated into classes that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market (as defined in Ind AS 113, *Fair Value Measurement*) and those that do not.

For example, and considering the level of general disclosures, an entity might distinguish between:

(i) cash and cash equivalents;

(ii) equity instruments (segregated by industry type, company size, geography etc);

(iii) debt instruments (segregated by type of issuer, credit quality, geography etc);

(iv) real estate (segregated by geography etc);

(v) derivatives (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, credit contracts, longevity swaps etc);

(vi) investment funds (segregated by type of fund);

(vii) asset-backed securities; and

(viii) structured debt.

❖ An entity shall disclose:

(a) the fair value of the entity's own transferable financial instruments held as plan assets; and

(b) the fair value of plan assets that are property occupied by, or other assets used by, the entity.

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❖ An entity shall disclose the significant actuarial assumptions used to determine the present value of the defined benefit obligation. Such disclosure shall be in absolute terms (e.g. as an absolute percentage, and not just as a margin between different percentages and other variables). When an entity provides disclosures in total for a grouping of plans, it shall provide such disclosures in the form of weighted averages or relatively narrow ranges.

1.13.4 Amount, timing and uncertainty of future cash flows

❖ An entity shall disclose:

(a) a sensitivity analysis for each significant actuarial assumption as of the end of the reporting period, showing how the defined benefit obligation would have been affected by changes in the relevant actuarial assumption that were reasonably possible at that date;

(b) the methods and assumptions used in preparing these sensitivity analyses and the limitations of those methods; and

(c) changes from the previous period in the methods and assumptions used in preparing the sensitivity analyses, and the reasons for such changes.

❖ To provide an indication of the effect of the defined benefit plan on the entity's future cash flows, an entity shall disclose:

(a) a description of any funding arrangements and funding policy that affect future contributions;

(b) the expected contributions to the plan for the next annual reporting period;

(c) information about the maturity profile of the defined benefit obligation. This will include the weighted average duration of the defined benefit obligation and may include other information about the distribution of the timing of benefit payments, such as a maturity analysis of the benefit payments.

1.13.5 Multi-employer plans

If an entity participates in a multi-employer defined benefit plan, it shall disclose:

(a) a description of the funding arrangements, including the method used to determine the entity's rate of contributions and any minimum funding requirements;

(b) a description of the extent to which the entity can be liable to the plan for other entities' obligations under the terms and conditions of the multi-employer plan; and

(c) a description of any agreed allocation of a deficit or surplus on:

(i) wind-up of the plan; or

(ii) the entity's withdrawal from the plan.

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(d) if the entity accounts for that plan as if it were a defined contribution plan in accordance with general principles applicable to liabilities and an entities own equity instruments, it shall disclose the following, in addition to the information required by (a)–(c) (refer section 1.13.2) and instead of the information required by paragraphs 139–147 (refer section 1.13.3 to 4):

(i) the fact that the plan is a defined benefit plan.

(ii) the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan.

(iii) the expected contributions to the plan for the next annual reporting period.

(iv) information about any deficit or surplus in the plan that may affect the amount of future contributions, including the basis used to determine that deficit or surplus and the implications, if any, for the entity.

(v) an indication of the level of participation of the entity in the plan compared with other participating entities. Examples of measures that might provide such an indication include the entity's proportion of the total contributions to the plan or the entity's proportion of the total number of active members, retired members, and former members entitled to benefits, if that information is available.

1.13.6 Defined benefit plans that share risks between entities under common control

If an entity participates in a defined benefit plan that shares risks between entities under common control, it shall disclose:

(a) the contractual agreement or stated policy for charging the net defined benefit cost or the fact that there is no such policy.

(b) the policy for determining the contribution to be paid by the entity.

(c) if the entity accounts for an allocation of the net defined benefit cost as mentioned in section 1.6.3 above, all the information about the plan as a whole as discussed in sections 1.13.1 to 1.13.4.

(d) if the entity accounts for the contribution payable for the period as noted in section 1.6.3 above, the relevant information about the plan as a whole as mentioned in sections 1.13.1 to 1.13.4.

(e) The information required by (c) and (d) above can be disclosed by cross-reference to disclosures in another group entity's financial statements if:

(a) that group entity's financial statements separately identify and disclose the information required about the plan; and

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(b) that group entity's financial statements are available to users of the financial statements on the same terms as the financial statements of the entity and at the same time as, or earlier than, the financial statements of the entity.

1.13.7 Disclosure requirements in other Ind AS

- Where required by Ind AS 24 *Related Party Disclosures,* an entity discloses information about:

  (a) related party transactions with post-employment benefit plans; and

  (b) post-employment benefits for key management personnel.

- Where required by Ind AS 37 *Provisions, Contingent liabilities and Contingent Assets*, an entity discloses information about contingent liabilities arising from post-employment benefit obligations.

1.14 OTHER LONG-TERM EMPLOYEE BENEFITS

- Other long-term employee benefits are those employee benefits which are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

- Other long-term employee benefits include, For example:

  (a) long-term paid absences such as long-service or sabbatical leave;

  (b) jubilee or other long-service benefits;

  (c) long-term disability benefits;

  (d) profit-sharing and bonuses; and

  (e) deferred remuneration.

- The measurement of other long-term employee benefits is not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. It is also there that the introduction of, or changes to, other long-term employee benefits rarely causes a material amount of past service cost. This method does not recognise remeasurements in other comprehensive income as required under the accounting required for post-employment benefits.

1.14.1 Recognition and measurement

- For other long-term employee benefits, an entity shall recognise the net total of the following amounts in profit or loss, except to the extent that another Standard requires or permits their inclusion in the cost of an asset:

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(a) service cost;

(b) net interest on the net defined benefit liability (asset); and

(c) remeasurements of the net defined benefit liability (asset).

❖ One form of other long-term employee benefit is long-term disability benefit. If the level of benefit depends on the length of service, an obligation arises when the service is rendered.

Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

1.14.2 Disclosure

Though this Standard does not require specific disclosures about other long-term employee benefits, other Standards may require disclosures.

For example:

a. Where the expense resulting from such benefits is material and so would require disclosure in accordance with Ind AS 1.

b. When required by Ind AS 24, an entity discloses information about other long-term employee benefits for key management personnel.

1.15 TERMINATION BENEFITS

❖ This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination of employment rather than employee service.

❖ Termination benefits results from either:

(a) an entity's decision to terminate the employment or

(b) an employee's decision to accept an entity's offer of benefits in exchange for termination of employment.

❖ Termination benefits do not include employee benefits resulting from termination of employment at the request of the employee without an entity's offer, or as a result of mandatory retirement requirements, because those benefits are post-employment benefits.

❖ Some entities provide a lower level of benefit for termination of employment at the request of the employee (in substance, a post-employment benefit) than for termination of employment at the request of the entity. The difference between the benefit provided for termination of employment at the request of the employee and a higher benefit provided at the request of the entity is a termination benefit.

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- The form of the employee benefit does not determine whether it is provided in exchange for service or in exchange for termination of the employee's employment. Termination benefits are typically lump sum payments, but sometimes also include

  (a) enhancement of post-employment benefits, either indirectly through an employee benefit plan or directly.

  (b) salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity.

- Indicators that an employee benefit is provided in exchange for services include the following:

  (a) the benefit is conditional on future service being provided (including benefits that increase if further service is provided).

  (b) the benefit is provided in accordance with the terms of an employee benefit plan.

- Employee benefits provided in accordance with the terms of an employee benefit plan are termination benefits if they both result from an entity's decision to terminate an employee's employment and are not conditional on future service being provided.

- Some employee benefits are provided regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits are described in some jurisdictions as termination indemnities or termination gratuities, they are post-employment benefits rather than termination benefits, and an entity accounts for them as post-employment benefits.

1.15.1 Recognition

- An entity is required to **recognise** a liability and expense for termination benefits **at the earlier of the following dates**:

  (a) when the entity can no longer withdraw the offer of those benefits; and

  (b) when the entity recognises costs for a restructuring which is within the scope of Ind AS 37 and involves the payment of termination benefits.

- For **termination benefits** payable **as a result of an employee's decision to accept an offer of** benefits in exchange for the **termination of employment**, the **time when an entity can no longer withdraw the offer** of termination benefits **is the earlier of**:

  (a) when the employee accepts the offer; and

  (b) when a restriction (e.g. a legal, regulatory or contractual requirement or other restriction) on the entity's ability to withdraw the offer takes effect.

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- For termination benefits payable as a result of an entity's decision to terminate an employee's employment, the entity can no longer withdraw the offer when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria:

  (a) Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.

  (b) The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations (but the plan need not identify each individual employee) and the expected completion date.

  (c) The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive when their employment is terminated.

- Where an entity recognises termination benefits, the entity may also have to account for a curtailment of retirement benefits or other employee benefits.

1.15.2 Measurement

An entity shall measure termination benefits on initial recognition, and shall measure and recognise subsequent changes, in accordance with the nature of the employee benefit, provided that if the termination benefits are an enhancement to post-employment benefits, the entity shall apply the requirements for post-employment benefits. Otherwise:

(a) If the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognised, the entity shall apply the requirements for short-term employee benefits.

(b) If the termination benefits are not expected to be settled wholly before twelve months after the end of the annual reporting period, the entity shall apply the requirements for other long-term employee benefits.

Because termination benefits are not provided in exchange for service, the concepts relating to the attribution of the benefit to periods of service as discussed for defined benefit plans are not relevant.

Example 4: On Termination Benefits

As a result of a recent acquisition, an entity plans to close a factory in ten months and, at that time, terminate the employment of all of the remaining employees at the factory. Because the entity needs the expertise of the employees at the factory to complete some contracts, it announces a plan of termination as follows.

Each employee who stays and renders service until the closure of the factory will receive on the termination date a cash payment of ₹ 30,000. Employees leaving before closure of the factory will receive ₹ 10,000.

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There are 120 employees at the factory. At the time of announcing the plan, the entity expects 20 of them to leave before closure. Therefore, the total expected cash outflows under the plan are ₹ 3,200,000 (i.e. (20 × ₹ 10,000) + (100 × ₹ 30,000)). As required by paragraph 160, the entity accounts for benefits provided in exchange for termination of employment as termination benefits and accounts for benefits provided in exchange for services as short-term employee benefits.

Termination benefits

The benefit provided in exchange for termination of employment is ₹ 10,000. This is the amount that an entity would have to pay for terminating the employment regardless of whether the employees stay and render service until closure of the factory or they leave before closure. Even though the employees can leave before closure, the termination of all employees' employment is a result of the entity's decision to close the factory and terminate their employment (i.e. all employees will leave employment when the factory closes). Therefore, the entity recognises a liability of ₹ 12,00,000 (i.e. 120 × ₹ 10,000) for the termination benefits provided in accordance with the employee benefit plan at the earlier of when the plan of termination is announced and when the entity recognises the restructuring costs associated with the closure of the factory.

Benefits provided in exchange for service

The incremental benefits that employees will receive if they provide services for the full ten-month period are in exchange for services provided over that period. The entity accounts for them as short-term employee benefits because the entity expects to settle them before twelve months after the end of the annual reporting period. In this example, discounting is not required, so an expense of ₹ 2,00,000 (i.e. ₹ 20,00,000 ÷ 10) is recognised in each month during the service period of ten months, with a corresponding increase in the carrying amount of the liability.

1.15.3 Disclosure

This Standard does not require specific disclosures about termination benefits, other Ind AS may require disclosures.

For example:

a. where required by Ind AS 24 an entity discloses information about termination benefits for key management personnel.

b. Ind AS 1 requires disclosure of employee benefits expense.

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1.16 IND AS 19 — THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION

1.16.1 Background

- Ind AS 19 limits the measurement of a net defined benefit asset to the lower of the surplus in the defined benefit plant and asset ceiling (i.e. the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan). Questions have arisen about when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists.
- Minimum funding requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period. Therefore, a minimum funding requirement may limit the ability of the entity to reduce future contributions.
- Further, the limit on the measurement of a defined benefit asset may cause a minimum funding requirement to be onerous. Normally, a requirement to make contributions to a plan would not affect the measurement of the defined benefit asset or liability. This is because the contributions, once paid, will become plan assets and so the additional net liability is nil. However, a minimum funding requirement may give rise to a liability if the required contributions will not be available to the entity once they have been paid.

1.16.2 Scope

This Appendix applies to all post-employment defined benefits and other long-term employee defined benefits. For the purpose of this Appendix, minimum funding requirements are any requirements to fund a post-employment or other long-term defined benefit plan.

1.16.3 Issues

The issues addressed in this Appendix are:

(a) when refunds or reductions in future contributions should be regarded as available in accordance with the definition of the asset ceiling.

(b) how a minimum funding requirement might affect the availability of reductions in future contributions.

(c) when a minimum funding requirement might give rise to a liability.

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1.16.4 Principles

1.16.4.1 Availability of a refund or reduction in future contributions

- An entity shall determine the availability of a refund or a reduction in future contributions in accordance with the terms and conditions of the plan and any statutory requirements in the jurisdiction of the plan.
- An economic benefit is available in the form of a refund or a reduction in future contributions if the entity can realise it at some point during the life of the plan or when the plan liabilities are settled.
- The economic benefit available does not depend on how the entity intends to use the surplus. An entity shall determine the maximum economic benefit that is available from refunds, reductions in future contributions or a combination of both. An entity shall not recognise economic benefits from a combination of refunds and reductions in future contributions based on assumptions that are mutually exclusive.
- In accordance with Ind AS 1, the entity shall disclose information about the key sources of estimation uncertainty at the end of the reporting period that have a significant risk of causing a material adjustment to the carrying amount of the net asset or liability recognised in the balance sheet. This might include disclosure of any restrictions on the current realisability of the surplus or disclosure of the basis used to determine the amount of the economic benefit available.

1.16.4.2 The economic benefit available as a refund

1. The right to a refund

- A refund is available to an entity only if the entity has an unconditional right to a refund:

  (a) during the life of the plan, without assuming that the plan liabilities must be settled in order to obtain the refund (e.g., in some jurisdictions, the entity may have a right to a refund during the life of the plan, irrespective of whether the plan liabilities are settled); or

  (b) assuming the gradual settlement of the plan liabilities over time until all members have left the plan; or

  (c) assuming the full settlement of the plan liabilities in a single event (i.e., as a plan wind-up).

- An unconditional right to a refund can exist whatever the funding level of a plan at the end of the reporting period.
- If the entity's right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within its control, the entity does not have an unconditional right and shall not recognise an asset.

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2. Measurement of the economic benefit

- An entity shall measure the economic benefit available as a refund as the amount of the surplus at the end of the reporting period (being the fair value of the plan assets less the present value of the defined benefit obligation) that the entity has a right to receive as a refund, less any associated costs.

  For instance, if a refund would be subject to a tax other than income tax, an entity shall measure the amount of the refund net of the tax.

- In measuring the amount of a refund available when the plan is wound up, an entity shall include the costs to the plan of settling the plan liabilities and making the refund.

  For example, an entity shall deduct professional fees if these are paid by the plan rather than the entity, and the costs of any insurance premiums that may be required to secure the liability on wind-up.

- If the amount of a refund is determined as the full amount or a proportion of the surplus, rather than a fixed amount, an entity shall make no adjustment for the time value of money, even if the refund is realisable only at a future date.

1.16.4.3 The economic benefit available as a contribution reduction

- The economic benefit available as a reduction in future contributions is the future service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity; and if there is no minimum funding requirement for contributions relating to future service. The future service cost to the entity excludes amounts that will be borne by employees.

- An entity shall determine the future service costs using assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. Therefore, an entity shall assume no change to the benefits to be provided by a plan in the future can be assumed by the entity until the plan is amended and shall assume a stable workforce in the future unless the entity makes a reduction in the number of employees covered by the plan. In the latter case, the assumption about the future workforce shall include the reduction.

1.16.4.4 The effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions

- An entity shall analyse any minimum funding requirement at a given date into contributions that are required to cover

  (a) any existing shortfall for past service on the minimum funding basis; and

  (b) future service.

  - Contributions to cover any existing shortfall on the minimum funding basis in respect of services already received do not affect future contributions for future service. They may give rise to a liability.

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- If there is a minimum funding requirement for contributions relating to the future service, the economic benefit available as a reduction in future contributions is the sum of:
  (a) any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e., paid the amount before being required to do so); and
  (b) the estimated future service cost in each period less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in (a).
- An entity shall estimate the future minimum funding requirement contributions for future service taking into account the effect of any existing surplus determined using the minimum funding basis but excluding the prepayment. An entity shall use assumptions consistent with the minimum funding basis and, for any factors not specified by that basis, assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. The estimate shall include any changes expected as a result of the entity paying the minimum contributions when they are due. However, the estimate shall not include the effect of expected changes in the terms and conditions of the minimum funding basis that are not substantively enacted or contractually agreed at the end of the reporting period.
- When an entity determines the amount, if the future minimum funding requirement contributions for future service exceed the future service cost in any given period, that excess reduces the amount of the economic benefit available as a reduction in future contributions.

1.16.4.6 When a minimum funding requirement may give rise to a liability

- If an entity has an obligation under a minimum funding requirement to pay contributions to cover an existing shortfall on the minimum funding basis in respect of services already received, the entity shall determine whether the contributions payable will be available as a refund or reduction in future contributions after they are paid into the plan.
- To the extent that the contributions payable will not be available after they are paid into the plan, the entity shall recognise a liability when the obligation arises. The liability shall reduce the defined benefit asset or increase the defined benefit liability so that no gain or loss is expected.

1.17 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Bharti Airtel Limited' for the financial year 2021-2022 with respect to 'Employee Benefits' and its accounting policy thereon.

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25.2 Employee benefits

The details of significant employee benefits are as follows:

	For the year ended March 31,2022		For the year ended March 31,2021	
	Gratuity	Compensated absences	Gratuity	Compensated absences
Obligation:				
Balance as at beginning of the year	1,949	774	1,852	724
Current service cost	270	162	257	167
Interest cost	132	53	128	50
Benefits paid	(395)	(170)	(256)	(102)
Transfers	(15)	(9)	(29)	(21)
Remeasurements	33	(71)	(3)	(44)
Present value of obligation	**1,974**	**739**	**1,949**	**774**
Current portion	528	739	609	774
Non-Current portion	1,446	-	1,340	-

As of March 31, 2022, expected contributions for the next annual reporting period is ₹446.

Amount recognised in Other Comprehensive Income

	For the year ended March 31, 2022	For the year ended March 31, 2021
Experience losses / (gains)	62	(18)
Losses from change in demographic assumptions	22	9
(Gains) / losses from change in financial assumptions	(51)	6
Remeasurements on defined benefit plans	**33**	**(3)**

ACCOUNTING POLICY

The Company's employee benefits mainly include wages, salaries, bonuses, defined contribution plans, defined benefits plans, compensated absences, deferred compensation, and share-based payments. The employee benefits are recognized in the year in which the associated services are rendered by the Company employees. Short-term employee benefits are recognized in the Statement of Profit and Loss at undiscounted amounts during the period in which the related services are rendered.

i. Defined Contribution plans

The contributions to defined contribution plans are recognized in profit or loss as and when the services are rendered by employees. The Company has no further obligations under these plans beyond its periodic contributions.

ii. Defined benefits plans

In accordance with the local laws and regulations, all the employees in India are entitled for the Gratuity plan. The said plan requires a lump-sum payment to eligible employees

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(meeting the required vesting service condition) at retirement or termination of employment, based on a pre-defined formula.

The Company provides for the liability towards the said plans on the basis of actuarial valuation carried out quarterly as at the reporting date, by an independent qualified actuary using the projected-unit-credit method.

The obligation towards the said benefits is recognized in the Balance Sheet, at the present value of the defined benefit obligations. The present value of the said obligation is determined by discounting the estimated future cash outflows, using interest rates of government bonds.

The interest expenses are calculated by applying the above-mentioned discount rate to defined benefits obligations. The interest expenses on the defined benefits obligations are recognized in the Statement of Profit and Loss. However, the related re-measurements of the defined benefits obligations are recognized directly in the other comprehensive income in the period in which they arise. The said re-measurements comprise of actuarial gains and losses (arising from experience adjustments and changes in actuarial assumptions). Re-measurements are not re-classified to the Statement of Profit and Loss in any of the subsequent periods.

a. Other long-term employee benefits

The employees of the Company are entitled to compensated absences as well as other long-term benefits. Compensated absences benefits comprise of encashment and availment of leave balances that were earned by the employees over the period of past employment.

The Company provides for the liability towards the said benefits on the basis of actuarial valuation carried out quarterly as at the reporting date, by an independent qualified actuary using the projected-unit-credit method. The related re-measurements are recognized in the Statement of Profit and Loss in the period in which they arise.

(Source: Annual Report 2021-2022 - 'Bharti Airtel Limited')

1.18 SIGNIFICANT DIFFERENCES IN IND AS 19 VIS-À-VIS AS 15

S. No.	Particulars	Ind AS 19	AS 15
1.	*Constructive Obligations*	In Ind AS 19 (paragraph 4(c), obligations arising from informal practices are referred to as constructive obligations	In AS 15 (paragraph 3(c) such obligations are simply referred to as obligations.

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2.	*Definition of Employee*	Ind AS 19 the term 'employee' includes directors whether they are whole-time or not. (Paragraph 7 of Ind AS 19)	As per AS 15, the term 'employee' includes whole-time directors
3.	*Other Definitions*	Definitions of short-term employee benefits, other long-term employee benefits, and past service cost is different in Ind AS 19 (Paragraph 8 of Ind AS 19)	Different definitions are given in AS 15
4.	*Contractual Agreement between a Multi-employer Plan and its Participants*	Ind AS 19 deals with situations where there is a contractual agreement between a multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants (or the deficit funded). (Paragraph 37 of Ind AS 19)	AS 15 does not deal with it
5.	*Participation in a Defined Benefit Plan Sharing Risks Between Various Entities under Common Control*	As per Ind AS 19, participation in a defined benefit plan sharing risks between various entities under common control is a related party transaction for each group entity and some disclosures are required in the separate or individual financial statements of an entity. (Paragraph 42 of Ind AS 19)	AS 15 does not contain similar provisions
6.	*Recognition of Past Service Cost*	As per Ind AS 19, past service cost (including curtailments) is recognised as an expense at the earlier of when the plan amendment or Curtailment occurs; and when the entity recognizes related restructuring costs or termination benefits.	As per AS 15, past service cost is recognised as an expense on a straight-line basis over the average period until the benefits become vested. If already vested, recognised as an expense immediately. Entities recognise a curtailment when it occurs. However, when curtailment is linked with a restructuring, it is accounted for at the same time as the related restructuring.

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7.	*Involvement of a qualified actuary*	Para 59 of Ind AS 19 encourages, but does not require, an entity to involve a qualified actuary in the measurement of all material post-employment benefit obligations. (Paragraph 59 of Ind AS 19)	AS 15 neither requires nor specifically encourage the same.
8.	*Actuarial valuation*	Detailed actuarial valuation to determine the present value of net defined benefit liability (asset) shall be performed with sufficient regularity so that the amounts recognized in the financial statements do not differ materially from the amounts that would have been determined at the end of the reporting period. Ind AS 19 does not define sufficient regularity.	Detailed actuarial valuation to determine the present value of defined benefit obligation is carried out at least once every 3 years and fair value of plan assets are determined at each balance sheet date.
9.	*Recognition of Actuarial Gains and Losses*	Ind AS 19 requires that the same shall be recognised in other comprehensive income and not reclassified to profit or loss in a subsequent period.	AS 15 requires recognition of actuarial gains and losses immediately in the profit and loss
10.	*Financial Assumptions*	Ind AS 19 makes it clear that financial assumptions shall be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled. (Paragraph 80 of Ind AS 19)	AS 15 does not clarify the same
11.	*Discounting of Post-employment Benefit Obligations*	As per Ind AS 19, subsidiaries, associates, joint ventures and branches domiciled outside India shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries where there is no deep market in such bonds, the	As per AS 15, the rate used to discount post-employment benefit obligations should always be determined by reference to market yields at the balance sheet date on government bond.

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		market yields (at the end of the reporting period) on government bonds of that country shall be used.	
12.	*Timing of Recognition of Termination Benefits*	As per Ind AS 19 para 165, an entity shall recognise a liability and expense for termination benefits at the earlier of the following dates: (a) when the entity can no longer withdraw the offer of those benefits; and (b) when the entity recognises costs for a restructuring that Employee Benefits within the scope of Ind AS 37 and involves the payment of termination benefits.	As per AS 15 para 134, an enterprise should recognise termination benefits as a liability and an expense when, and only when: (a) the enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation.
13.	*Guidance on Interaction of Ceiling of Asset Recognition and Minimum Funding Requirement*	Ind AS 19 gives guidance on the interaction of ceiling of asset recognition and minimum funding requirement in the case of defined benefit obligations. (Appendix B of Ind AS 19)	Such guidance is not available in AS 15.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. An entity has 100 employees, who are each entitled to five working days of paid sick leaves for each year. Unused sick leave may be carried forward for one calendar year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (LIFO basis).

   At 31st March, 20X1, the average unused entitlement is two days per employee. The entity expects, on the basis of experience that is expected to continue, that 92 employees will take no more than five days of paid sick leaves in 20X1-20X2 and that the remaining eight employees will take an average of six and a half days each.

   The entity expects that it will pay an additional twelve days of sick pay as a result of the unused entitlement that has accumulated at 31st March, 20X1 (one and a half days each, for eight employees).

   Comment whether the entity would require to recognize any liability in respect of leaves.

2. A plan provides a monthly pension of 0.3% of final salary for each year of service. The pension is payable from the age of 65.

   Determine the current service cost.

3. A plan pays a benefit of ₹ 140 for each year of service, excluding service before the age of 25. The benefits vest immediately.

   Compute the benefit to be attributed before the age of 25 and after 25?

4. B Pvt. Ltd. has a post-employment medical plan which will reimburse 20% of an employee's post-employment medical costs if the employee leaves after more than ten and less than

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twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.

State how would you measure the benefit to be attributed for the employee service for the last 20 years, 10 and 20 years and within 10 years.

5. Cisca Pvt. Ltd. has a headcount of around 1,000 employees in the organisation in 20X0-20X1. As per the company's policy, the employees are given 35 days of privilege leaves (PL), 15 days of sick leaves (SL) and 10 days of casual leaves. Out of the total PL and sick leaves, 10 PL leaves and 5 sick leaves can be carried forward to next year. On the basis of past trends, it has been noted that 200 employees will take 5 days of PL and 2 days of SL and 800 employees will avail 10 days of PL and 5 days of SL.

   Also the company has been incurring profits since 20XX. It has decided in 20X0-20X1 to distribute profits to its employees @ 4% during the year. However, due to the employee turnover in the organisation, the expected pay-out of the Cisca Pvt. Ltd. is expected to be around 3.5%. The profits earned during 20X0-20X1 is ₹ 2,000 crores.

   Cisca Pvt. Ltd. has a post-employment benefit plan also available which is in the nature of defined contribution plan where contribution to the fund amounts to ₹ 100 crores which will fall due within 12 months from the end of accounting period.

   The company has paid ₹ 20 crores to its employees in 20X0-20X1.State what would be the treatment of the short-term compensating absences, profit-sharing plan and the defined contribution plan in the books of Cisca Pvt. Ltd. Also state what would be the treatment, if the contribution paid from defined contribution plan exceeds the contribution due. Further, determine what would be the accounting if the payment from defined contribution plan does not fall due within 12 months from the end of accounting period.

6. OPQ Ltd is a listed company having its corporate office at Nagpur. The company has a branch office at Chennai. The company has been operating in Indian market for the last 10 years.

   The company operates a pension plan that provides a pension of 2.5% of the final salary for each year of service. The benefits become vested after seven years of service.

   On 1st April, 20X8, the company increased the pension to 3% of the final salary for each year of service starting from 1st April, 20X1. On the date of the improvement, the present value of the additional benefits for service from 1st April, 20X1 to 1st April 20X8 was as follows:

   - Employees with more than seven years' service on 1st January 20X8 – ₹ 2,75,000
   - Employees with less than 7 years of service – ₹ 2,21,000 (average 4 years to go).

   Provide the accounting treatment in this case.

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7. SA Pvt Ltd is engaged in the business of retail having 100 retail outlets across Northern and Southern India. The company's head office is located at Chennai.

SA Pvt Ltd is a subsidiary of SAG Ltd. SAG Ltd is listed on the National Stock Exchange in India.

Following information is available for SA Pvt Ltd:

Plan Assets

At 1st April, 20X1, the fair value of plan assets was ₹ 10,000.

Contribution to the plan assets done on 31st March, 20X2 – ₹ 3,000

Amount paid on 31st March, 20X2 – ₹ 300

At 31st March, 20X2, the fair value of plan assets was ₹ 14,700

Actual return on plan assets – ₹ 2,000

Defined Benefit Obligation

At 1st April, 20X1, present value of the defined benefit obligation was ₹ 12,000.

At 31st March, 20X2, present value of the defined benefit obligation was ₹ 15,500.

Actuarial losses on the obligation for the year ended 31st March, 20X2 were ₹ 100.

Current Service Cost – ₹ 2,500

Benefit paid – ₹ 300

Discount rate used to calculate defined benefit liability - 10%.

Suggest if there is any amount based on the above-mentioned information that would be taken to other comprehensive income (with workings). Also compute net interest on the net defined benefit liability (asset).

8. A Ltd. prepares its financial statements to 31st March each year. It operates a defined benefit retirement benefits plan on behalf of current and former employees. A Ltd. receives advice from actuaries regarding contribution levels and overall liabilities of the plan to pay benefits. On 1st April, 20X1, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,00,00,000. On the same date, the fair value of the assets of the defined benefit plan was ₹ 5,20,00,000. On 1st April, 20X1, the annual market yield on government bonds was 5%. During the year ended 31st March, 20X2, A Ltd. made contributions of ₹ 70,00,000 into the plan and the plan paid out benefits of ₹ 42,00,000 to retired members. Both these payments were made on 31st March, 20X2.

The actuaries advised that the current service cost for the year ended 31st March, 20X2 was ₹ 62,00,000. On 28th February, 20X2, the rules of the plan were amended with retrospective effect. These amendments meant that the present value of the defined benefit obligation was increased by ₹ 15,00,000 from that date.

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During the year ended 31st March, 20X2, A Ltd. was in negotiation with employee representatives regarding planned redundancies. The negotiations were completed shortly before the year end and redundancy packages were agreed. The impact of these redundancies was to reduce the present value of the defined benefit obligation by ₹ 80,00,000. Before 31st March, 20X2, A Ltd. made payments of ₹ 75,00,000 to the employees affected by the redundancies in compensation for the curtailment of their benefits. These payments were made out of the assets of the retirement benefits plan.

On 31st March, 20X2, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,80,00,000. On the same date, the fair value of the assets of the defined benefit plan were ₹ 5,60,00,000.

Examine and present how the above event would be reported in the financial statements of A Ltd. for the year ended 31st March, 20X2 as per Ind AS. Finance cost is to be computed on the opening balances.

9. On 1st April 20X1, the fair value of the assets of XYZ Ltd.'s defined benefit plan were valued at ₹ 20,40,000 and the present value of the defined obligation was ₹ 21,25,000. On 31st March,20X2 the plan received contributions from XYZ Ltd amounting to ₹ 4,25,000 and paid out benefits of ₹ 2,55,000. The current service cost for the financial year ending 31st March 20X2 is ₹ 5,10,000. An interest rate of 5% is to be applied to the plan assets and obligations. The fair value of the plan assets at 31st March 20X2 was ₹ 23,80,000, and the present value of the defined benefit obligation was ₹ 27,20,000.

   Provide a reconciliation from the opening balance to the closing balance for plan assets and defined benefit obligation. Also show how much amount should be recognised in the statement of profit and loss, other comprehensive income and balance sheet?

Answers

1. At 31st March, 20X1, the average unused entitlement is two days per employee. The entity expects, on the basis of experience that is expected to continue, that 92 employees will take no more than five days of paid sick leaves in 20X1-20X2 and that the remaining eight employees will take an average of six and a half days each.

The entity expects that it will pay an additional twelve days of sick pay as a result of the unused entitlement that has accumulated at 31st March, 20X1 (one and a half days each, for eight employees).

Therefore, the entity would recognize a liability equal to twelve days of sick pay.

2. Benefit equal to the present value, at the expected retirement date, of a monthly pension of 0.3% of the estimated final salary payable from the expected retirement date until the expected date of death is attributed to each year of service. The current service cost is the present value of that benefit.

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The present value of the defined benefit obligation is the present value of monthly pension payments of 0.3% of final salary, multiplied by the number of years of service up to the end of the reporting period. The current service cost and the present value of the defined benefit obligation are discounted because pension payments begin at the age of 65.

3. No benefit is attributed to service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional). A benefit of ₹ 140 is attributed to each subsequent year.

4. As per Ind AS 19, the benefit will be attributed till the period the employee service will lead to no material amount of benefits. And service in later years will lead to a materially higher level of benefit than in earlier years. Therefore, for employees expected to leave after twenty or more years, the entity would attribute benefit on a straight-line basis. Service beyond twenty years will lead to no material amount of further benefits. Therefore, the benefit attributed to each of the first twenty years is 2.5% (i.e. 50% divided by 20) of the present value of the expected medical costs.

For employees expected to leave between ten and twenty years, the benefit attributed to each of the first ten years is 2% (20 % divided by 10) of the present value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

For employees expected to leave within ten years, no benefit is attributed.

5. (i) Cisca Pvt. Ltd. will recognise a liability in its books to the extent of 5 days of PL for 200 employees and 10 days of PL for remaining 800 employees and 2 days of SL for 200 employees and 5 days of SL for remaining 800 employees in its books as an unused entitlement that has accumulated in 20X0-20X1 as short-term compensated absences.

(ii) Cisca Pvt. Ltd. will recognise ₹ 70 crores (2,000 x 3.5%) as a liability and expense in its books of account.

(iii) When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service.

Under Ind AS 19, the amount of ₹ 80 crores will be recognised as a liability (accrued expense), after deducting any contribution already paid (100-20) and an expense in the statement of profit and loss. However, if the contribution already paid would have exceeded the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense).

Since the contributions are payable within 12 months from the end of the year in which the employees render the related service, they will not be discounted. However, where contributions to a defined contribution plan do not fall due wholly within twelve months after

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the end of the period in which the employees render the related service, they shall be discounted using the discount rate.

6. OPQ Ltd increased the pension to 3% of the final salary for each year of service starting from 1st April, 20X1 to 1st April, 20X8.

The company would recognize the total amount of ₹ 4,96,000 (i.e. ₹ 2,75,000 + ₹ 2,21,000) immediately, as for the purpose of recognition it does not make any difference as to whether the benefits are already vested or not.

7. As per Ind AS 19, net remeasurement of ₹ 900 would be recognized in other comprehensive income.

Computation of Net remeasurement

= Remeasurement – Actuarial loss

= ₹ 1000 (Refer WN - 1) – ₹ 100 (Given in the question) = ₹ 900.

Computation of net interest expense

Particulars	Amount in ₹
Defined benefit liability as at 1st April 20X1 **(A) (Given in the question)**	12,000
Fair value of plan asset as at 1st April 20X1 **(B) (Given in the question)**	(10,000)
Net defined benefit liability **(A - B)**	2,000
Net interest expense (as it is net liability) (Refer note given below)	200

Note:

Net interest expense would be computed on net defined benefit liability using discount rate of 10% given in the question-

= Net defined benefit liability x Discount rate

= 2,000 x 10%

= ₹ 200.

Working Note:

Computation of amount of remeasurement

Particulars	₹
Actual return on plan asset for the year ended 31st March 20X2 **(C) (Given in the question)**	2,000
Less: Interest income on ₹ 10,000 held for 12 months at 10% **(D)**	(1,000)
Remeasurement **(E = C - D)**	1,000

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8. All figures are ₹ in '000.

On 31st March, 20X2, A Ltd. will report a net pension liability in the statement of financial position. The amount of the liability will be 12,000 (68,000 – 56,000).

For the year ended 31st March, 20X2, A Ltd. will report the current service cost as an operating cost in the statement of profit or loss. The amount reported will be 6,200. The same treatment applies to the past service cost of 1,500.

For the year ended 31st March, 20X2, A Ltd. will report a finance cost in profit or loss based on the net pension liability at the start of the year of 8,000 (60,000 – 52,000). The amount of the finance cost will be 400 (8,000 x 5%).

The redundancy programme represents the partial settlement of the curtailment of a defined benefit obligation. The gain on settlement of 500 (8,000 – 7,500) will be reported in the statement of profit or loss.

Other movements in the net pension liability will be reported as remeasurement gains or losses in other comprehensive income.

For the year ended 31st March, 20X2, the remeasurement loss will be 3,400 (Refer W. N.).

Working Note:

Remeasurement of gain or loss

	₹ in '000
Liability at the start of the year (60,000 – 52,000)	8,000
Current service cost	6,200
Past service cost	1,500
Net finance cost	400
Gain on settlement	(500)
Contributions to plan	(7,000)
Remeasurement loss (balancing figure)	3,400
Liability at the end of the year (68,000 – 56,000)	12,000

9. Reconciliation of Plan assets and Defined benefit obligation

	Plan Assets ₹	Defined benefit obligation ₹
Fair value/present value as at 1st April 20X1	20,40,000	21,25,000
Interest @ 5%	1,02,000	1,06,250

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Current service cost		5,10,000
Contributions received	4,25,000	-
Benefits paid	(2,55,000)	(2,55,000)
Return on plan assets (gain) (assets) (balancing figure)	68,000	-
Actuarial Loss (balancing figure)	-	2,33,750
Closing balance as at 31st March, 20X2	23,80,000	27,20,000

In the Statement of Profit and loss, the following will be recognised:	₹
Current service cost	5,10,000
Net interest on net defined liability (₹ 1,06,250 – ₹ 1,02,000)	4,250

Defined benefit re-measurements recognised in Other Comprehensive Income:	₹
Loss on defined benefit obligation	(2,33,750)
Gain on plan assets	68,000
	(1,65,750)

In the Balance sheet, the following will be recognised:	₹
Net defined benefit liability (₹ 27,20,000 – ₹ 23,80,000)	3,40,000

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UNIT 2:
INDIAN ACCOUNTING STANDARD 37: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

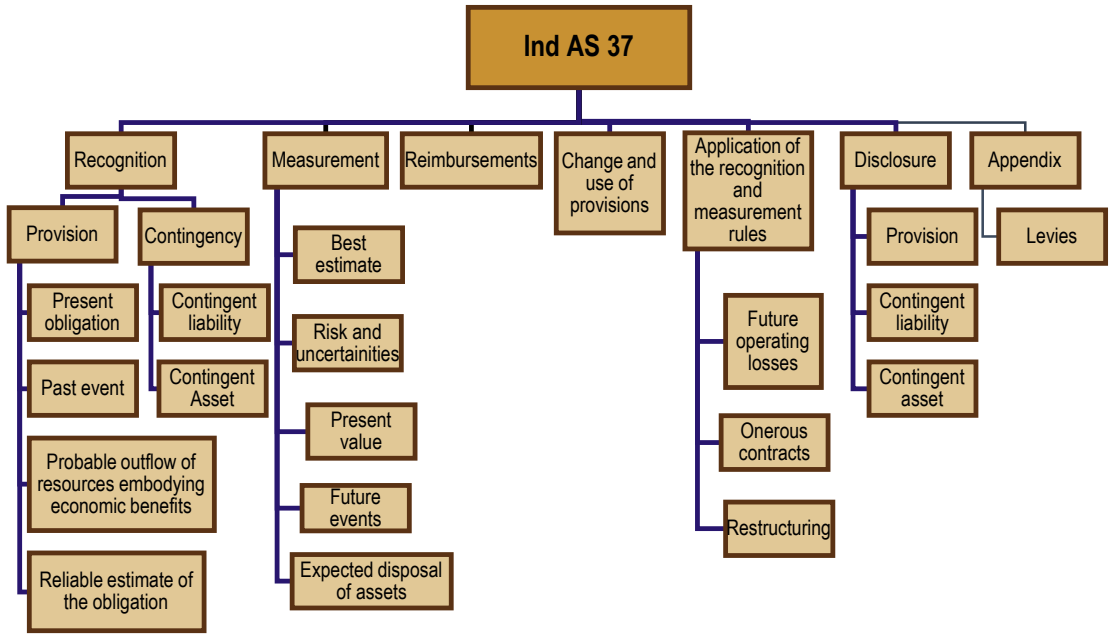
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define the terms like 'provision', 'contingent liability', 'contingent asset', obligating event, legal obligation, constructive obligation, onerous contracts and restructuring
- Appreciate the relationship between provision and contingent liability
- Recognise provision by examining present and past obligation, probability and estimate of the cash outflow.
- Apply the recognition principles of contingent assets and contingent liabilities
- Apply the recognition and measurement principles for future operating losses, Onerous contracts and restructuring
- Comply with the disclosure requirements with regard to disclosure of provisions, contingent liabilities and contingent assets as per Ind AS 37
- Differentiate between Ind AS 37 and AS 29

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UNIT OVERVIEW



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2.1 OBJECTIVE

The objective of Ind AS 37 is to ensure that

- appropriate recognition criteria and measurement bases are applied to
  - provisions
  - contingent liabilities and
  - contingent assets and
- sufficient information is disclosed in the notes to enable users to understand their
  - nature
  - timing and
  - amount.

2.2 SCOPE

Ind AS 37 should be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, **except:**

(a) those resulting from **executory contracts**, except where the contract is onerous; and

(b) financial instruments (including guarantees) that are within the scope of Ind AS 109, *Financial Instruments;*

(c) those covered by another Standard such as:

(i) revenue from contracts with customers covered by Ind AS 115. However, Ind AS 115 contains no specific requirement to address onerous contracts with customers. Hence, Ind AS 37 applies to such cases;

(ii) income taxes (Ind AS 12, *Income Taxes*);

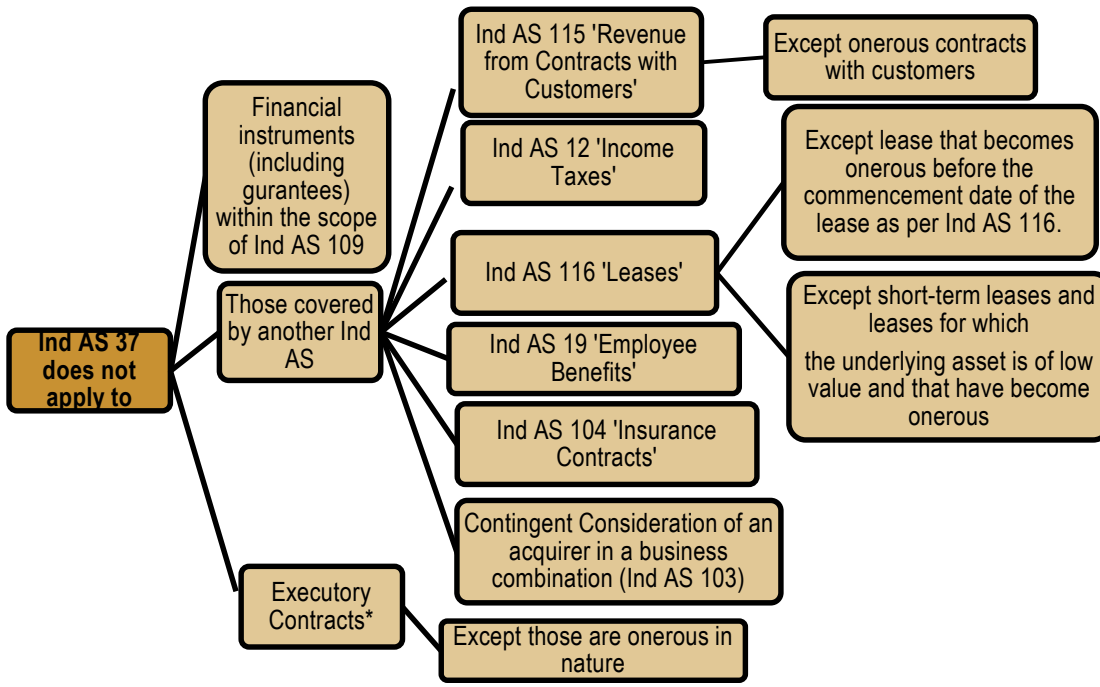
(iii) leases (Ind AS 116, *Leases*). However, this Standard applies to any lease that becomes onerous before the commencement date of the lease as defined in Ind AS 116. This Standard also applies to short-term leases and leases for which the underlying asset is of low value accounted for in accordance with paragraph 6 of Ind AS 116 and that have become onerous;

(iv) employee benefits (Ind AS 19, *Employee Benefits*); and

(v) insurance contracts (Ind AS 104, *Insurance Contracts*). However, Ind AS 37 applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of Ind AS 104.

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(vi) Contingent consideration of an acquirer in a business combination (Ind AS 103, *Business Combinations*)



2.2.1 Executory Contracts

Executory contracts are contracts under which

- ❖ neither party has performed any of its obligations or
- ❖ both parties have partially performed their obligations to an equal extent.

For example:

- employee contracts in respect of continuing employment;
- contracts for future delivery of services such as gas and electricity;
- obligations to pay local authority charges etc are executory contracts.

Note: Ind AS 37 is applied to executory contracts only if they are onerous. For example, a long-term purchase contract that has a higher unit cost than unit sales price.

Example 1 : Where both parties have performed their obligations to an equal extent

On 1st April 20X2, Company XYZ Limited enters into a contract with Company PQR Limited for the manufacture and delivery of 200 units of component A at five different dates in the future, i.e. 1,000 units are to be delivered in total. Payment is due on delivery of the units.

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On 1st April 20X2, the contract between Company XYZ Limited and Company PQR Limited is executory because neither party has performed any of its obligations; Company XYZ Limited has not manufactured or delivered any of the units, nor has Company PQR Limited paid for any of them.

By 1st June 20X2, Company XYZ Limited has produced and delivered 400 of the units and Company PQR Limited has paid in full for those 400 units. At this date, the contract between Company XYZ Limited and Company PQR Limited continues to be executory because both parties have partially performed their obligations to an equal extent.

By 1st September 20X2, Company XYZ Limited has produced and delivered the full 1000 units, but Company PQR Limited has only paid for 800 units in total. The contract between Company XYZ Limited and Company PQR Limited no longer meets the definition of an executory contract because the two parties have not performed under the terms of the contract to an equal extent. Company PQR Limited is required to recognise a liability for the final 200 units of component A for which it has not yet paid.

2.2.2 Provisions when relate to the recognition of revenue or expense/losses

- Some amounts treated as provisions may relate to the recognition of revenue.

Example: Where an entity gives guarantees in exchange for a fee.

Ind AS 37 does not address the recognition of revenue since there is a separate standard on it i.e. Ind AS 115, *Revenue from Contracts with Customers.* However, Ind AS 115 does not deal with onerous contracts with customers, so Ind AS 37 will deal with the same.

- As per Ind AS 37, provisions are liabilities of uncertain timing or amount. However, the term 'provision' is also used for certain adjustments which are made to the carrying amounts of assets.

Example: Depreciation, impairment of assets and doubtful debts.

The provisions which are adjustments to the carrying amounts of assets are not addressed in Ind AS 37 since other Ind AS specifies their treatment. Ind AS 37 neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

- Ind AS 37 applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations.*

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2.3 DEFINITIONS

The following definitions are relevant for the purpose of understanding the requirements of Ind AS 37.

1. A ***provision*** is a liability of uncertain timing or amount.

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

3. An ***obligating event*** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Example 2

X Ltd. entered into a contract with Y Ltd. for supply of some material. As per the terms of contract in case of breach of contract, the party who breaches the contract has to pay ₹ 50,00,000 to other party. X Ltd. breached the contract with Y Ltd. Now in this case the obligating event is the breach of contract that gave rise to present obligation and X Ltd. must settle the obligation.

4. A ***legal obligation*** is an obligation that derives from:

   (a) a contract (through its explicit or implicit terms);

   (b) legislation; or

   (c) other operation of law.

Example

In the aforesaid example regarding breach of the contract, the obligation is a legal obligation that arises from the terms of contract.

5. A ***constructive obligation*** is an obligation that derives from an entity's actions where:

   (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

   (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

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* The definition of a liability in this Standard is not revised following the revision of the definition of a liability in the *Conceptual Framework for Financial Reporting under Indian Accounting Standards* issued in 2021 by the Institute of Chartered Accountants of India.

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Examples 3 - 5

3. X Ltd. is engaged in the manufacture of fertilisers. Effluents discharged in the manufacturing process have polluted the river near the manufacturing plant. The residents of the nearby locality launched a massive agitation against the pollution. X Ltd. agreed to their demands to reduce the water pollution by installing the necessary Effluent Treatment Plant. However, during the year no steps are taken to install the plant. No legislation requiring the company to reduce its pollution is in existence. In this case, though there is no law but by promising to take steps to reduce pollution, X Ltd. has created a valid expectation on the part of public that it will discharge its responsibilities. So the obligation in this case is a constructive obligation.

4. An entity has prepared a formal plan for a re-organisation involving site closures and redundancies. The plan has been approved by the board at the year end, but the entity will not implement or announce the re-organisation until after the year end. There is no constructive obligation, even if there is an announcement after the entity's year end but before its financial statements are approved. The announcement is a non-adjusting post balance sheet event and there was no commitment to restructure at the year end. The entity could change its plans completely after the year end. A constructive obligation would exist if the entity has raised a valid expectation in those affected by beginning to implement the re-organisation by the end of the year (for example, by scrapping the plant or informing employees and suppliers of the re-organisation), despite the absence of a formal announcement.

5. A retail store has a generally known policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. In these circumstances, the sale of its products gives rise to a constructive obligation because the entity (through its reputation for providing refunds) has created a valid expectation on the part of customers that a refund will be given if they are dissatisfied with their purchase.

6. A **contingent liability** is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

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Example 6

A tax case pending before the court, the liability for payment arising or not in respect of which depends on the outcome of court decision is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

7. A ***contingent asset*** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Example 7

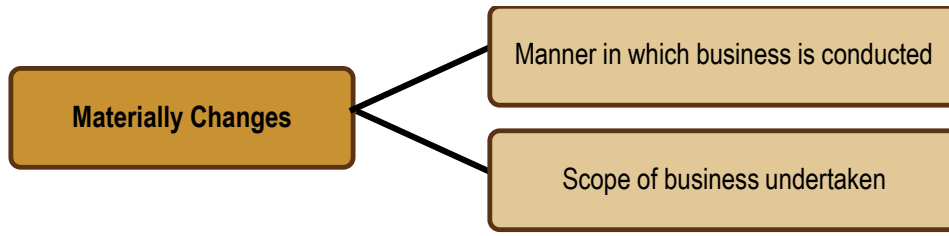
X Ltd. filed a legal suit against a supplier of goods for compensation against damages on non–supply of contracted goods. This meets the definition of a contingent asset since there is a possible asset (compensation against damages) that arose from past event (contract with the supplier) and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future event not wholly within the control of the entity (i.e., the outcome of the legal suit).

8. An ***onerous contract*** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

9. A ***restructuring*** is a programme that is planned and controlled by management, and materially changes either:

   (a) the scope of a business undertaken by an entity; or

   (b) the manner in which that business is conducted.



2.4 PROVISIONS AND OTHER LIABILITIES

Since there is uncertainty about the timing or amount of the future expenditure required in settlement of the provisions, they are different from liabilities. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

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(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees.

Example: Amounts relating to accrued vacation pay.

Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Note: Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

Examples on provisions and other liabilities:

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. The timing for payment is known since the utility companies have fixed dates every month/period for the purpose of settlement of dues. A reliable estimate of the amount of payment can be made based on the quantum of consumption, prevailing rates or on the basis of earlier bills.
Goods or services received, but not invoiced	No	Amount payable for supply of goods and services received under a formally agreed contract represents trade payables even if invoice has not been received. 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*

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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.

2.5 RELATIONSHIP BETWEEN PROVISIONS AND CONTINGENT LIABILITIES

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, Ind AS 37 distinguishes between the term 'contingent' and 'provisions'.

(a) **Provisions** – which **are recognised as liabilities** (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

Provision = Present obligation from past event + Outflow is probable + Ability to measure

(b) **Contingent Liabilities** – which **are not recognised as liabilities** because they are either:

(i) **possible obligations**, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

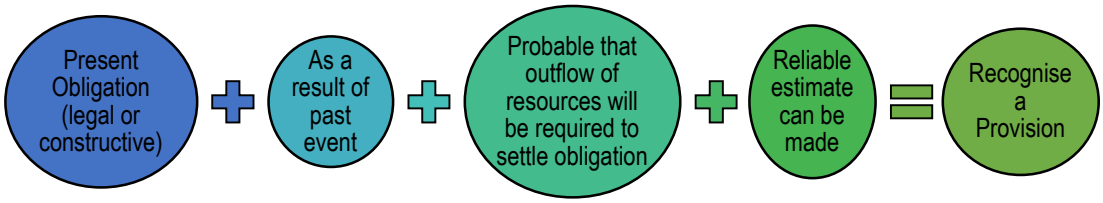
(ii) **present obligations** that do not meet the recognition criteria in Ind AS 37 (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

Contingent Liability = Possible obligation from past event and /or Outflow is not probable and /or Unable to measure

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2.6 RECOGNITION

2.6.1 Provisions



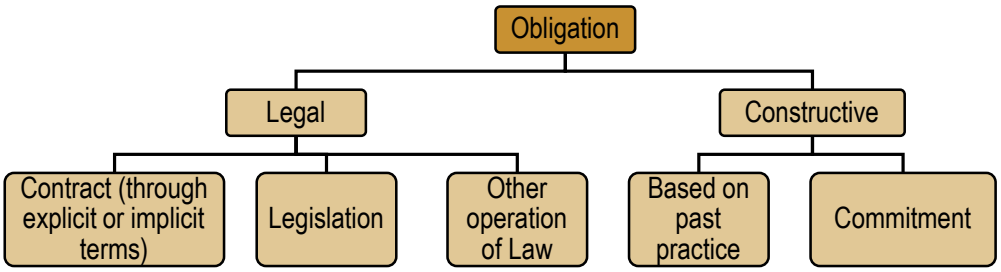
A provision should be recognised when:

(a) an entity has a **present obligation** (legal or constructive) as a result of a **past event**;

(b) it is **probable that an outflow of resources embodying economic benefits** will be required to settle the obligation; and

(c) a **reliable estimate** can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.



2.6.1.1 Present Obligation

- In general, it is clear that there is a present obligation. Only, in rare cases it is not clear whether there is a present obligation.
- In almost all cases it will be clear whether a past event has given rise to a present obligation.

Illustration 1

ABC Limited is an automobile component manufacturer. The automobile manufacturer has specified a delivery schedule, non-adherence to which will entail a penalty. As on 31st March, 20X1, the reporting date, the manufacturer has a delivery scheduled for June 20X2. However, the manufacturer is aware that he will not be able to meet the delivery schedule in June 20X2.

Determine whether the entity has a present obligation as at 31st March, 20X1, requiring recognition of provision.

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Solution

In this case, there is no present obligation arising out of a past event as the goods are scheduled for delivery in June 20X2 and there is no delay as at 31st March, 20X1. Hence, there is no present obligation to pay the penalty in the current year. Therefore, there is no present obligation to recognise the provision.

*****

- Where it is not clear whether there is a present obligation, past event shall be evaluated.
- In such a case, an entity should take into account all available evidence, including the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period.
- On the basis of such evidence:

  (a) where it is **probable (i.e. more likely than not) that a present obligation exists** at the end of the reporting period,

  ✓ the entity **recognises a provision** (if the recognition criteria are met); and

  (b) where it is **more likely that no present obligation exists** at the end of the reporting period,

  ✓ the entity discloses a contingent liability, if the possibility of an outflow of resources embodying economic benefits is not remote.

Note: It may be inferred that if the possibility of an outflow of resources embodying economic benefits is remote, then the entity need not disclose the contingent liability.

2.6.1.2 Past Event

- A past event that leads to a present obligation is called an obligating event. Obligating event, is the event where the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

  (a) where the settlement of the obligation can be enforced by law; or

  (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

- There should be a past event which lead to present obligation and give rise to a liability for which a provision is required to be made.

Example 8

1. In respect of contamination of land, it would be the original contamination.
2. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

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- No provision is recognised for costs that need to be incurred by an entity to operate in the future.
- The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.
- It is only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) that should be recognised as provisions.

Examples 9 & 10

9. Penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.
10. Similarly, an entity should recognise a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused.

- In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future.
- The entity can avoid the future expenditure by its future actions (for example by changing its method of operation). In such a case, it has no present obligation for that future expenditure and no provision is recognised.

Example 11 : Fitting smoke filters in a certain type of factory.

Since, the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

Example 12 : Staff retraining as a result of changes in the income tax system

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff has taken place. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no obligation because no obligating event (retraining) has taken place.

Conclusion – No provision is recognised.

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Example 13: 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.

Example 14: Repairs and maintenance

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. Ind AS 16, *Property, Plant and Equipment* gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

Example 15: Refurbishment costs – no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

Conclusion – No provision is recognised.

The cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the company's future

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actions—even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e., it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Example 16: Refurbishment costs – legislative requirement

An airline is required by law to overhaul its aircraft once every three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

Conclusion – No provision is recognised.

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in above example on refurbishment costs. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e., an amount equivalent to the expected maintenance costs is depreciated over three years.

Illustration 2

X Shipping Ltd. is required by law to overhaul its shipping fleet once in every 3 years. The company's finance team was of the view that recognising the costs only when paid would prevent matching of revenue earned all the time with certain costs of large amounts which are incurred occasional. Thereby, it has formulated an accounting policy of providing in its books of account for the future cost of maintenance (overhauls, annual inspection etc.) by calculating a rate per hours sailed on sea and accumulating a provision over time. The provision is adjusted when the expenditure is actually incurred.

Comment whether the accounting policy of X Shipping Ltd. is correct.

Solution

A provision is made for a present obligation arising out of a past event. Even a legal requirement to overhaul does not make the cost of overhaul a liability, because no obligation exists to overhaul the ships independently of the company's future actions - the company could avoid the future expenditure by its future actions for example by selling the ships. So there is no present obligation.

As per the standard, financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only

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liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.

Therefore, the accounting policy of X Shipping Ltd. is not correct. The company should adopt the component approach in Ind AS 16, *Property, Plant and Equipment*, for accounting for the refurbishment cost.

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- An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed.
- A management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.
- An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation.

Example 17

An entity may not be obliged to remedy the consequences due to causing of environmental damage by it. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

- Where details of a proposed new law have yet to be finalised, an obligation would arise only when the legislation is virtually certain to be enacted as drafted. For the purpose of Ind AS 37, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Example 18: Contaminated land – legislation virtually certain to be enacted

An entity in the oil industry (having 31st March year-end) causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At 31st March, 20X1, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

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An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the costs of the clean-up.

Example 19: 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 honouring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement- Probable.

Conclusion- A provision is recognised for the best estimate of the costs of clean-up.

Example 20: Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Example 21: A Court case

After a wedding in 20X1-20X2, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of approval of the financial statements for the year to 31st March 20X2 for issue, the entity's lawyers advise that it is probable that the entity will

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not be found liable. However, when the entity prepares the financial statements for the year to 31st March 20X3, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31st March 20X2

Present obligation as a result of a past obligating event – On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion – No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31st March 20X3

Present obligation as a result of a past obligating event – On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the amount to settle the obligation.

Illustration 3

X Chemical Ltd. is operating in the vicinity of a river since 20 years. A community living near X Chemical Ltd. claims that its operations has caused contamination of drinking water. X Chemical Ltd. has received notice from the governmental environmental agency that official investigations will be made into claims of pollution caused by the entity. If it is found that X Chemical Ltd. has caused contamination, then penalties and fine would be levied on it.

X Chemical Ltd. believes that it has implemented all environmental safety measures to an extent that it is unlikely to cause pollution. Management is not sure whether it has all the information about the entire 20 years. Therefore, neither management nor external experts are able to assess X Chemical Ltd.'s responsibility until the investigation has completed.

In such situation, how should management of X Chemical Ltd. account for a liability?

Solution

As per the standard, in the present case, the available evidence does not support a conclusion that a present obligation exists. However, there is a possible obligation which exists and will be confirmed upon completion of investigations. Therefore, management should disclose the contingent liability for potential penalties and fines that may be imposed if contamination is proved.

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2.6.1.3 Probable Outflow of Resources Embodying Economic Benefits

❖ For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

Note: For the purpose of Ind AS 37[1], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

❖ Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

❖ Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision should be recognised (if the other recognition criteria are met).

Example 22: 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.

2.6.1.4 Reliable Estimate of the Obligation

❖ The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the balance sheet.

[1] The interpretation of 'probable' in Ind AS 37 as 'more likely than not' does not necessarily apply in other Ind AS.

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❖ Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

Illustration 4

X Ltd. has entered into an agreement with its selling agent Y, in accordance with which X Ltd. has to pay a base percentage of commission on export sales and an additional commission is to be paid if the export incentives are received. As per the accounting policy of X Ltd., it recognises export incentives when actually realised, on account of the uncertainty in realising such incentives. Export incentives have not been received for the year 20X1-20X2, however X Ltd. is hopeful of receiving the export incentives in the year 20X2-20X3.

State whether in the financial statements for 20X1-20X2, should X Ltd. provide for both base commission and additional commission.

Solution

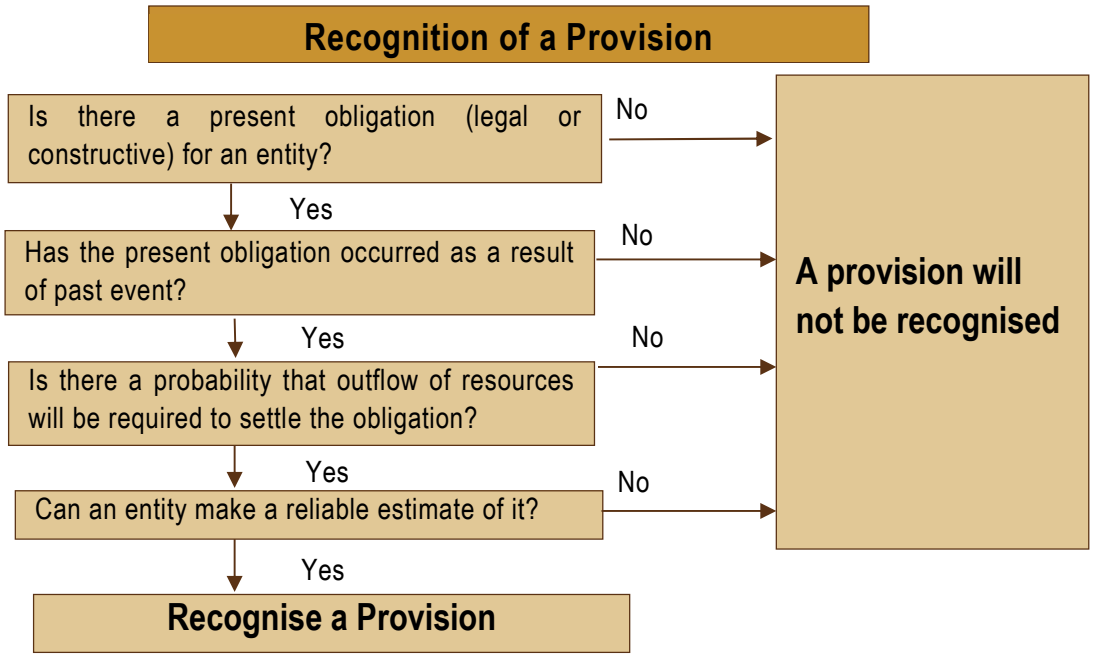
So far as the base percentage of sales commission is concerned, it is a present obligation arising out of past events. The obligating event takes place when the sales are made and also since commission is based on percentage of sale, reliable estimation can also be made. Therefore, the base percentage of sales commission should be provided.

However, in respect of additional commission, it is to be paid when the export incentives are recognised and export incentives are recognised only when it is received. Therefore, the obligating event will arise only when export incentives are received. Hence, no provision for additional commission is to be made in financial year 20X1-20X2. The expectation of X Ltd. to receive the export incentives in next year would not make any difference as on 31st March 20X2.

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❖ In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.

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2.6.2 Contingent Liabilities

- An entity should not recognise a contingent liability.
- A contingent liability should be disclosed, if the possibility of an outflow of resources embodying economic benefits is not remote.
- Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties should be treated as a contingent liability.
- The entity should recognise a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.
- Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.
- If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision should be recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

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The principles describing provisions and contingent liabilities is as follows:

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.		
There is a present obligation that probably requires an outflow of resources.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognised.	No provision is recognised.	No provision is recognised.
Disclosures are required for the provision.	Disclosures are required for the contingent liability.	No disclosure is required.

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability.

2.6.3 Contingent Assets

- An entity should not recognise a contingent asset.
- Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

Example

A claim that an entity is pursuing through legal processes, where the outcome is uncertain.

- Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised.
- However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- A contingent asset should be disclosed, where an inflow of economic benefits is probable.
- Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements **of the period in which the change occurs.**

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Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity		
The inflow of economic benefits is virtually certain	**The inflow of economic benefits is probable, but not virtually certain**	**The inflow is not probable**
The asset is not contingent and its recognition is appropriate	No asset is recognised	No asset is recognised
	Disclosures are required	No disclosure is required

Tabular depiction

Likelihood of outcome	Contingent liability	Contingent asset
Virtually certain (greater than 95% probability)	Recognise the provision	Recognise the asset
Probable (50% - 95% of probability)	Recognise the provision	Disclose about the contingent asset
Possible but not probable (5% - 50% of probability)	Disclose the contingency	No disclosure permitted
Remote (less than 5% probability)	No disclosure required	No disclosure permitted

2.7 MEASUREMENT

- Best Estimate
- Risk and Uncertainity
- Present Value
- Future Events
- Expected Disposal of Assets

2.7.1 Best Estimate

❖ The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

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- The estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and in some cases, reports from independent experts, for example, in legal cases, expert legal advice might be taken. The evidence considered includes any additional evidence provided by events after the reporting period.
- Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, for example, customer refunds, warranties, etc., the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60% or 90%.
- Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

Illustration 5

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of ₹ 1 million would result. If major defects were detected in all products sold, repair costs of ₹ 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects.

Assess the probability of an outflow for the warranty obligations as a whole.

Solution

The expected value of the cost of repairs is:

(75% of nil) + (20% of 1m) + (5% of 4m) = ₹ 4,00,000

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- Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes.

Example 23

An entity faces a single legal claim, with a 40 per cent 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

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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.

- Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

Examples 24 & 25

24. If an entity has an environmental obligation to clean up the drinking water that got contaminated, there might be a number of different ways to carry out this work. Each of these methods would have different probabilities of success and would cost different amounts. In such case, the entity might choose the method which has the most likely possibility of success.

25. If an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of ₹ 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

- Generally, when the most likely outcome is close to the expected value, it will be appropriate to provide for the most likely outcome because expected value provides evidence of the probable outflow of benefits.

Example 26

An entity is required to replace a major component of an asset under warranty. Each time replacement costs ₹ 1 million. From experience, there is a 30 per cent chance of a single failure, a 50 per cent chance of two failures, and a 20 per cent chance of three failures.

The most likely outcome is two failures, costing ₹ 2 million. The expected value is ₹ 1.9 million [(30 per cent x ₹ 1 million) + (50 per cent x ₹ 2 million) + (20 per cent x ₹ 3 million)]. The expected value supports the provision for the most likely outcome of ₹ 2 million.

- The provision should be measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under Ind AS 12.

2.7.2 Risks and Uncertainties

- The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.
- Risk describes variability of outcome.
- A risk adjustment should be made for the amount that the entity would pay in excess of the

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expected present value of outflows due to uncertainty attached with the actual outcome.

- A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities.

  For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case.

- Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

- Risk adjustment can be accounted for in number of ways such as:
  - Adding it to the expected present value of future outflows.
  - Adjusting the estimates of future outflows.
  - Adjusting the discount rate.

- Disclosure of the uncertainties surrounding the amount of the expenditure should be made.

2.7.3 Present Value

- Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.

- Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions should therefore be discounted, where the effect is material.

- Ind AS 37 does not require cash flows to be discounted unless this has a material effect.

- The expected present value of outflows are calculated as follows:
  - Each outcome is discounted to its present value.
  - The present value of outcomes are weighted by their associated probabilities.

- **The discount rate (or rates) should be a pre-tax rate (or rates)** that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

- The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Illustration 6

X Solar Power Ltd., a power company, has a present obligation to dismantle its plant after 35 years of useful life. X Solar Power Ltd. cannot cancel this obligation or transfer to third

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party. X Solar Power Ltd. has estimated the total cost of dismantling at ₹ 50,00,000, the present value of which is ₹ 30,00,000. Based on the facts and circumstances, X Solar Power Ltd. considers the risk factor of 5% i.e., the risk that the actual outflows would be more from the expected present value.

State how should X Solar Power Ltd. account for the obligation.

Solution

The obligation should be measured at the present value of outflows i.e., ₹ 30,00,000. Further a risk adjustment of 5% i.e., ₹ 1,50,000 (₹ 30,00,000 x 5%) would be made.

So, the liability will be recognised at = ₹ 30,00,000 + ₹1,50,000 = ₹ 31,50,000.

Illustration 7

ABC Ltd. has an obligation to restore the seabed for the damage it has caused in the past. It has to pay ₹ 10,00,000 cash on 31st March 20X3 relating to this liability. ABC Ltd.'s management considers that 5% is an appropriate discount rate.

Calculate the amount to be provided for at 31st March 20X1 for the costs of restoring the seabed.

Solution

Discounting factor of 5% for 2nd year as on 31st March 20X1 = $(1/1.05)^2$ = 0.907

The present value of the provision as on 31st March 20X1 is = ₹ 10,00,000 x 0.907

= ₹ 9,07,000

The amount of increase in the provision resulting from unwinding of discounting to reflect the passage of time should be included as an element of borrowing cost in determining the profit or loss for the year.

The provision should be initially recognised at ₹ 9,07,000 which is the present value of ₹ 10,00,000 discounted at 5% for two years. At the end of year 1 i.e. 31st March 20X2, the provision increases to ₹ 9,52,350, and the difference of ₹ 45,350 is recognised as borrowing cost. Similarly, for the year ending 31st March 20X3, the provision will increase to 10,00,000 and the increase being recognised as borrowing cost. Consequently, at the end of year 2 the amount of provision will be equal to the amount due, i.e., ₹ 10,00,000.

Note: There may be some difference in amount due to approximation (limiting discounting factor to 3 place decimal), which can be overcome either by full scale calculation or adjustment at the end.

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2.7.4 Future Events

❖ Future events that may affect the amount required to settle an obligation should be

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reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

- Expected future events may be particularly important in measuring provisions.

  For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology.

  The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence. It is fine to anticipate the use of existing method with the some refinement, adaptation and cost reduction, if there is sufficient evidence that such factors are likely to arise in future. However, it would not be acceptable to assume that there would be a completely new idea or a new method, which would be significantly cost effective.

- The effect of possible new legislation should be taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Illustration 8

X Chemicals Ltd. engaged in the chemical industry causes environmental damage by dumping waste in the river near its factory. It does not clean up because there is no environmental legislation requiring cleaning up and X Chemicals Ltd. is causing damage for last 40 years. As at 31st March, 20X2, the State Legislature has passed a path breaking legislation requiring all polluting factories to clean-up the river water already contaminated. The formal Gazette notification of the law is pending.

Comment on how should X Chemicals Ltd. deal with this situation.

Solution

The obligating event is the contamination of water and because of the virtually certainty of legislation requiring cleaning up, an outflow of resources is certain. It is possible to arrive at best estimated cost for the cleanup activity. So, a provision should be recognised in the books of X Chemicals Ltd. for 20X1-20X2.

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2.7.5 Expected Disposal of Assets

- Gains on the expected disposal of assets should not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.
- Instead, an entity should recognise gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned.

Example 27

At the end of 20X1, an entity is demonstrably committed to the closure of some facilities, having drawn up a detailed plan and made appropriate announcements. The expected impact of the plan is as follows:

	20X2	20X3
Committed closure costs	₹ 10,00,000	
Gain from sale of property		₹ 2,00,000

The provision required at the end of 20X1 is ₹ 10,00,000 (ignoring discounting). The expected gain on the sale of the property is dealt with separately under the derecognition criteria in Ind AS 16.

2.8 REIMBURSEMENTS

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.
- In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.
- Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly.
- In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision should be recognised for the full amount of the liability, and a separate asset for the expected reimbursement should be recognised when it is virtually

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certain that reimbursement will be received if the entity settles the liability.

- In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they should not be included in the provision.
- As noted earlier, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

In various situations where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the treatment would be as follows:

Reimbursements			
Situation	**The entity has no obligation for the part of the expenditure to be reimbursed by the other party**	**Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party and it is virtually certain that reimbursement will be received if the entity settles the provision**	**Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party but the reimbursement is NOT virtually certain**
Recognition	The entity has no liability for the amount to be reimbursed. Hence no provision will be made.	• The reimbursement is recognised as a separate asset in the balance sheet • In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement. • The amount recognised for the expected reimbursement shall not exceed the liability.	The expected reimbursement is not recognised as an asset.
Disclosure	No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement.	The expected reimbursement is disclosed.

Illustration 9

X Beauty Solutions Ltd. is selling cosmetic products under its brand name 'B', but it is getting its product manufactured from Y Ltd. It has an understanding (enforceable agreement) with Y Ltd. that if the company becomes liable for any damage claims, due to any injury or harm to the

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customer of the cosmetic products, 30% will be reimbursed to it by Y Ltd. During the financial year 20X1-20X2, an estimate of the claim of ₹ 30,00,000 may be payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?

Solution

Since the understanding results in an enforceable agreement, the reimbursement of ₹ 9,00,000 (₹ 30,00,000 x 30%) shall be recognised as a reimbursement right and provision will be recognised for ₹ 30,00,000. The reimbursement right shall be treated as a separate asset and shall not be offset with the provision. In the statement of profit and loss, the expense may be presented as ₹ 21,00,000 after offsetting the reimbursement right.

*****

2.9 CHANGES IN PROVISIONS

- Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.
- Once the amount of the obligation is crystallised and there is no uncertainty associated with an obligation, the liability is no longer a provision. The same should be reclassified as an element within liabilities.

Example 28

Customer X has made a claim of ₹ 2 million for liquidated damages, the entity is disputing the amount of claim. Due to the uncertainty involved in the amount payable, the entity recognises this as a provision. After negotiation with the customer, the amount is agreed at ₹ 1.5 million. As there is no uncertainty involved relating to the amount payable, it no longer meets the definition of provision and should be reclassified to an appropriate category within liabilities.

- Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Illustration 10

X Telecom Ltd. has income tax litigation pending before appellate authorities. Legal advisor's opinion is that X Telecom Ltd. will lose the case and estimated that liability of ₹ 1,00,00,000 may arise in two years. The liability is recognised on a discounted basis. The discount rate at which

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the liability has been discounted is 10% and it is assumed that discount rate does not change over the period of 2 years.

How should X Telecom Ltd. calculate the amount of finance cost?

Solution

The discount factor of 10% for 2 years is 0.826. X Telecom Ltd. will initially recognise provision for ₹ 82,60,000 (₹ 1,00,00,000 x 0.826).

The discount factor of 10% at the end of year 1 is 0.909. At the end of year 1, provision amount would be ₹ 90,90,000 (₹ 1,00,00,000 x 0.909).

As per the standard, the difference between the two present values i.e., ₹ 8,30,000 (90,90,000-82,60,000) is recognised as a finance cost in year 1.

At the end of the Year 2, the liability would be ₹ 1,00,00,000.

The difference between the two present values i.e., ₹ 9,10,000 (₹ 1,00,00,000 - ₹ 90,90,000) is recognised as finance cost in year 2.

*****

2.10 USE OF PROVISIONS

- A provision should be used only for expenditures for which the provision was originally recognised. Repurposing of the provisions is not allowed.
- Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

2.11 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

2.11.1 Future Operating Losses

- Provisions should not be recognised for future operating losses.
- Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions as specified in the standard. Ind AS 37 does not permit recognition of provision for future operating losses this since they do not stem from a past event.
- An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity should test these assets for impairment under Ind AS 36, *Impairment of Assets.*

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Illustration 11

X Packaging Ltd. has two segments, packaging division and paper division. In March 20X1, the board of directors approved and announced a formal plan to sell the paper division in June 20X1. Operating losses of the paper division are estimated to be approximately ₹ 50,00,000 during the period from 1st April, 20X1 to the expected date of disposal. Management of X Packaging Ltd. wants to include the future operating loss of ₹ 50,00,000 in a provision for restructuring in the financial statements for the period ended 31st March, 20X1.

Recommend whether X Packaging Ltd. can include these operating losses in a provision for restructuring.

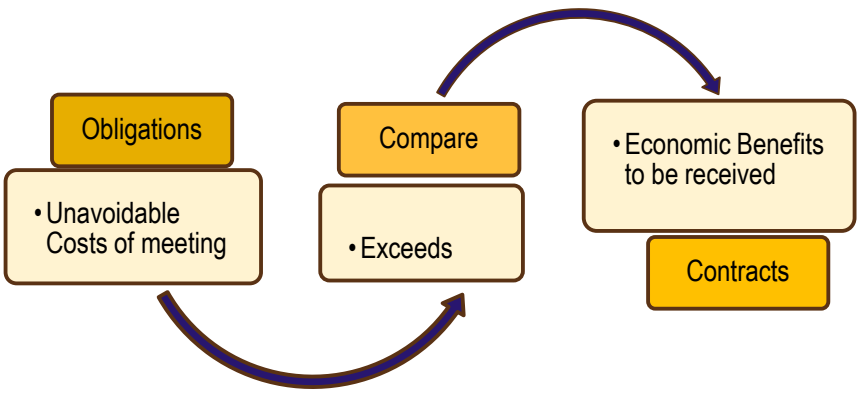
Solution

Standard states that provision should not be made for future operating losses. Since Ind AS 37 prohibits the recognition of future operating losses, so X Packaging Ltd. should not include these future operating losses in a provision for restructuring even though these losses relate to the disposal group.

*****

2.11.2 Onerous contracts

❖ If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision.



❖ Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of Ind AS 37 and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of Ind AS 37.

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❖ Ind AS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

Note: Both the incremental costs to fulfil a contract and allocation of directly attributable costs will form part of the cost used for determination of onerous contract.

❖ Before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets used in fulfilling that contract (in accordance with Ind AS 36).

Examples 29- 32

29. **Contract not onerous:** An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. The gas will be used to generate electricity, which will be sold at a profit. The economic benefits from the contract include the benefits to the entity of using the gas in its business and, because the electricity will be sold at a profit, the contract is not onerous.

30. **Impairment of assets:** The contract's terms and market prices are the same as in example 29. However, the electricity is sold at a loss, and the entity makes an overall operating loss. All of the gas purchased by the entity is used to generate electricity using dedicated assets. The electricity is sold to a wide range of customers. The entity first considers whether the assets used to generate electricity are impaired. To the extent that there is still a loss after the assets have been written down, a provision for an onerous contract should be recorded.

31. **Sale to third party at below purchase price:** The contract terms and market price are the same as in example 29. However, in this example, the entity sells the gas under contract, which it no longer needs, to a third party for 18p per unit (5p below cost). The entity determines that it would have to pay ₹ 55,000 to exit the purchase contract. The only economic benefit from the purchase contract costing ₹ 2,30,000 are the proceeds from the sales contract, which are ₹ 1,80,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of the cost of fulfilling the contract and the penalty cost of cancellation (₹ 55,000).

32. **Contract termination costs:** In the year ended 31st December 20X1, an entity has a contract with a third party supplier. The entity wishes to terminate this contract in 20X2 because it can enter into a cheaper contract with a new supplier, even though it will still have two years to run. It will incur a charge for terminating the contract. Does the entity have to provide in 20X1-20X2 for the contract that it will be exiting in 20X2-20X3? A provision should be recognised only if the contract is onerous. If the

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goods received under the supply contract are sold at a profit, the contract is not onerous and provision should not be made in 20X1-20X2. The termination cost should be recognised as incurred in 20X2-20X3.

Illustration 12

X Metals Ltd. had entered into a non-cancellable contract with Y Ltd. to purchase 10,000 units of raw material at ₹ 50 per unit at a contract price of ₹ 5,00,000. As per the terms of contract, X Metals Ltd. would have to pay ₹ 60,000 to exit the said contract. X Metals Ltd. has discontinued manufacturing the product that would use the said raw material. For that X Metals Ltd. has identified a third party to whom it can sell the said raw material at ₹ 45 per unit.

State how should X Metals Ltd. account for this transaction in its books of account in respect of the above contract?

Solution

These circumstances do indicate an onerous contract. The only benefit to be derived from the purchase contract costing ₹ 5,00,000 are the proceeds from the sale contact, which are ₹ 4,50,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of cost of fulfilling the contract and the penal cost of cancellation of ₹ 60,000.

*****

2.11.3 Restructuring

- The following are examples of events that may fall under the definition of restructuring:
  - (a) sale or termination of a line of business;
  - (b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
  - (c) changes in management structure, for example, eliminating a layer of management; and
  - (d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.
- A provision for restructuring costs should be recognised only when the general recognition criteria for provisions set out the standard are met.
- A constructive obligation to restructure arises only when an entity:
  - (a) has a detailed formal plan for the restructuring identifying at least:
    - (i) the business or part of a business concerned;

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(ii) the principal locations affected;

(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

(iv) the expenditures that will be undertaken; and

(v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Example 33: Closure of a division – no implementation before end of the reporting period

On 12th March, 20X1 the board of an entity decided to close down a division. Before the end of the reporting period (31st March, 20X1) the decision was not communicated to any of those affected and no other steps were taken to implement the decision. it is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There has been no obligating event and so there is no obligation.

Conclusion – No provision is recognised.

Example 34: 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.

❖ Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a

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constructive obligation to restructure only if it is made in such a way and in sufficient detail (i.e., setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

- For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.
- A management or board decision to restructure taken before the end of the reporting period does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period:

  (a) started to implement the restructuring plan; or

  (b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

  If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting period, disclosure is required under, Ind AS 10, Events after the Reporting Period, if the restructuring is material and non-disclosure could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.
- Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of the standard are met.
- In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (e.g., employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.
- No obligation arises for the sale of an operation until the entity is committed to the sale, i.e., there is a binding sale agreement.

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- Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Ind AS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.
- A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

  (a) necessarily entailed by the restructuring; and

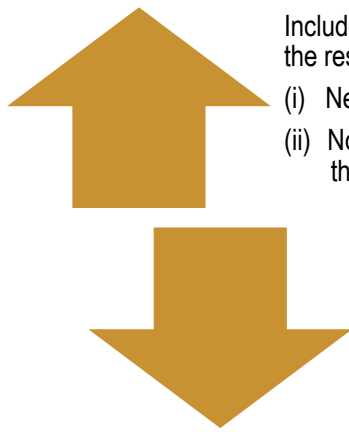
  (b) not associated with the ongoing activities of the entity.
- A restructuring provision does not include such costs as:

  (a) retraining or relocating continuing staff;

  (b) marketing; or

  (c) investment in new systems and distribution networks.

  These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures should be recognised on the same basis as if they arose independently of a restructuring.
- Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract.
- Gains on the expected disposal of assets should not be taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.



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Illustration 13

X Cements Ltd. has three manufacturing units situated in three different states of India. The board of directors of X Cements Ltd., in their meeting held on 10th January, 20X1, decided to close down its operations in one particular state on account of environmental reasons. A detailed formal plan for *shutting down the above unit was also formalised and agreed by the board of directors in that meeting, which specifies the approximate number of employees who will be compensated and expenditure expected to be incurred. Date of implementation of plan has also been mentioned. Meetings were also held with customers, suppliers, and workers to communicate the features of the formal plan to close down the operations in the said state, and representatives of all interested parties were present in those meetings.*

Evaluate whether the actions of the board of directors create a constructive obligation that needs a provision for restructuring.

Solution

As per Ind AS 37, the conditions prescribed are:

(a) there should be detailed formal plan of restructuring;

(b) which should have raised valid expectations in the minds of those affected that the entity would carry out the restructuring by announcing the main features of its plans to restructure.

The board of directors did discuss and formalise a formal plan of winding up the operation in the above said state. This plan was communicated to the parties affected and created a valid expectation in their minds that X Cements Ltd. would go ahead with its plans to close down operations in that state. Thus, there is a constructive obligation that needs to be provided at year-end.

*****

2.12 DISCLOSURE

❖ For each class of provision, an entity should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e., incurred and charged against the provision) during the period;

(d) unused amounts reversed during the period; and

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(e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required to be disclosed.

- An entity should disclose the following for each class of provision:

  (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

  (b) an indication of the uncertainties about the amount or timing of those outflows.

  Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events; and

  (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

- Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

  (a) an estimate of its financial effect, measured in the standard;

  (b) an indication of the uncertainties relating to the amount or timing of any outflow; and

  (c) the possibility of any reimbursement.

- In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of the standard and

- Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

- Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by the standard in a way that shows the link between the provision and the contingent liability.

- Where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in the standard.

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- ❖ It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.
- ❖ Where any of the information required by the standard is not disclosed because it is not practicable to do so, that fact should be stated.
- ❖ In extremely rare cases, disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Illustration 14 : Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the end of the reporting period, a provision of ₹ 60,000 has been recognised for the sale made during the year. The provision has not been discounted as the effect of discounting is not material.

Draft the Note.

Solution

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the current financial year. It is assumed that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years from the reporting period.

*****

2.13 LEVIES (APPENDIX C OF IND AS 37)

2.13.1 Appendix C deals with

- the accounting for a liability to pay a levy if that liability is within the scope of Ind AS 37
- accounting for a liability to pay a levy whose timing and amount is certain.

2.13.2 Appendix C does not deal with

- the accounting for the costs that arise from recognising a liability to pay a levy.

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Note: Entities should apply other Standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense.

2.13.3 What is a Levy?

A charge imposed by governments on entities in accordance with laws and/or regulations. It leads to outflow of resources embodying economic benefits

It excludes

- outflows of resources that are within the scope of other Ind AS
- fines or other penalties that are imposed for breaches of the legislation
- payment made to the government for acquiring assets or for rendering services as per the contractual agreement
- liabilities that arise from emissions trading schemes.

Note: Government' refers to government, government agencies and similar bodies whether local, national or international.

2.13.4 Accounting Principles

- If and activity triggers the payment of the levy, it will be considered as an obligating event that gives rise to a liability to pay a levy

Example 35

If the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to create a present obligation.

- Any compulsion to operate in future will not be considered as constructive obligation for an entity, to pay a levy.
- The preparation of financial statements under the going concern assumption does not imply that an entity has a present obligation to pay a levy that will be triggered by operating in a future period.

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- The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (ie if the activity that triggers the payment of the levy, as identified by the legislation, occurs over a period of time).

Example

If the obligating event is the generation of revenue over a period of time, the corresponding liability is recognised as the entity generates that revenue.

- If an obligation to pay a levy is triggered when a minimum threshold is reached, the accounting for the liability that arises from that obligation shall be consistent with the principles established in the standard.

Example

If the obligating event is the reaching of a minimum activity threshold (such as a minimum amount of revenue or sales generated or outputs produced), the corresponding liability is recognised when that minimum activity threshold is reached.

- An entity shall apply the same recognition principles in the interim financial report that it applies in the annual financial statements. As a result, in the interim financial report, a liability to pay a levy:

  (a) shall not be recognised if there is no present obligation to pay the levy at the end of the interim reporting period; and

  (b) shall be recognised if a present obligation to pay the levy exists at the end of the interim reporting period.

- An entity shall recognise an asset if it has prepaid a levy but does not yet have a present obligation to pay that levy.

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2.14 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'UPL Limited' for the financial year 2021 – 2022 with respect to Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets':

35. CONTINGENT LIABILITIES

The Company is involved in a number of appellate, judicial and arbitration proceedings (including those described below) concerning matters arising in the course of conduct of the Company's businesses. Some of these proceedings in respect of matters under litigation are in early stages, and in some other cases, the claims are indeterminate. A summary of claims asserted on the Group in respect of these cases have been summarised below.

Amounts in respect of claims asserted by various revenue authorities on the Company, in respect of taxes, which are in dispute, have been tabulated below:

₹ in Crores

	As at March 31, 2022	As at March 31, 2021
Disputed Income-Tax Liability (excluding interest)	26	33
Disputed Excise Duty / Service Tax liability (excluding interest)	182	186
Disputed Sales Tax/ GST liability	20	25
Disputed Custom Duty liability	22	22
Disputed Fiscal Penalty for cancellation of licenses	33	33
Claims against the Company not acknowledged as debts	1	4

The management believes that the claims made are untenable and is contesting them. As of the reporting date, the management is unable to determine the ultimate outcome of above matters. However, in the event the revenue authorities succeed with enforcement of their assessments, the Company may be required to pay some or all of the asserted claims and the consequential interest and penalties, which would reduce net income and could have a material adverse effect on net income in the respective reported period.

Management is generally unable to reasonably estimate a range of possible loss for proceedings or disputes other than those included in the estimate above, including where:

i. plaintiffs / parties have not claimed an amount of money damages, unless management can otherwise determine an appropriate amount;

ii. the proceedings are in early stages;

iii. there is uncertainty as to the outcome of pending appeals or motions or negotiations;

iv. there are significant factual issues to be resolved; and/or

v. there are novel legal issues presented.

However, in respect of the above matters, management does not believe, based on currently available information, that the outcomes of the litigation, will have a material adverse effect on the Company's standalone financial condition, though the outcomes could be material to the Group's operating results for any particular period, depending, in part, upon the operating results for such period.

(Source: Annual Report of financial year 2021 – 2022 of UPL Limited')

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2.15 SIGNIFICANT DIFFERENCES IN IND AS 37 VIS-A-VIS AS 29

S. No.	Particulars	Ind AS 37	AS 29
1.	*Constructive obligations*	Ind AS 37 explicitly defines the term 'constructive obligations' and uses term in certain paragraphs.	Paragraph 11 of AS 29 included expression similar to constructive obligations in the context of explaining when the obligations arise i.e. obligation also arises from normal business practices, custom and a desire to maintain good business relations or to act in an equitable manner.
2.	*Discounting*	Ind AS 37 requires discounting the amounts of provisions, if effect of the time value of money is material.	AS 29 prohibits discounting the amounts of provisions except in case of decommissioning, restoration and similar liabilities that are recognised as cost of property, plant and equipment.
3.	*Contingent asset*	Ind AS 37 requires disclosure of contingent assets in the financial statements when the inflow of economic benefits is probable. The disclosure, however, should avoid misleading indications of the likelihood of income arising.	AS 29 prohibits disclosure of a contingent asset in the financial statements and mentions that it is usually disclosed in the report of the approving authority, where an inflow of economic benefits is probable.
4.	*Onerous Contracts*	Ind AS 37 makes it clear that before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36.	There is no such specific provision in the existing standard.

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5.	*Future Operating Losses*	Ind AS 37 gives an exception to this principle viz. such losses related to an onerous contract.	AS 29 states that identifiable future operating losses up to the date of restructuring are not included in a provision.
6.	*Additional guidance*	Ind AS 37 gives guidance on: (a) Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds (b) Liabilities arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment (c) Levies (imposed by government).	AS 29 does not give such guidance.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. X Ltd. is operating in the telecom industry. During the Financial Year 20X1-20X2, the Income Tax authorities sent a scrutiny assessment notice under Section 143(2) of the Income-tax Act, 1961, in respect to return filed under Section 139 of this Act for Previous Year 20X0-20X1 (Assessment Year 20X1-20X2) and initiated assessment proceedings on account of a deduction claimed by the company which in the view of the authorities was inadmissible.

   During the financial year 20X1-20X2 itself, the assessment proceedings were completed and the assessing officer did not allow the deduction and raised a demand of ₹ 1,00,00,000 against the company. The company contested such levy and filed an appeal with the Appellate authority. At the end of the financial year 20X1-20X2, the appeal had not been heard. The company is not confident whether that the company would win the appeal. However, the company was advised by its legal counsel that on a similar matter, two appellate authorities of different jurisdictions had given conflicting judgements, one in favour of the assessee and one against the assessee. The legal counsel further stated it had 50% chance of winning the appeal.

   Advise how the company should account for these transactions in the financial year 20X1-20X2.

2. An entity is a telecom operator. Laying of cables across the world is a requirement to enable the entity to run its business. Cables are also laid under the sea and contracts are entered into for the same. By virtue of laws of the countries through which the cable passes, the entity is required to restore the sea bed at the end of the contract period.

   State the nature of obligation that the entity has in such a case.

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3. U Ltd. is a large conglomerate with a number of subsidiaries. It is preparing consolidated financial statements as on 31st March 20X2 as per the notified Ind AS. The financial statements are due to be approved for issue on 15th May 20X2. Following are a few transactions that have taken place in some of its subsidiaries during the year:

   G Ltd. is a wholly owned subsidiary of U Ltd. engaged in management consultancy services. On 31st January 20X2, the board of directors of U Ltd. decided to discontinue the business of G Ltd. from 30th April 20X2. They made a public announcement of their decision on 15th February 20X2.

   G Ltd. does not have many assets or liabilities and it is estimated that the outstanding trade receivables and payables would be settled by 31st May 20X2. U Ltd. would collect any amounts still owed by G Ltd.'s customers after 31st May 20X2. They have offered the employees of G Ltd. termination payments or alternative employment opportunities.

   Following are some of the details relating to G Ltd.:

   - On the date of public announcement, it is estimated by G Ltd. that it would have to pay ₹ 540 lakhs as termination payments to employees and the costs for relocation of employees who would remain with the Group would be ₹ 60 lakhs. The actual termination payments totalling to ₹ 520 lakhs were made in full on 15th May 20X2. As per latest estimates made on 15th May 20X2, the total relocation cost is ₹ 63 lakhs.
   - G Ltd. had taken a property on lease, which was expiring on 31st March 20X6. The present value of the future lease rentals (using an appropriate discount rate) is ₹ 430 lakhs. On 15th May 20X2, G Ltd. made a payment to the lessor of ₹ 410 lakhs in return for early termination of the lease.

   The loss after tax of G Ltd. for the year ended 31st March 20X2 was ₹ 400 lakhs. G Ltd. made further operating losses totalling ₹ 60 lakhs till 30th April 20X2.

   Determine the provisions that the Company is required to make as per Ind AS 37?

4. A company manufacturing and supplying process control equipment is entitled to duty draw back if it exceeds its turnover above a specified limit. To claim duty drawback, the company needs to file application within 15 days of meeting the specified turnover. If application is not filed within stipulated time, the Department has discretionary power of giving duty draw back credit. For the year 20X1-20X2 the company has exceeded the specified limit of turnover by the end of the reporting period. However, duty drawback can be claimed on filing of application within the stipulated time or on discretion of the Department if filing of application is late. The application for duty drawback is filed on 20th April, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition. Duty drawback has been credited by the Department on 28th June, 20X2 and financial statements have been approved by the Board of Directors of the company on 26th July, 20X2.

   Identify the treatment of duty drawback credit as per the given information.

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5. Entity XYZ entered into a contract to supply 1000 television sets for ₹ 2 million. An increase in the cost of inputs has resulted into an increase in the cost of sales to ₹ 2.5 million. The penalty for non- performance of the contract is expected to be ₹ 0.25 million.

   Evaluate whether the contract is onerous and also determine the amount of provision to be made in this regard.

6. Marico has an obligation to restore environmental damage in the area surrounding its factory. Expert advice indicates that the restoration will be carried out in two distinct phases; the first phase requiring expenditure of ₹ 2 million to remove the contaminated soil from the area and the second phase, commencing three years later from the end of first phase, to replant the area with suitable trees and vegetation. The estimated cost of replanting is ₹ 3.5 million. Marico uses a cost of capital (before taxation) of 10% and the expenditure, when incurred, will attract tax relief at the company's marginal tax rate of 30%. Marico has not recognised any provision for such costs in the past and today's date is 31st March 20X2. The first phase of the clean-up will commence in a few months time and will be completed on 31st March 20X3 when the first payment of ₹ 2 million will be made. Phase 2 costs will be paid three years later from the end of first phase.

   Calculate the amount to be provided at 31st March 20X2 for the restoration costs.

Answers

1. Ind AS 37 provides that in rare cases it not clear whether there is a present obligation, for example, in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity should determine whether a present obligation exits at the end of the reporting period by taking account of all available evidence, for example, the opinion of experts.

In the present case, the company is not confident that whether it would win the appeal. By taking into account the opinion of the legal counsel, it is not sure that whether the company would win the appeal. On the basis of such evidence, it is more likely than not that a present obligation exists at the end of the reporting period. Therefore, the entity should recognise a provision. The company should provide for a liability of ₹ 1,00,00,000.

2. Paragraph 14 of Ind AS 37 states that a provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised.

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Further, with regard to past event paragraph 17 of Ind AS 37 states that a past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation."

On the basis of the above, provision should be recognised as soon as the obligating event takes place because the entity is under legal obligation to restore the sea bed, provided the other recognition criteria stated in paragraph 14 reproduced above are met. Moreover, the amount of the provision would depend on the extent of the obligation arising from the obligating event. In the instant case, an obligating event is the laying of cables under the sea. To the extent the cables have been laid down under the sea, a legal obligation has arisen and to that extent provision for restoration of sea bed should be recognised.

3. A discontinued operation is one that is discontinued in the period or classified as held for sale at the year end. The operations of G Ltd were discontinued on 30th April 20X2 and therefore, would be treated as discontinued operation for the year ending 31st March 20X3. It does not meet the criteria for held for sale since the company is terminating its business and does not hold these for sale.

As per para 72 of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', restructuring includes sale or termination of a line of business. A constructive obligation to restructure arises when:

(a) an entity has a detailed formal plan for the restructuring

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

The Board of directors of U Ltd have decided to terminate the operations of G Ltd. from 30th April 20X2. They have made a formal announcement on 15th February 20X2, thus creating a valid expectation that the termination will be implemented. This creates a constructive obligation on the company and requires provisions for restructuring.

A restructuring provision includes only the direct expenditures arising from the restructuring that are necessarily entailed by the restructuring and are not associated with the ongoing activities of the entity.

The termination payments fulfil the above condition. As per Ind AS 10 'Events after Reporting Date', events that provide additional evidence of conditions existing at the

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reporting date should be reflected in the financial statements. Therefore, the company should make a provision for ₹ 520 lakhs in this respect.

The relocation costs relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Hence, these would be recognised on the same basis as if they arose independently of a restructuring.

The lease would be regarded as an onerous contract. A provision would be made at the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Hence, a provision shall be made for ₹ 410 lakhs.

Further operating losses relate to future events and do not form a part of the closure provision.

Therefore, the total provision required = ₹ 520 lakhs + ₹ 410 lakhs = ₹ 930 lakhs

4. In the instant case, the condition of exceeding the specified turnover was met at the end of the reporting period and the company was entitled for the duty drawback. However, the application for the same has been filed after the stipulated time. Therefore, credit of duty drawback was discretionary in the hands of the Department. Since the claim was to be accrued only after filing of application, its accrual will be considered in the year 20X2-20X3 only.

Accordingly, the duty drawback credit is a contingent asset as at the end of the reporting period 20X1-20X2, which will be realised when the Department credits the same.

As per para 35 of Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset.

In accordance with the above, the duty drawback credit which was contingent asset for the financial year 20X1-20X2 should be recognised as asset and related income should be recognized in the reporting period in which the change occurs. i.e., in the period in which realisation becomes virtually certain, i.e., financial year 20X2-20X3.

5. Ind AS 37 *"Provisions, Contingent Liabilities and Contingent Assets"* defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Paragraph 68 of Ind AS 37 states that the unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and

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any compensation or penalties arising from failure to fulfill it.

In the instant case, cost of fulfilling the contract is ₹ 0.5 million (₹ 2.5 million – ₹ 2 million) and cost of exiting from the contract by paying penalty is ₹ 0.25 million.

In accordance with the above reproduced paragraph, it is an onerous contract as cost of meeting the contract exceeds the economic benefits.

Therefore, the provision should be recognised at the best estimate of the unavoidable cost, which is lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it, i.e., at ₹ 0.25 million (lower of ₹ 0.25 million and ₹ 0.5 million).

6.

Year	Cash Flow	10% Discount factor	Present Value
20X2-20X3	20,00,000	0.909	18,18,000
20X5-20X6	35,00,000	0.683	23,90,500
Provision required at 31st March 20X2			**42,08,500**

The provision is calculated using the pre-tax costs and a pre-tax cost of capital. The fact that the eventual payment will attract tax relief will be reflected in the recognition of a deferred tax asset for the deductible temporary difference (assuming that the recognition criteria for deferred tax assets are met.)

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NOTES

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CHAPTER 9

IND AS ON ITEMS IMPACTING THE FINANCIAL STATEMENTS



UNIT 1: INDIAN ACCOUNTING STANDARD 12 : INCOME TAXES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- List the objective and scope of the standard
- Define the terms used in the standard like accounting profit, taxable profit (tax loss), tax expense (tax income), current tax, deferred tax liabilities, deferred tax assets, temporary differences, taxable temporary differences, deductible temporary differences and the tax base
- Recognise current tax liabilities and current tax assets
- Recognise deferred tax liabilities and deferred tax assets
- Demonstrate when Ind AS permit or require certain assets to be carried at fair value or to be revalued
- Identify the situations where temporary difference may arise on initial recognition of an asset or liability
- Recognise deferred tax asset for all deductible temporary differences
- Evaluate the cases, when a deferred tax asset arises on initial recognition of an asset

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- Measure current tax liabilities (assets) for the current and prior periods
- Measure deferred tax assets and liabilities using the tax rates
- Identify the items recognised outside profit or loss
- Calculate the deferred tax arising from a business combination
- Calculate current and deferred tax arising from share-based payment transactions
- Account for tax assets and tax liabilities
- Offset tax assets with tax liabilities
- Present the tax expense in the Statement of Profit and Loss with respect to various transactions
- Disclose the major components of tax expense (income)
- Account for the income taxes on account of changes in the tax status of an entity or its shareholders.

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UNIT OVERVIEW

Definition	• Accounting profit • Taxable profit (tax loss) • Tax expense (tax income) • Current tax • Deferred tax liabilities • Deferred tax assets • Temporary differences • Taxable temporary differences • Deductible temporary differences • Tax base
Tax Expense	• Current Tax • Deferred Tax
Current tax	• Recognition • Measurement • Accounting of Current Tax Effects • Offsetting Current Tax Assets and Current Tax Liabilities
Deferred Tax	• Compute carrying amount • Compute tax base • Compute temporary differences • Classify temporary differences • Identify exceptions • Assess (also reassess) deductible temporary differences, tax losses and tax credits • Determine the tax rate (law) • Calculate and recognise deferred tax • Accounting of deferred tax • Offsetting deferred tax assets and deferred tax liabilities
Practical Application	• Deferred tax arising from a business combination • Current and deferred tax arising from share-based payment transactions • Change in tax status of an entity or its shareholders
Disclosure	• Disclose components of tax expenses (income) • Tax related to items charged directly to equity • Tax related to items recognised in statement of other comprehensive income • Explanation of the relationship between tax expense (income) and accounting profit • Change in tax rates • Unrecognised deductible temporary differences, unused tax losses and unused tax credits • Temporary differences associated with investments in subsidiaries etc. • Amount of deferred tax liabilities (assets) or income (expense)

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1.1 OBJECTIVE

There was a time in India, few decades back when the concept of zero income tax entities was prevalent. Due to various income tax benefits, these companies had no current tax liability for any income tax that was payable based on that year's accounting profit. Thus, no provision of income tax was created. Profit after tax used to be equal to profit before tax. But from accounting perspective, this was not a correct reflection of results. Quite a few of these tax benefits were primarily accelerated benefits.

For example, depreciation was deductible in taxation on written down value method (WDV) whereas in the books of accounts, entities could claim depreciation on straight line method (SLM). As everybody knows that under WDV method, in initial years' depreciation charge is greater than depreciation under SLM. This resulted into accounting profits but no taxable profits. But over the useful life of the asset, depreciation under both methods is equal. In later years, depreciation charge under SLM would be higher than in depreciation under WDV. Therefore, in later years, in such a situation, the taxable profits will be higher than the book profits. This will require a higher tax provision in books when compared to the accounting profits of that year. Basically, this differential will be due to non-provision of tax liability in an earlier year.

Example 1

An entity has acquired an asset for ₹ 10,000. The depreciation rate as per income tax is 40% on WDV basis. In books of account, entity claims depreciation on equivalent SLM basis of 16.21%. The entity has accounting and taxable profits of ₹ 20,000 from year 1 to year 4, inclusive, before any allowance of depreciation in either case.

The tax rate is 30%. Assuming no concept of deferred tax, the provision for current tax would be computed as under:

Year	1	2	3	4
Cost of the asset	10,000	10,000	10,000	10,000
Depreciation rate – WDV	40%	40%	40%	40%
Depreciation amount – WDV	4,000	2,400	1,440	864
Taxable profits before depreciation	20,000	20,000	20,000	20,000
Less: Depreciation	(4,000)	(2,400)	(1,440)	(864)
Taxable profits after depreciation	16,000	17,600	18,560	19,136
Tax rate	30%	30%	30%	30%
Tax amount	4,800	5,280	5,568	5,741

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However, in the books of accounts, the situation will be as under:				
Year	**1**	**2**	**3**	**4**
(a) Cost of the asset	10,000	10,000	10,000	10,000
(b) Depreciation rate – SLM	16.21%	16.21%	16.21%	16.21%
(c) Depreciation amount – SLM	1,621	1,621	1,621	1,621
(d) Accounting profits before depreciation	20,000	20,000	20,000	20,000
(e) Less: Depreciation	(1,621)	(1,621)	(1,621)	(1,621)
(f) Accounting profits after depreciation	18,379	18,379	18,379	18,379
(g) Tax amount – as above	4,800	5,280	5,568	5,741
(h) Effective tax rate=(g)/(f)	26.12%	28.73%	30.30%	31.24%
(i) Tax @ 30% tax rate {30%*(f)}	5,514	5,514	5,514	5,514

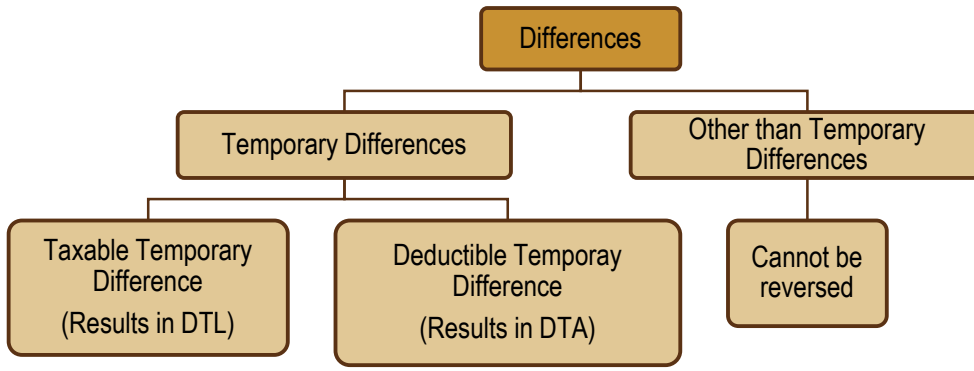
Thus, from the above two tables, for an accountant the tax should be ₹ 5,514 in all cases as per the accounting profit. The results are distorted. You will observe that in year 3, in books, the amount of tax provision is higher by ₹ 54 (5,568 – 5,514) and in year 4, it is higher by ₹ 227 (5,741 - 5,514). This is so because in year 1 & 2, these figures are lower by ₹ 714 (5,514 – 4,800) & ₹ 234 (5,514 – 5,280). Thus, the liability that was incurred in year 1 & 2 is paid year 3 onwards. However, no provision of the differential (₹ 714 in year 1 & ₹ 234 in year 2) is made.

The provision of differential should have been made by the entity following three major accounting concepts and convention of periodicity, matching and accrual. The entity has merely deferred the payment of tax to subsequent year. This understanding and appreciation of situation gave rise to the concept of deferred tax liabilities or deferred tax assets.

In earlier years, deferred tax was recognised based on concepts of timing differences and permanent differences based on differences in accounting profits and taxable profits known as income tax liability method. This concept stands revised with this Accounting Standard which recognised deferred tax based on temporary differences that arises due to difference in the carrying value of an item of asset or liability as per books of accounts with the carrying value of that item as per income tax provisions, known as tax base. This method is known as balance sheet approach.

This Accounting Standard though titled as 'income taxes' primarily deals with deferred tax though guidance is provided on current tax.

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1.2 SCOPE

- The objective of this Standard is to prescribe the accounting treatment for income taxes. Income taxes for the purpose of this Standard includes:

  (a) all domestic and foreign taxes which are based on taxable profits;

  (b) taxes, such as withholding taxes (Tax Deducted at Source), which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.

Domestic and Foreign Taxes; Including withholding taxes which are payable by a subsidiary, Associate or Joint Arrangements on distributions to the Reporting Entity	Methods of Accounting for Government Grants or Investment tax credits (But it deals with accounting for temporary differences arising from such grants and investment tax credits)

- Further, the income-tax for the purpose of this Standard could be classified as:

  (a) ***Current tax*** being current tax consequence that arises due to transactions and other events of the current period that are recognised in an entity's financial statements.

  (b) ***Deferred tax*** being future tax consequence that arises due to the future

    (i) recovery of the carrying amount of assets or

    (ii) settlement of carrying amount of the liabilities that are recognised in an entity's balance sheet. For example: Recovery of fixed assets means by way of depreciation or sale and for other assets by way of realization.

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- Before we proceed further, it is essential to understand the fundamental principle in recognising deferred tax. This is enunciated in the Standard as under:

  It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset).

  Let us try to understand the aforesaid principle with the help of an example:

Example 2

(a) Whenever an entity recognises an asset, it expects that it will recover the carrying value of that asset. For example, if an entity recognises an item of land at ₹ 1,00,000, it expects that it will be able to recover at least ₹ 1,00,000 if that land is sold sometime in the future.

(b) Assume that under the income tax provisions, if this piece of land is sold after holding it for more than one year, there will be an indexation benefit @ 10% per year. Thus, if the land is sold after one year, the cost of the land will for the purpose of taxation will be assumed at ₹ 1,10,000 (₹ 1,00,000 + 10%). If it is sold after two years, the cost of the land for the purpose of taxation will be assumed at ₹ 1,21,000 (₹ 1,10,000 + 10%).

(c) The tax rate in all years continues to be flat 30%.

(d) Thus, the recovery of the carrying value of land after two years will result into a tax saving of ₹ 6,300 i.e. 30% of 21,000 (1,21,000-1,00,000). For instance, if after two and half years, the land is sold for ₹ 1,50,000, the entity will pay a tax of ₹ 8,700 at 30% of ₹ 29,000 (₹ 1,50,000 – ₹ 1,21,000). If there would have been no indexation benefits, the tax liability would have been ₹ 15,000 at 30% of ₹ 50,000 (₹ 1,50,000 – ₹ 1,00,000). Saving in tax is of ₹ 6,300 (15,000-8,700).

(e) In view of the above savings, the entity should recognise a deferred tax asset of ₹ 6,300 in this case in Year 1.

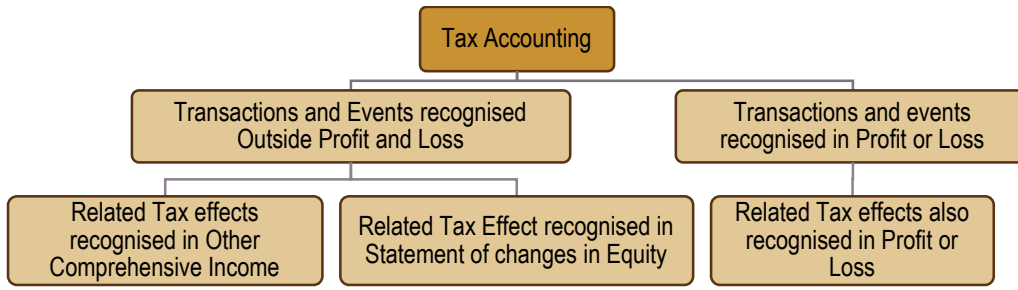
(f) This principle has to be applied to each item of asset or liability.

Note: There are controversial views in case of Indexation of land for a temporary difference because if the land is not going to be sold in a near future particularly in business then in such case it is not advisable to calculate temporary difference.

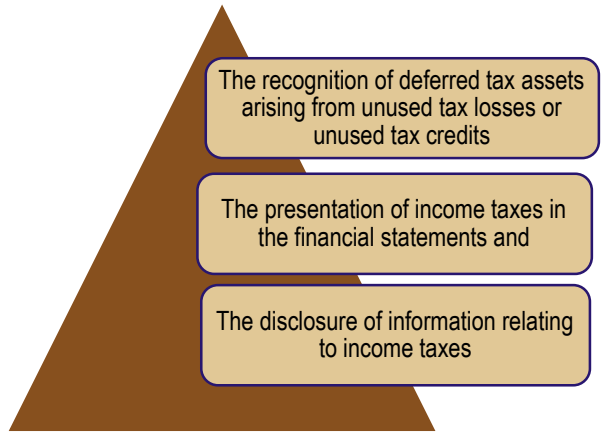
- The Standard also provides guidance as to where the current tax or deferred tax should be recognised, accounted and presented.

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- An entity may incur a loss in the current period and set off against a profit in the earlier period. As the entity would recover a tax paid in the earlier year, the entity should recognize the benefit of tax recoverable as an asset.
- Items of current tax or defer tax recognized in profit and loss are subject to two exceptions:
  1. An item of current tax or defer tax pertaining to other comprehensive income should be recognized in other comprehensive income
  2. An item of current tax or defer tax pertaining to direct equity should be recognized in direct equity



- In addition, the Standard deals with the:
  (a) recognition of deferred tax assets arising from unused tax losses or unused tax credits;
  (b) presentation of income taxes in the financial statements; and
  (c) disclosure of information relating to income taxes.



- The Standard however, **does not deal** with the methods of accounting for government grants (see Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*) or investment tax credits. However, it deals with the accounting for temporary differences that may arise from such grants or investment tax credits.

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1.3 DEFINITIONS

Having understood, the basic concepts of current tax and deferred tax, the following definitions needs to be appreciated:

(a) ***Accounting profit*** is profit or loss for a period before deducting tax expense.

(b) ***Taxable profit (tax loss)*** is the profit (loss) for a period, computed as per the income tax act, upon which income taxes are payable (recoverable).

(c) ***Tax expense (tax income)*** is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

(d) ***Current tax*** is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

(e) ***Deferred tax liabilities*** are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

(f) ***Deferred tax assets*** are the amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences;
- the carry forward of unused tax losses; and
- the carry forward of unused tax credits.

(g) ***Temporary differences*** are differences between the carrying amount of an asset or liability in the balance sheet and its tax base.

(h) ***Temporary differences*** may be either:

- **taxable temporary differences,** which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or
- **deductible temporary differences,** which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Comparison with AS 22:

- ***Timing differences*** *are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.*
- *Thus, it can be seen that while AS 22 spoke of timing differences with reference to income,*

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Ind AS 12 speaks of temporary differences with reference to carrying amounts and tax bases of assets and liabilities. In other words, AS 22 adopts a P/L approach, whereas Ind AS 12 adopts a balance sheet approach towards accounting for taxes on income.

(i) The **tax base** of an asset or liability is the carrying amount to that asset or liability for tax purposes.

To facilitate, easy understanding, this chapter has been divided as under:

(a) Part A : Tax Expense

(b) Part B : Current Tax, its Recognition, Measurement and Presentation

(c) Part C : Deferred Tax, its Recognition, Measurement and Presentation

(d) Part D : Practical Application

(e) Part E : Disclosures

1.4 PART A: TAX EXPENSE (TAX INCOME)

- Tax expense or tax income is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.
- The following needs to be appreciated:

  (a) Tax expense could be positive or negative. Thus, there could be a tax income.

  (b) Tax expense is the aggregate of:

  - **current tax; and**
  - **deferred** tax.

1.5 PART B: CURRENT TAX, ITS RECOGNITION, MEASUREMENT AND PRESENTATION

1.5.1 Current Tax

Current tax is the amount of *income taxes* payable (recoverable) in respect of the *taxable profit (tax loss)* for a period.

1.5.2 Recognition

(a) Current tax liability

- Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability.

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- The exact liability of current tax crystallises only on preparation and finalisation of financial statements at the end of the reporting period.
- Any excess of this liability over the prepaid taxes (advance tax) and withhold taxes (TDS) is to be treated as current liability. This liability may be for the current reporting period or may relate to earlier reporting periods.

(b) Current tax assets

If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.

1.5.3 Measurement

(a) Current tax liabilities (assets) for the current and prior periods shall be measured at the amount *expected* to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted.

(b) Uncertain tax position interpretations

- An entity computes its current income-taxes in accordance with the provisions contained in the taxation laws. Taxation laws provide certain benefits or require enhancements in accordance with the fiscal, economic and other policies of the country. These at times are prone to varying interpretations and settled by the appellate authorities after a considerable period from the reporting period. The taxability remains uncertain.
- Ind AS 12 requires that current tax liabilities or assets for the current period or the period should be computed based on the amount it expects to pay. It is suggested that statistical tools may be used in computing the current tax with respect to the uncertain tax interpretations.
- Thus, computation of current tax at best is an estimate. Any change in this estimate based on subsequent developments should be treated as a change in estimate in accordance with Ind AS 8.

(c) Enacted or substantive enacted

- The tax rates in computing the current tax should be based on taxation laws that have enacted or substantively enacted.
- A proposed legislation is enacted when all the formalities with respect to the legislation is completed. In India, the enactment occurs when the legislation is notified in the gazette on and from the date it comes into force as mentioned in the said gazette notification.
- Implicit in the word 'substantively enacted' is the emphasis that in the relevant situation the enactment process is not fully completed. The process of enactment of a taxation

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law in India is as under:

— Finance bill is presented in Lok Sabha of Indian Parliament.

— It is discussed and passed by the Lok Sabha.

— It then moves to Rajya Sabha of Indian Parliament.

— It is discussed in the Rajya Sabha.

— It is then presented before the President for assent.

— It is then notified in the gazette of India.

- Now, at which stage an entity should conclude that the legislation is substantively enacted becomes a key consideration. More so, the finance bill in India is normally presented on the last day of February and is enacted by the 3rd week of May. The reporting period of most of the entities ends on 31st March and listed entities attempt to issue their financial statements within 4-6 weeks of the reporting date.
- Ind AS 12 does not provide any guidance.
- It is therefore suggested that the entity should explicitly disclose in its financial statements the accounting policy with respect to the adoption of tax rates based on the principle of 'substantive enactment'. Needless to add, the policy should be applied consistently. If material, the variation due to adoption of rates based on 'substantive enactment' should also be disclosed.

1.5.4 Accounting of Current Tax Effects

(a) The accounting of current tax effects of a transaction of an event is consistent with the accounting for that transaction or event.

(b) The current tax effects of a transaction shall follow its accounting treatment if the item is recognised in statement of profit or loss, its current tax effect will be recognised in statement of profit or loss.

(c) For further discussion on this topic, refer Accounting for Deferred Tax.

1.5.5 Offsetting Current Tax Assets and Current Tax Liabilities

(a) An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:

- has a legally enforceable right to set off the recognised amounts; and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(b) Although current tax assets and liabilities are separately recognised and measured they are offset in the balance sheet subject to criteria similar to those established for financial instruments in Ind AS 32. An entity will normally have a legally enforceable right to set off a

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current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation laws permit the entity to make or receive a single net payment.

(c) In consolidated financial statements, a current tax asset of one entity in a group is offset against a current tax liability of another entity in the group if, and only if, the entities concerned have a legally enforceable right to make or receive a single net payment and the entities intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

Illustration 1A

H Ltd. is a manufacturing company, wanting to calculate its taxable profit or loss for the year ended 31 March 20X8. The statement of profit and loss and other comprehensive income, the balance sheet and the notes are given below.

Tax rate for the financial year 20X7-20X8 is 30%, but the new tax rate of 32%, for the year 20X8-20X9 and beyond, has already been enacted before the year end.

Calculate taxable profit for the financial year 20X7-20X8 and the related current tax expense.

Balance Sheet as of 31 March 20X8

	₹
ASSETS	
Non-current assets	
Property, plant and equipment	*4,20,00,000*
Product development costs	*21,00,000*
Investment in subsidiary – S Ltd.	*1,54,00,000*
Current assets	
Trading investments	*72,80,000*
Trade receivables	*2,19,10,000*
Inventories	*1,06,40,000*
Cash and cash equivalents	*63,00,000*
TOTAL ASSETS	*10,56,30,000*
EQUITY & LIABILITIES	
Equity	
Share capital	*4,20,00,000*
Accumulated profits	*2,86,24,330*
Revaluation surplus	*30,80,000*

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Non-current liabilities	
Deferred income - government grants	*14,00,000*
Liability for product warranty costs	*5,60,000*
Deferred tax liability (from 20X6-20X7)	*7,75,670*
Current liabilities	
Trade payables	*2,67,40,000*
Medical benefits for employees	*24,50,000*
TOTAL EQUITY & LIABILITIES	*10,56,30,000*

Extract of Statement of profit and loss for the year ended 31 March 20X8

Revenue	*16,81,40,000*
Cost of sales	*(13,44,00,000)*
Gross profit	*3,37,40,000*
Operating costs	*(2,68,80,000)*
Profit from operations	*68,60,000*
Finance costs	*(9,10,000)*
Profit before taxation	*59,50,000*

Notes:

1. *Depreciation expense for the year financial year 20X7-20X8 allowable as per the Income Tax Rules is ₹ 72,10,000. Depreciation as allowed for the purposes of financial reporting included in operating costs is ₹ 59,50,000. Cost of PPE is ₹ 5,60,00,000 and H Ltd. deducted expenses of ₹ 1,45,60,000 in its tax returns prior to financial year 20X7-20X8. Further, as of 31 March 20X8, H Ltd. for the first time revalued its property, plant and equipment to market value of ₹ 4,20,00,000 (revaluation surplus = ₹ 30,80,000).*

2. *In 20X4-20X5, H Ltd. incurred product development costs of ₹ 35,00,000. These costs were recognized as an asset and amortized over period of 10 years. For tax purposes, H Ltd. deducted full product development costs when they were in 20X4-20X5.*

3. *Trading investments were acquired in the preceding year at a cost of ₹ 80,50,000. These investments are classified as at fair value through profit or loss and thus recognized in their fair value. Fair value adjustments are not allowable by the tax authorities.*

4. *Bad debt provision amounts to ₹ 45,50,000 and relates to 2 debtors: debtor A – ₹ 28,00,000 (receivable originates in 20X5-20X6 and 100% provision was recognized in the preceding year) and debtor B – ₹ 17,50,000 (receivable originates in 20X6-20X7 and 100% provision was recognized in F.Y. 20X7-20X8). Tax law allows deduction of 20% of provision for debtors*

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overdue for more than 1 year, another 30% for debtors overdue for more than 2 years and remaining 50% for debtors overdue for more than 3 years.

5. *H Ltd. created a provision for inventory obsolescence in accordance with Ind AS 2 requirements. New provision created in 20X7-20X8 was ₹ 3,78,000 (total provision: ₹ 6,30,000). Being a general provision, this provision is not tax deductible.*

6. *Government grants are not taxable. Full government grant received in 20X7-20X8 is included in the balance sheet.*

7. *In 20X7-20X8, H Ltd. increased a liability for product warranty costs by ₹ 1,75,000. Product warranty costs are not tax deductible until the company pays claims. Claims paid in 20X7-20X8 amounted to ₹ 2,17,000.*

8. *During the year, H Ltd. introduced health care benefits for employees. The expenses are allowable for tax purposes only when benefits are paid but in line with Ind AS 19, recognized in profit or loss when employees provide service.*

9. *Penalties towards violation of laws included in operating expenses amount to ₹ 63,000. These are not deductible for tax purposes.*

10. *Tax law allows to deduct expenses for petrol only up to ₹ 1,40,000 per vehicle per year. H Ltd. had 4 vehicles in 20X7-20X8 and its total petrol expenses amounted to ₹ 7,21,000.*

Note: This illustration is prepared for the purposes of understanding the computation of current tax and is in no way based on the provisions of the Income Tax Act, 1961. For the purposes of Financial Reporting, the tax treatments will be given in the question.

Solution:

Calculation of current tax expense

Accounting profit	(A)	59,50,000
Add back:		
Accounting depreciation		59,50,000
Amortization of product development costs (W.N.1)		3,50,000
Revaluation of trading investments		7,70,000
Bad debt provisions - 20X7-20X8		17,50,000
Inventory obsolescence provision		3,78,000
Product warranty costs provision - 20X7-20X8		1,75,000
Provision for health care benefit costs		24,50,000
Fines and Penalties disallowed for tax purposes		63,000
Petrol over limit (W.N.3)		1,61,000
Total	(B)	120,47,000

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Deduct:		
Tax depreciation		(72,10,000)
Tax allowance for bad debt provisions (W.N.2)		(11,90,000)
Product warranty costs provision - claims paid		(2,17,000)
Total	(C)	(86,17,000)
Taxable profit / loss:	(A+B-C)	93,80,000
Tax rate is 30%		
Current income tax (93,80,000 x 30%)		28,14,000

Journal Entry

Profit or loss - Current income tax expense	Dr.	28,14,000	
To Credit Current income tax liabilities			28,14,000

Working Notes:

1. Product development costs:

Annual amortization (₹ 35,00,000/ 10)	3,50,000

2. Bad debt provisions:

Debtor A - ₹ 28,00,000 from 20X5-20X6	
> 2 years - 30% deductible in 20X7-20X8	8,40,000
Debtor B - ₹ 17,50,000 from 20X6-20X7	
> 1 year - 20% deductible in 20X7-20X8	3,50,000
Total - tax deductible in 20X7-20X8	11,90,000

3. Petrol expenses

Actual expenses	7,21,000
Tax deductible (4 x 140,000)	5,60,000
Excess	1,61,000

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1.6 PART C: DEFERRED TAX, ITS RECOGNITION, MEASUREMENT AND PRESENTATION

The following steps should be followed in the recognition, measurement and presentation of deferred tax liabilities or assets:

Step 1: Compute carrying amounts of assets and liabilities

Step 2: Compute tax base

Step 3: Compute temporary differences

Step 4: Classify temporary differences into either:

- Taxable temporary difference
- Deductible temporary difference

Step 5: Identify exceptions

Step 6: Assess deductible temporary differences, tax losses and tax credits

Step 7: Determine the tax rate

Step 8: Calculate and recognise deferred tax

Step 9: Accounting of deferred tax

Step 10: Offsetting of deferred tax liabilities and deferred tax assets

These are now discussed in detail.

1.6.1 Step 1: Compute carrying amount

For the purpose of this Standard, we can define carrying amount at which an asset or liability is recognised in the balance sheet, after making necessary adjustments like depreciation, impairment, etc. In other words, carrying amount of the assets and liabilities means balance as per the ledger.

Example 3

Entity A had acquired an item of plant and machinery for ₹ 1,00,000 on 1st April, 20X1. It depreciated this item @ 10% per annum on SLM basis. For the year ended 31st March, 20X2, it provides depreciation of ₹ 10,000. The carrying amount of this item of plant and machinery as on 31st March, 20X2 is ₹ 90,000.

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1.6.2 Step 2: Compute tax base

(a) The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Example 4

Entity A had acquired an item of plant and machinery for ₹ 1,00,000 on 1st April, 20X1. It depreciated this item @ 10% per annum on SLM basis. For the year ended 31st March, 20X2, it provides depreciation of ₹ 10,000. The carrying amount of this item of plant and machinery as on 31st March, 20X2 is ₹ 90,000. As per taxation laws, this item of plant and machinery has to be depreciated @ 30% per annum on WDV basis. Thus, the entity, for the purposes of taxation, computes depreciation of ₹ 30,000. The tax base of this item of plant and machinery is ₹ 70,000 (₹ 1,00,000 – ₹ 30,000).

In the above scenario, if Entity A decides to revalue the item of plant and machinery and measures it at ₹ 1,50,000, the carrying value of the item of plant and machinery will be ₹ 1,50,000. For tax purposes, if the revaluation is ignored, the tax base remains ₹ 70,000 (Initial cost ₹ 1,00,000 – ₹ 30,000).

(b) Four scenarios could be anticipated for computation of the tax base of either an asset or a liability:

- Tax base of an asset.
- Tax base of a liability.
- Items with a tax base but no carrying amount.
- Items of assets and liabilities where tax base is not apparent.

Let us examine and compute tax base under each of the four scenarios:

(i) Tax base of an asset

The principle to compute tax base of an asset is as under:

- The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset.
- The carrying amount of the asset could be recovered either through sale of the asset or through its use or partly through use and partly through sale. The method of recovery has to be determined at each reporting date.

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Examples 5-9

5. Entity A has inventory with carrying amount of ₹ 1,00,000 as at the reporting date. It recovers the value of inventory through sale in a subsequent reporting period. The sale value is the economic benefit derived by the entity and is taxable. However, as per the matching and other concepts, against this sale the entity is entitled to deduct its cost. The cost is the carrying amount of the inventory i.e., ₹ 1,00,000. The tax base in this case is ₹ 1,00,000.

6. Entity A has acquired an item of asset for ₹ 1,00,000 for production of certain items to be sold by the entity. It is deductible equally over two years in the books of accounts. The carrying amount as the end of first reporting period is ₹ 50,000 (₹ 1,00,000 – ₹ 50,000). In the income tax, ₹ 75,000 is deductible in year 1 and balance is deductible in year 2. We have to compute its tax base as on the last day of the first reporting period. However, in income-tax, it can claim only ₹ 25,000 being 25% of the cost of the asset as 75% has already been claimed in year 1. Thus, the tax base in this case is ₹ 25,000.

7. Interest receivable has a carrying amount of 100. The related interest revenue will be taxed on a cash basis. The tax base of the interest receivable is nil.

8. An entity that follows mercantile system of accounting has trade receivables of ₹ 1,000. It creates a general bad debt allowance of ₹ 50. The carrying amount in the books of accounts of trade receivables is thus ₹ 950. However, in income-tax, general bad debt provision is not deductible. In the subsequent period, entity is able to recover only ₹ 950. The amount recovered is a taxable economic benefit. But for tax purposes, entity is entitled for a deduction of ₹ 1,000 against this recovery of trade receivable. The tax base in the current year is ₹ 1,000.

9. An entity that follows mercantile system of accounting has trade receivables of ₹ 1,000. It creates a specific bad debt of ₹ 50. The carrying amount in the books of accounts of trade receivables is thus ₹ 950. In the subsequent period, entity is able to recover only ₹ 950. Further, in income-tax, specific bad debt provision is deductible in the very year it is created. The amount recovered is a taxable economic benefit. For tax purposes, entity will be entitled for a deduction of ₹ 950 against this recovery of trade receivable. The tax base is ₹ 950.

- If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- It is quite feasible that in certain cases, the economic benefits that are derived from the recovery of an asset are not taxable. In these situations, the tax base of the asset is taken at its carrying amount.

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Examples 10 & 11

10. An entity has an investment in listed equity shares. There is no tax on gains that arise on sale of these listed equity shares. Thus, the tax base in this case will be the carrying amount of the investments.

11. An entity has given a loan of ₹ 10,000 which is the carrying amount. The repayment of loan has no tax consequences. The tax base is ₹ 10,000.

(ii) Tax base of a liability

The principle to compute tax base of a liability is as under:

- The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

Examples 12 & 13

12. Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense will be deducted for tax purposes on a cash basis.

    The tax base of the accrued expenses is nil.

13. Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense has already been deducted for tax purposes.

    The tax base of the accrued expenses is ₹ 100.

- If those liabilities are not tax deductible, the tax base of that liability is equal to its carrying amount.

Example 14

Current liabilities include accrued fines and penalties with a carrying amount of ₹ 100. Fines and penalties are not deductible for tax purposes.

The tax base of the accrued fines and penalties is ₹ 100.

- It is an other than temporary difference, as the expenses are not allowable as per income tax.

Example 15

A loan payable has a carrying amount of ₹ 100. The repayment of the loan will have no tax consequences.

The tax base of the loan is ₹ 100.

- In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

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Example 16

Current liabilities include interest revenue received in advance, with a carrying amount of ₹ 100. The related interest revenue was taxed on a cash basis.

The tax base of the interest received in advance is nil.

(iii) Items with a tax base but no carrying amount

- There are certain items that have a tax base but no carrying amount. These include items that are charged to revenue statement in the period in which they are incurred but are allowed as a deduction over a number of periods as per the taxation laws.

Examples 17 & 18

17. A Limited has been incorporated recently. It incurred ₹ 1,00,000 on its incorporation. It has been charged to revenue in the very first accounting period. The taxation laws allow deduction over a period of 5 years. The carrying amount at the end of year 1 is Nil.

    The tax base will be ₹ 80,000 (20,000 x 4) as ₹ 20,000 being 1/5th is allowable as a deduction in taxation laws over 4 years.

18. Public issue expenses. The entity may have written off the public issue expenses in the very first year. But since tax laws permit deduction over 5 years, the temporary differences will exist till complete deduction is claimed in taxation laws.

(iv) Items of assets and liabilities where tax base is not apparent

- There could be situations where it may be difficult to compute the tax base of an item. One however, knows the carrying amount. This is because of the provisions of taxation laws. Whereas in books of accounts, all or most of the revenue and gains are included as part of one single performance statement, in the taxation laws they are charged under different head.

- The taxable amount amongst other things depends under which head an item at the time of recovery may be charged. In India, income or gains are charged either as 'Salaries', 'Income from house property', 'Profits and gains of business', 'Capital Gain' & 'Income from other sources'. Further certain specific or weighted deductions are also permissible. For example, rental income is subject to a flat deduction. So how will you compute the rental income received in advance? Moreover, there are cases depending upon the substance of the transaction, the rental income is to be charged as business income. At times, reverse may be the case. Many more similar situations could be anticipated.

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Example 19

Entity A has an industrial undertaking that consists of land, building, plant and machinery. It is contemplating disposing the entity. It has the option to recover the carrying amount of the entity either by disposing the entire entity as a slump sale or dispose of each asset on a piecemeal basis. Depending upon the manner of recovery and period of holding, the carrying amount may be subject to indexation benefit, the recovery may be charged either as a business profit or capital gains. Again, it could be long-term gain capital gain or short-term capital gain. As at the end of the reporting period, the entity is not sure of the manner and time of recovery.

- So, how should one proceed with the determination of the tax base? It is a matter of judgment. The Standard states that one should refer the fundamental principle as enumerated in the Standard. The principle is reproduced hereunder:

  It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset)

- It is recommended, if material, the basis of judgment and related uncertainties should be disclosed.

(c) Tax base is determined with reference to the tax returns of each entity. This poses no problems when computing tax base of a stand-alone entity. In some jurisdiction, taxation laws, in the case of a group permits a consolidated tax return. In such cases, tax bases should be determined based on a consolidated tax return. If this is not so, then the basis should be individual tax returns. The carrying amount in both the cases shall be determined on the basis of consolidated financial statements.

Illustration 1B (in continuation to Illustration 1A):

Based on the balance sheet and notes of H Ltd. from previous example, calculate tax base of its assets and liabilities as of 31 March 20X8. Note that balance sheet has been adjusted by current tax expense and liability.

Balance Sheet as of 31 March 20X8

ASSETS	₹
Non-current assets	
Property, plant and equipment	*420,00,000*
Product development costs	*21,00,000*

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Investment in subsidiary – S Ltd.	*154,00,000*
Current assets	
Trading investments	*72,80,000*
Trade receivables	*219,10,000*
Inventories	*106,40,000*
Cash and cash equivalents	*63,00,000*
Total Assets	***10,56,30,000***
EQUITY & LIABILITIES	₹
Equity	
Share capital	*420,00,000*
Accumulated profits	*258,10,330*
Revaluation surplus	*30,80,000*
Long-term liabilities	
Deferred income - government grants	*14,00,000*
Liability for product warranty costs	*5,60,000*
Deferred tax liability (from 20X6-20X7)	*7,75,670*
Current liabilities	
Trade payables	*267,40,000*
Medical benefits for employees	*24,50,000*
Current Tax Liability	*28,14,000*
Total Equity & Liabilities	***10,56,30,000***

Remaining information are same as per Illustration 1A.

Solution:

Determination of Tax Base

Item	Carrying amount	Tax base
Property, plant and equipment	420,00,000	342,30,000
Product development costs	21,00,000	0
Investment in subsidiary	154,00,000	154,00,000
Trading investments	72,80,000	80,50,000
Trade receivables	219,10,000	247,10,000
Inventories	106,40,000	112,70,000

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Cash and cash equivalents	63,00,000	63,00,000
Deferred income - government grants	-14,00,000	0
Liability for product warranty costs	-5,60,000	0
Trade payables	-267,40,000	-267,40,000
Health care benefits for employees	-24,50,000	0

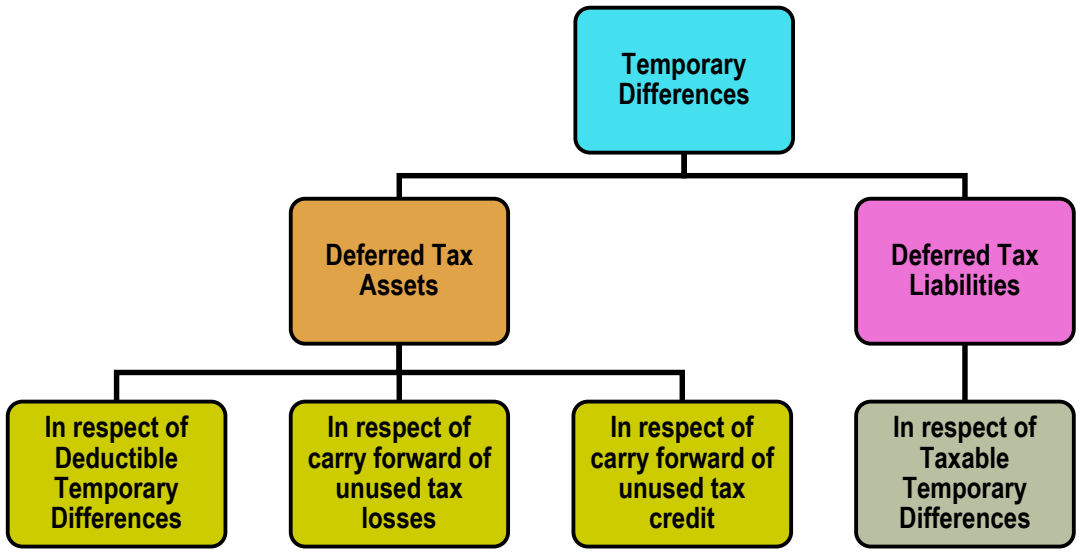
Working Notes:

1.	**Property, plant and equipment**		
	Cost	560,00,000	
	Less: current tax depreciation	(72,10,000)	
	Less: PY tax depreciation	(145,60,000)	
	Tax base	**3,42,30,000**	
2.	**Trade receivables - bad debt provisions:**		
I	**Calculation of cost**		
	Carrying amount	219,10,000	
	Add back: bad debt provision	45,50,000	
	Cost	**2,64,60,000**	**A**
II	**Debtor A - ₹ 28,00,000 from 20X5-20X6**		
	> 1 year - 20% deducted in 20X6-20X7	5,60,000	
	> 2 years - 30% deducted in 20X7-20X8	8,40,000	
	Already deducted for tax:	**14,00,000**	
III	**Debtor B - ₹ 17,50,000 from 20X6-20X7**		
	> 1 year - 20% deducted in 20X7-20X8	3,50,000	
	Total deducted for tax purposes	17,50,000	**B**
	Tax base of trade receivables:	**2,47,10,000**	**A-B**

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1.6.3 Step 3: Compute temporary differences



(a) The term temporary difference is defined as the difference between the carrying amount of an asset or liability in the balance sheet and its tax base.

Example 20

An entity has an item of plant and machinery acquired on the first day of the reporting period for ₹ 1,00,000. It depreciates it @ 20% p.a on SLM basis. The carrying amount in balance sheet is ₹ 80,000. The taxation laws require depreciation @ 30% on WDV basis. The tax base at the end of the reporting period is ₹ 70,000. The temporary difference is ₹ 10,000 (₹ 80,000 – ₹ 70,000).

(b) The contention in favour of temporary difference is that at the end of the day, all differences between the carrying amount and tax base of an asset or liability will reverse. At most the entity may be able to delay the timing of reversal but the difference will ultimately have reversed, therefore the term 'temporary difference' is used. The cumulative impact is 'zero'.

Example 21

An entity acquires an asset on the first day of reporting period for ₹ 120 with a useful life of 6 years and no residual value. It depreciates the asset on SLM basis. The tax rate is 30%. The tax depreciation is as assumed in the computation below.

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The following computations are performed.

Financial Statements

Year	1	2	3	4	5	6
Gross Block	120	120	120	120	120	120
Cumulative Depreciation	(20)	(40)	(60)	(80)	(100)	(120)
Carrying Amount	100	80	60	40	20	0

Tax Computation

Year	1	2	3	4	5	6
Tax base brought forward	120	30	20	13	8	3
Depreciation charge (assumed)	(90)	(10)	(7)	(5)	(5)	(3)
Tax base carried forward	30	20	13	8	3	0

Temporary Difference

Year	1	2	3	4	5	6
Carrying Amount	100	80	60	40	20	0
Tax base carried forward	(30)	(20)	(13)	(8)	(3)	0
Temporary difference	70	60	47	32	17	0
Cumulative impact	+70	–10	–13	–15	–15	–17
	+70	–70				

Movement in Balance Sheet

Year	1	2	3	4	5	6
Temporary difference	70	60	47	32	17	0
Deferred tax liability	21	18	14	10	5	0
Movement in provision	+21	-3	-4	-4	-5	-5
Cumulative	+21	-21				

(c) To some, it may appear that temporary differences and timing differences are one and the same term. It is not so. It can however, be said that temporary difference includes timing differences. Timing differences arise when income or expense is included in accounting profit in one period but is included in taxable profit in a different period.

(d) Examples of temporary differences in the nature of timing differences are as under.

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Example 22

- Interest income recognized in income statement on a time proportion basis but recognized in taxable profit on cash basis as and when income is received.
- Depreciation used in determining taxable income may differ from that used in determining accounting profit.
- Development costs may be capitalized and amortize over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred.

(e) Examples of temporary differences other than in the nature of timing differences are as under:

Example 23: Business combinations

The identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with Ind AS 103, *Business Combinations,* but no equivalent adjustment is made for tax purposes.

With limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently.

For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. However, it may be noted that the resulting deferred tax liability affects goodwill.

Example 24: *Revaluation: assets are revalued and no equivalent adjustment is made for tax purposes.*

Indian Accounting Standards permit or require certain assets to be carried at fair value or to be revalued (see, for example, Ind AS 16, *Property, Plant and Equipment*, Ind AS 38, *Intangible Assets*, Ind AS 109, *Financial Instruments* and Ind AS 116 *Leases*).

In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises.

In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted.

Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will

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differ from the amount of those economic benefits. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

This is true even if:

(a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or

(b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

1.6.4 Step 4: Classify temporary differences

(a) Temporary differences are to be classified into:

- Taxable temporary differences
- Deductible temporary differences

(b) Taxable temporary differences are those temporary differences that results in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

As the name 'taxable temporary difference' suggests, these are the temporary differences that will be taxed in future. These taxable temporary differences will increase tax liabilities. All taxable temporary differences, subject to limited exceptions, give rise to deferred tax liability.

Taxable temporary difference arises where the:

- carrying amount of an asset exceeds its tax base; or
- tax base of a liability exceeds its carrying amount.

Example 25

An asset which costs ₹ 150 has a carrying amount of ₹ 100. Cumulative depreciation for tax purposes is ₹ 90 and the tax rate is 25%.

The tax base of the asset is ₹ 60 (cost of ₹ 150 less cumulative tax depreciation of ₹ 90). To recover the carrying amount of ₹ 100, the entity must earn taxable income of ₹ 100 but will only be able to deduct tax depreciation of ₹ 60. Consequently, the entity will pay income taxes of ₹ 10 (₹ 40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of ₹ 100 and the tax base of ₹ 60 is a taxable temporary difference of ₹ 40.

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(c) Deductible temporary differences are those temporary differences that results in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Again, it should be noted, the name 'deductible temporary difference' suggests, these are the temporary differences that will be deducted in future when computing the tax liability. These deductible temporary differences will reduce tax liabilities. All deductible temporary differences, subject to exceptions/recognition criteria, give rise to deferred tax assets.

Deductible temporary difference arises where the:

- carrying amount of a liability exceeds its tax base; or
- tax base of an asset exceeds its carrying amount.

Example 26

An entity recognises a liability of ₹ 100 for gratuity and leave encashment expenses by creating a provision for gratuity and leave encashment. For tax purposes, any amount with regard to gratuity and leave encashment will not be deductible until the entity pays the same. The tax rate is 25%.

The tax base of the liability is nil (carrying amount of ₹ 100, less the amount that will be deductible for tax purposes in respect of that liability in future periods). In settling the liability for its carrying amount, the entity will reduce its future taxable profit by an amount of ₹ 100 and, consequently, reduce its future tax payments by ₹ 25 (₹ 100 at 25%). The difference between the carrying amount of ₹ 100 and the tax base of nil is a deductible temporary difference of ₹ 100.

(d) Based on the above discussions, a matrix as under may be drawn:

	For Assets	For Liabilities
If carrying amount > tax base	Taxable Temporary Difference ↓ Deferred Tax Liability (e.g. WDV as per books > WDV as per Income Tax)	Deductible Temporary Difference ↓ Deferred Tax Asset (e.g. Provision for Bonus as per books > Provision for Bonus as per IT)
If carrying amount < tax base	Deductible Temporary Difference ↓ Deferred Tax Asset (e.g. WDV as per books < WDV as per Income Tax)	Taxable Temporary Difference ↓ Deferred Tax Liability (e.g. Loan carrying amount as per books< Loan carrying amounts as per tax)
If carrying amount = tax base	No temporary difference	No temporary difference

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(e) Further examples of taxable temporary differences:

- **Transactions that affect profit or loss**

Example 27

1. Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.
2. Revenue from the sale of goods is included in accounting profit when goods are delivered but is included in taxable profit when cash is collected.

   In this case, there is also a deductible temporary difference associated with any related inventory.
3. Depreciation of an asset is accelerated for tax purposes.
4. Development costs have been capitalised and will be amortised to the statement of profit and loss but were deducted in determining taxable profit in the period in which they were incurred.
5. Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

- **Transactions that affect the balance sheet**

Example 28

1. Depreciation of an asset is not deductible for tax purposes and no deduction will be available for tax purposes when the asset is sold or scrapped.
2. A borrower records a loan at the proceeds received (which equal the amount due at maturity), less transaction costs. Subsequently, the carrying amount of the loan is increased by amortisation of the transaction costs to accounting profit using effective rate of interest. The transaction costs were deducted for tax purposes in the period when the loan was first recognised.
3. A loan payable was measured on initial recognition at the amount of the net proceeds, net of transaction costs. The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods.
4. The liability component of a compound financial instrument (for example a convertible bond) is measured at a discount to the amount repayable on maturity (see Ind AS 32, *Financial Instruments: Presentation*). The discount is not deductible in determining taxable profit (tax loss).

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- **Fair value adjustments and revaluation**

Example 29

1. Financial assets are carried at fair value which exceeds cost, but no equivalent adjustment is made for tax purposes.
2. An entity revalues property, plant and equipment (under the revaluation model treatment in Ind AS 16, *Property, Plant and Equipment*) but no equivalent adjustment is made for tax purposes.

- **Business combinations and consolidation**

Example 30

1. The carrying amount of an asset is increased to fair value in a business combination and no equivalent adjustment is made for tax purposes.
2. Reductions in the carrying amount of goodwill are not deductible in determining taxable profit and the cost of the goodwill would not be deductible on disposal of the business.
3. Unrealised losses resulting from intragroup transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.
4. Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent.
5. Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.
6. The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency.

- **Hyperinflation**

Example 31

Non-monetary assets are restated in terms of the measuring unit current at the end of the reporting period (see Ind AS 29, *Financial Reporting in Hyperinflationary Economies*) and no equivalent adjustment is made for tax purposes.

(f) Further examples of deductible temporary differences:

- **Transactions that affect profit or loss**

Example 32

1. Retirement benefit costs are deducted in determining accounting profit as service

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is provided by the employee, but are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. *(note: similar deductible temporary differences arise where other expenses, such as gratuity and leave encashment or interest, are deductible on a cash basis in determining taxable profit.)*

2. Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the end of the reporting period for tax purposes.

3. The cost of inventories sold before the end of the reporting period is deducted in determining accounting profit when goods or services are delivered but is deducted in determining taxable profit when cash is collected. *(it may be noted, there is also a taxable temporary difference associated with the related trade receivable.)*

4. The net realisable value of an item of inventory, or the recoverable amount of an item of property, plant or equipment, is less than the previous carrying amount and an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.

5. Preliminary expenses (or organisation or other start-up costs) are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.

6. Income is deferred in the balance sheet but has already been included in taxable profit in current or prior periods.

7. A government grant which is included in the balance sheet as deferred income will not be taxable in future periods.

- **Fair value adjustments and revaluation**

Example 33

Financial assets are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

- **Business combinations and consolidation**

Example 34

1. A liability is recognised at its fair value in a business combination, but none of the related expense is deducted in determining taxable profit until a later period.

2. Unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

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3. Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.
4. The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency.

❖ Deferred tax liabilities are created for all taxable temporary differences with limited exceptions. Similarly, deferred tax assets are created for all deductible temporary differences subject to limited exceptions and recognition criteria. In Step 5 we will discuss the exceptions with respect to creation to deferred tax and in Step 6 we will discuss the recognition criteria area for deferred tax assets. However, before we proceed further, let's discuss the principle in recognising deferred tax liabilities or deferred tax asset.

❖ These are:

(a) Deferred tax liability

- A deferred tax liability shall be recognized for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
  - (a) the initial recognition of goodwill; or
  - (b) the initial recognition of an asset or liability in a transaction which:
    - (i) is not a business combination; and
    - (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)
- However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised in accordance with paragraph 39 of Ind AS 12.

(b) Deferred tax asset

- A deferred tax asset shall be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:
  - (a) is not a business combination; and
  - (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

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- However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognised in accordance with paragraph 44 of Ind AS 12.

❖ From a reading of the aforesaid principles, deferred tax liabilities and deferred tax assets needs to be recognised in most of the cases. But the recognition of deferred tax liabilities or deferred tax assets are subject to exceptions with respect to the following items:

(a) the initial recognition of goodwill arising in a business combination (exception 1);

(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination; and

(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss) (exception 2);

(c) temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures (exception 3).

These exceptions are discussed in Step 5.

❖ Also deferred tax assets should be created only to the extent of the probability of availability of taxable profits. In case, this probability of availability of taxable profits is missing, deferred tax assets should not be created. The profit probability recognition criterion is discussed in Step 6.

Illustration 1C (in continuation to Illustration 1A):

Based on the data from above illustration 1A of H Ltd., calculate temporary differences and deferred tax. Note from Illustration 1A: Tax rate for 20X7-20X8 is 30%, but the new tax rate of 32% for the year 20X8-20X9 and beyond has already been enacted before the year end.

Solution:

Calculation of Temporary Differences / Deferred Tax

Item	Carrying amount	Tax base	Temporary difference	Taxable / deductible	DTA / DTL at 32%
Property, plant and equipment	4,20,00,000	3,42,30,000	77,70,000	taxable	(24,86,400)
Product development costs	21,00,000	0	21,00,000	taxable	(6,72,000)
Investment in subsidiary S Ltd.	1,54,00,000	1,54,00,000	0		0
Trading investments	72,80,000	80,50,000	(7,70,000)	deductible	2,46,400

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Trade receivables	2,19,10,000	2,47,10,000	(28,00,000)	deductible	8,96,000
Inventories	1,06,40,000	1,12,70,000	(6,30,000)	deductible	2,01,600
Cash and cash equivalents	63,00,000	63,00,000	0		0
Deferred income - government grants	(14,00,000)	0	(14,00,000)	**excluded**	0
Liability for product warranty costs	(5,60,000)	0	(5,60,000)	deductible	1,79,200
Trade payables	(2,67,40,000)	(2,67,40,000)	0		0
Medical benefits for employees	(24,50,000)	0	(24,50,000)	deductible	7,84,000
Deferred tax asset - total					***23,07,200***
Deferred tax liability - total					***(31,58,400)***
Deferred tax total					**(8,51,200)**

*****

1.6.5 Step 5: Identify exceptions

(a) Exception 1: The initial recognition of goodwill in the case of a business combination

- In the case of a business combination, when the consideration paid exceeds the net identifiable assets, goodwill is created.
- Technically speaking, goodwill arising in a business combination is measured as the excess of (a) over (b) below:

  (a) the aggregate of:

  (i) the consideration transferred measured in accordance with Ind AS 103, which generally requires acquisition date fair value;

  (ii) the amount of any non-controlling interest in the acquiree recognized in accordance with Ind AS 103; and

  (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

  (b) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured in accordance with Ind AS 103.
- As per principles enunciated in this Ind AS 12, the entity has to determine the tax base of this goodwill to compute the temporary difference, either taxable or deductible, at the time of recognition and subsequently when impairment takes place. The Standard provides separate guidance for taxable temporary difference (Situation A) and deductible temporary difference (Situation B).
- **Situation A:** Where the temporary difference is in the nature of taxable temporary difference. Again, in this case, the prescribed treatment is different where good will is

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not tax deductible (Situation A1) and where it is tax deductible (Situation A2).

- **(Situation A1: Where it is not tax deductible)**

(a) At the time of initial recognition of goodwill:

(i) Quite a few tax jurisdictions do not permit this goodwill as a tax deductible expense. Also, the cost of goodwill is often not deductible when a subsidiary dispose of its underlying business. Put simply, the tax base of goodwill is Nil. But the entity has a taxable temporary difference as the goodwill (an asset) has a carrying amount leading to a deferred tax liability.

(ii) The Standard does not permit the recognition of the resulting deferred tax liability as goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill, resulting into a circular type of computation.

Deferred tax liability is not recognised for goodwill since the recognition shall be done through goodwill itself. This is going to result in inflating the goodwill amount, and therefore is not permitted.

Example 35

An entity acquires a subsidiary and pays ₹ 1,00,000. The fair value of net identifiable assets is ₹ 65,000. The following entry shall be made in the books:

Entry 1:

Goodwill	Dr.	35,000	
Net Assets	Dr.	65,000	
To Consideration			1,00,000

The tax base of goodwill is Nil. Hence the taxable temporary difference is ₹ 35,000. Assuming tax rate to be 30%, deferred tax liability of ₹ 10,500 needs to be created. Now because of recognition of this deferred tax liability, the following entry needs to be passed instead of the above entry:

Entry 2:

Goodwill	Dr.	45,500	
Net assets	Dr.	65,000	
To Consideration			1,00,000
To Deferred tax liability			10,500

The temporary difference now is ₹ 45,500 and not ₹ 35,000 and the resultant

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deferred tax liability should be ₹ 13,650 (45,500 x 30%) and not ₹ 10,500. Thus, deferred tax liability in entry 2 should be increased by ₹ 3,150 which in turn will increase goodwill by a similar amount. This is going to inflate the goodwill since the impact is taken in goodwill itself.

Therefore, no deferred tax liability is to be recognised in the case of taxable temporary difference arising on the initial recognition of goodwill in a business combination in tax jurisdiction where such goodwill is not tax deductible.

(b) Subsequently at the time of impairment, if required, in the carrying amount:

(i) This goodwill as per Ind AS 103 is not amortised though tested for impairment.

(ii) Subsequent reduction in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill is also regarded as arising from the initial recognition of goodwill and is therefore not recognised.

Example 36

In the aforesaid Example 35, after 2 years goodwill is tested for impairment and the entity recognises an impairment loss of ₹ 10,000, the amount of the taxable temporary difference relating to the goodwill is reduced from ₹ 35,000 to ₹ 25,000, with a resulting decrease in the value of the unrecognised deferred tax liability. That decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill and is therefore prohibited from being recognised as per this Ind AS 12.

- **Situation A2: Where it is tax deductible**

  In tax jurisdiction, where goodwill is tax deductible, deferred tax liability should be recognised for the taxable temporary difference.

- **Situation B: where the difference is in the nature of deductible difference**

  In all cases, deferred tax asset, subject to recognition criteria discussed in step 6 below, should be recognised.

- **Summary of Exception 1**

  No deferred tax liability is to be recognised for taxable temporary difference arising on goodwill arising in a business combination in tax jurisdictions where such goodwill is not tax deductible.

  In all other cases of temporary difference, either taxable or deferred, either deferred tax liability or deferred tax asset should be recognised in accordance with other provisions of this Ind AS.

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(b) Exception 2: The initial recognition of an asset or liability in a transaction which: (i) is not a business combination; and (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)

- The Standard prohibits recognition of deferred tax liability or deferred tax assets in cases of either taxable or deductible temporary difference arising in a transaction:

  (a) is not a business combination; and

  (b) does not affect neither the accounting profit nor the taxable profit.

- As per the Standard, three types of transactions of assets or liabilities could be anticipated:

  Type 1: In the nature of business combination

  In such a case, recognise deferred tax liabilities or deferred tax assets on temporary differences between the carrying amount and respective tax base of assets or liabilities except on goodwill (in certain circumstances)

  Type 2: Where the transaction impacts accounting profit (i.e. statement of profit or loss) (like sale of goods, recognition of debtors)

  In such a case, recognise any deferred tax in statement of profit or loss:

  Type 3: Where the transaction is not a business combination & does not impact accounting profit nor taxable profit, such as purchase of assets or receipt of government grants.

  This exception relates to the transaction of the third type.

Example 37

Entity A acquires a foreign made vehicle for ₹ 1,00,000 directly from the vehicle manufacturer. The transaction is not a part of any business combination. The tax laws do not permit any depreciation thereon. Also, any profits at the time of sale are not taxable or losses are not tax deductible. This vehicle thus has a tax base of Nil. There is a taxable temporary difference of ₹ 1,00,000. Assuming a tax rate of 30%, the entity should create a deferred tax liability of ₹ 30,000. But the Standard does not permit.

- The Standard implies that if the carrying amount of any asset or liability is not equal to its tax base at the time of its transaction where the transaction is:

  (i) Not in the nature of business combination.

  (ii) Not impacting either the accounting profit or the taxable profit.

  (iii) Neither deferred tax liability nor deferred tax asset should be recognised.

- The following is a brief checklist:

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(i) Is the transaction in the nature of business combination?

(ii) Whether the transaction impacts accounting profit?

(iii) Whether the transaction impacts taxable profits?

(iv) Whether the carrying amount is equal to tax base?

- Depending on the answers to the checklist, deferred tax asset or liability needs to be determined in accordance with the guidance under this exception.
- Furthermore, an entity does not recognise subsequent changes in unrecognised deferred tax liability or asset as the asset is depreciated.

Example 38

Entity X acquired an intangible asset (a license) for ₹ 10 Cr that has a life of five years. The asset will be solely recovered through use. No tax deductions can be claimed, as the license is amortised or as when the license expires. No tax deductions are available on disposal. Trading profits from using the license will be taxed at 30%.

The tax base of the asset is nil, because the cost of the intangible asset is not deductible for tax purposes (either in use or on disposal). A temporary difference of ₹ 10 Cr arises; prima facie a deferred tax liability of ₹ 3 Cr should be recognized on this amount. However, no deferred tax is recognised on the asset's initial recognition. This is because the temporary difference did not arise from a business combination and did not affect accounting or taxable profit at the time of the recognition.

The asset will have a carrying amount of ₹ 8 Cr at the end of year 1. The entity will pay tax of ₹ 2.40 Cr through recovery of the asset by earning taxable amounts of ₹ 8 Cr. The deferred tax liability is not recognised, because it arises from initial recognition of an asset. Similarly, no deferred tax is recognised in later periods.

(c) Exception 3: Temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures

- Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest.
- Such differences may arise in a number of different circumstances, for example:

(i) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;

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(ii) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and

(iii) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

- Should an entity recognise a deferred tax liability in these cases? The guiding principle is:

An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

(i) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and

(ii) it is probable that the temporary difference will not reverse in the foreseeable future.

Now let us examine where the parent, investor or venture is able to control the timing of reversal of taxable temporary difference. Generally, the taxable temporary difference will get reversed on distribution of dividends.

- ***Subsidiary/branches*:** As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with that investment (including the temporary differences arising not only from undistributed profits but also from any foreign exchange translation differences). Furthermore, it would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability. The same considerations apply to investments in branches.

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Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

Annual Report of Bharti Airtel Ltd. for the year ending 31 March 2022 (Page 358)

> The Group has not recognised deferred tax liability with respect to unremitted retained earnings and associated foreign currency translation reserve with respect to certain of its subsidiaries and joint ventures where the Group is in a position to control the timing of the distribution of profits and it is probable that the subsidiaries will not distribute the profits in the foreseeable future. The taxable temporary difference associated with respect to unremitted retained earnings and associated foreign currency translation reserve is ₹98,427 and ₹79,800 as of March 31, 2022 and March 31, 2021, respectively. The distribution of the same is expected to attract tax in the range of NIL to 20% depending on the tax rates applicable as of March 31, 2022 in the jurisdiction in which the respective Group entity operates.

***(Source:** Annual report for 2021-2022 of Bharti Airtel Ltd.)*

The non-monetary assets and liabilities of an entity are measured in its functional currency (see Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*) in the exchange rate which give rise to temporary differences that result in a recognised deferred tax liability or (subject to recognition criteria) asset. The resulting deferred tax is charged or credited to profit or loss.

- ***Associate*:** An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.
- ***Joint Venture*:** The arrangement between the parties to a joint venture usually deals with the sharing of the profits and identifies whether decisions on such matters require the consent of all the venturers or a specified majority of the venturers. When the venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred tax liability is not recognised.

The aforesaid discussion related to recognition of deferred tax liability on taxable temporary difference. But there could be deductible temporary differences. So what is the guiding principle for recognition of deferred tax assets on deductible temporary differences?

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- The principle is:

  An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that:

  (i) the temporary difference will reverse in the foreseeable future; and

  (ii) taxable profit will be available against which the temporary difference can be utilised.

  Both the conditions have to be satisfied.

- In deciding whether a deferred tax asset is recognised for deductible temporary differences associated with its investments in subsidiaries, branches and associates, and its interests in joint ventures, an entity considers the guidance set out in Step 6 below.

1.6.6 Step 6: Assess (also reassess) deductible temporary differences, tax losses and tax credits

(a) As we are aware that deductible temporary differences reduce the taxable profits of future periods. It signifies that future tax payments will be smaller by a particular amount. However, economic benefits will flow to the entity in the form of lower tax liability in future only in case it has future profits. If there are no future profits, it means there are no tax payments which in turn mean that deductible temporary differences are of no benefit.

Illustration 2

The directors of H Ltd. wish to recognise a material deferred tax asset in relation to ₹ 250 Cr of unused trading losses which have accumulated as at 31st March 20X1. H Ltd. has budgeted profits for ₹ 80 Cr for the year ended 31st March 20X2. The directors have forecast that profits will grow by 20% each year thereafter.

However, the market is currently depressed and sales orders are at a lower level for the first quarter of 20X2 than they were for the same period in any of the previous five years. On extrapolating the sales order book, it is noted that the improvement in trading results may occur after the next couple of years to come at the position of breakeven and the budgeted profits shared by the directors of H Ltd. do not appear to be in line with the sales order book. H Ltd. operates under a tax jurisdiction which allows for trading losses to be only carried forward for a maximum of two years.

Analyse whether a deferred tax asset can be recognized in the financial statements of H Ltd. for the year ended 31st March 20X1?

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Solution

In relation to unused trading losses, the carrying amount is zero since the losses have not yet been recognised in the financial statements of H Ltd. A potential deferred tax asset does arise but the determination of the tax base is more problematic.

The tax base of an asset is the amount which will be deductible against taxable economic benefits from recovering the carrying amount of the asset. Where recovery of an asset will have no tax consequences, the tax base is equal to the carrying amount. H Ltd. operates under a tax jurisdiction which only allows losses to be carried forward for two years. The maximum the tax base could be is therefore equal to the amount of unused losses for years 20X0 and 20X1 since these only are available to be deducted from future profits. The tax base though needs to be restricted to the extent that there is a probability of sufficient future profits to offset the trading losses. The directors of H Ltd. should base their forecast of the future profitability on reasonable and supportable assumptions. There appears to be evidence that this is not the case.

H Ltd. has accumulated trading losses and there is little evidence that there will be an improvement in trading results within the next couple of years. The market is depressed and sales orders for the first quarter of 20X2 are below levels in any of the previous five years.

The forecast profitability for 20X2 and subsequent growth rate therefore appear to be unrealistically optimistic.

Given that losses can only be carried forward for a maximum of two years, it is unlikely that any deferred tax asset should be recognised.

Hence, the contention of directors to recognized deferred tax assets in relation to ₹ 250 crores is not correct.

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Example 39

Entity A has deductible temporary difference of ₹ 1,00,000 for the financial year ended 31st March, 20X1. It anticipates a future profit of ₹ 3,00,000 in next year against which the said deductible temporary differences could be set off. The tax rate is 30%. Thus, in future the entity will pay tax on ₹ 2,00,000 (₹ 3,00,000 – ₹ 1,00,000). The tax liability is ₹ 60,000 @ 30% tax rate.

Had there been no deductible temporary difference, the tax liability would be ₹ 90,000 @ 30% on ₹ 3,00,000. Thus, there is an inflow of economic benefit of ₹ 30,000 through a lower cash outflow.

However, if there is no probability of taxable profits in future, the entity is not able to derive any economic benefit (by way of lower cash outflow in future) because of the existing of deductible temporary difference.

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(b) Therefore, an entity should recognise deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised. This is based on the principle of prudence and conservatism. It should be noted that the entity has to make sufficient taxable profits in future. Not making losses will not suffice.

(c) If tax law does not impose any restrictions on sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference, an entity assesses a deductible temporary difference in combination with all of its other deductible temporary differences.

(d) If tax law restricts the utilisation of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences.

(e) Probable means more likely than not. The Standard provides a three step criteria to be applied in a serial order. The criterion is applied in the case of the same taxable entity assessed by the same taxation authority.

Criteria No. 1 : Existence of taxable temporary differences

The entity at the balance sheet should see whether there are sufficient taxable temporary differences whose reversal pattern matches with the reversal profile of deductible temporary differences.

Particulars	Year		
	1	2	3
Taxable temporary difference			
Opening balance	10,000	5,000	2,000
Recognised in taxable income	5,000	3,000	2,000
Closing balance	5,000	2,000	-
Deductible temporary difference			
Opening balance	8,000	4,000	1,000
Recognised in taxable income	4,000	3,000	1,000
Closing balance	4,000	1,000	-
Statement of taxable income			
Taxable temporary difference	5,000	3,000	2,000
Deductible temporary difference	4,000	3,000	1,000

The entity can recognise deferred tax assets for the entire deductible temporary differences.

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Example 40

As at 31st March, 20X1, an entity has both taxable temporary differences and deductible temporary difference with the following reversal pattern. Deductible temporary differences cannot be carried forward.

Particulars	Year		
	1	2	3
Taxable temporary difference			
Opening balance	10,000	5,000	2,000
Recognized in taxable income	5,000	3,000	2,000
Closing balance	5,000	2,000	-
Deductible temporary difference			
Opening balance	8,000	4,000	-
Recognized in taxable income	4,000	4,000	-
Closing balance	4,000	-	-
Statement of taxable income			
Taxable temporary difference	5,000	3,000	2,000
Deductible temporary difference	4,000	4,000	-

The entity can recognize deferred tax assets for the deductible temporary differences up to ₹ 7,000 (₹ 4,000 for year 1 & ₹ 3,000 for year 2) as a taxable temporary difference of that amount is available.

Criteria No. 2: Probability of future profits

The entity has to apply probability criteria on its future profitability. If it is probable that there will be sufficient taxable profits, then to the extent of available profits, deductible temporary differences should be applied for recognition of deferred tax assets.

Examples 41- 43

41. If in the aforesaid example 40, the entity expects a profit of ₹ 750 in year 2, then deferred tax asset should be created on ₹ 7,750 (₹ 4,000 + ₹ 3,000 + ₹ 750).

    However, taxable profits arising in future from future origination of deductible temporary differences should not be considered as deductible temporary differences will require future taxable profits for utilisation.

42. An entity has unutilised deductible temporary difference of ₹ 1,000 at the end of year 1 that is going to be reversed in the year 2. In year 2, taxable profits are computed because of tax disallowances of unpaid statutory liabilities of ₹ 1,000 which can be claimed as deduction only in year 3, if paid, but cannot be carried forward. The entity expects nil taxable profit in year 3. In this case, no deferred tax asset will be created.

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43. An entity has unutilised deductible temporary difference of ₹ 1,000 at the end of year 1 that is going to be reversed in the year 2. In year 2, taxable profits are computed because of tax disallowances of unpaid statutory liabilities of ₹ 1,000 which can be claimed as deduction only in year 3, if paid, but cannot be carried forward. The entity expects taxable profit of ₹ 450 in year 3. In this case, deferred tax asset will be created at appropriate rate on deductible temporary difference of ₹ 450 only.

Criteria No. 3: Availability of tax planning opportunities

If even after applying criteria no. 2, still there are unrecognised deductible temporary differences, the entity endeavour to see whether any tax planning opportunities are available.

Tax planning opportunities are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carry forward.

For example, in some jurisdictions, taxable profit may be created or increased by:

(i) electing to have interest income taxed on either a received or receivable basis;

(ii) deferring the claim for certain deductions from taxable profit;

(iii) selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation; and

(iv) selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or tax credit carry forward still depends on the existence of future taxable profit from sources other than future originating temporary differences.

(d) Unused tax losses and unused tax credits:

- A deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.
- The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused

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tax credits can be utilised by the entity. In such circumstances, paragraph 82 of Ind AS 12 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

(e) When an entity has a history of recent losses, the entity should consider the following guidance:

- The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences.
- However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.
- In such circumstances, this Ind AS requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.
- To assess the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the entity should consider the following:

  (i) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;

  (ii) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

  (iii) whether the unused tax losses result from identifiable causes which are unlikely to recur; and

  (iv) whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.
- To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not to be recognised.

(f) Reassessment of unrecognised Deferred Tax Assets:

- At the end of each reporting period, the entity should reassess unrecognised deferred tax assets. It may need to recognise a previously unrecognised deferred tax asset to

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the extent it has now become probable that future taxable profits will be available for deferred tax assets to be recovered. For example, improvement in trading conditions may make it probable for an entity to generate sufficient taxable profits in future years to enable it to meet the recognition criteria laid down above.

(g) Uncertainty over income tax treatment

- In assessing whether and how an uncertain tax treatment affects the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates, an entity shall assume that a taxation authority will examine amounts it has a right to examine and have full knowledge of all related information when making those examinations.
- If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.
- If an entity concludes it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates. An entity shall reflect the effect of uncertainty for each uncertain tax treatment by using either of the following methods, depending on which method the entity expects to better predict the resolution of the uncertainty:

  (a) The most likely amount—the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value.

  (b) The expected value—the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

- If an uncertain tax treatment affects current tax and deferred tax (for example, if it affects both taxable profit used to determine current tax and tax bases used to determine deferred tax), an entity shall make consistent judgements and estimates for both current tax and deferred tax.

Comparison to AS 22:

Para 15: *Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.*

Para 16: *While recognising the tax effect of timing differences, consideration of prudence cannot*

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be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future.

***Para 17:** Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.*

Ind AS 12 and AS 22 both require exercise of prudence while recognizing deferred tax assets. However, AS 22 emphasizes on virtual certainty supported by convincing evidence for recognizing deferred tax asset, whereas Ind AS 12 requires only probable existence of taxable profit against which deductible temporary differences can be utilized. Thus, the requirement of recognizing deferred tax asset under AS 22 is very strict (virtual certainty moves towards more than 95% certainty through evidence such as a strong order book for the future, firm orders in hand etc.), whereas under Ind AS 12, the same is more realistic focusing only on probable existence of taxable profits. Ind AS 12 moves to exercise caution only in case of unused tax losses, where it specifies that deferred tax asset arising from unused tax losses or tax credits can be recognized only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.

1.6.7 Step 7: Determine the tax rate (law)

(a) Having determined the taxable temporary differences and deductible temporary difference that needs to be considered for recognition of deferred tax liabilities or assets respectively, we now need to determine the tax for creation to deferred tax liabilities or assets. The principal is:

Deferred tax assets and liabilities shall be measured:

(i) at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled;

(ii) based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

(b) We have already discussed above the meaning of 'enacted' or 'substantively enacted'.

The same discussion applies here also. But another key word that needs to be understood in the principle is 'expected to apply'. Since, we are dealing in the future and future is uncertain, we have to measure this uncertainty. This leads to application of judgment. The tax rates or the tax laws that will apply in future depends on various factors such as manner

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of recovery of asset or settlement of liability, levels of income, distribution of profits among others. These are now discussed below.

It should however be remembered that the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

(c) Manner of recovery of asset or settlement of liability:

- In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and (b) the tax base of the asset (liability). In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

Examples 44 & 45

44. An asset has a carrying amount of ₹ 100 and a tax base of ₹ 60. A tax rate of 20% would apply if the asset was sold and a tax rate of 30% would apply to other income.

The entity recognises a deferred tax liability of ₹ 8 (₹ 40 at 20%) if it expects to sell the asset without further use or a deferred tax liability of ₹ 12 (₹ 40 at 30%) if it expects to retain the asset and recover its carrying amount through use.

45. An asset with a cost of ₹ 100 and a carrying amount of ₹ 80 is revalued to ₹ 150. No equivalent adjustment is made for tax purposes. Accumulated depreciation for tax purposes is ₹ 30 and the tax rate is 30%. If the asset's sale proceeds exceeds the cost (₹ 100), a gain of only ₹ 30 (being the cumulative tax depreciation of ₹ 30 claimed) will be included in taxable income but sale proceeds in excess of cost (₹ 100) will not be taxable.

The tax base of the asset is ₹ 70 and there is a taxable temporary difference of ₹ 80 (₹ 150 the revalued amount is the carrying amount).

If the entity expects to recover the carrying amount by using the asset, it must generate taxable income of ₹ 150, but will only be able to deduct depreciation of ₹ 70. On this basis, there is a deferred tax liability of ₹ 24 (₹ 80 at 30%).

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of ₹ 150, the deferred tax liability is computed as follows:

(i)	Sale proceeds	₹	150
(ii)	Sale proceeds in excess of cost (₹ 100)	₹	50

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(iii)	Taxable proceeds	₹ 100
(iv)	Tax base	₹ 70
(v)	Taxable temporary difference	₹ 30
(vi)	Tax rate	30%
(vii)	Deferred tax liability	₹ 9

- Thus, the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.
- However, an issue may arise as to how to interpret the term 'recovery' in relation to an asset that is not depreciated (non-depreciable asset) and is revalued in accordance with paragraph 31 (revaluation model) of Ind AS 16.
- **The accounting principle in this case is as under:**
  - ♦ The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset in accordance with paragraph 31 of Ind AS 16 shall be measured on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset.
  - ♦ Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate (tax rate applicable to the taxable amount derived from the sale of an asset) is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

(d) Levels of taxable income:

When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse.

(e) Distribution of dividends:

In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. *In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits*.

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Example 46

The following example deals with the measurement of current and deferred tax assets and liabilities for an entity in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50%) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35%. At the end of the reporting period, 31st December, 20X1, the entity does not recognise a liability for dividends proposed or declared after the reporting period. As a result, no dividends are recognised in the year 20X1. Taxable income for 20X1 is ₹ 1,00,000. The net taxable temporary difference for the year 20X1 is ₹ 40,000.

The entity recognises a current tax liability and a current income tax expense of ₹ 50,000. No asset is recognised for the amount potentially recoverable as a result of future dividends. The entity also recognises a deferred tax liability and deferred tax expense of ₹ 20,000 (₹ 40,000 at 50%) representing the income taxes that the entity will pay when it recovers or settles the carrying amounts of its assets and liabilities based on the tax rate applicable to undistributed profits.

Subsequently, on 15th March, 20X2 the entity recognises dividends of ₹ 10,000 from previous operating profits as a liability.

On 15th March, 20X2, the entity recognises the recovery of income taxes of ₹ 1,500 (15% of the dividends recognised as a liability) as a current tax asset and as a reduction of current income tax expense for 20X2.

1.6.8 Step 8: Calculate and recognise deferred tax

(a) This is the simplest of all steps. Having determined the taxable temporary differences and the deductible temporary differences as per Step 6 and the applicable tax rates with reference to tax laws, one has to multiply amount determined in Step 6 with the rates determined in Step 7.

- Taxable temporary differences when multiplied with tax rates will lead to deferred tax liabilities.
- Deductible temporary differences when multiplied with rates will lead to deferred tax assets.

(b) The following should be kept in mind:

- Deferred tax liabilities or assets should not be discounted.
- The carrying amount of a deferred tax asset shall be reviewed at the end of each reporting period.
- An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit

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of part or all of that deferred tax asset to be utilised.

- Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.

1.6.9 Step 9: Accounting of deferred tax

(a) The accounting of deferred tax effects of a transaction of an event is consistent with the accounting for that transaction or event.

(b) A transaction and the deferred tax effects of a transaction may be accounted for in:

- Statement of profit and loss;
- Outside profit and loss account:
  - (i) In other comprehensive income such as revaluation amount in accordance with Ind AS 16, *Property, Plant and Equipment*
  - (ii) Directly in equity such as correction of an error in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

(c) However, the carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences.

- This can result, for example, from:
  - — a change in tax rates or tax laws;
  - — a reassessment of the recoverability of deferred tax assets; or
  - — a change in the expected manner of recovery of an asset.
- In such cases, the resulting deferred tax is recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss.

(d) In exceptional circumstances, it may be difficult to determine the amount of current and deferred tax that relates to items recognised outside profit or loss (either in other comprehensive income or directly in equity).

- This may be the case, for example, when a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss; or
- In such cases, the current and deferred tax related to items that are recognised outside profit or loss are based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.

(e) Ind AS 16 does not specify whether an entity should transfer each year from revaluation surplus to retained earnings an amount equal to the difference between the depreciation or

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amortisation on a revalued asset and the depreciation or amortisation based on the cost of that asset.

- If an entity makes such a transfer, the amount transferred is net of any related deferred tax.
- Similar considerations apply to transfers made on disposal of an item of property, plant or equipment.

(f) When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment of the tax base are recognised in other comprehensive income in the periods in which they occur.

(g) When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends to taxation authorities on behalf of shareholders. In many jurisdictions this amount is referred to as a withholding tax. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends.

1.6.10 Step 10: Offsetting deferred tax assets and deferred tax liabilities

(a) An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:

  (i) the same taxable entity; or

  (ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

(b) To avoid the need for detailed scheduling of the timing of the reversal of each temporary difference, this Standard requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.

(c) In rare circumstances, an entity may have a legally enforceable right of set off, and an intention to settle net, for some periods but not for others. In such rare circumstances, detailed scheduling may be required to establish reliably whether the deferred tax liability of one taxable entity will result in increased tax payments in the same period in which a deferred

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tax asset of another taxable entity will result in decreased payments by that second taxable entity.

Illustration 3

On 1st April 20X1, S Ltd. leased a machine over a 5 year period. The present value of lease liability is ₹ 120 Cr (discount rate of 8%) and is recognized as lease liability and corresponding Right of Use (RoU) Asset on the same date. The RoU Asset is depreciated under straight line method over the 5 years. The annual lease rentals are ₹ 30 Cr payable starting 31st March 20X2. The tax law permits tax deduction on the basis of payment of rent.

Assuming tax rate of 30%, you are required to explain the deferred tax consequences for the above transaction for the year ended 31st March 20X2.

Solution

A temporary difference effectively arises between the value of the machine for accounting purposes and the amount of lease liability, since the rent payment is eligible for tax deduction.

Tax base of the machine is nil as the amount is not eligible for deduction for tax purposes.

Tax base of the lease liability is nil as it is measured at carrying amount less any future tax deductible amount

Recognition of deferred tax on 31st March 20X2:

Carrying amount in balance sheet	
RoU Asset (120 Cr – 24 Cr (Depreciation))	₹ 96.00 Dr
Lease Liability (120 Cr + 9.60 Cr (120 Cr x 8%) - 30 Cr)	₹ 99.60 Cr
Net Amount	**₹ 3.60 Cr**
Tax Base	₹ 0.00 Cr
Temporary Difference (deductible)	₹ 3.60 Cr
Deferred Tax asset to be recognized (₹ 3.60 Cr x 30%)	₹ 1.08 Cr

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1.7 PART D: PRACTICAL APPLICATION

1.7.1 Deferred tax arising from a business combination

(a) As discussed above, temporary differences may arise in a business combination. In accordance with Ind AS 103, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and deferred

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tax liabilities affect the amount of goodwill or the bargain purchase gain the entity recognises. However, in accordance with this Ind AS, in certain circumstances, an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.

Illustration 4

On 1st April 20X1, A Ltd. acquired 12 Cr shares (representing 80% stake) in B Ltd. by means of a cash payment of ₹ 25 Cr. It is the group policy to value the non-controlling interest in subsidiaries at the date of acquisition at fair value. The market value of an equity share in B Ltd. at 1st April 20X1 can be used for this purpose. On 1st April 20X1, the market value of a B Ltd. share was ₹ 2.00

On 1st April 20X1, the individual financial statements of B Ltd. showed the net assets at ₹ 23 Cr.

The directors of A Ltd. carried out a fair value exercise to measure the identifiable assets and liabilities of B Ltd. at 1st April 20X1. The following matters emerged:

- *Property having a carrying value of ₹ 15 Cr at 1st April 20X1 had an estimated market value of ₹ 18 Cr at that date.*
- *Plant and equipment having a carrying value of ₹ 11 Cr at 1st April 20X1 had an estimated market value of ₹ 13 Cr at that date.*
- *Inventory in the books of B Ltd. is shown at a cost of ₹ 2.50 Cr. The fair value of the inventory on the acquisition date is ₹ 3 Cr.*

The fair value adjustments have not been reflected in the individual financial statements of B Ltd. In the consolidated financial statements, the fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

Assume that the current book value (prior to fair valuation exercise under Ind AS 103) equals the tax base.

Calculate the deferred tax impact on above and calculate the goodwill arising on acquisition of B Ltd.

Solution

Computation of Net Assets of B Ltd.

As per books	₹ 23.00 Cr
Add: Fair value differences not recognized in books of B Ltd.:	
Property (18 Cr – 15 Cr)	₹ 3.00 Cr
Plant and Equipment (13 Cr – 11 Cr)	₹ 2.00 Cr

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Inventory (3 Cr – 2.5 Cr)	₹ 0.50 Cr
	₹ 28.5 Cr
Less: Deferred tax liability on fair value difference @ 20%	
[(3 Cr + 2 Cr + 0.50 Cr) x 20%]	(₹ 1.10 Cr)
Total Net Assets at Fair Value	₹ 27.40 Cr
Computation of Goodwill:	
Purchase Consideration	₹ 25.00 Cr
Add: Non-Controlling Interest [{(12 Cr x (20% / 80%)} x ₹ 2 per share]	₹ 6.00 Cr
	₹ 31.00 Cr
Less: Net Assets at Fair Value	(₹ 27.40 Cr)
Goodwill on acquisition date	₹ 3.60 Cr

*****

(b) As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as a result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination.

(c) The potential benefit of the acquiree's income tax loss carry forwards or other deferred tax assets might not satisfy the criteria for separate recognition when a business combination is initially accounted for but might be realised subsequently. An entity shall recognise acquired deferred tax benefits that it realises after the business combination as follows:

- Acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in other comprehensive income and accumulated in equity as capital reserve or recognised directly in capital reserve, depending on whether paragraph 34 or paragraph 36A of Ind AS 103 would have applied had the measurement period adjustments been known on the date of acquisition itself.

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- All other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).

1.7.2 Current and deferred tax arising from share-based payment transactions

(a) In some tax jurisdictions, an entity receives a tax deduction (i.e., an amount that is deductible in determining taxable profit) that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for the consumption of employee services received as consideration for share options granted, in accordance with Ind AS 102, *Share- based Payment*, and not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise.

(b) As with the preliminary expenses, the difference between the tax base of the employee services received to date (being the amount permitted as a deduction in future periods under taxation laws), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. If the amount permitted as a deduction in future periods under taxation laws is not known at the end of the period, it shall be estimated, based on information available at the end of the period. For example, if the amount permitted as a deduction in future periods under taxation laws is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period.

(c) As noted above, in (a), the amount of the tax deduction or estimated future tax deduction, measured in accordance with paragraph (b) above may differ from the related cumulative remuneration expense. This Standard requires that current and deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from (a) a transaction or event that is recognised, in the same or a different period, outside profit or loss, or (b) a business combination. If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity.

Illustration 5

On 1st April 20X1, P Ltd. had granted 1 Cr share options worth ₹ 4 Cr s(fair value) ubject to a two-year vesting period. The income tax law permits a tax deduction at the exercise date of the intrinsic value of the options. The intrinsic value of the options at 31st March 20X2 was ₹ 1.60 Cr and at 31st March 20X3 was ₹ 4.60 Cr. The increase in the fair value of the options on 31st March 20X3 was not foreseeable at 31st March 20X2. The options were exercised at 31st March 20X3.

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Give the accounting for the above transaction for deferred tax for period ending 31st March, 20X2 and 31st March, 20X3. Assume that there are sufficient taxable profits available in future against any deferred tax assets. Tax rate of 30% is applicable to P Ltd.

Solution:

On 31st March 20X2:

The tax benefit is calculated as under:

Carrying amount of Share based payment	₹ 0.00 Cr
Tax Base of Share based payment (₹ 1.60 Cr x ½)	₹ 0.80 Cr
Temporary Difference (Carrying amount – tax base)	₹ 0.80 Cr
Deferred Tax Asset recognized (Temporary Difference x Tax rate)	
(0.80 Cr x 30%)	₹ 0.24 Cr

Journal Entry for above:

Deferred Tax Asset	Dr.	₹ 0.24 Cr	
To Tax Expense			₹ 0.24 Cr

(Being DTA recognized on equity option)

On 31st March 20X3:

The options have been exercised and a current tax benefit will be available to the entity on the basis of intrinsic value of ₹ 4.60 Cr. Initially recognized deferred tax asset will no longer be required.

The accounting entry will be done as under:

Tax Expense	Dr	₹ 0.24 Cr	
To Deferred Tax Asset			₹ 0.24 Cr

(Being DTA reversed on the exercise of the option)

*****

1.7.3 Change in tax status of an entity or its shareholders

(a) A change in the tax status of an entity or of its shareholders may have consequences for an entity by increasing or decreasing its tax liabilities or assets. This may, for example, occur upon the public listing of an entity's equity instruments or upon the restructuring of an entity's equity. It may also occur upon a controlling shareholder's move to a foreign country. As a result of such an event, an entity may be taxed differently; it may for example gain or lose tax incentives or become subject to a different rate of tax in the future.

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(b) A change in the tax status of an entity or its shareholders may have an immediate effect on the entity's current tax liabilities or assets. The change may also increase or decrease the deferred tax liabilities and assets recognised by the entity, depending on the effect the change in tax status has on the tax consequences that will arise from recovering or settling the carrying amount of the entity's assets and liabilities.

(c) The issue is how an entity should account for the tax consequences of a change in its tax status or that of its shareholders.

(d) The accounting principles that should be adopted in this situation are as under:

- A change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognised outside profit or loss.
- The current and deferred tax consequences of a change in tax status shall be included in profit or loss for the period,
  - — unless those consequences relate to transactions and events that result,
  - — in the same or a different period,
  - — in a direct credit or charge to the recognised amount of equity or in amounts recognised in other comprehensive income.
- Those tax consequences that relate to changes in the recognised amount of equity, in the same or a different period (not included in profit or loss), shall be charged or credited directly to equity.
- Those tax consequences that relate to amounts recognised in other comprehensive income shall be recognised in other comprehensive income.

1.8 PART E: DISCLOSURES

This Ind AS not only deals with recognition and measurement of income-taxes but also requires quite a few disclosures with respect to these income tax. These are discussed as under.

1.8.1 Disclosure 1: Disclose components of tax expenses (income)

(a) Each of the major components of tax expense (income) is to be disclosed separately.

(b) As we know, tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax. The tax expense (income) related to profit or loss or loss from ordinary activities shall be presented in statement of profit or loss.

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(c) The components of tax expense (income) include:

- ♦ current tax expense (income);
- ♦ any adjustments recognised in the period for current tax of prior periods;
- ♦ the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
- ♦ the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
- ♦ the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
- ♦ the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;
- ♦ deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset; and
- ♦ the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with Ind AS 8, because they cannot be accounted for retrospectively.

1.8.2 Disclosure 2: Tax related to items charged directly to equity

(a) Indian Accounting Standards require or permit particular items to be credited or charged directly to equity.

(b) Examples of such items are:

- ♦ an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*); and
- ♦ amounts arising on initial recognition of the equity component of a compound financial instrument (see paragraph 23).

(c) The current and deferred tax relating to these items have to be recognised and accounted for directly in equity.

(d) This Ind AS requires disclosure of the aggregate current and deferred tax relating to items that are charged or credited directly to equity.

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1.8.3 Disclosure 3: Tax related to items recognised in statement of other comprehensive income

(a) Indian Accounting Standards require or permit particular items to be recognised in other comprehensive income.

(b) Examples of such items are:

- a change in carrying amount arising from the revaluation of property, plant and equipment (see Ind AS 16); and
- exchange differences arising on the translation of the financial statements of a foreign operation (see Ind AS 21).

(c) The current and deferred tax relating to these items have to be recognised and accounted for in the statement of other comprehensive income.

(d) This Ind AS requires disclosure of the amount of income tax relating to each component of other comprehensive income.

1.8.4 Disclosure 4: Explanation of the relationship between tax expense (income) and accounting profit

(a) In ideal situation, if accounting profit is say ₹ 100 and tax rate is 30%, the tax expense should be ₹ 30. But this is seldom the case due to differences in accounting principles and standards vis–a–vis tax laws.

(b) Therefore, this Standard requires an explanation to be disclosed of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

- a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
- a numerical reconciliation between the average effective tax rate (tax expense divided by the accounting profit) and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

Example 47

An entity has made an accounting profit of ₹ 1,00,000. The tax rate is 30%. In computing the accounting profit, a penalty of ₹ 10,000 has been considered which is not tax deductible. There are no other tax impacts. In this case, the taxable profits are ₹ 1,10,000 (₹ 1,00,000 + ₹ 10,000) and tax expense @ 30% is ₹ 33,000.

The two types of disclosures are as under:

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Particulars	Amount (₹)
Accounting profit	1,00,000
Tax at the applicable tax rate of 30%	30,000
Tax effect of expenses that are not deductible in determining taxable profits:	
Penalties	3,000
Tax expense	33,000

The effective tax rate is as per the national income-tax rate.

Particulars	%
Applicable tax rate	30
Tax effect of expenses that are not deductible in determining taxable profits - Penalties	3
Average effective tax rate	33

The effective tax rate is as per the national income-tax rate.

(c) These disclosures enable users of financial statements to understand whether the relationship between tax expense (income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in the future. The relationship between tax expense (income) and accounting profit may be affected by such factors as revenue that is exempt from taxation, expenses that are not deductible in determining taxable profit (tax loss), the effect of tax losses and the effect of foreign tax rates.

(d) In explaining the relationship between tax expense (income) and accounting profit, an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial statements. Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss).

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Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

1. *Annual Report of Reliance Industries Ltd. for the year ending 31st March 2022 (Page 335):*

(₹ in crore)

	Year ended 31st March, 2022	Year ended 31st March, 2021
12. Taxation		
Tax Expenses Recognised in Statement of Profit and Loss		
Current tax	787	-
Deferred tax	6,915	(4,732)
Tax expenses recognised in the current year	**7,702**	**(4,732)**

(₹ in crore)

	Year ended 31st March, 2022	Year ended 31st March, 2021
Tax expenses for the year can be reconciled to the accounting profit as follows:		
Profit Before Tax and Exceptional Items	46,786	22,908
Applicable Tax Rate	34.944%	34.944%
Computed Tax Expense	16,349	8,005
Tax Effect of:		
Exempted income	(1,574)	(133)
Expenses disallowed	5,716	4,910
Additional allowances net of MAT Credit	(19,704)	(12,782)
Current Tax Provision (A)	**787**	**-**
Incremental Deferred tax Liability/(Asset) on account of Property, Plant and Equipment and Intangible Assets	771	2,354
Incremental Deferred tax Liability / (Asset) on account of Financial Assets and Other items	6,144	(7,086)
Deferred Tax Provision (B)	**6,915**	**(4,732)**
Tax Expenses Recognised in Statement of Profit and Loss (A+B)	**7,702**	**(4,732)**
Effective Tax Rate	**16.46%**	**-**
Tax on Exceptional Item *	**(6,386)**	**(14,062)**

* Refer Note 32

(Source: Annual report for 2021-2022 of Reliance Industries Ltd.)

2. *Annual Report of Hindustan Unilever Ltd. for the year ending 31st March 2022 (Page 160)*

B. Reconciliation of Effective Tax Rate

The reconciliation between the statutory income tax rate applicable to the Company and the effective income tax rate of the Company is as follows:

	Year ended 31st March, 2022	Year ended 31st March, 2021
Statutory income tax rate applicable for the year	25.2%	25.2%
Differences due to:		
Expenses not deductible for tax purposes	1.0%	1.1%
Income exempt from income tax	-0.3%	-0.2%
Others*	-1.0%	-1.9%
Effective tax rate	**24.9%**	**24.2%**

* Others include prior period adjustment tax refunds and tax on exceptional items.

(Source: Annual report for 2021-2022 of Hindustan Unilever Ltd.)

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3. *Annual Report of Larsen & Toubro Ltd. for the year ending 31st March 2022 (Page 438)*

[NOTE 44]
Disclosure pursuant to Ind AS 12 "Income Taxes": *(contd.)*
(b) Reconciliation of tax expense and the accounting profit multiplied by domestic tax rate applicable in India:

₹ crore

Sr. No.	Particulars	2021-22	2020-21
(1)	Profit before tax from:		
	Continuing Operations (including exceptional items)	10031.47	5318.73
	Discontinued Operations	–	11199.23
		10031.47	16517.96
(2)	Corporate tax rate as per Income Tax Act, 1961	25.17%	25.17%
(3)	Tax on Accounting profit (3)=(1)*(2)	2524.72	4157.24
(4)	(i) Tax on expenses not tax deductible:		
	(A) Corporate social responsibility	33.14	39.08
	(B) Tax on employee perquisites borne by the Company	3.04	2.52
	(ii) Tax effect on impairment recognised on which deferred tax asset is not recognised	–	795.33
	(iii) Effect of current tax related to earlier years	3.08	5.73
	(iv) Effect of lower tax rate on long term capital gains	(12.96)	(266.65)
	(v) Tax effect of losses in joint operation of current year on which no deferred tax benefit is recognised	3.48	6.95
	(vi) Effect of deduction with respect to dividend income	(407.49)	(260.34)
	(vii) Reversal of deferred tax on brought forward losses on utlisation as set off against gains	–	103.51
	(viii) Tax effect on various other items	5.01	136.80
	Total effect of tax adjustments [(i) to (viii)]	(372.70)	562.93
(5)	Tax expense recognised during the year (5)=(3)+(4)	2152.02	4720.17
(6)	Effective tax Rate (6)=(5)/(1)	21.45%	28.58%

(Source: Annual report for 2021-2022 of Larsen & Toubro Ltd.)

4. *Annual Report of SpiceJet Ltd. for the year ending 31st March 2022 (Page 110)*

52. Income tax expense

Reconciliation of tax expense and the accounting profit multiplied by India's domestic tax rate for March 31, 2022 and March 31, 2021 :

Particulars	Year ended March 31, 2022	Year ended March 31, 2021
Accounting loss before income tax	**(17,254.65)**	**(9,983.02)**
Loss before income tax multiplied by standard rate of corporate tax in India 25.168% (March 31, 2021: 25.168%)	(4,342.65)	(2,512.53)
Effects of:		
Non-deductible expenses for tax purposes	(824.72)	(485.40)
Set-off of brought forward losses	5,167.37	2,997.92
Net effective income tax	-	-

(Source: Annual report for 2021-2022 of SpiceJet Ltd.)

(e) However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. The following example illustrates how the selection of the applicable tax rate affects the presentation of the numerical reconciliation.

Example 48

In 20X2, an entity has accounting profit in its own jurisdiction (country A) of ₹ 1,500 (20X1:

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₹ 2,000) and in country B of ₹ 1,500 (20X1: ₹ 500). The tax rate is 30% in country A and 20% in country B. In country A, expenses of ₹ 100 (20X1: ₹ 200) are not deductible for tax purposes.

The following reconciliation will be prepared:

Particulars	Amount (₹)	
	20X2	20X1
Accounting profit	3,000	2,500
Tax at the domestic rate of 30%	900	750
Tax effect of expenses that are not deductible for tax purposes	30	60
Effect of lower tax rates in country B	(150)	(50)
Tax expense	780	760

Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

Annual Report of Bharti Airtel Ltd. for the year ending 31st March 2022 (Page 357):

The impact of different tax rates is disclosed separately in Consolidated Financial Statements whose extract is given below [10th line item with amounts of ₹ 2,594 and ₹ (13,887)]:

The reconciliation between the amount computed by applying the statutory income tax rate to the loss before tax and the income tax charge is summarised below:

	For the year ended March 31, 2022	For the year ended March 31, 2021
Profit / (loss) before tax (from continuing and discontinued operations)	124,831	(31,184)
Enacted tax rates in India	25.168%	25.168%
Tax expense @ Company's domestic tax rate 25.168%	31,418	(7,849)
Effect of:		
Share of profits in associates and joint ventures	(6,093)	(1,728)
Tax holiday	1,913	542
Adjustments in respect of previous years	(420)	(481)
Effect of changes in tax rate including MAT	-	85,369
Additional taxes / taxes for which no credit is allowed	158	690
Difference in tax rate applicable to group companies	2,594	(13,887)
Adjustment in respect of tax amnesty scheme	-	(20,280)
Losses against which no deferred tax asset recognised	-	36,690
Expense / (Income) not deductible / (taxable) (net)	6,823	(8,262)
Tax on undistributed retained earnings of subsidiaries / joint venture	8,745	2,908
Items for which no deferred tax has been recognised	(2,866)	16,746
Settlement of various disputes	385	766
Tax on common control transactions	-	(9)
Others	(878)	1,241
Income tax expense	**41,779**	**92,456**

(Source: Annual report for 2021-2022 of Bharti Airtel Ltd.)

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Illustration 6

A Ltd.'s profit before tax according to Ind AS for Year 20X1-20X2 is ₹ 100 thousand and taxable profit for year 20X1-20X2 is ₹ 104 thousand. The difference between these amounts arose as follows:

1. *On 1st February, 20X2, it acquired a machine for ₹ 120 thousand. Depreciation is charged on the machine on a monthly basis for accounting purpose. Under the tax law, the machine will be depreciated for 6 months. The machine's useful life is 10 years according to Ind AS as well as for tax purposes.*
2. *In the year 20X1-20X2, expenses of ₹ 8 thousand were incurred for charitable donations. These are not deductible for tax purposes.*

Prepare necessary entries as at 31st March 20X2, taking current and deferred tax into account. The tax rate is 25%. Also prepare the tax reconciliation in absolute numbers as well as the tax rate reconciliation.

Solution

Current tax= Taxable profit x Tax rate = ₹ 104 thousand x 25% = ₹ 26 thousand.

Computation of Taxable Profit:

	₹ in thousand
Accounting profit	100
Add: Donation not deductible	8
Less: Excess Depreciation (6-2)	(4)
Total Taxable profit	104

		₹ in thousand	₹ in thousand
Profit & loss A/c	Dr.	26	
To Current Tax			26

Deferred tax:

Machine's carrying amount according to Ind AS is ₹ 118 thousand (₹ 120 thousand – ₹ 2 thousand)

Machine's carrying amount for taxation purpose = ₹ 114 thousand (₹ 120 thousand – ₹ 6 thousand)

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Deferred Tax Liability = ₹ 4 thousand x 25%

		₹ in thousand	
Profit & loss A/c	Dr.	1	
To Deferred Tax Liability			1

Tax reconciliation in absolute numbers:

	₹ in thousand
Profit before tax according to Ind AS	100
Applicable tax rate @ 25%	
Tax	25
Expenses not deductible for tax purposes (₹ 8 thousand x 25%)	2
Tax expense (Current and deferred)	27

Tax rate reconciliation

Applicable tax rate	25%
Expenses not deductible for tax purposes	2%
Average effective tax rate	27%

*****

1.8.5 Disclosure 5: Change in tax rates

(a) The applicable tax rates may change due to variety of reasons. There could be a change in the manner of recovery of the asset. The tax laws may have changed. There could be a change in the structure of the entity.

(b) In case there are changes in the applicable tax rate(s) compared to the previous accounting period, an explanation has to be provided.

1.8.6 Disclosure 6: Unrecognised deductible temporary differences, unused tax losses and unused tax credits

(a) The Standard lays down criteria for recognising deferred tax assets on deductible temporary differences, unused tax losses and unused tax credits. For example, whether a sufficient taxable temporary difference is available, is there a probability of future profits and are there any tax planning opportunities.

(b) If the laid down recognition criteria could not be met, no deferred tax asset is recognised on these deductible temporary differences, unused tax losses and unused tax credits.

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(c) The Standard requires the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the balance sheet, to be disclosed.

Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

A. Annual Report of SpiceJet Ltd. for the year ending 31st March 2022 (Page 111):

Brought forward losses and unabsorbed depreciation for which no deferred tax assets have been recognized are attributable to the following:

Particulars	As at March 31, 2022	As at March 31, 2021
Unused tax losses *	19,886.84	10,551.73
Unabsorbed tax depreciation #	17,632.43	16,587.47
Net deferred tax asset/ (liabilities)	**37,519.27**	**27,139.20**

 # Unabsorbed depreciation does not have any expiry period under the Income-tax Act, 1961

*The following table details the expiry of the brought forward tax losses

0-4 years	9,022.44	1,823.32
4-8 years	10,864.40	8,728.41
Total	**19,886.84**	**10,551.73**

The brought forward losses and unabsorbed depreciation considered above includes information from tax records and returns of the Company filed upto Assessment Year 2021-22 and does not consider the potential effect of matters under dispute/ litigation with the tax authorities which are currently sub-judice at various levels. Also refer note 48.

(Source: Annual report for 2021-2022 of SpiceJet Ltd.)

Annual Report of Larsen and Toubro Ltd. for the year ending 31st March 2020 (Page 416):

[NOTE 44]

Disclosure pursuant to Ind AS 12 "Income Taxes" *(contd.)*

(c) (i) Unused tax losses for which no deferred tax asset (DTA) is recognised in Balance Sheet

Sr. No.	Particulars	As at 31-3-2020			As at 31-3-2019		
		Base Amount (₹ crore)	Deferred Tax (₹ crore)	Expiry date	Base Amount (₹ crore)	Deferred Tax (₹ crore)	Expiry date
	Business loss and unabsorbed depreciation						
	- Amount of losses having expiry	2028.43	510.52	FY 2021-28	*2033.64*	*710.63*	*FY 2020-28*
	- Amount of losses having no expiry	981.38	246.99		*981.38*	*342.93*	
	Capital loss	–	–		*3355.81*	*614.38*	*FY 2025-27*
	Total	3009.81	757.51		*6370.83*	*1667.94*	

(ii) Unrecognised deductible temporary differences for which no deferred tax asset (DTA) is recognised in Balance Sheet

₹ crore

Sr. No.	Particulars	As at 31-3-2020		As at 31-3-2019	
		Base Amount	Deferred Tax	Base Amount	Deferred Tax
1.	Deductible temporary differences towards provision for diminution in value of investments on which DTA not created	2966.98	686.82	*3017.55*	*705.59*
2.	Temporary differences arising out of revaluation of tax base of assets (on account of indexation benefit)	6541.94	1496.80	*5813.32*	*1354.27*
3.	Other items giving rise to temporary differences	78.08	19.65	*78.08*	*27.29*
	Total	9587.00	2203.27	*8908.95*	*2087.15*

(Source: Annual report for 2021-2022 of Larsen and Toubro Ltd.)

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1.8.7 Disclosure 7: Temporary differences associated with investments in subsidiaries etc.

(a) The aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised should be disclosed.

(b) It would often be impracticable to compute the amount of unrecognised deferred tax liabilities arising from investments in subsidiaries, branches and associates and interests in joint ventures. Therefore, this Standard requires an entity to disclose the aggregate amount of the underlying temporary differences but does not require disclosure of the deferred tax liabilities.

(c) Nevertheless, where practicable, entities are encouraged to disclose the amounts of the unrecognised deferred tax liabilities because financial statement users may find such information useful.

Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

A *Annual Report of SpiceJet Ltd. for the year ending 31 March 2022 (Page 111):*

Brought forward losses and unabsorbed depreciation for which no deferred tax assets have been recognized are attributable to the following:

Particulars	As at March 31, 2022	As at March 31, 2021
Unused tax losses *	19,886.84	10,551.73
Unabsorbed tax depreciation #	17,632.43	16,587.47
Net deferred tax asset/ (liabilities)	**37,519.27**	**27,139.20**

 # Unabsorbed depreciation does not have any expiry period under the Income-tax Act, 1961

*The following table details the expiry of the brought forward tax losses

0-4 years	9,022.44	1,823.32
4-8 years	10,864.40	8,728.41
Total	**19,886.84**	**10,551.73**

The brought forward losses and unabsorbed depreciation considered above includes information from tax records and returns of the Company filed upto Assessment Year 2021-22 and does not consider the potential effect of matters under dispute/ litigation with the tax authorities which are currently sub-judice at various levels. Also refer note 48.

(Source: Annual report for 2021-2022 of SpiceJet Ltd.)

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B. Annual Report of Larsen and Toubro Ltd. for the year ending 31 March 2020 (Page 416):

[NOTE 44]

Disclosure pursuant to Ind AS 12 "Income Taxes" *(contd.)*

(c) (i) Unused tax losses for which no deferred tax asset (DTA) is recognised in Balance Sheet

Sr. No.	Particulars	As at 31-3-2020			As at 31-3-2019		
		Base Amount (₹ crore)	Deferred Tax (₹ crore)	Expiry date	Base Amount (₹ crore)	Deferred Tax (₹ crore)	Expiry date
	Business loss and unabsorbed depreciation						
	- Amount of losses having expiry	2028.43	510.52	FY 2021-28	2033.64	710.63	FY 2020-28
	- Amount of losses having no expiry	981.38	246.99		981.38	342.93	
	Capital loss	-	-		3355.81	614.38	FY 2025-27
	Total	3009.81	757.51		6370.83	1667.94	

(ii) Unrecognised deductible temporary differences for which no deferred tax asset (DTA) is recognised in Balance Sheet

₹ crore

Sr. No.	Particulars	As at 31-3-2020		As at 31-3-2019	
		Base Amount	Deferred Tax	Base Amount	Deferred Tax
1.	Deductible temporary differences towards provision for diminution in value of investments on which DTA not created	2966.98	686.82	3017.55	705.59
2.	Temporary differences arising out of revaluation of tax base of assets (on account of indexation benefit)	6541.94	1496.80	5813.32	1354.27
3.	Other items giving rise to temporary differences	78.08	19.65	78.08	27.29
	Total	9587.00	2203.27	8908.95	2087.15

(Source: Annual report for 2021-2022 of Larsen and Toubro Ltd.)

1.8.8 Disclosure 8: Amount of deferred tax liabilities (assets) or income (expenses)

(a) As per the criteria laid down in the Standard, deferred tax liabilities have to be recognised for taxable temporary differences and deferred tax assets have to be recognised for deductible temporary differences, unused tax losses and unused tax credits.

(b) Where deferred taxes have been recognised, the following should be disclosed in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

- the amount of the deferred tax assets and liabilities recognised in the balance sheet for each period presented;
- the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the balance sheet.

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1.8.9 Disclosure 9: Discontinued operations

The following should be disclosed in respect of discontinued operations, the tax expense relating to:

(i) the gain or loss on discontinuance; and

(ii) the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

1.8.10 Disclosure 10: Dividend tax

(a) At times dividends relating to the reporting period are proposed or declared after the reporting date but before the financial statements are approved for issue. These are disclosed but not recognised in financial statements.

(b) In such a situation, an entity should disclose the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were approved for issue, but are not recognised as a liability in the financial statements.

1.8.11 Disclosures 11: In case of business combination

The following should be disclosed:

- if a business combination in which the entity is the acquirer causes a change in the amount recognised for its pre-acquisition deferred tax asset, the amount of that change; and
- if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date, a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.

1.8.12 Disclosure 12: Deferred tax asset and evidence thereto where based on future taxable profits

An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

- the utilization of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
- the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

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1.8.13 Disclosure 13: Tax consequences of distribution of dividends

(a) As discussed above, in some tax jurisdiction tax rates depend on the fact whether dividend is distributed or not.

(b) In these circumstances, an entity shall disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable.

(c) The aforesaid disclosure requirement requires an entity to disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. An entity also discloses the important features of the income tax systems and the factors that will affect the amount of the potential income tax consequences of dividends.

(d) However, it would sometimes not be practicable to compute the total amount of the of the total amount may be easily determinable. For example, in a consolidated group, a parent and some of its subsidiaries may have paid income taxes at a higher rate on undistributed profits and be aware of the amount that would be refunded on the payment of future dividends to shareholders from consolidated retained earnings. In this case, that refundable amount is disclosed.

(e) If applicable, the entity also discloses that there are additional potential income tax consequences not practicably determinable. In the parent's separate financial statements, if any, the disclosure of the potential income tax consequences relates to the parent's retained earnings.

(f) An entity required to provide the disclosures referred above is also required to provide disclosures related to temporary differences associated with investments in subsidiaries, branches and associates or interests in joint ventures. In such cases, an entity considers this in determining the information to be disclosed under this requirement. For example, an entity ay be required to disclose the aggregate amount of temporary differences associated with investments in subsidiaries for which no deferred tax liabilities have been recognised. If it is impracticable to compute the amounts of unrecognised deferred tax liabilities, there may be amounts of potential income tax consequences of dividends not practicably determinable related to these subsidiaries.

1.8.14 Disclosure 14: Tax related contingencies

An entity discloses any tax-related contingent liabilities and contingent assets in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities.

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1.8.15 Disclosure 15: Change in tax rates or tax laws

Where changes in tax rates or tax laws are enacted or announced after the reporting period, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities (see Ind AS 10, *Events after the Reporting Period*).

Relevant Extracts from Financial Statements of selected Listed Entities are presented below:

Annual Report of SpiceJet Ltd. for the year ending 31st March 2020 (Page 415):

[NOTE 44]

Disclosure pursuant to Ind AS 12 "Income Taxes" *(contd.)*

(b) Reconciliation of tax expense and the accounting profit multiplied by domestic tax rate applicable in India:

₹ crore

Sr. No.	Particulars	2019-20	2018-19
(1)	Profit before tax from:		
	Continuing Operations	6985.91	9219.46
	Discontinued Operations	865.38	812.40
		7851.29	10031.86
(2)	Corporate tax rate as per Income tax Act, 1961	25.17%	34.94%
(3)	Tax on accounting profit (3)=(1)*(2)	1976.01	3505.53
(4)	(i) Tax on Income exempt from tax :		
	(A) Dividend income	(347.18)	(523.73)
	(B) Long-term capital gains exempt from tax	(121.27)	(978.42)
	(C) Interest on tax free bonds	(1.04)	(2.50)
	(ii) Tax on expenses not tax deductible:		
	(A) CSR expenses	36.57	42.52
	(B) Expenses in relation to exempt income	36.42	28.35
	(C) Tax on employee perquisites borne by the Company	2.08	1.52
	(iii) Weighted deductions on R&D expenditure and deduction u/s 80IA	–	(147.05)
	(iv) Effect of previously unrecognised tax losses used to reduce deferred tax expense	(787.94)	(0.27)
	(v) Tax effect on impairment and fair valuation losses recognised on which deferred tax asset is not recognised	–	685.62
	(vi) Effect on deferred tax balances due to the change in income tax rate	179.67	–
	(vii) Effect of current year net capital/business loss on which no deferred tax asset is recognised	–	(123.61)
	(viii) Effect of current tax related to earlier years	(60.68)	227.14
	(ix) Effect of previously unrecognised tax losses used to reduce current tax expense	–	(477.86)
	(x) Tax effect of losses in joint operation of current year on which no deferred tax asset is recognised	3.87	37.68
	(xi) Tax effect on various other items	25.34	18.33
	(xii) Reversal of MAT credit entitlement	230.23	–
	Total effect of tax adjustments [(i) to (xii)]	(803.93)	(965.08)
(5)	Tax expense recognised during the year (5)=(3)+(4)	1172.08	2540.47
(6)	Effective tax Rate (6)=(5)/(1)	14.93%	25.32%

The Company has opted to pay the tax under section 115BAA of the Income Tax Act,1961. Accordingly;

(I) the provision for current and deferred tax has been determined at the rate of 25.17%,

(II) the deferred tax assets and deferred tax liabilities as at April 1, 2019 have been restated at the rate of 25.17% and

(III) the unutilised credit for minimum alternate tax as at April 1, 2019 has been written-off.

(Source : Annual report of 2019-2020 of SpiceJet Ltd.)

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Illustration 7

An entity has a deductible temporary difference of ₹ 50,000. It has no taxable temporary differences against which it can be offset. The entity is also not anticipating any future profits. However, it can implement a tax planning strategy which can generate profits up to ₹ 60,000. The cost of implementing this tax planning strategy is ₹ 12,000. The tax rate is 30%. Compute the deferred tax asset that should be recognised.

Solution

The entity should recognise a deferred tax asset of ₹ 14,400 @ 30% of ₹ 48,000 (₹ 60,000 – ₹ 12,000).

The balance deferred tax asset of ₹ 600 @ 30% on ₹ 2,000 (₹ 50,000 – ₹ 48,000) shall remain unrecognised.

*****

Illustration 8

A Limited recognises interest income in its books on accrual basis. However, for income tax purposes the method is 'cash basis'. On 31st December, 20X1, it has interest receivable of ₹ 10,000 and the tax rate was 25%. On 28th February, 20X2, the finance bill is introduced in the legislation that changes the tax rate to 30%. The finance bill is enacted as Act on 21st May, 20X2.

Discuss the treatment of deferred tax in case the reporting date of A Limited's financial statement is 31st December, 20X1 and these are approved for issued on 31st May, 20X2.

Solution

The difference of ₹ 10,000 between the carrying value of interest receivable of ₹ 10,000 and its tax base of NIL is a taxable temporary difference.

A Limited has to recognise a deferred tax liability of ₹ 2,500 (₹ 10,000 x 25%) in its financial statements for the reporting period ended on 31st December, 20X1.

It will not recognise the deferred tax liability @ 30% because as on 31st December, 20X1, this tax rate was neither substantively enacted or enacted on the reporting date. However, if the effect of this change is material, A Limited should disclose this difference in its financial statements.

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Illustration 9

A Ltd prepares financial statements to 31st March each year. The rate of income tax applicable to A Ltd is 20%. The following information relates to transactions, assets and liabilities of A Ltd during the year ended 31st March 20X2:

(i) A Ltd has a 40% shareholding in L Ltd. A Ltd purchased this shareholding for ₹ 45 Cr. The shareholding gives A Ltd significant influence over L Ltd but not control and therefore A Ltd.

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accounts for its interest in L Ltd using the equity method. The equity method carrying value of A Ltd's investment in L Ltd was ₹ 70 Cr on 31st March 20X1 and ₹ 75 Cr on 31st March 20X2. In the tax jurisdiction in which A Ltd operates, profits recognised under the equity method are taxed if and when they are distributed as a dividend or the relevant investment is disposed of.

(ii) A Ltd. measures its head office building using the revaluation model. The building is revalued every year on 31st March. On 31st March 20X1, carrying value of the building (after revaluation) was ₹ 40 Cr and its tax base was ₹ 22 Cr. During the year ended 31st March 20X2, A Ltd charged depreciation in its statement of profit or loss of ₹ 2 Cr and claimed a tax deduction for tax depreciation of ₹ 1.25 Cr. On 31st March 20X2, the building was revalued to ₹ 45 Cr. In the tax jurisdiction in which A Ltd operates, revaluation of property, plant and equipment does not affect taxable income at the time of revaluation.

Basis the above information, you are required to compute:

(a) The deferred tax liability of A Ltd at 31st March 20X2

(b) The charge or credit to both profit or loss and other comprehensive income relating to deferred tax for the year ended 31st March 20X2

Solution:

(A) Deferred Tax Liability as at 31st March 20X2

Investment in L Ltd:

Carrying Amount	=	₹ 75 Cr
Tax base	=	₹ 45 Cr (Purchase cost)
Temporary Difference	=	₹ 30 Cr

Since carrying amount is higher than the tax base, the temporary difference is recognized as a taxable temporary difference. Using the tax rate of 20%, a deferred tax liability of ₹ 6 Cr is recognized:

Head office building

Carrying Amount	=	₹ 45 Cr (Revalued amount on 31st March 20X2)
Tax base	=	₹ 20.75 Cr (22 Cr – 1.25 Cr)
Temporary Difference	=	₹ 24.25 Cr

Since carrying amount is higher than the tax base, the temporary difference is recognized as a taxable temporary difference. Using the tax rate of 20%, a deferred tax liability of ₹ 4.85 Cr is created.

Total Deferred Tax Liability ₹ 6 Cr + ₹ 4.85 Cr = ₹ 10.85 Cr

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(B) Charge to Statement of Profit or Loss for the year ended 31st March 20X2:

Investment in L Ltd.

Particulars	Carrying amount	Tax Base	Temporary Difference
Opening Balance (1st April 20X1)	₹ 70 Cr	₹ 45 Cr	₹ 25 Cr
Closing Balance (31st March 20X2)	₹ 75 Cr	₹ 45 Cr	₹ 30 Cr
Net Change			₹ 5 Cr
Increase in Deferred Tax Liability (20% tax rate)			₹ 1 Cr

Considering the increase in the value of investment arising through Statement of Profit or Loss, the accounting for the increase in deferred tax liability is made as under:

Tax expense (Profit or Loss Statement)	Dr	₹ 1 Cr	
To Deferred Tax Liability			₹ 1 Cr

(Being increase in deferred tax liability recognized)

Head Office Building:

The deferred tax liability at 31st March 20X1 is ₹ 3.6 Cr (20% x {₹ 40 Cr – ₹ 22 Cr}).

At 31st March 20X2, prior to revaluation, the carrying amount of the property is ₹ 38 Cr and its tax base is ₹ 20.75 Cr (₹ 22 Cr – ₹ 1.25 Cr). The deferred tax liability at this point is ₹ 3.45 Cr (20% x {₹ 38 Cr – ₹ 20.75 Cr}).

The reduction in this liability is ₹ 0.15 Cr (₹ 3.6 Cr – ₹ 3.45 Cr). This would be credited to income tax expense in arriving at profit or loss.

Post revaluation, the carrying value of the building becomes ₹ 45 Cr and the tax base stays the same. Therefore, the new deferred tax liability is ₹ 4.85 Cr (20% x (₹ 45 Cr – ₹ 20.75 Cr)). The increase in the deferred tax liability of ₹ 1.4 Cr (₹ 4.85 Cr – ₹ 3.45 Cr) is charged to other comprehensive income.

*****

Illustration 10

K Ltd prepares consolidated financial statements to 31st March each year. During the year ended 31st March 20X2, K Ltd entered into the following transactions:

(a) On 1st April 20X1, K Ltd purchased an equity investment for ₹ 2,00,000. The investment was designated as fair value through other comprehensive income. On 31st March 20X2, the fair value of the investment was ₹ 2,40,000. In the tax jurisdiction in which K Ltd operates, unrealised gains and losses arising on the revaluation of investments of this nature are not

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taxable unless the investment is sold. K Ltd has no intention of selling the investment in the foreseeable future.

(b) On 1st August 20X1, K Ltd sold products to A Ltd, a wholly owned subsidiary operating in the same tax jurisdiction as K Ltd, for ₹ 80,000. The goods had cost to K Ltd for ₹ 64,000. By 31st March 20X2, A Ltd had sold 40% of these goods, selling the remaining during next year.

(c) On 31st October 20X1, K Ltd received ₹ 2,00,000 from a customer. This payment was in respect of services to be provided by K Ltd from 1st November 20X1 to 31st July 20X2. K Ltd recognised revenue of ₹ 1,20,000 in respect of this transaction in the year ended 31st March 20X2 and will recognise the remainder in the year ended 31st March 20X3. Under the tax jurisdiction in which K Ltd operates, ₹ 2,00,000 received on 31st October 20X1 was included in the taxable profits of K Ltd for the year ended 31st March 20X2.

Explain and show how the tax consequences (current and deferred) of the three transactions would be reported in its statement of profit or loss and other comprehensive income for the year ended 31st March 20X2. Assume tax rate to be 25%.

Solution:

(a) Because the unrealised gain on revaluation of the equity investment is not taxable until sold, there are no current tax consequences. The tax base of the investment is ₹ 2,00,000. The revaluation creates a taxable temporary difference of ₹ 40,000 (₹ 2,40,000 – ₹ 2,00,000).

This creates a deferred tax liability of ₹ 10,000 (₹ 40,000 x 25%). The liability would be non-current. The fact that there is no intention to dispose of the investment does not affect the accounting treatment. Because the unrealised gain is reported in other comprehensive income, the related deferred tax expense is also reported in other comprehensive income.

(b) When K Ltd sold the products to A Ltd, K Ltd would have generated a taxable profit of ₹ 16,000 (₹ 80,000 – ₹ 64,000). This would have created a current tax liability for K Ltd and the group of ₹ 4,000 (₹ 16,000 x 25%). This liability would be shown as a current liability and charged as an expense in arriving at profit or loss for the period.

In the consolidated financial statements the carrying value of the unsold inventory would be ₹ 38,400 (₹ 64,000 x 60%). The tax base of the unsold inventory would be ₹ 48,000 (₹ 80,000 x 60%). In the consolidated financial statements there would be a deductible temporary difference of ₹ 9,600 (₹ 38,400 – ₹ 48,000) and a potential deferred tax asset of ₹ 2,400 (₹ 9,600 x 25%). This would be recognised as a deferred tax asset since A Ltd is expected to generate sufficient taxable profits against which to utilise the deductible temporary difference. The resulting credit would reduce consolidated deferred tax expense in arriving at profit or loss.

(c) The receipt of revenue in advance on 1st October 20X1 would create a current tax liability of ₹ 50,000 (₹ 200,000 x 25%) as at 31st March 20X2. The carrying value of the revenue received in advance at 31st March 20X2 is ₹ 80,000 (₹ 200,000 – ₹ 120,000). Its tax base is

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nil. The deductible temporary difference of ₹ 80,000 would create a deferred tax asset of ₹ 20,000 (₹ 80,000 x 25%). The asset can be recognised because K Ltd has sufficient taxable profits against which to utilise the deductible temporary difference.

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1.9 SIGNIFICANT CHANGES IN IND AS 12 VIS-À-VIS AS 22

S. No.	Particulars	Ind AS 12	AS 22
1.	*Approach for creating Deferred Tax*	Ind AS 12 is based on balance sheet approach. It requires recognition of tax consequences of differences between the carrying amounts of assets and liabilities and their tax base.	AS 22 is based on income statement approach. It requires recognition of tax consequences of differences between taxable income and accounting income. For this purpose, differences between taxable income and accounting income are classified into permanent and timing differences.
2.	*Limited Exceptions for Recognition of Deferred Tax Asset*	As per Ind AS 12, subject to limited exceptions, deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same that for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future	As per AS 22, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised. Where deferred tax asset is recognised against unabsorbed depreciation or carry forward of losses under tax laws, it is recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available

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		taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.	against which such deferred tax assets can be realised. AS 22 explains what may be considered as virtual certainty supported by convincing evidence.
3.	*Recognition of Current and Deferred Tax*	As per Ind AS 12, current and deferred tax are recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from a transaction or event which is recognised outside profit or loss, either in other comprehensive income or directly in equity, in those cases tax is also recognised in other comprehensive income or in equity, as appropriate.	AS 22 does not specifically deal with this aspect.
4.	*Investments in subsidiaries, associates and joint ventures*	As per Ind AS 12, deferred tax liability is recognised for all taxable temporary differences associated with investments in subsidiaries, associates and joint ventures, if certain conditions are satisfied.	AS 22 does not deal with this aspect.
5.	*Elimination of profit and losses resulting from the intra- group transactions*	As per Ind AS 12, deferred tax should be recognised on temporary differences that arise from the elimination of	As per AS 22, deferred tax in consolidated financials are a simple aggregation of the

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		profit and losses resulting from the intra- group transactions.	deferred tax recognised by the group entities.
6.	*DTA/DTL arising out of Revaluation of Assets*	Ind AS 12 requires that deferred tax asset/liability arising from revaluation of non-depreciable assets shall be measured on the basis of tax consequences from the sale of asset rather than through use.	AS 22 does not deal with this aspect.
7.	*Changes in Entities Tax Status or that of its Shareholders*	Ind AS 12 provides guidance as to how an entity should account for the tax consequences of a change in its tax status or that of its shareholders.	AS 22 does not deal with this aspect.
8.	*Guidance for Recognition of Deferred Tax in a Tax Holiday Period*	Ind AS 12 does not specifically deal with these situations.	AS 22 specifically provides guidance regarding recognition of deferred tax in the situations of Tax Holiday under Sections 80-IA and 80-IB and Tax Holiday under Sections 10A and 10B of the Income Tax Act, 1961. Similarly, AS 22 provides guidance regarding recognition of deferred tax asset in case of loss under the head 'capital gains'
9.	*In case of a company paying tax under section 115JB.*	Ind AS 12 does not specifically deal with this aspect.	AS 22 specifically provides guidance regarding tax rates to be applied in measuring deferred tax assets/liabilities in a situation where a company pays tax under section 115JB.
10.	*Guidance on Uncertainty Over Income Tax Treatment*	Ind AS 12 gives special guidance on it.	AS 11 gives no such guidance.

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Questions

1. An asset which cost ₹ 150 has a carrying amount of ₹ 100. Cumulative depreciation for tax purposes is ₹ 90 and the tax rate is 25%. Calculate the tax base and the corresponding deferred tax or liability, if any.

2. On 1st April 20X1, ABC Ltd acquired 100% shares of XYZ Ltd for ₹ 4,373 crore. By 31st March, 20X5, XYZ Ltd had made profits of ₹ 5 crore, which remain undistributed. Based on the tax legislation in India, the tax base investment in XYZ Ltd is its original cost. Show deferred tax treatment.

3. ABC Ltd. acquired 30% of the shares in PQR Ltd. on 1st January, 20X1 for ₹ 1,000 crore. By 31st March, 20X5, PQR Ltd. had made profits of ₹ 50 crore (ABC Ltd.'s share), which remained undistributed. Based on the tax legislation in India, the tax base of the investment in PQR Ltd. is its original cost. Show deferred tax treatment.

4. A company had purchased an asset at ₹ 1,00,000. Estimated useful life of the asset is 5 years and depreciation rate is 20% SLM. Depreciation rate for tax purposes is 25% SLM. The operating profit is ₹ 1,00,000 for all the 5 years. Tax rate is 30% for the next 5 years. Calculate the Book Value as per financial and tax purposes and then DTL.

5. A Ltd. acquired B Ltd. The following assets and liabilities are acquired in a business combination: **₹ 000's**

	Fair Value	Carrying amount	Temporary Difference
Plant and Equipment	250	260	(10)
Inventory	120	125	(5)

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Debtors	200	210	(10)
	570	595	(25)
9% Debentures	(100)	(100)	
	470	495	
Consideration paid	500	500	
Goodwill	30	5	(25)

Assume tax rate as 30%.

Calculate deferred tax asset assuming that the carrying amount is the tax base and prepare the journal entries.

6. B Limited is a newly incorporated entity. Its first financial period ends on 31st March, 20X1. As on the said date, the following temporary differences exist:

   (a) Taxable temporary differences relating to accelerated depreciation of ₹ 9,000. These are expected to reverse equally over next 3 years.

   (b) Deductible temporary differences relating to preliminary expenses of ₹ 4,000 expected to reverse equally over next 4 years.

   It is expected that B Limited will continue to make losses for next 5 years. Tax rate is 30%. Losses can be carried forward but not backwards.

   Discuss the treatment of deferred tax as on 31st March, 20X1.

7. X Ltd. prepares consolidated financial statements to 31st March each year. During the year ended 31st March 20X2, the following events affected the tax position of the group:

   (i) Y Ltd., a wholly owned subsidiary of X Ltd., made a loss adjusted for tax purposes of ₹ 30,00,000. Y Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow Y Ltd. to transfer the tax loss to other group companies. However, it allows Y Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of X Ltd. do not consider that Y Ltd. will make taxable profits in the foreseeable future.

   (ii) Just before 31st March, 20X2, X Ltd. committed itself to closing a division after the year end, making a number of employees redundant. Therefore, X Ltd. recognised a provision for closure costs of ₹ 20,00,000 in its statement of financial position as at 31st March, 20X2. Income-tax Act allows tax deductions for closure costs only when the closure actually takes place. In the year ended 31st March 20X3, X Ltd. expects to make taxable profits which are well in excess of ₹ 20,00,000. On 31st March, 20X2, X Ltd. had taxable temporary differences from other sources which were greater than ₹ 20,00,000.

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(iii) During the year ended 31st March, 20X1, X Ltd. capitalised development costs which satisfied the criteria in paragraph 57 of Ind AS 38 'Intangible Assets'. The total amount capitalised was ₹ 16,00,000. The development project began to generate economic benefits for X Ltd. from 1st January, 20X2. The directors of X Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31st March, 20X2.

(iv) On 1st April, 20X1, X Ltd. borrowed ₹ 1,00,00,000. The cost to X Ltd. of arranging the borrowing was ₹ 2,00,000 and this cost qualified for a tax deduction on 1st April, 20X1. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31st March, 20X4 will be ₹ 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of ₹ 30,43,800 will be claimable when the loan is repaid on 31st March, 20X4.

Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of X Ltd. group at 31st March, 20X2 as per Ind AS. Assume the rate of corporate income tax is 20%.

8. PQR Ltd., a manufacturing company, prepares consolidated financial statements to 31st March each year. During the year ended 31st March, 20X2, the following events affected the tax position of the group:

- QPR Ltd., a wholly owned subsidiary of PQR Ltd., incurred a loss adjusted for tax purposes of ₹ 30,00,000. QPR Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow QPR Ltd. to transfer the tax loss to other group companies. However, it allows QPR Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of PQR Ltd. do not consider that QPR Ltd. will make taxable profits in the foreseeable future.
- During the year ended 31st March, 20X2, PQR Ltd. capitalised development costs which satisfied the criteria as per Ind AS 38 'Intangible Assets'. The total amount capitalised was ₹ 16,00,000. The development project began to generate economic benefits for PQR Ltd. from 1st January, 20X2. The directors of PQR Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31st March, 20X2.
- On 1st April, 20X1, PQR Ltd. borrowed ₹ 1,00,00,000. The cost to PQR Ltd. of arranging the borrowing was ₹ 2,00,000 and this cost qualified for a tax deduction on 1st April 20X1. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31st March 20X4 will be ₹ 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of ₹ 30,43,800 will be claimable when the loan is repaid on 31st March, 20X4.

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Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of PQR Ltd. group at 31st March, 20X2 as per Ind AS. The rate of corporate income tax is 30%.

9. An entity is finalising its financial statements for the year ended 31st March, 20X2. Before 31st March, 20X2, the government announced that the tax rate was to be amended from 40 per cent to 45 per cent of taxable profit from 30th June, 20X2.

The legislation to amend the tax rate has not yet been approved by the legislature. However, the government has a significant majority and it is usual, in the tax jurisdiction concerned, to regard an announcement of a change in the tax rate as having the substantive effect of actual enactment (i.e. it is substantively enacted).

After performing the income tax calculations at the rate of 40 per cent, the entity has the following deferred tax asset and deferred tax liability balances:

Deferred tax asset	₹ 80,000
Deferred tax liability	₹ 60,000

Of the deferred tax asset balance, ₹ 28,000 related to a temporary difference. This deferred tax asset had previously been recognised in OCI and accumulated in equity as a revaluation surplus.

The entity reviewed the carrying amount of the asset in accordance with para 56 of Ind AS 12 and determined that it was probable that sufficient taxable profit to allow utilisation of the deferred tax asset would be available in the future.

Show the revised amount of Deferred tax asset & Deferred tax liability and present the necessary journal entries.

10. On 1st January 20X2, entity H acquired 100% share capital of entity S for ₹ 15,00,000. The book values and the fair values of the identifiable assets and liabilities of entity S at the date of acquisition are set out below, together with their tax bases in entity S's tax jurisdictions. Any goodwill arising on the acquisition is not deductible for tax purposes. The tax rates in entity H's and entity S's jurisdictions are 30% and 40% respectively.

Acquisitions	Book values ₹'000	Tax base ₹'000	Fair values ₹'000
Land and buildings	600	500	700
Property, plant and equipment	250	200	270
Inventory	100	100	80
Accounts receivable	150	150	150
Cash and cash equivalents	130	130	130

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Accounts payable	(160)	(160)	(160)
Retirement benefit obligations	(100)	-	(100)

You are required to calculate the deferred tax arising on acquisition of Entity S. Also calculate the Goodwill arising on acquisition.

Answers

1. The tax base of the asset is ₹ 60 (cost of ₹ 150 less cumulative tax depreciation of ₹ 90). To recover the carrying amount of ₹ 100, the entity must earn taxable income of ₹ 100, but will only be able to deduct tax depreciation of ₹ 60. Consequently, the entity will pay income taxes of ₹ 10 (₹ 40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of ₹ 100 and the tax base of ₹ 60 is a taxable temporary difference of ₹ 40. Therefore, the entity recognises a deferred tax liability of ₹ 10 (₹ 40 at 25%) representing the income taxes that it will pay when it recovers the carrying amount of the asset.

2. A taxable temporary difference of ₹ 5 crore exists between the carrying value of the investment in XYZ at the reporting date of ₹ 4,378 crore (₹ 4,373 crore + ₹ 5 crore) and its tax base of ₹ 4,373 crore. Since a parent, by definition, controls a subsidiary, it will be able to control the reversal of this temporary difference, for example - through control of the dividend policy of the subsidiary. Therefore, deferred tax on such temporary difference is generally not provided unless it is probable that the temporary will reverse in the foreseeable future.

3. A taxable temporary difference of ₹ 50 crore therefore exists between the carrying value of the investment in PQR at the reporting date of ₹ 1,050 crore (₹ 1,000 crore + ₹ 50 crore) and its tax base of ₹ 1,000 crore. As ABC Ltd. does not completely control PQR Ltd. it is not in a position to control the dividend policy of PQR Ltd. As a result, it cannot control the reversal of this temporary difference and deferred tax is provided on temporary differences arising on investments in PQR Ltd. i.e.₹ 50 crore.

4. Calculation of the Book Value as per financial and tax purposes.

Financial Accounting: ₹ 000's

Year	1	2	3	4	5
Gross Block	100	100	100	100	100
Accumulated Depreciation	20	40	60	80	100
Carrying Amount	80	60	40	20	0

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Tax Accounting: ₹ 000's

Year	1	2	3	4	5
Gross Block	100	100	100	100	100
Accumulated Depreciation	25	50	75	100	100
Carrying Amount	75	50	25	0	0

Calculation of DTL: ₹ 000's

Year	1	2	3	4	5
Carrying Amount	80	60	40	20	0
Tax Base	75	50	25	0	0
Difference	5	10	15	20	0
Deferred Tax Liability (Difference x 30%)	1.5	3	4.5	6	0

5. In this case there is a Deferred Tax Asset as the Tax base of assets acquired is higher by 25,000. DTA would be ₹ 7,500 (25,000 x 30%)

Journal entry:

Plant and equipment	Dr	250	
Inventory	Dr	120	
Debtors	Dr	200	
Goodwill	Dr	22.5 (30- 7.5)	
DTA	Dr	7.5	
To 9% Debentures			100
To Bank			500

6. The year-wise anticipated reversal of temporary differences is as under:

Particulars	Year ending on 31st March, 20X2	Year ending on 31st March, 20X3	Year ending on 31st March, 20X4	Year ending on 31st March, 20X5
Reversal of taxable temporary difference relating to accelerated depreciation over next 3 years (₹ 9,000/3)	3,000	3,000	3,000	Nil
Reversal of deductible temporary				

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difference relating to preliminary expenses over next 4 years (₹ 4,000/4)	1,000	1,000	1,000	1,000

B Limited will recognise a deferred tax liability of ₹ 2,700 on taxable temporary difference relating to accelerated depreciation of ₹ 9,000 @ 30%.

However, it will limit and recognise a deferred tax asset on reversal of deductible temporary difference relating to preliminary expenses reversing up to year ending 31st March, 20X4 amounting to ₹ 900 (₹ 3,000 @ 30%). No deferred tax asset shall be recognized for the reversal of deductible temporary difference for the year ending on 31st March, 20X5 as there are no taxable temporary differences. Further, the outlook is also a loss. However, if there are tax planning opportunities that could be identified for the year ending on 31st March, 20X5 deferred tax asset on the remainder of ₹ 1,000 (₹ 4,000 – ₹ 3,000) of deductible temporary difference could be recognised at the 30% tax rate.

7. (i) The tax loss creates a potential deferred tax asset for the group since its carrying value is nil and its tax base is ₹ 30,00,000.

However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.

(ii) The provision creates a potential deferred tax asset for the group since its carrying value is ₹ 20,00,000 and its tax base is nil.

This deferred tax asset can be recognised because X Ltd. is expected to generate taxable profits in excess of ₹ 20,00,000 in the year to 31st March, 20X3.

The amount of the deferred tax asset will be ₹ 4,00,000 (₹ 20,00,000 x 20%).

This asset will be presented as a deduction from the deferred tax liabilities caused by the (larger) taxable temporary differences.

(iii) The development costs have a carrying value of ₹ 15,20,000 (₹ 16,00,000 – (₹ 16,00,000 x 1/5 x 3/12)).

The tax base of the development costs is nil since the relevant tax deduction has already been claimed.

The deferred tax liability will be ₹ 3,04,000 (₹ 15,20,000 x 20%). All deferred tax liabilities are shown as non-current.

(iv) The carrying value of the loan at 31st March, 20X2 is ₹ 1,07,80,000 (₹ 1,00,00,000 – ₹ 2,00,000 + (₹ 98,00,000 x 10%)).

The tax base of the loan is ₹ 1,00,00,000.

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This creates a deductible temporary difference of ₹ 7,80,000 (₹ 1,07,80,000 – ₹ 1,00,00,000) and a potential deferred tax asset of ₹ 1,56,000 (₹ 7,80,000 x 20%).

Due to the availability of taxable profits next year (see part (ii) above), this asset can be recognised as a deduction from deferred tax liabilities.

8. Impact on consolidated balance sheet of PQR Ltd. group at 31st March, 20X2

- The tax loss creates a potential deferred tax asset for the PQR Ltd. group since its carrying value is nil and its tax base is ₹ 30,00,000. However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.
- The development costs have a carrying value of ₹ 15,20,000 (₹ 16,00,000 – (₹ 16,00,000 x 1/5 x 3/12)). The tax base of the development costs is nil since the relevant tax deduction has already been claimed. The deferred tax liability will be ₹ 4,56,000 (₹ 15,20,000 x 30%). All deferred tax liabilities are shown as non-current.
- The carrying value of the loan at 31st March, 20X2 is ₹ 1,07,80,000 (₹ 1,00,00,000 – ₹ 200,000 + (₹ 98,00,000 x 10%)). The tax base of the loan is 1,00,00,000. This creates a deductible temporary difference of ₹ 7,80,000 and a potential deferred tax asset of ₹ 2,34,000 (₹ 7,80,000 x 30%).

9. Calculation of Deductible temporary differences:

Deferred tax asset	=	₹ 80,000
Existing tax rate	=	40%
Deductible temporary differences	=	80,000/40%
	=	₹ 2,00,000

Calculation of Taxable temporary differences:

Deferred tax liability	=	₹ 60,000
Existing tax rate	=	40%
Deductible temporary differences	=	60,000 / 40%
	=	₹ 1,50,000

Of the total deferred tax asset balance of ₹ 80,000, ₹ 28,000 is recognized in OCI

Hence, Deferred tax asset balance of Profit & Loss is ₹ 80,000 - ₹ 28,000 = ₹ 52,000

Deductible temporary difference recognized in Profit & Loss is ₹ 1,30,000 (52,000 / 40%)

Deductible temporary difference recognized in OCI is ₹ 70,000 (28,000 / 40%)

The adjusted balances of the deferred tax accounts under the new tax rate are:

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Deferred tax asset		₹
Previously credited to OCI-equity	₹ 70,000 x 0.45	31,500
Previously recognised as Income	₹ 1,30,000 x 0.45	58,500
		90,000
Deferred tax liability		
Previously recognized as expense	₹ 1,50,000 x 0.45	67,500

The net adjustment to deferred tax expense is a reduction of ₹ 2,500. Of this amount, ₹ 3,500 is recognised in OCI and ₹ 1,000 is charged to P&L.

The amounts are calculated as follows:

	Carrying amount at 45%	Carrying amount at 40%	Increase (decrease) in deferred tax expense
Deferred tax assets			
Previously credited to OCI-equity	31,500	28,000	(3,500)
Previously recognised as Income	58,500	52,000	(6,500)
	90,000	80,000	(10,000)
Deferred tax liability			
Previously recognized as expense	67,500	60,000	7,500
Net adjustment			(2,500)

An alternative method of calculation is:		₹
DTA shown in OCI	₹ 70,000 x (0.45 - 0.40)	3,500
DTA shown in Profit or Loss	₹ 1,30,000 x (0.45-0.40)	6,500
DTL shown in Profit or Loss	₹ 1,50,000 x (0.45 -0.40)	7,500

Journal Entries

		₹	₹
Deferred tax asset	Dr.	3,500	
OCI –revaluation surplus			3,500
Deferred tax asset	Dr.	6,500	
Deferred tax expense			6,500

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Deferred tax expense	Dr.	7,500	
Deferred tax liability			7,500

Alternatively, a combined journal entry may be passed as follows:

		₹	₹
Deferred tax asset	Dr.	10,000	
Deferred tax expense	Dr.	1,000	
To OCI –revaluation surplus			3,500
To Deferred tax liability			7,500

10. Calculation of Net assets acquired (excluding the effect of deferred tax liability):

Net assets acquired	Tax base ₹'000	Fair values ₹'000
Land and buildings	500	700
Property, plant and equipment	200	270
Inventory	100	80
Accounts receivable	150	150
Cash and cash equivalents	130	130
Total assets	1,080	1,330
Accounts payable	(160)	(160)
Retirement benefit obligations	-	(100)
Net assets before deferred tax liability	920	1,070

Calculation of deferred tax arising on acquisition of entity S and goodwill

	₹ '000	₹ '000
Fair values of S's identifiable assets and liabilities (excluding deferred tax)		1,070
Less: Tax base		(920)
Temporary difference arising on acquisition		150
Net deferred tax liability arising on acquisition of entity S (₹ 1,50,000 @ 40%)		60
Purchase consideration		1,500

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Less: Fair values of entity S's identifiable assets and liabilities (excluding deferred tax)	1,070	
Deferred tax liability	(60)	(1,010)
Goodwill arising on acquisition		490

Note: Since, the tax base of the goodwill is nil, taxable temporary difference of ₹ 4,90,000 arises on goodwill. However, no deferred tax is recognised on the goodwill. The deferred tax on other temporary differences arising on acquisition is provided at 40% and not 30%, because taxes will be payable or recoverable in entity S's tax jurisdictions when the temporary differences will be reversed.

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UNIT 2 :
INDIAN ACCOUNTING STANDARD 21 : THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

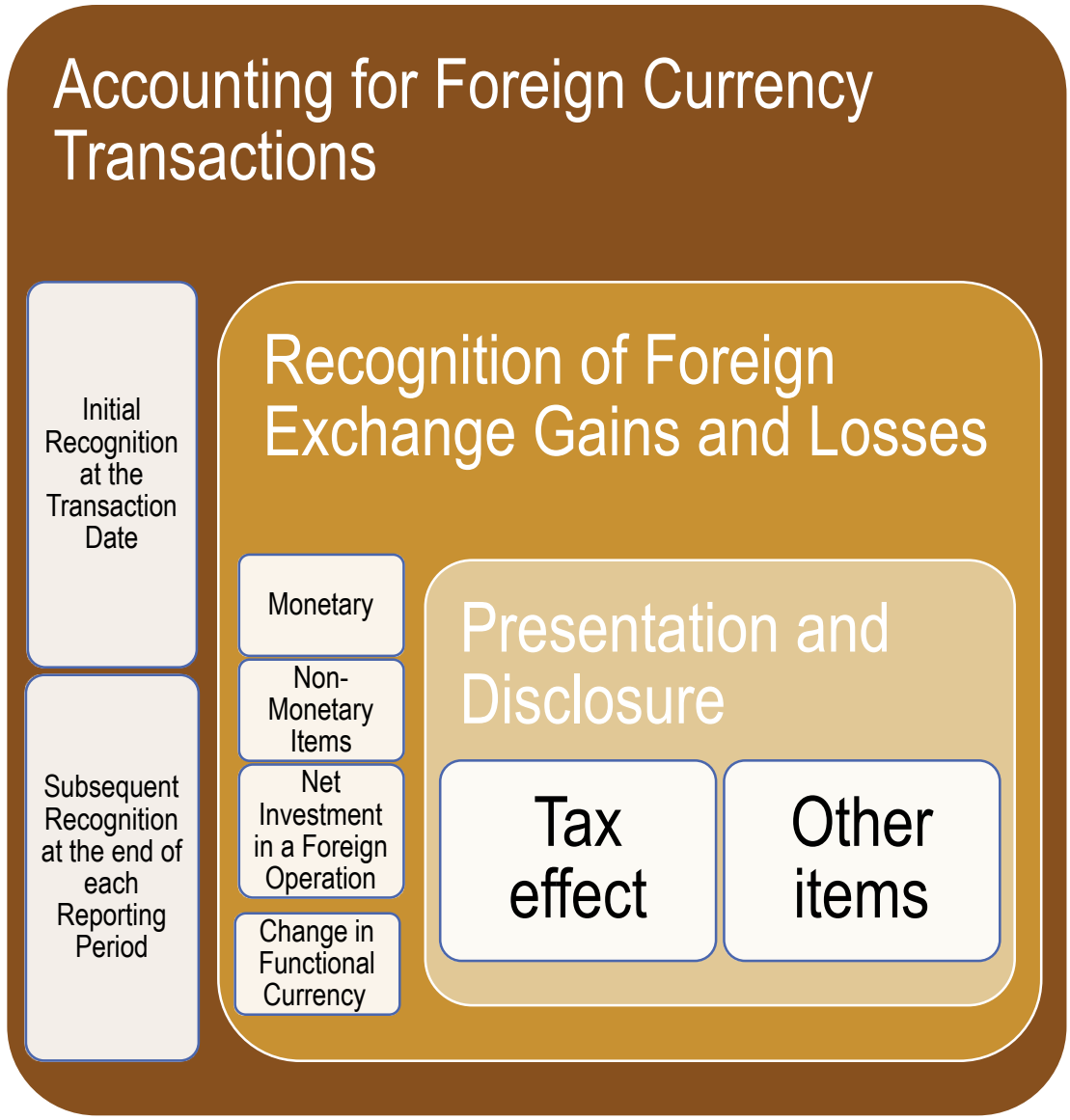
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Describe the objective and scope of the standard
- Define the terms used in the standard like closing rate, exchange difference, exchange rate, fair value, foreign currency, foreign operation, functional currency, monetary items, group, net investment in a foreign operation, presentation currency and spot exchange rate
- Report foreign currency transactions in the functional currency
- Report at the end of subsequent reporting periods foreign currency monetary and non-monetary items
- Recognise and account for the exchange differences
- Apply the translation procedures in case of change in functional currency
- Recognise the presentation currency and translate the items into it from the functional currency
- Incorporate the results and financial position of a foreign operation on translation
- Apply the provisions of translation in case of consolidation
- Deal with the disposal or partial disposal of a foreign operation
- Compute tax effects of all exchange differences
- Comply with the disclosure requirements given in the standard

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UNIT OVERVIEW



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2.1 OBJECTIVE

The objective of the Standard is to address the accounting for foreign activities which include:

- transactions in foreign currencies; or
- foreign operations.

Considering that an entity may present its financial statements in a foreign currency, the Standard also seeks to prescribe how to translate financial statements into a presentation currency.

In this context, the Standard defines ***foreign currency*** as a currency other than the functional currency of the entity.

1. ***Functional currency*** is the currency of the primary economic environment in which the entity operates.

   In this regard, the primary economic environment will normally be the one in which it primarily generates and expends cash i.e. it operates. The functional currency is normally the currency of the country in which the entity is located. It might, however, be a different currency.

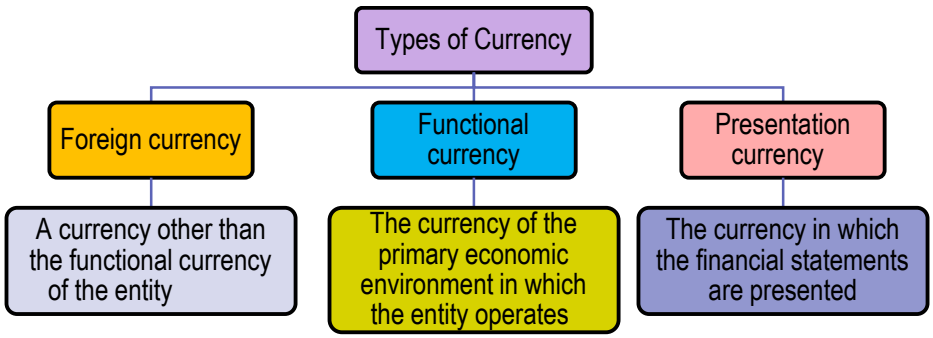
2. ***Foreign operation*** has been defined as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

3. ***Presentation currency*** is the currency in which the financial statements are presented, the presentation currency may be different from the entity's functional currency.

4. **Spot exchange rate** is the exchange rate for immediate delivery.

5. **Closing rate** is the spot exchange rate at the end of the reporting period.

6. **Exchange difference** is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates is the exchange rate for immediate delivery.



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2.2 SCOPE

- Ind AS 21 shall be applied:

  (a) in accounting for transactions and balances in foreign currencies, except for derivative transactions and balances covered by Ind AS 109.

  Foreign currency derivatives not covered by Ind AS 109 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard.

  The Standard also applies for translation of amounts relating to derivatives from functional currency to presentation currency.

  (b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and

  (c) in translating an entity's results and financial position into a presentation currency.

- Ind AS 21 **does not apply** to:

  (a) hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation; Ind AS 109 should be applied for hedge accounting;

  (b) presentation of cash flows from transactions in a foreign currency or to translation of cash flows of a foreign operation in the statement of cash flows (Refer Ind AS 7, Statement of Cash Flows); and

  (c) long term foreign currency monetary items for which an entity has opted for the exemption as per Ind AS 101. Such an entity may continue to apply the accounting policy as opted for such long term foreign currency monetary items.

2.3 FUNCTIONAL CURRENCY

- An entity measures its assets, liabilities, equity, income and expenses in its functional currency.
- All transactions in currencies other than the functional currency are foreign currency transactions.

Ind AS 21 requires each entity to determine its functional currency.

- In determining its functional currency, an entity emphasises the currency that determines the pricing of the transactions that it undertakes, rather than focusing on the currency in which those transactions are denominated.
- The following are the factors that may be considered in determining an appropriate functional currency (**Primary indicators**):

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(a) the currency:

i. that mainly influences sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and

ii. of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.

- Other factors that may provide supporting evidence to determine an entity's functional currency are (**Secondary indicators**):

(a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and

(b) the currency in which receipts from operating activities are usually retained.

- **If an entity is a foreign operation**, additional factors are set out in this Standard which should be considered to determine whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint venture:

(a) Whether the activities of foreign operations are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;

> **An example of the former is when** the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it.
>
> **An example of the latter** is when the foreign operations accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

(b) Whether the transactions with the reporting entity are a high or a low proportion of the foreign operation's activities;

(c) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity.

These factors also demonstrate whether the entity is integral to the reporting entity or not. In practice, the functional currency of a foreign operation that is integral to the parent / reporting entity will usually be the same as that of the parent / reporting entity.

- Determining an entity's functional currency depends on the facts and circumstances.

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- When the above indicators are mixed and the functional currency is not obvious, the management will be required to use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, management has to give priority to the primary indicators before considering the other indicators, which are designed to provide additional supporting evidence to determine an entity's functional currency.

Illustration 1

Future Ltd. sells a revitalising energy drink that is sold throughout the world. Sales of the energy drink comprise over 90% of the revenue of Future Ltd. For convenience and consistency in pricing, sales of the energy drink are denominated in USD. All financing activities of Future Ltd. are in its local currency (L$), although the company holds some USD cash reserves. Almost all of the costs incurred by Future Ltd. are denominated in L$.

Determine the functional currency of Future Ltd.

Solution

The functional currency of Future Ltd. is L$ looking at the primary indicators. The facts presented indicate that the currency that mainly influence the cost of producing the energy drink is the L$. As stated in the fact pattern, pricing of the product in USD is done for convenience and consistency purposes; there is no indication that the sales price is influenced by the USD.

*****

Illustration 2

Small India Private Limited (Small), a subsidiary of Big Inc., takes orders from Indian customers for Big Inc's merchandise and then bills and collects for the sale of the merchandise in Rupees. Small also has a local warehouse in India to facilitate timely delivery and ensures that it remits to its parent all cash flows that it generates as the operations of Small are primarily financed by Big Inc. Big Inc is based out of US and has its functional currency as USD.

Determine the functional currency of Small India Private Limited.

Solution

Small, although based in India with its cash flows generated in India, is essentially a "pass through company" established by its parent. Small is totally reliant on Big Inc. for financing and goods to be sold, despite the fact that goods are sold within India and in Rupees (₹). Therefore, Small is not a self-contained entity in India, rather an entity that is dependent on its parent.

Due to this dependence of Small on its parent company, it can be said that the primary economic environment for Small is that of US and thus, its functional currency should also be USD.

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Hence all the transactions of Small which are denominated in any currency other than USD should be recorded in USD at the spot rate and any changes in the exchange rate would result in an exchange gain or loss to be taken to the statement of profit or loss.

*****

Illustration 3

A is an Oman based company having a foreign operation, B, in India. The foreign operation was primarily set up to execute a construction project in India. The functional currency of A is OMR.

78% of entity B's finances have been raised in USD by way of contribution from A. B's bank accounts are maintained in USD as well as Rupees (₹). Cash flows generated by B are transferred to A on a monthly basis in USD in respect of repayment of finance received from A.

Revenues of B are in USD. Its competitors are globally based. Tendering for the construction project happened in USD.

B incurs 70% of the cost in Rupees (₹) and remaining 30% costs in USD.

Comment since B is located in India, can it presume its functional currency to be Rupees (₹).

Solution

No, B cannot presume Rupees (₹) to be its functional currency on the basis of its location. It needs to consider various factors listed in Ind AS for determination of functional currency.

Primary indicators:

1. the currency that mainly influences
   (a) sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
   (b) labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.
2. Other factors that may provide supporting evidence to determine an entity's functional currency are (**Secondary indicators**):
   (a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
   (b) the currency in which receipts from operating activities are usually retained.
3. **If an entity is a foreign operation**, additional factors set out in Ind AS 21 should be considered to determine whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint venture:
   (a) Whether the activities of foreign operations are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;

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(b) Whether the transactions with the reporting entity are a high or a low proportion of the foreign operation's activities;

(c) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity.

On the basis of additional factors mentioned in point 3 above, B cannot be said to have functional currency same as that of A Ltd.

Hence primary and secondary indicators should be used for the determination of functional currency of B giving priority to primary indicators. The analysis is given below:

- Its significant revenues and competitive forces are in USD.
- Its significant portion of cost is incurred in Rupees (₹). Only 30% costs are in USD.
- 78% of its finances have been raised in USD.
- It retains its operating cash flows partially in USD and partially in Rupees (₹).

Keeping these factors in view, USD should be considered as the functional currency of B.

*****

Illustration 4

S Ltd is a company based out of India which got listed on Bombay Stock Exchange in the financial year ended 31st March, 20X1. Since then, the company's operations have increased considerably. The company was engaged in the business of trading of motorcycles. The company only deals in imported motorcycles. These motorcycles are imported from US.

After importing the motorcycles, these are sold across India through its various distribution channels. The company had only private customers earlier, but the company also started corporate tie-up and increased its customer base to corporates also. The purchase of the motorcycles are in USD because the vendor(s) from whom these motorcycles are purchased those are all located in US.

All other operating expenses of the company are incurred in India only because of its location and they generally happen to be in Rupees (₹).

Currently, its customers are both corporate and private in the ratio of 70:30 approximately. The USD denominated prices of motorcycles in India are different from those in other countries.

The company is also expecting that in the coming years, its customers base will increase significantly in India and the current proportion may also change.

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Currently, the invoices are raised to the corporate customers in USD for the purpose of hedging. However, private customers don't accept the same arrangement and hence invoices are raised to them in Rupees (₹).

Determine the functional currency of the company.

Solution

The functional currency of S Ltd is Rupees (₹).

Following factors need to be considered for determination of functional currency:

Primary indicators

1. the currency that mainly influences

(a) sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.

2. Other factors that may provide supporting evidence to determine an entity's functional currency are (**Secondary indicators**):

(a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and

(b) the currency in which receipts from operating activities are usually retained.

Primary and secondary indicators should be used for the determination of functional currency of S Ltd. giving priority to primary indicators.

The analysis is given below:

Ind AS 21 gives greater emphasis to the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated.

Sales prices for motorcycles are mainly influenced by the competitive forces and regulations in India. The market for motorcycles depends on the economic situation in India and the company is in competition with importers of other motor cycle brands.

Even though 70% of the revenue of the company is denominated in USD, Indian economic conditions are the main factors affecting the prices. This is evidenced by the fact that USD denominated sales prices in India are different from USD denominated sales prices for the same motorcycles in other countries.

Management is able to determine the functional currency because the revenue is clearly influenced by the Indian economic environment and expenses are mixed.

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On the basis of above analysis, Rupees (₹) should be considered as the functional currency of the company.

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2.4 ACCOUNTING FOR FOREIGN CURRENCY TRANSACTIONS

2.4.1 Initial recognition at the transaction date

- A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency (i.e., a currency other than the functional currency of the entity), including transactions arising when an entity:

  (a) buys or sells goods or services whose price is denominated in a foreign currency;

  (b) borrows or lends funds with amounts denominated in a foreign currency; or

  (c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

- A foreign currency transaction is initially recorded by translation in the entity's functional currency at the exchange rate on the transaction date.

  For practical reasons, a rate that approximates the actual exchange rate is often used.

Example

An average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period.

However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

2.4.2 Monetary vs non-monetary items

S. No.	Particulars	Monetary items	Non-monetary item
1.	Units of currency	Units of currency held and assets and liabilities to be received or paid are in a fixed or determinable number of units of currency.	There is no fixed or determinable number of units of currency

- **Examples of monetary items** include:
  - ♦ pensions and other employee benefits to be paid in cash;
  - ♦ provisions that are to be settled in cash;
  - ♦ lease liabilities;

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- cash dividends that are recognised as a liability;
- contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value* to be received (or delivered) equals a fixed or determinable number of units of currency.
- Most debt securities are considered as monetary items because their contractual cash flows are fixed or determinable.

Note: Fair value is the price that would be recovered to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- **Examples of non-monetary items** include**:**
  - amounts prepaid for goods and services and income received in advance, on the basis that no money will be paid or received in the future;
  - goodwill;
  - intangible assets;
  - inventories;
  - property, plant and equipment;
  - right-of-use assets;
  - provisions that are to be settled by the delivery of a non-monetary asset.

2.4.3 Subsequent recognition at the end of each reporting period

- At the reporting date, assets and liabilities denominated in a foreign currency are translated as follows:
  (a) **monetary items** are translated at the exchange rate at the reporting date i.e., closing rate;
  (b) **non-monetary items measured at historical cost** are translated at the exchange rate at the date of the transaction; and
  (c) **non-monetary items measured at fair value in a foreign currency** are translated at the exchange rate on the date the fair value was determined.
- The carrying amount of the item is determined applying the relevant Accounting Standard.

Example

Property, plant and equipment may be measured at fair value or historical cost as per Ind AS 16, *Property, Plant and Equipment*.

The carrying amount so determined, be it on the basis of historical cost or fair value, if in foreign currency, is translated into the functional currency in accordance with this Standard.

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- In some cases, the carrying amount of items is determined by comparing two or more amounts e.g.:
  - ♦ Inventories - measured at lower of cost and net realisable value.
  - ♦ Asset subject to impairment loss - lower of an asset's carrying amount and its recoverable amount.

  If such an asset is non-monetary and measured in a foreign currency, the carrying amount is determined by comparing:

  (a) the cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e. the rate at the date of the transaction for an item measured in terms of historical cost); and

  (b) the net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (eg. the closing rate at the end of the reporting period).

  The above may result in an impairment loss being recognised in the functional currency but not in the foreign currency, or vice versa.

Example 1

A foreign currency asset amounting to Euro 2,00,000 is recorded at the date of purchase when the exchange rate was ₹ 52 at ₹ 104 lacs.

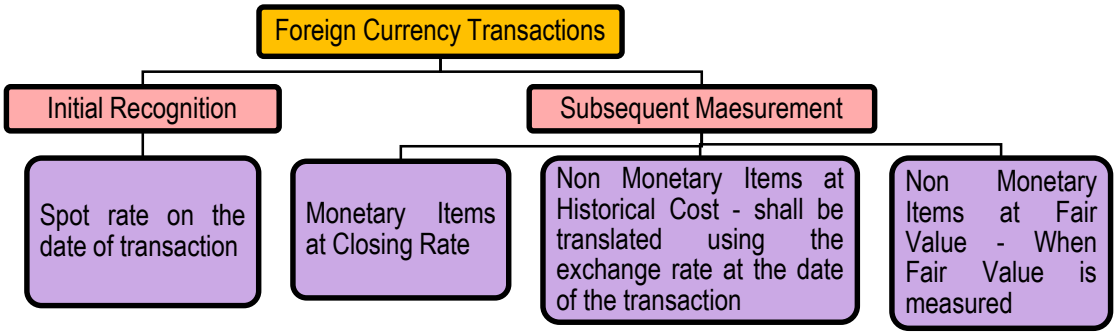
The recoverable amount of the asset on the reporting date is calculated as Euro 1,75,000. The exchange rate on the date of valuation was ₹ 60 to a Euro.

The carrying value of the foreign currency asset will be determined based on the recoverable amount of the asset converted into functional currency at the exchange rate on valuation date which is ₹ 105 lacs.

The impairment loss of Euro 25,000 in foreign currency is not recognised.

- Where a country has multiple exchange rates, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.

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2.4.4 Recognition of foreign exchange gains and losses

- Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.
- When the transaction occurs and settles within the same accounting period, all the exchange difference is recognized in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference is recognised in each period till settlement date based on change in exchange rates during each period.

2.4.4.1 Monetary items

Exchange differences arising on the settlement of monetary items or on translating monetary items are recognised in profit or loss, except:

(i) for accounting of exchange difference as required by application of hedge accounting under Ind AS 109. For example - Ind AS 109 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge should be recognised initially in other comprehensive income to the extent that the hedge is effective;

(ii) for monetary items that in substance form part of the reporting entity's net investment in a foreign operation (discussed below);

(iii) for long-term foreign currency monetary items in case the entity has exercised the option for recognising exchange differences on such items in equity (discussed below).

2.4.4.2 Non-monetary items

- Ind AS requires certain gains and losses to be recognised in other comprehensive income.

> **For example**, revaluation gain or loss on property, plant and equipment is recognised in other comprehensive income as per Ind AS 16. When such an asset is measured in a foreign currency and its revalued amount is translated as per this Standard using the rate at the date the fair value was determined, the resulting exchange gain or loss is also recognised in other comprehensive income.

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- If the gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss is also recognized in profit or loss.

2.4.4.3 Net investment in a foreign operation

- **Net investment in a foreign operation** is the amount of the reporting entity's interest in the net assets of that operation.
- A monetary item receivable from or payable to a foreign operation may form part of the net investment in a foreign operation if the settlement of the monetary item is neither planned nor likely to occur in the foreseeable future.

  A loan to a foreign entity which is repayable on demand might seem to be a short-term item, rather than part of capital. However, if there is demonstrably no intent or expectation to demand repayment (e.g., the short-term loan is getting rolled over continuously, whether or not the foreign subsidiary is able to repay it), the loan has the same economic effect as that of a capital contribution.

  On the other hand, when there is a long-term loan with a fixed maturity period (say, 10 to 15 years) it does not automatically qualify to be treated as being part of the net investment simply because it is of a long duration, unless management has expressed its intention to renew the loan at maturity and accordingly, the period of repayment is not foreseeable.

  It lies on the management to document its intention to renew by auditable evidence, such as board minutes. Otherwise, in the absence of management's intention to renew, the loan's maturity date implies that its settlement is planned in the foreseeable future.
- Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.
- Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation (i.e. a subsidiary, associate or joint venture) should be treated as follows:
  - Such exchange differences are recognised in profit or loss in the separate financial statements of the reporting entity and/or the individual financial statements of the foreign operation, as appropriate:
    - If such an item is denominated in the functional currency of the reporting entity, an exchange difference arises in the foreign operation's individual financial statements.
    - If such an item is denominated in the functional currency of the foreign operation, an exchange difference arises in the reporting entity's separate financial statements.
    - If such an item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, an exchange difference arises

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in the reporting entity's separate financial statements and in the foreign operation's individual financial statements.

- In the financial statements that include the foreign operation and the reporting entity (e.g., consolidated financial statements when the foreign operation is a subsidiary, associate or joint venture), such exchange differences are recognised initially in other comprehensive income and then reclassified from equity to profit or loss on disposal of the net investment.

Illustration 5

Functional currency of parent P is EURO while the functional currency of its subsidiary S is USD. P sells inventory to S and a transaction for the same was made for USD 300 during the year. At the year end, a balance of the same amount is outstanding as receivable from S. It has been observed that such balance amount has been continuing as receivable from S year on year and even though the payments in respect of these balances are expected to be received in the foreseeable future but if we look at the year-end then we see this balance as outstanding every year.

In addition to the trading balances between P and S, P has lent an amount of USD 500 to S that is not expected to be repaid in the foreseeable future.

Analyse whether the exchange difference, if any, should be recognised in the profit and loss.

Solution

The exchange gain or loss will arise in the books of accounts of P in respect of its trading balance with S and the same should be recognised in profit or loss. This being a balance for in the nature of trade receivable for P, it would not be considered as its net investment in a foreign operation (i.e. S).

The amount lent by P should be regarded as its net investment in S (i.e. foreign operation). Thus, the exchange gain or loss incurred by P on the USD 500 loan should be recognised in profit or loss in P's separate financial statements and in other comprehensive income in its consolidated financial statements.

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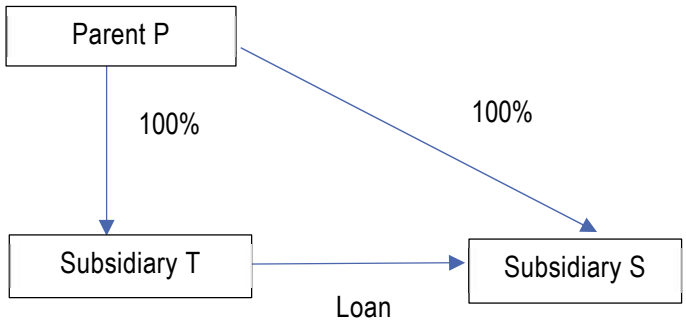
Illustration 6

In the above illustration, suppose that for tax reasons, the 'permanent' funding (i.e. loan amount) extended to S is made via another entity in the group, T, rather than from P directly. That is, on the directions of P, T gives the loan to S. T is also a subsidiary of P.

Demonstrate where should the exchange difference, if any, be recognised.

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Solution



Any exchange difference in respect of the loan is recognised in other comprehensive income in the consolidated financial statements because from the group's point of view the funding relates to an investment in a foreign operation. This is the case irrespective of the currency in which the loan is denominated. So, if the loan is denominated in T's functional currency, and this is different from that of S, then exchange differences still should be recognised in other comprehensive income in the consolidated financial statements.

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2.4.5 Change in functional currency

- Once an entity has determined its functional currency, it is not changed unless there is a change in the relevant underlying transactions, events and conditions.
- If circumstances change and a change in functional currency is appropriate, then the change is accounted for prospectively from the date of the change.

For example, a change in the currency that mainly influences the sales price of goods and services may lead to a change in an entity's functional currency.

- For accounting the effect of a change in functional currency prospectively:
  - ♦ All items are translated into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost.
  - ♦ Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation.
  - ♦ Exchange gain or loss from long-term monetary items accumulated in equity (where such option is exercised) are not transferred to profit or loss immediately on change of the entity's functional currency; the balance would be transferred to profit or loss as per the manner provided by the option.

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- Since entities prefer to present financial statements in their functional currency, a change in functional currency may be accompanied by a change in presentation currency. The choice of presentation currency represents an accounting policy, and any change should be applied retrospectively in accordance with Ind AS 8, unless impracticable. This means that the change should be treated as if the new presentation currency had always been the entity's presentation currency, with comparative amounts being restated into the new presentation currency.

2.5 USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

2.5.1 Translation to the presentation currency

- An entity measures items in its financial statements; but it may decide to present its financial statements in a currency or currencies other than its functional currency.

For example, an entity with Rupees (₹) functional currency may choose to present its financial statements in US Dollar because of its reporting requirement in US.

- There can be situations wherein a group comprises operations with a number of functional currencies. Under Ind AS 21, there is no concept of a "group" functional currency. Rather the group has a presentation currency only. Each entity in the group prepares financial statements in its own functional currency and translates these financial statements into the group's presentation currency (if different) for consolidation purposes.
- The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency as follows:

  (a) **assets and liabilities** for each balance sheet presented (i.e., including comparatives) are translated **at the closing rate** at the date of that balance sheet;

  (b) **income and expenses** are translated at exchange rates at the dates of relevant transactions; **average rates** for the period if often used if they are a reasonable approximation;

  (c) all **resulting exchange differences** should be **recognised in other comprehensive income** as they have little or no direct effect on the present and future cash flows from operations and are presented in a separate component of equity (generally referred to as the foreign currency translation reserve or currency translation adjustment) until disposal of the foreign operation;

  (d) cash flows are translated at exchange rates at the dates of the relevant transactions, although an appropriate average rate may be used.

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- When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognized as a part of, non-controlling interest in the consolidated balance sheet.
- The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy shall be translated into a different presentation currency as follows:

  (a) all amounts (i.e. assets, liabilities, equity items, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent balance sheet, except that

  (b) when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (ie not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).

    - When an entity's functional currency is the currency of a hyperinflationary economy, the entity shall restate its financial statements in accordance with Ind AS 29 before applying the translation method set out above, except for comparative amounts that are translated into a currency of a non-hyperinflationary economy.

2.6 TRANSLATION OF FOREIGN OPERATIONS

- The guidance provided on determining an entity's functional currency equally applies to determine the functional currency of a foreign operation of the entity.
- Effectively, the translation procedures those for translating foreign operations are the same as those followed when an entity presents its financial statements in a presentation currency that is different from its functional currency:

  (a) assets and liabilities are translated at the exchange rate at the reporting date;

  (b) items of income and expense are translated at exchange rates at the dates of the relevant transactions, although appropriate average rates may be used;

  (c) the resulting exchange differences are recognised in other comprehensive income and are presented in a separate component of equity (generally referred to as the foreign currency translation reserve or currency translation adjustment) until disposal of the foreign operation; and

  (d) cash flows are translated at exchange rates at the dates of the relevant transactions, although an appropriate average rate may be used.

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- In addition to the exchange difference as stated above, the foreign currency translation reserve may include exchange differences arising from loans that form part of the parent's net investment in the foreign operation and gains and losses related to hedges of a net investment in a foreign operation.

2.7 DIFFERENCE IN THE REPORTING DATES

- When there is difference in the year end of foreign operation and that of the reporting entity, the foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements.
- When such financial statements are not prepared, Ind AS 110 allows the use of a different date provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates.
- In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the end of the reporting period of the foreign operation.
- Adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity in accordance with Ind AS 110.
- A similar approach is used in applying the equity method to associates and joint ventures in accordance with Ind AS 28, *Investment in Associates and Joint Ventures.*

2.8 INTRA-GROUP TRANSACTIONS

- Although intra-group balances are eliminated on consolidation, any related foreign exchange gains or losses will not be eliminated. This is because the group has a real exposure to a foreign currency since one of the entities will need to obtain or sell foreign currency in order to settle the obligation or realise the proceeds received.
- Accordingly, in the consolidated financial statements of the reporting entity, the exchange difference arising on such intra group transactions is recognised in the statement of profit or loss account, unless it arises from a monetary item that forms part of a reporting entity's net investment in a foreign operation in which case it is taken to other comprehensive income.
- A Group may have intra-group transactions like sale and purchase of various assets such as property, plant and equipment, intangible assets or inventory. These transactions could result in intra-group profits or losses. At the time of consolidation, these profits / losses are eliminated until the profit or loss is realized i.e. when the asset is sold outside the group, depreciated, amortised or written off as per the requirements of Ind AS 110. The elimination of intra-group profits / losses arising from such transactions, like sales between entities that are consolidated,

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should be based on the spot rate i.e. the exchange rate of the date of the sale.

Example 2

Parent P has USD as its functional currency and Subsidiary S has Euro as its functional currency. P, whose reporting date is 31st March, lends USD 100 to S on 30th September, 20X1. S converted the loan amount received into Euro on receipt.

	USD		**EURO**
Exchange rate at 30th September, 20X1	1	=	1.5
Exchange rate at 31st March, 20X2	1	=	2.0

Entries in the books of account of S

Date	Particulars		**Debit (EURO)**	**Credit (EURO)**
30th September, 20X1	Bank A/c	Dr.	150	
	To Intra-group payable			150
	(To recognize intra-group loan)			
31st March, 20X2	Exchange loss A/c	Dr.	50	
	To Intra-group payable			50
	(To recognize exchange loss on intra-group loan)			

In S's second entry, the liability is remeasured at 31st March, 20X2 and a translation loss is recorded.

Entries in the books of account of P

			Debit (USD)	**Credit (USD)**
30th September,20X1	Intra group receivable	Dr.	100	
	To Cash			100
	(To recognize intra-group loan on issue)			

On consolidation at 31st March, 20X2, the receivable and payable (in respect of Intra-group receivable and payable) will be eliminated. However, an exchange loss equivalent to EURO 50 for the year ended 31st March, 20X2 will remain on consolidation. This is appropriate because S will need to obtain USD in order to repay the liability. Therefore, the group has a foreign currency exposure. The exchange loss will be taken to consolidated profit or loss, unless the loan forms part of P's net investment in S in which case it will be transferred to other comprehensive income at the time of consolidation.

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Illustration 7

The functional and presentation currency of parent P is USD while the functional currency of its subsidiary S is EURO. P sold goods having a value of USD 100 to S when the exchange rate was USD 1 = Euro 2. At year-end, the amount is still due, and the exchange rate is USD 1 = Euro 2.2.

Advise how should the exchange difference, if any, be accounted for in the consolidated financial statements.

Solution

At year-end, S should restate its accounts payable to EURO 220, recognising a loss of Euro 20 in its profit or loss. Thus, in the books of S, the balance payable to P will appear at EURO 220 while in the books of P the balance receivable from S will be USD 100.

For consolidation purposes, the assets and liabilities of S will be translated to USD at the closing rate.

At the time of consolidation, USD 100 which will get eliminated against the receivable in the books of P but the exchange loss of EURO 20 recorded in the subsidiary's statement of profit or loss has no equivalent gain in the parent's financial statements. Therefore, exchange loss of EURO 20 will remain in the consolidated statement of profit or loss.

The reason for this is that the intra-group balance represents a commitment to translate Euro into USD and this is similar to holding a foreign currency asset in the books of the parent company. i.e. the subsidiary would be required to buy USD to settle the obligation to the parent, so the Group has an exposure to foreign currency risk.

*****

Illustration 8

M Ltd is engaged in the business of manufacturing of bottles for pharmaceutical companies and non-pharmaceutical companies. It has a wholly owned subsidiary, G Ltd, which is engaged in the business of pharmaceuticals. G Ltd purchases the pharmaceutical bottles from its parent company. The demand of G Ltd is very high and hence to cater to its shortfall, G Ltd also purchases the bottles from other companies. Purchases are made at the competitive prices.

M Ltd sold pharmaceuticals bottles to G Ltd for Euro 12 lacs on 1st February, 20X1. The cost of these bottles was ₹ 830 lacs in the books of M Ltd at the time of sale. At the year-end i.e. 31st March, 20X1, all these bottles were lying as closing stock and payable with G Ltd.

Euro is the functional currency of G Ltd. while Indian Rupee is the functional currency of M Ltd.

Following additional information is available:

Exchange rate on 1st February, 20X1	*1 Euro = ₹ 83*
Exchange rate on 31st March, 20X1	*1 Euro = ₹ 85*

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Provide the accounting treatment for the above in books of M Ltd. and G Ltd. Also show its impact on consolidated financial statements. Support your answer by Journal entries, wherever necessary, in the books of M Ltd.

Solution

Accounting treatment in the books of M Ltd (Functional Currency Rupees (₹))

M Ltd will recognize sales of ₹ 996 lacs (12 lacs Euro x 83)

Profit on sale of inventory = 996 lacs – 830 lacs = ₹ 166 lacs.

On balance sheet date receivable from G Ltd. will be translated at closing rate i.e. 1 Euro = ₹ 85. Therefore, unrealised forex gain will be recorded in standalone profit and loss of ₹ 24 lacs. (i.e. (85 - 83) x 12 Lacs)

Journal Entries

		₹ (in Lacs)	₹ (in Lacs)
G Ltd. A/c	Dr.	996	
To Sales			996
(Being revenue recorded on initial recognition)			
G Ltd. A/c	Dr.	24	
To Foreign exchange difference (unrealised)			24
(Being foreign exchange difference recorded at year end)			

Accounting treatment in the books of G Ltd (Functional currency EURO)

G Ltd will recognize purchases on 1st February, 20X1 of Euro 12 lacs which will also be its closing stock at year end.

Journal Entry

		(in Euros)	(in Euros)
Purchases	Dr.	12 lakhs	
To M Ltd.			12 lakhs

Accounting treatment in the consolidated financial statements

Receivable and payable in respect of above-mentioned sale / purchase between M Ltd and G Ltd will get eliminated.

The closing stock of G Ltd will be recorded at lower of cost or NRV.

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	Euro (in lacs)	Rate	₹ (in lacs)
Cost	12	83	**996**
NRV (Assumed Same)	12	85	1020

Therefore, no write off is required.

The amount of closing stock of ₹ 996 lacs includes two components–

- Cost of inventory for ₹ 830 lacs; and
- Profit element of ₹ 166 lacs; and

At the time of consolidation, the second element amounting to ₹ 166 lacs will be eliminated from the closing stock.

Journal Entry

		₹ (in Lacs)	₹ (in Lacs)
Consolidated P&L A/c	Dr.	166	
To Inventory			166
(Being profit element of intragroup transaction eliminated)			

*****

2.8.1 Dividends

If a subsidiary pays a dividend to the parent during the year the parent should record the dividend at the rate ruling when the dividend was declared. An exchange difference will arise in the parent's own financial statements if the exchange rate moves between the declaration date and the date the dividend is actually received. This exchange difference is required to be recognised in profit or loss and will remain there on consolidation.

The same will apply if the subsidiary declares a dividend to its parent on the last day of its financial year and this is recorded at the year-end in both entities' financial statements. There is no problem in that year as both the intragroup balances and the dividends will eliminate on consolidation with no exchange differences arising. However, as the dividend will not be received until the following year an exchange difference will arise in the parent's financial statements in that year if exchange rates have moved in the meantime. Again, this exchange difference should remain in consolidated profit or loss as it is no different from any other exchange difference arising on intragroup balances resulting from other types of intragroup transactions. It should not be recognised in other comprehensive income.

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It may seem odd that the consolidated results can be affected by exchange differences on inter-company dividends. However, once the dividend has been declared, the parent now effectively has a functional currency exposure to assets that were previously regarded as part of the net investment. In order to minimise the effect of exchange rate movements entities should, therefore, arrange for inter-company dividends to be paid on the same day the dividend is declared, or as soon after the dividend is declared as possible.

2.9 GOODWILL AND FAIR VALUE ADJUSTMENTS ARISING FROM A BUSINESS COMBINATION

- Any goodwill and any fair value adjustments to the carrying amounts of assets and liabilities arising on a foreign operation's acquisition are treated as assets and liabilities of the foreign operation.
- Hence, they are expressed in the functional currency of the foreign operation and should be translated at the closing exchange rate as is the case for other assets and liabilities.

2.10 DISPOSAL OR PARTIAL DISPOSAL OF FOREIGN OPERATIONS

2.10.1 Full disposal

- A disposal may arise, for example, through sale, liquidation or repayment of share capital. On disposal of the foreign operation, the cumulative exchange differences relating to that foreign operation recognised in other comprehensive income and accumulated in equity are reclassified from equity to profit or loss (reclassification adjustment) when the gain or loss on disposal is recognised.
- On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences related to that foreign operation that have been attributed to the non-controlling interests is derecognised, but it is not reclassified to profit or loss.
- In addition to the disposal of an entity's entire interest in a foreign operation, the following partial disposals are accounted for as disposals:
  - when the partial disposal involves the loss of control of a subsidiary that includes a foreign operation, regardless of whether the entity retains a non-controlling interest (NCI) in its former subsidiary after the partial disposal; and
  - when the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes a foreign operation.

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Example 3

Parent P owns 100 percent of foreign subsidiary S. P sells 70 percent of its investment and loses control of S. The entire balance in the foreign currency translation reserve in respect of S is reclassified to profit or loss.

2.10.2 Partial disposal

A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except for those reductions that are accounted for as disposals.

In the case of the partial disposal of a subsidiary that includes a foreign operation, the entity re-attributes the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the NCI in that foreign operation.

In any other partial disposal of a foreign operation, the entity reclassifies to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.

Examples 4 & 5

4. Parent P owns 100 percent of foreign subsidiary S. P sells 10 percent of its investment and retains control over S. Therefore, 10 percent of the balance in the foreign currency translation reserve is reclassified to NCI.
5. Parent P owns 35 percent of foreign associate B. P sells a 5 percent stake and retains significant influence over B. Therefore, one-seventh (5/35) of the balance in the foreign currency translation reserve is reclassified to profit or loss.

A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

2.11 TAX EFFECT OF ALL EXCHANGE DIFFERENCES

Ind AS 12, Income Taxes, applies to tax effects of gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency.

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2.12 DISCLOSURES

Ind AS 21 requires following disclosures:

(a) amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with Ind AS 109;

(b) net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, along with the reconciliation of the amount at the beginning and end of the period;

(c) when the presentation currency is different from the functional currency - that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency;

(d) in case of change in functional currency of either the reporting entity or a significant foreign operation:

  (i) fact of such change;

  (ii) reason for the change and;

  (iii) date of change in functional currency;

(e) if presentation currency is different from functional currency, the financial statements can be described as complying with Ind AS only if all Ind AS including the translation method of this Standard is complied with.

  However, if an entity presents its financial statements or supplementary financial information in a currency other than its functional or presentation currency:

  (i) the information should be clearly identified as supplementary information to distinguish it from the information that complies with Ind AS;

  (ii) the currency in which the supplementary information is displayed should be disclosed; and

  (iii) the entity's functional currency and the method of translation used to determine the supplementary information should be disclosed.

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2.13 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Tata Consultancy Services Limited' for the financial year 2021-2022 with respect to Ind AS 21 'The Effects of Changes in Foreign Exchange Rates'.

Basis of preparation

The functional currency of the Company and its Indian subsidiaries is the Indian Rupee (`). The functional currency of foreign subsidiaries is the currency of the primary economic environment in which the entity operates. Foreign currency transactions are recorded at exchange rates prevailing on the date of the transaction. Foreign currency denominated monetary assets and liabilities are retranslated at the exchange rate prevailing on the balance sheet dates and exchange gains and losses arising on settlement and restatement are recognised in the statement of profit and loss. Non-monetary assets and liabilities that are measured in terms of historical cost in foreign currencies are not retranslated.

Foreign currency translation reserve

The exchange differences arising from the translation of financial statements of foreign operations with functional currency other than Indian Rupee is recognised in other comprehensive income and is presented within equity in the foreign currency translation reserve.

(Source: Annual Report for 2021-2022 of Tata Consultancy Services Limited)

2.14 SIGNIFICANT DIFFERENCES IN IND AS 21 VIS-À-VIS AS 11

S. No.	Particulars	Ind AS 21	AS 11
1.	*Forward Exchange Contracts and other similar Financial Instruments*	Excludes from its scope forward exchange contracts and other similar financial instruments, which are treated in accordance with Ind AS 109.	AS 11 deals with accounting for forward exchange contracts (except forward exchange contracts entered into to hedge the foreign currency risks of future transactions in respect of which firm commitments are

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			made or which are highly probable forecast transactions).
2.	*Exchange Differences arising on Translation of Certain Long-term Monetary Items from Foreign Currency to Functional Currency*	Ind AS 21 does not give the above option. However, Ind AS 21 does not apply to long-term foreign currency monetary items recognised in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP, i.e. AS 11. However, as provided in Ind AS 101, such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items as per the previous GAAP.	AS 11, gives an option to recognise exchange differences arising on translation of certain long-term monetary items from foreign currency to functional currency directly in equity, to be transferred to profit or loss over the life of the relevant liability/asset if such items are not related to acquisition of depreciable capital assets; where such items are related to acquisition of depreciable capital assets, the foreign exchange differences can be recognised as part of the cost of the asset. (paragraphs 46 and 46A of AS 11)
3.	*Approach for Translation*	Ind AS 21 is based on functional currency approach. An entity is required to determine its functional currency which can be different from its presentation currency based on factors envisaged in the standard.	Under AS 11 there is no concept of functional currency. The method used to translate the financial statements of a foreign operation depends on the classification of foreign operation (integral foreign operation or non-integral foreign operation).
4.	*Presentation Currency*	As per Ind AS 21, presentation currency can be different from local currency and it gives detailed guidance in this regard.	AS 11 does not explicitly state so.
5.	*Exchange differences on monetary items,*	As per Ind AS 21 (paragraph 32), exchange differences on	As per AS 11, exchange differences on monetary items,

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	forming part of net investment in a foreign operation	monetary items, that in substance, form part of net investment in a foreign operation, are recognised in profit or loss in the period in which they arise in the separate financial statements and in other comprehensive income in the consolidated financial statements and reclassified from equity to profit or loss on disposal of the net investment.	that in substance, form part of net investment in a foreign operation, are recognised in 'Foreign Currency Translation Reserve' both in the separate and consolidated financial statements until the disposal of the net investment, at which time income or expense on the same are recognised in profit or loss.
6.	*Guidance on foreign Currency Transactions and Advance Consideration*	Ind AS 21 includes Appendix B which gives guidance on foreign Currency Transactions and Advance Consideration	AS 11 does not contain such guidance.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. Parent P acquired 90 percent of subsidiary S some years ago. P now sells its entire investment in S for ₹ 1,500 lakhs. The net assets of S are 1,000 and the NCI in S is ₹ 100 lakhs. The cumulative exchange differences that have arisen during P's ownership are gains of ₹ 200 lakhs, resulting in P's foreign currency translation reserve in respect of S having a credit balance of ₹ 180 lakhs, while the cumulative amount of exchange differences that have been attributed to the NCI is ₹ 20 lakhs

   Calculate P's gain on disposal in its consolidated financial statements.

2. Entity A, whose functional currency is Rupees (₹), has a foreign operation, Entity B, with a Euro functional currency. Entity B issues to A perpetual debt (i.e. it has no maturity) denominated in euros with an annual interest rate of 6 per cent. The perpetual debt has no issuer call option or holder put option. Thus, contractually it is just an infinite stream of interest payments in Euros.

   Analyse in A's consolidated financial statements, whether the perpetual debt can be considered in accordance with para 15 of Ind AS 21, a monetary item "for which settlement is neither planned nor likely to occur in the foreseeable future" (i.e. part of A's net investment in B), with the exchange gains and losses on the perpetual debt therefore being recorded in equity?

3. Infotech Global Ltd. has a functional currency of USD and needs to translate its financial statements into the functional and presentation currency of Infotech Inc. (L$).

   The following balances appear in the books of Infotech Global Ltd. at the year-end prior to translation:

	USD	L$
Property, plant and equipment	50,000	

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Receivables	9,35,000	
Total assets	**9,85,000**	
Issued capital	50,000	30,055
Opening retained earnings	28,000	15,274
Profit & Loss A/c (Profit for the year)	20,000	
Accounts payable	8,40,000	
Accrued liabilities	47,000	
Total equity and liabilities	**9,85,000**	

Translate the above balances of Infotech Global Ltd. into L$ ready for consolidation by Infotech Inc. (Share capital and opening retained earnings have been pre-populated.)

Prepare a working of the cumulative balance of the foreign currency translation reserve.

Additional information:

Relevant exchange rates are:

Rate at beginning of the year L$ 1 = USD 1.22

Average rate for the year L$ 1 = USD 1.175

Rate at end of the year L$ 1 = USD 1.13

4. On 30th January, 20X1, A Ltd. purchased a machinery for $ 5,000 from USA supplier on credit basis. A Ltd.'s functional currency is Rupees. The exchange rate on the date of transaction is 1 $ = ₹ 60. The fair value of the machinery determined on 31st March, 20X1 is $ 5,500. The exchange rate on 31st March, 20X1 is 1$ = ₹ 65. The payment to overseas supplier done on 31st March 20X2 and the exchange rate on 31st March 20X2 is 1$ = ₹ 67. The fair value of the machinery remains unchanged for the year ended on 31st March 20X2. Tax rate is 30%. A Ltd. follows revaluation method in respect of Plant & Machinery.

   Pass the Journal entries for the year ended on 31st March 20X1 and year 20X2 according to Ind AS 21.

5. On 1st January, 20X2, P Ltd. purchased a machine for $ 2 lakhs. The functional currency of P Ltd. is Rupees. At that date the exchange rate was $1= ₹ 68. P Ltd. is not required to pay for this purchase until 30th June, 20X2. Rupees strengthened against the $ in the three months following purchase and by 31st March, 20X2 the exchange rate was $1 = ₹ 65. CFO of P Ltd. feels that these exchange fluctuations wouldn't affect the financial statements because P Ltd. has an asset and a liability denominated in rupees, which was initially the same amount. He also feels that P Ltd. depreciates this machine over four years so the future year-end amounts won't be the same.

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Examine the impact of this transaction on the financial statements of P Ltd. for the year ended 31st March, 20X2 as per Ind AS.

6. Supplier, A Ltd., enters into a contract with a customer, B Ltd., on 1st January, 20X2 to deliver goods in exchange for total consideration of USD 50 million and receives an upfront payment of USD 20 million on this date. The functional currency of the supplier is Rupees (₹). The goods are delivered and revenue is recognised on 31st March, 20X2. USD 30 million is received on 1st April, 20X2 in full and final settlement of the purchase consideration.

   The exchange rates on 1st January, 20X2 and 31st March, 20X2 are ₹ 72 per USD and ₹ 75 per USD respectively.

   State the date of transaction for advance consideration and recognition of revenue. Also state the amount of revenue in Rupees (₹) to be recognized on the date of recognition of revenue.

7. Global Limited, an Indian company acquired on 30th September, 20X1 70% of the share capital of Mark Limited, an entity registered as company in Germany. The functional currency of Global Limited is Rupees and its financial year end is 31st March, 20X2.

   (i) The fair value of the net assets of Mark Limited was 23 million EURO and the purchase consideration paid is 17.5 million EURO on 30th September, 20X1.

   The exchange rates as at 30th September, 20X1 was ₹ 82 / EURO and at 31st March, 20X2 was ₹ 84 / EURO.

   Determine the value at which the goodwill has to be recognised in the financial statements of Global Limited as on 31st March, 20X2, when NCI is valued at proportionate share of fair value of net assets of Mark Limited.

   (ii) Mark Limited sold goods costing 2.4 million EURO to Global Limited for 4.2 million EURO during the year ended 31st March, 20X2. The exchange rate on the date of purchase by Global Limited was ₹ 83 / EURO and on 31st March, 20X2 was ₹ 84 / EURO. The entire goods purchased from Mark Limited are unsold as on 31st March, 20X2.

   Determine the unrealised profit to be eliminated in the preparation of consolidated financial statements.

8. On 1st April, 20X1, Makers Ltd. raised a long term loan from foreign investors. The investors subscribed for 6 million Foreign Currency (FCY) loan notes at par. It incurred incremental issue costs of FCY 2,00,000. Interest of FCY 6,00,000 is payable annually on 31st March, starting from 31st March, 20X2. The loan is repayable in FCY on 31st March, 20X7 at a premium and the effective annual interest rate implicit in the loan is 12%. The appropriate measurement basis for this loan is amortised cost. Relevant exchange rates are as follows:

   - 1st April, 20X1 - FCY 1 = ₹ 2.50.

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- 31st March, 20X2 – FCY 1 = ₹ 2.75.
- Average rate for the year ended 31st Match, 20X2 – FCY 1 = ₹ 2.42. The functional currency of the group is Indian Rupee.

Advise the appropriate accounting treatment for the foreign currency loan in the books of Makers Ltd. for the financial year 20X1-20X2. Also calculate the initial measurement amount for the loan, finance cost for the year, closing balance and exchange gain / loss.

Answers

1. P's gain on disposal in its consolidated financial statements would be calculated in the following manner:

	(₹ in Lakhs)
Sale proceeds	1,500
Net assets of S	(1,000)
NCI derecognised	100
Foreign currency translation reserve	180
Gain on disposal	780

2. Yes, as per Ind AS 21 net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

As per para 15 of Ind AS 21, an entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

Analysis on the basis of above mentioned guidance

Through the origination of the perpetual debt, A has made a permanent investment in B. The interest payments are treated as interest receivable by A and interest payable by B, not as repayment of the principal debt. Hence, the fact that the interest payments are perpetual does not mean that settlement is planned or likely to occur. The perpetual debt can be considered part of A's net investment in B.

In accordance with para 15 of Ind AS 21, the foreign exchange gains and losses should be recorded in equity at the consolidated level because settlement of that perpetual debt is neither planned nor likely to occur.

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3. Translation of the balances for the purpose of consolidation

	USD	Rate	L$
Property, plant and equipment	50,000	1.13	44,248
Receivables	9,35,000	1.13	8,27,434
Total assets	**9,85,000**		**8,71,682**
Issued capital	50,000	—	30,055
Opening retained earnings	28,000	—	15,274
Profit for the year	20,000	1.175	17,021
Accounts payable	8,40,000	1.13	7,43,363
Accrued liabilities	47,000	1.13	41,593
Total equity and liabilities USD	**9,85,000**		**8,47,306**
Foreign Currency Translation Reserve (Refer WN-1)			**24,376**
Total equity and liabilities L$			**8,71,682**

Working Note

1 Cumulative balance of the FCTR

Particulars	Actual translated amount in L$	Amount (Refer WN-2)	Difference
	A	B	B-A
Issued capital	30,055	44,248	14,193
Opening retained earnings	15,274	24,779	9,505
Profit for the year	17,021	17,699	678
	62,350	**86,726**	**24,376**

2 Translated amount if the same conversion rate is applied to following items as applied on other items

			Translated amount
Issued capital	50,000	1.13	44,248
Opening retained earnings	28,000	1.13	24,779
Profit for the year	20,000	1.13	17,699
	98,000		**86,726**

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4. Journal Entries

Purchase of Machinery on credit basis on 30th January 20X1:

		₹	₹
Machinery A/c ($ 5,000 x ₹ 60)	Dr.	3,00,000	
To Creditors-Machinery A/c			3,00,000
(Initial transaction will be recorded at exchange rate on the date of transaction)			

Exchange difference arising on translating monetary item on 31st March 20X1:

		₹	₹
Profit & Loss A/c [($ 5,000 x ₹ 65) – ($ 5,000 x ₹ 60)]	Dr.	25,000	
To Creditors-Machinery A/c			25,000
Machinery A/c	Dr.	30,000	
To Revaluation Surplus (OCI)			30,000
[Being Machinery revalued to USD 5,500; (₹ 60 x ($ 5,500 - $ 5,000)]			
Machinery A/c	Dr.	27,500	
To Revaluation Surplus (OCI)			27,500
(Being Machinery measured at the exchange rate on 31.3.20X1 [$ 5,500 x (₹ 65 - ₹ 60)]			
Revaluation Surplus (OCI)	Dr.	17,250	
To Deferred Tax Liability			17,250
(DTL created @ of 30% of the total OCI amount)			

Exchange difference arising on translating monetary item and settlement of creditors on 31st March 20X2:

		₹	₹
Creditors-Machinery A/c ($ 5,000 x ₹ 65)	Dr.	3,25,000	
Profit & loss A/c [(5,000 x (₹ 67 -₹ 65)]	Dr.	10,000	
To Bank A/c			3,35,000
Machinery A/c [{$ 5,500 x (₹ 67 - ₹ 65)}]	Dr.	11,000	

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To Revaluation Surplus (OCI)			11,000
Revaluation Surplus (OCI)	Dr.	3,300	
To Deferred Tax Liability			3,300
(DTL created @ of 30% of the total OCI amount)			

5. As per Ind AS 21 'The Effects of Changes in Foreign Exchange Rates' the asset and liability would initially be recognised at the rate of exchange in force at the transaction date ie 1st January, 20X2. Therefore, the amount initially recognised would be ₹ 1,36,00,000 ($ 2,00,000 x ₹ 68).

The liability is a monetary item, so it is retranslated using the rate of exchange in force at 31st March, 20X2. This makes the closing liability of ₹ 1,30,00,000 ($ 2,00,000 x ₹ 65).

The gain on re-translation of ₹ 6,00,000 (₹ 1,36,00,000 – ₹ 1,30,00,000) is recognised in the Statement of profit and loss.

The machine is a non-monetary asset carried at historical cost. Therefore, it continues to be translated using the rate of ₹ 68 to $ 1.

Depreciation of ₹ 8,50,000 (₹ 1,36,00,000 x ¼ x 3/12) would be charged to profit or loss for the year ended 31st March, 20X2.

The closing balance in property, plant and equipment would be ₹ 1,27,50,000 (₹ 1,36,00,000 – ₹ 8,50,000). This would be shown as a non-current asset in the balance sheet.

6. This is the case of Revenue recognised at a single point in time with multiple payments. As per the guidance given in Appendix B to Ind AS 21:

A Ltd. will recognise a non-monetary contract liability amounting ₹ 1,440 million, by translating USD 20 million at the exchange rate on 1st January, 20X2 ie ₹ 72 per USD.

A Ltd. will recognise revenue at 31st March, 20X2 (that is, the date on which it transfers the goods to the customer).

A Ltd. determines that the date of the transaction for the revenue relating to the advance consideration of USD 20 million is 1st January, 20X2. Applying paragraph 22 of Ind AS 21, A Ltd. determines that the date of the transaction for the remainder of the revenue as 31st March, 20X2.

On 31st March, 20X2, A Ltd. will:

- derecognise the non-monetary contract liability of USD 20 million and recognise USD 20 million of revenue using the exchange rate as at 1st January, 20X2 ie ₹ 72 per USD; and

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- recognise revenue and a receivable for the remaining USD 30 million, using the exchange rate on 31st March, 20X2 ie ₹ 75 per USD.
- the receivable of USD 30 million is a monetary item, so it should be translated using the closing rate until the receivable is settled.

7. **(i)** Para 47 of Ind AS 21 requires that goodwill arose on business combination shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate in accordance with paragraphs 39 and 42. In this case the amount of goodwill in EURO will be as follows:

Net identifiable asset	Dr.	23 million	
Goodwill (bal. fig.)	Dr.	1.4 million	
To Bank			17.5 million
To NCI (23 x 30%)			6.9 million

Thus, goodwill on reporting date would be 1.4 million EURO x ₹ 84 =₹ 117.6 million

(ii)

Particulars	EURO in million
Sale price of Inventory	4.20
Unrealised Profit [a]	1.80

Exchange rate as on date of purchase of Inventory [b]` 83 / Euro

Unrealized profit to be eliminated [a x b]` 149.40 million

As per para 39 of Ind AS 21 "income and expenses for each statement of profit and loss presented (ie including comparatives) shall be translated at exchange rates at the dates of the transactions".

In the given case, purchase of inventory is an expense item shown in the statement profit and loss. Hence, the exchange rate on the date of purchase of inventory is taken for calculation of unrealized profit which is to be eliminated while preparation of financial statements.

8. **Initial carrying amount of loan in books**

Loan amount received = 60,00,000 FCY

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

58,00,000 FCY

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

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first recognized.

Loan to be converted in Rupees (₹) = 58,00,000 FCY x ₹ 2.50/FCY

= ₹ 1,45,00,000

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

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

Period	Opening Financial Liability (FCY) A	Interest @ 12% (FCY) B	Cash Flow (FCY) C	Closing Financial Liability (FCY) A+B-C
20X1-20X2	58,00,000	6,96,000	6,00,000	58,96,000

The finance cost in FCY is 6,96,000

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

Hence, the finance cost for financial year 20X1-20X2 in Rupees (₹) is ₹ 16,84,320 (6,96,000 FCY x ₹ 2.42 / FCY)

The actual payment of interest would be recorded at 6,00,000 x 2.75 = ₹ 16,50,000

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

So, the closing loan balance in Rupees (₹) is 58,96,000 FCY x ₹ 2.75 / FCY = ₹ 1,62,14,000

The exchange differences that are created by this treatment are recognized in profit and loss.

In this case, the exchange difference is

₹ [1,62,14,000 - (1,45,00,000 + 16,84,320 – 16,50,000)] = ₹ 16,79,680.

This exchange difference is taken to profit and loss.

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NOTES

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CHAPTER 10

IND AS ON DISCLOSURES IN THE FINANCIAL STATEMENTS



UNIT 1: INDIAN ACCOUNTING STANDARD 24: RELATED PARTY DISCLOSURES

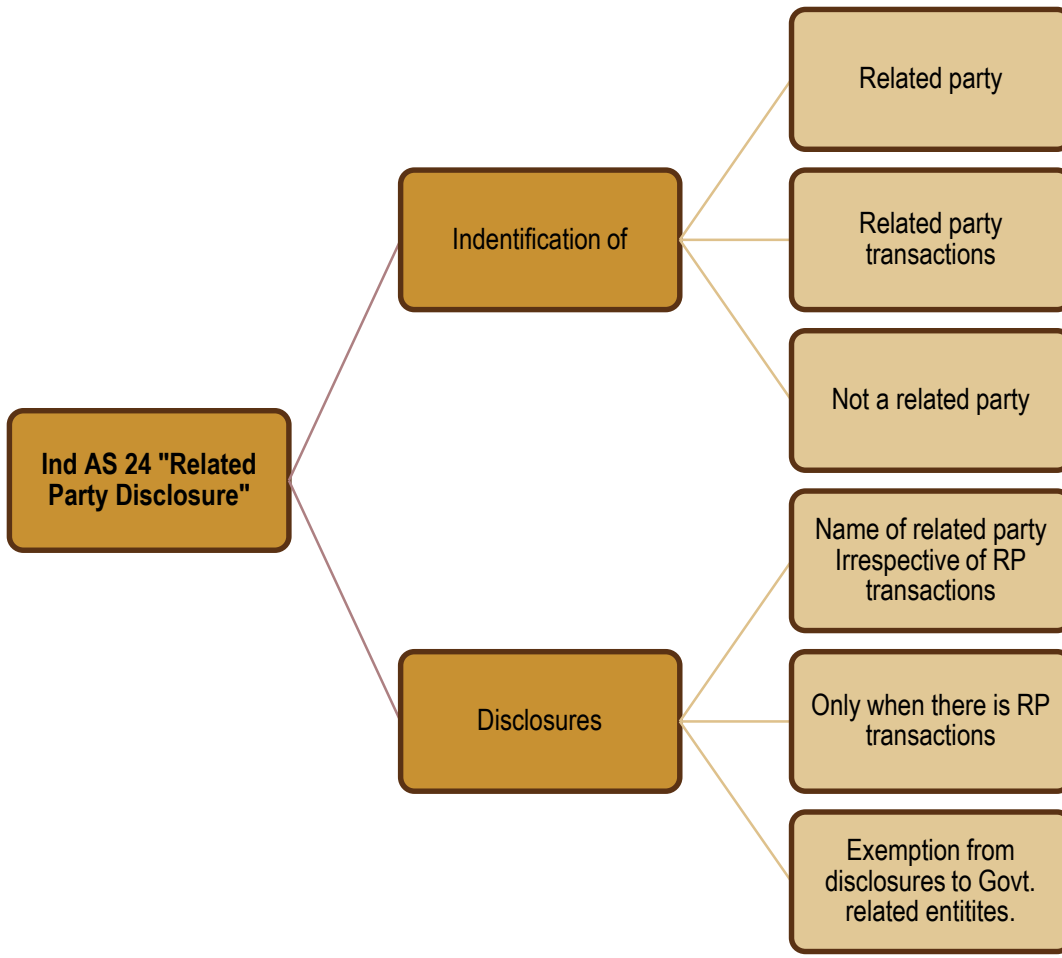
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objective, scope and purpose of related party disclosures in the financial statements
- Define the terms related party, related party transactions, close members of the family of a person, key management personnel, government related entity and other related terms.
- Ensure the necessary disclosures to be made by an entity in its financial statements.
- Analyse the effect of related party transactions in the financial position & profit or loss due to existence of such related parties.
- Understand the significant differences between Ind AS 24 and AS 18.

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UNIT OVERVIEW



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1.1 INTRODUCTION

An entity in the course of its commerce and business enters into numerous transactions and gets impacted by various related party relationships. It is a normal feature of commerce and business to have related party relationships. Entities frequently carry on their business activities through subsidiaries, joint ventures or associates. The entity has the ability to affect the financial and operating policy of a subsidiary generally as it has control over it. In the case of joint venture, it has joint control whereas in the case of an associate it has significant influence.

It is quite probable that related party relationship may have an effect on the profit or loss and financial position of an entity. The effect gets manifested through:

(a) Transactions that are entered between related parties may not be entered with unrelated parties;

- **Example :** An entity may sell goods to its parent at cost. It may not sell goods at cost to an unrelated party.

(b) Transactions with unrelated parties get influenced because of related party relationships.

- **Example :** S Limited, a subsidiary of H Limited, in steel manufacturing used to purchase billets from UR Limited. H Limited acquires 100% stake in FS Limited who also manufactures billets. FS Limited is now a fellow subsidiary of S Limited. H Limited instructs S Limited not to purchase billets from UR Limited but from FS Limited.

Therefore, the users of the financial statements of any entity should have:

(a) the knowledge of:

- related party relationships of an entity;
- entity's transactions, outstanding balances, commitments etc. with such related parties;

(b) as it may affect the user's assessments:

- of operations of the entity and
- the risks and opportunities faced by the entity.

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1.2 OBJECTIVE

The objective of the Standard is to ensure that the financial statements of an entity contains necessary disclosures with respect to:

(a) related party relationships;

(b) related party transactions;

(c) outstanding balances with related parties; and

(d) commitments with related parties.

The disclosures are necessary so that users' attention could be drawn to the possibility that financial statements may be affected by such related party relationships and other items as mentioned above.

1.3 SCOPE

The Standard has to be applied in:

(a) identifying related party relationships;	(b) identifying related party transactions;	(c) identifying outstanding balances between an entity and its related parties;
(d) identifying commitments between an entity and its related parties;	(e) identifying the circumstances in which disclosures of above items is to be made; and	(f) determining the disclosures to be made about the above items.

The disclosures are to be made in:

(a) Individual financial statements of the entity.

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(b) Consolidated and separate financial statements of a parent, venturer or an investor prepared in accordance with Ind AS 110 'Consolidated Financial Statements' or Ind AS 27, 'Separate Financial Statements'.

- Related party transactions and outstanding balances with other entities in a group are disclosed in an entity's financial statements, however, intra-group related party transactions and outstanding balances are eliminated in the preparation of consolidated financial statements of the group.

Exception:

If the above intra group related party transactions & outstanding balances between investment entity and its subsidiary are measured at fair value through profit or loss, then not eliminated.

- Disclosures not required when either
  - ♦ such disclosures are in conflict with the entity's duties of confidentiality in terms of a statute, regulator or similar competent authority governing the entity; or
  - ♦ the entity is prohibited by the statute, regulator or similar competent authority to disclose certain information otherwise required to be disclosed as per this Standard.

Example 1

Banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings.

1.4 DEFINITIONS

The following definitions are relevant for understanding the Standard:

1. A **related party** is (i) a person or (ii) an entity that is related to the reporting entity.
2. A **reporting entity** in this Standard is an entity that is preparing its financial statements.

Thus two types of related party relationships are envisaged.

- ♦ One relationship is between the reporting entity and a person or persons.
- ♦ The other relationship is between the reporting entity and another entity or entities.

Note: The Standard clarifies that in considering each possible related party relationship, the attention should be directed to the substance of the relationship and not merely the legal form.

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1.4.1 Understanding relationship between the reporting entity and a person(s)

3. A **person** or **a close member of that person's family is related to a reporting entity** if that person:

(a) has control or joint control over the reporting entity;

(b) has significant influence over the reporting entity; or

(c) is a member of the key management personnel of

- the reporting entity or
- a parent of the reporting entity.

4. **Close members of the family of a person** are the one who may be expected to influence or be influenced by that person in their dealings with the entity. It includes:

(a) that person's children, spouse or domestic partner, brother, sister, father and mother;

(b) children of that person's spouse or domestic partner; and

(c) dependents of that person or that person's spouse or domestic partner.

5. A **parent** is an entity that controls one or more entities and present consolidated financial statements.

Examples 2-5

2. Mr. A holds 51% in equity share capital of A Limited. A Limited has no other form of share capital. As Mr. A controls A Limited, he is a related party.

3. Mrs. A is wife of Mr. A. Mr. A holds 51% of equity shares of A Limited. A Limited has no other form of share capital. Mr. A controls A Limited. Since Mr. A is a related party, Mrs. A is also a related party of A Limited.

4. Mr. D is a director of A Limited. Being a member of key management personnel of A Limited, he is related to A Limited.

5. Mr. D is a director of H Limited. S Limited is a subsidiary of H Limited. Mr. D is related to S Limited.

1.4.2 Understanding relationship between the reporting entity and another entity/entities

6. An **entity is related to a reporting entity** if any of the following conditions applies:

(a) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

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Example 6

SA Limited and SB Limited are subsidiaries of H Limited. SA Limited, SB Limited and H Limited are related to each other.

(b) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

Example 7

AS Limited is an associate of S Limited. S Limited is a subsidiary of H Limited. SH Limited is another subsidiary of H Limited. AS Limited and SH Limited are related parties.

(c) Both entities are joint ventures of the same third party.

Example 8

H Limited has entered into 2 joint ventures, JHA Limited (joint venture with A Limited) and JHB Limited (joint venture with B Limited). JHA Limited and JHB Limited are related parties.

(d) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

Example 9

JH Limited is a joint venture of H Limited. AH limited is an associate of H Limited. JH Limited and AH Limited are related parties.

(e) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

(f) The entity is controlled or jointly controlled by a person identified in 3 above.

Example 10

Mr. A controls A Limited (the reporting entity). He also controls B Limited. A Limited and B Limited are related to each other.

(g) A person identified in 3(a) above has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

Example 11

Mr. A controls A Limited (the reporting entity). He is a non-executive director in B Limited. A Limited and B Limited are related parties.

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(h) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

Example 12

A Ltd is a parent company with 3 subsidiary companies- B Ltd. C Ltd & D Ltd. It also has an associate company E Ltd. Subsidiary F Ltd of E Ltd provides key management personnel services to A Ltd. F Ltd. is in a related party relationship with A, B, C D & E Ltd.

The aforesaid definition is wide and exhaustive. It is quite possible that the identification of related parties may become an onerous task. The standard, therefore, as has been stated above, lays emphasis on the substance of the relationship rather than legal form.

7. **Control** exists when the investor is exposed or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over investee.

8. **Joint Control** is the contractually agreed sharing of control of an arrangement which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

9. **Significant influence** is the power to participate in the financial and operating policy decisions of the investee, but is not control of those policies.

The terms 'control', 'joint control' and 'significant influence' are discussed in detail in chapters on Ind AS 110, *Consolidated Financial Statements,* Ind AS 111 *Joint Arrangements*' & Ind AS 28, *Investments in Associates & Joint Ventures.*

10. **Key management personnel** are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

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Analysis:

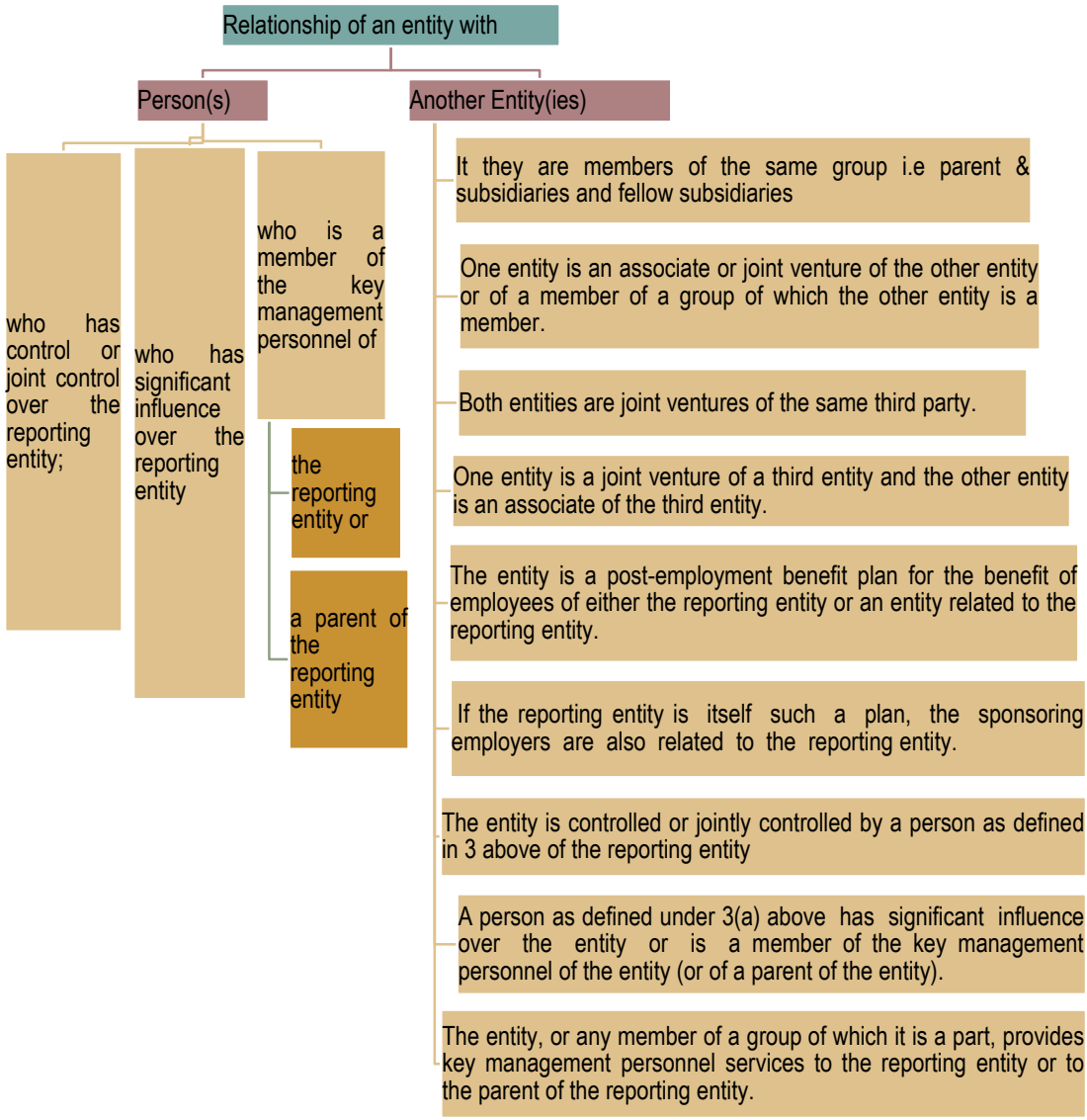
The definition includes executive as well as non-executive directors who have responsibility for the management and direction of a significant part of the business. It is not necessary that these people should have the 'director' designation. The term also includes members of the management committee(s), if those committee(s) have the authority for planning, directing and controlling the entity's activities.

The Standard further states that in the definition of a related party, an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture.

Example 13

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.

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1.4.3 Understanding who are not related parties

The Standard clarifies that certain relationships are not related party relationships. These are as follows:

(a) Two entities are not related parties simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

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Examples 14 & 15

14. 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.

15. 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. Further information and analysis are required here to conclude; by virtue of the transaction only, it cannot be said that they are related parties.

(b) Two venturers are not related parties simply because they share joint control over a joint venture.

Example 16

JV Limited is an equal joint venture of J Limited and V Limited. J Limited and V Limited are not related parties.

(c) (i) providers of finance, (ii) trade unions, (iii) public utilities, and (iv) departments and agencies of a government that does **not** control, jointly control or significantly influence the reporting entity, are not related parties simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).

Example 17

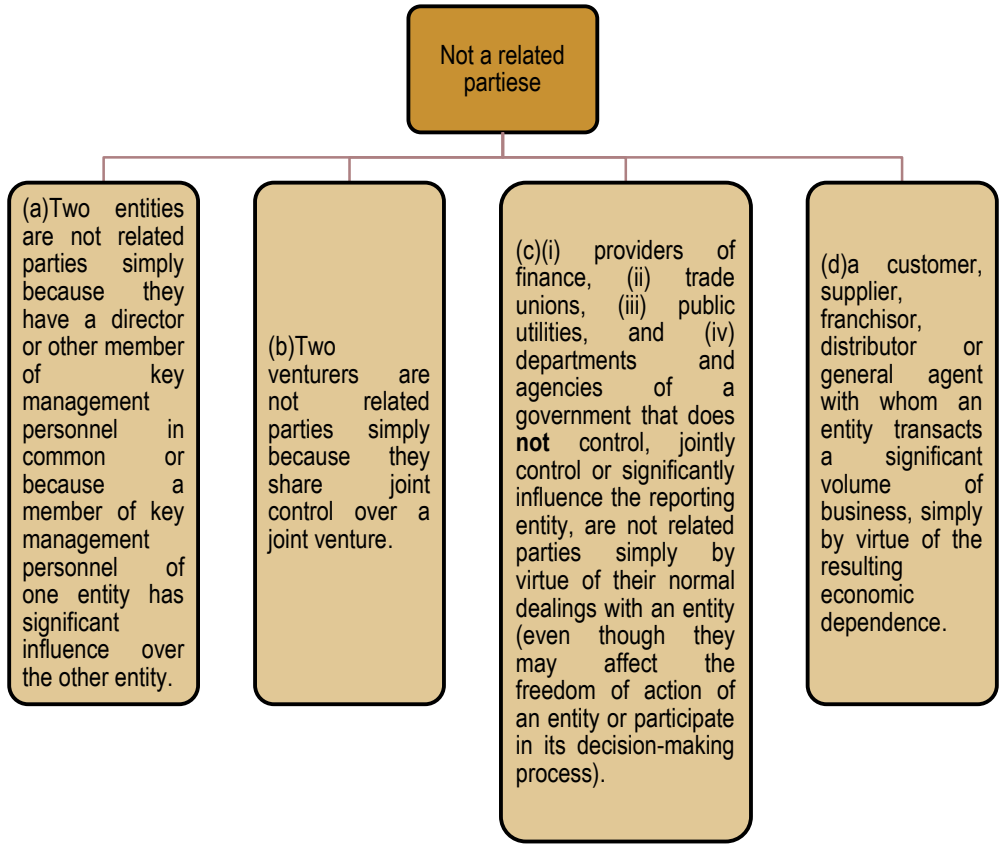
A Bank and B Bank has provided finance to XY Limited. By virtue of loan agreement, they occupy a non-executive observer seat on the Board of Directors of XY Limited. A Bank and B Bank are not related parties of XY Limited.

(d) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.

Example 18

A Limited is an auto ancillary of an automobile company. It supplies all its production to the automobile company. Automobile company has no other interest in A Limited. A Limited and automobile company are not related parties.

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1.4.4 Understanding related party transactions

11. A **related party transaction** is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Examples

(a) purchases or sales of goods (finished or unfinished);

(b) purchases or sales of property and other assets;

(c) rendering or receiving of services;

(d) leases;

(e) transfers of research and development;

(f) transfers under licence agreements;

(g) transfers under finance arrangements (including loans and equity contributions in cash or in kind);

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(h) provision of guarantees or collateral;

(i) commitments to do something if a particular event occurs or does not occur in the future, including executory contracts1 (recognised and unrecognised);

(j) settlement of liabilities on behalf of the entity or by the entity on behalf of that related party; and

(k) management contracts including for deputation of employees.

Note: It is not necessary for any consideration to be passed for the related party transactions.

Also, participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities is a transaction between related parties.

1.4.5 Other Important Definitions

12. **Compensation** includes all employee benefits (as defined in Ind AS 19, *Employee Benefits*) including employee benefits to which Ind AS 102, *Share-based Payments,* applies. Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity. Compensation includes:

(a) short-term employee benefits, monetary such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non—monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long service leave or sabbatical leave, jubilee or other long service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;

(d) termination benefits; and

(e) share-based payment.

13. **Government** refers to government, government agencies and similar bodies whether local, national or international.

14. A **government-related entity** is an entity that is controlled, jointly controlled or significantly influenced by a government.

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1.5 DISCLOSURES

The disclosure requirements can be broadly classified into two categories.

(a) Category 1 requires disclosures of relationships even though there are no related party transactions between the disclosed related parties.

(b) Category 2 requires disclosures of relationships and transactions only when there are related party transactions.

1.5.1 Disclosure- Relationships between parent and subsidiaries

The following disclosures of relationships, if exist, must be made irrespective of the fact whether there have been related party transactions by the entity:

- Under this an entity is required to disclose the name of its parent and, if different, the ultimate controlling party. It may be noted that the ultimate controlling party may be a person.

Example 19

S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. S4 Limited, S3 Limited, S2 Limited and S1 Limited must disclose the name and relationship with S3 Limited, S2 Limited and S1 Limited respectively and with H Limited.

- If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

Examples 20 & 21

20. S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. Only S2 Limited and S1 Limited produces consolidated financial statements for public use. S4 Limited must disclose the name and relationship with S3 Limited, S2 Limited, S1 Limited and H Limited.

21. S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. S3 Limited, S2 Limited, S1 Limited and H Limited all produces consolidated financial statements for public use. S4 Limited must disclose the name and relationship with S3 Limited and H Limited.

- The disclosure of relationship between a parent and its subsidiary (reporting entity) is important because the existence of control relationship may prevent the reporting entity

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from being independent in making its financial and operating decisions. The disclosure of the name of the related party and the nature of the related party relationship where control exists may sometimes be at least as relevant in appraising an entity's prospects as are the operating results and the financial position presented in its financial statements. Such a related party may establish the entity's credit standing, determine the source and price of its raw materials, and determine to whom and at what price the product is sold.

- The Standard clarifies that the requirement to disclose related party relationships between a parent and its subsidiaries is in addition to the disclosure requirements in Ind AS 110, *Consolidated Financial Statements,* Ind AS 28, *Investments in Associates,* and *Joint Ventures*.

1.5.2 Category 2 Disclosure

Under this category, two types of disclosures are required. The first requires disclosures related to compensation to key management personnel. The second requires other disclosures where there have been related party transactions during the year.

1.5.2.1 Disclosures of compensation to key management personnel

An entity is required to disclose

(i) total compensation to key management personnel and

(ii) Compensation for each of the following categories:

(a) short–term employee benefits;

(b) post–employment benefits;

(c) other long-term benefits;

(d) termination benefits;

(e) share–based payments.

If an entity obtains key management personnel services from another entity (the 'management entity'), the entity is not required to apply the requirements to the compensation paid or payable by the management entity to the management entity's employees or directors.

1.5.2.2 Disclosures where there have been related party transactions during the year

- Where an entity has had related party transactions during the periods covered by the financial statements, it shall disclose, in addition to disclosures listed above, the following for the users to understand the potential effect of these relationships and transactions on the financial statements:

(a) the nature of the related party relationship;

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(b) the information about these related party transactions and outstanding balances, including commitments.

- The disclosures, at a minimum, shall include:

  (a) the amount of the transactions;

  (b) the amount of outstanding balances, including commitments, and:

  - their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
  - details of any guarantees given or received;

  (c) provisions for doubtful debts related to the amount of outstanding balances; and

  (d) the expense recognized during the period in respect of bad or doubtful debts due from related parties.

- Amounts incurred by the entity for the provision of key management personnel services that are provided by a separate management entity shall be disclosed.
- The aforesaid disclosures shall be made separately for each of the following categories:

  (a) the parent;

  (b) entities with joint control or significant influence over the entity;

  (c) subsidiaries;

  (d) associates;

  (e) joint ventures in which the entity is a joint venturer;

  (f) key management personnel of the entity or its parent; and

  (g) other related parties.

- The classification of amounts payable to, and receivable from, related parties in the different categories is an extension of the disclosure requirements in Ind AS 1, *Presentation of Financial Statements,* for information to be presented either in the balance sheet or in the notes. The categories are extended to provide a more comprehensive analysis of related party balances and apply to related party transactions.
- However, disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made only if such terms can be substantiated.
- Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

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- Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions.

Example 22

Purchases or sales of goods are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

Following is the extract from the financial statements of the listed entity 'ITC Limited' for the financial year 2021-2022 with respect to 'Related Party disclosure as per Ind AS 24'.

29. Related Party Disclosures

1. ENTERPRISES WHERE CONTROL EXISTS:

Subsidiaries:

a) Srinivasa Resorts Limited
b) Fortune Park Hotels Limited
c) Bay Islands Hotels Limited
d) WelcomHotels Lanka (Private) Limited, Sri Lanka
e) Landbase India Limited
f) Russell Credit Limited and its subsidiary
   Greenacre Holdings Limited
g) Technico Pty Limited, Australia and its subsidiaries
   Technico Technologies Inc., Canada
   Technico Asia Holdings Pty Limited, Australia and its subsidiary
   Technico Horticultural (Kunming) Co. Limited, China
h) Technico Agri Sciences Limited
i) Wimco Limited
j) Pavan Poplar Limited
k) Prag Agro Farm Limited
l) ITC Infotech India Limited and its subsidiaries
   ITC Infotech Limited, UK
   ITC Infotech (USA), Inc. and its subsidiary
   Indivate Inc., USA
m) Gold Flake Corporation Limited

2. OTHER RELATED PARTIES WITH WHOM THE COMPANY HAD TRANSACTIONS

i) Associates & Joint Ventures:

Associates

a) Gujarat Hotels Limited
b) International Travel House Limited
c) Delectable Technologies Private Limited
   – being associates of the Company, and
d) Tobacco Manufacturers (India) Limited (of which the Company is an associate) and the subsidiaries of its ultimate parent company (British American Tobacco p.l.c.)

Associates of the Company's subsidiaries

a) ATC Limited
   – being associate of Gold Flake Corporation Limited
b) Divya Management Limited, and
c) Antrang Finance Limited
   – being associates of Russell Credit Limited

Joint Ventures

Maharaja Heritage Resorts Limited

Joint Venture of the Company's subsidiary

ITC Essentra Limited
– being joint venture of Gold Flake Corporation Limited

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ii) a) Key Management Personnel:

S. Puri	Chairman & Managing Director
N. Anand	Executive Director
B. Sumant	Executive Director
R. Tandon	Executive Director
S. Banerjee#	Non-Executive Director
H. Bhargava#	Non-Executive Director @
N. Doda	Non-Executive Director (w.e.f. 11.08.2021)
A. Duggal#	Non-Executive Director
M. Gupta	Non-Executive Director (w.e.f. 27.10.2021)
S. Mukherjee#	Non-Executive Director (w.e.f. 11.08.2021)
A. Nayak#	Non-Executive Director
S. Panray	Non-Executive Director (w.e.f. 11.08.2021)
N. Rao#	Non-Executive Director
A. K. Seth#	Non-Executive Director
M. Shankar#	Non-Executive Director
D. R. Simpson	Non-Executive Director
A. Jerath	Non-Executive Director (up to 30.04.2021)
S. B. Mathur#	Non-Executive Director (up to 14.09.2021)

@ Non-Executive Director up to 22.08.2021. Appointed as Independent Director w.e.f. 20.12.2021.
# Independent Directors

Chief Financial Officer
S. Dutta
Company Secretary
R. K. Singhi

b) Relatives of Key Management Personnel:

T. Anand (wife of N. Anand)
R. Tandon (wife of R. Tandon)
N. Singhi (wife of R. K. Singhi)

iii) Employee Trusts:

a) IATC Provident Fund
b) ITC Defined Contribution Pension Fund
c) ITC Management Staff Gratuity Fund
d) ITC Employees Gratuity Fund
e) ITC Gratuity Fund 'C'
f) ITC Pension Fund
g) ILTD Seasonal Employees Pension Fund
h) ITC Platinum Jubilee Pension Fund
i) ITC Bhadrachalam Paperboards Limited Management Staff Pension Fund
j) ITC Bhadrachalam Paperboards Limited Gratuity Fund 'A'
k) ITC Bhadrachalam Paperboards Limited Gratuity Fund 'C'
l) ITC Hotels Limited Employees Superannuation Scheme
m) Sunrise Spices Limited Employees Gratuity Fund

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29. Related Party Disclosures (Contd.)

3. DISCLOSURE OF TRANSACTIONS BETWEEN THE COMPANY AND RELATED PARTIES AND THE STATUS OF OUTSTANDING BALANCES AS AT 31.03.2022

(₹ in Crores)

	RELATED PARTY TRANSACTIONS SUMMARY	Enterprises where control exists – Subsidiaries		Associates		Joint Ventures		Key Management Personnel		Relatives of Key Management Personnel		Employee Trusts		Total	
		2022	2021	2022	2021	2022	2021	2022	2021	2022	2021	2022	2021	2022	2021
1.	Sale of Goods/Services	322.83	255.72	1080.07	773.43	54.19	34.04							1457.09	1063.19
2.	Purchase of Goods/Services	394.12	422.08	66.18	60.37	280.30	229.79							740.60	712.24
3.	Acquisition cost of Property, Plant and Equipment	10.58	2.07											10.58	2.07
4.	Sale of Property, Plant and Equipment	–	12.62											–	12.62
5.	Investment in Subsidiaries/Associate	427.24	360.57	1.87	–									429.11	360.57
6.	Renunciation of Rights Issue entitlement	–	6.45											–	6.45
7.	Value of Share Based Payment														
7A.	Capital Contribution for Share Based Payments	(22.06)	(9.80)											(22.06)	(9.80)
7B.	Reimbursement for Share Based Payments	1.66	1.94	0.41	0.39	0.08	0.09							2.15	2.42
8.	Rent Received	25.60	25.86	0.72	0.63									26.32	26.49
9.	Rent Paid*	9.89	8.05	2.51	1.17			1.05	0.58	0.32	0.32			13.77	10.12
10.	Remuneration of Managers on Deputation reimbursed	2.41	2.50	5.36	6.00									7.77	8.50
11.	Remuneration of Managers on Deputation recovered	36.32	30.65	6.83	6.23	1.43	1.29							44.58	38.17
12.	Contribution to Employees' Benefit Plans											178.43	112.98	178.43	112.98
13.	Dividend Income	857.14	723.43	0.31	0.43									857.45	723.86
14.	Dividend Payments			3981.58	5483.72			5.70	5.51					3987.28	5489.23
15.	Interest Income	2.42	2.70											2.42	2.70
16.	Expenses Recovered	10.01	10.75	21.59	4.98	0.11	0.20							31.71	15.93
17.	Expenses Reimbursed	2.81	3.08	0.26	0.23			0.05	0.02					3.12	3.33
18.	Advances Given during the year	0.45	–	–	0.06									0.45	0.06
19.	Adjustment/Receipt towards Refund of Advances	0.45	–	...	0.11									0.45	0.11
20.	Advances Received during the year	85.32	127.76	1496.60	598.34									1581.92	726.10
21.	Adjustment/Payment towards Refund of Advances	152.01	108.61	972.02	659.70									1124.03	768.31
22.	Deposits Given during the year							...	–					...	–
23.	Deposits Refunded during the year			–	0.02									–	0.02
24.	Remuneration to Key Management Personnel (KMP)[1]														
24A.	– Short term benefits							69.33	49.64					69.33	49.64
24B.	– Other remuneration							10.51	8.96					10.51	8.96
24C.	– Stock options granted[2]														
25.	Outstanding Balances[#]														
	i) Receivables	68.76	50.40	78.17	59.16	14.66	11.13							161.59	120.69
	ii) Advances Given			–	...									–	...
	iii) Deposits Given	0.60	0.60					0.08	0.08	0.07	0.07			0.75	0.75
	iv) Advance Taken	147.83	214.52	692.41	167.83									840.24	382.35
	v) Deposits Taken			0.04	0.04									0.04	0.04
	vi) Payables	12.17	10.58	5.91	5.72	13.83	20.98					29.20	130.53	61.11	167.81
26.	Commitments	1.51	0.07											1.51	0.07

* Includes rent pertaining to leases classified as Right of Use Assets.

\# The amounts outstanding are unsecured and will be settled in cash.

[1] Post employment benefits are actuarially determined on overall basis and hence not separately provided.

[2] During the year, the Company granted Stock Options to eligible employees, including Executive Directors and KMPs, under its Employee Stock Option Schemes at 'market price' (within the meaning of the Securities and Exchange Board of India (Share Based Employee Benefits and Sweat Equity) Regulations, 2021). The Company has also granted Employee Stock Appreciation Linked Reward Units (ESAR Units) to the aforesaid persons in the previous years under the 'ITC Employee Cash Settled Stock Appreciation Linked Reward Plan'. Since such Stock Options and ESAR Units are not tradeable, no perquisite or benefit is immediately conferred upon the employee by grant of such Stock Options/ESAR Units, and accordingly the said grants have not been considered as remuneration. However, in accordance with Ind AS -102, the Company has recorded employee benefits expense by way of share based payments to employees at ₹ 61.20 Crores for the year ended 31st March, 2022 (2021 - ₹ 56.69 Crores), of which ₹ 23.14 Crores (2021 - ₹ 27.71 Crores) is attributable to Executive Directors and KMPs.

(Source: Annual Report for 2021-2022 of 'ITC Limited')

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1.6 EXEMPTION TO GOVERNMENT–RELATED ENTITIES

- A reporting entity is 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, in case the reporting entity opts to apply the exemption, it shall disclose:

  (a) the name of the government;

  (b) the nature of the government's relationship with the entity (whether the government has control, joint control or significant influence over the entity);

  (c) to enable the users of the entity's financial statements to understand the effect of related party transactions on its financial statements, the following information in sufficient details:

    - the nature and amount of each individually significant transaction;
    - for other transactions that are not significant individually but are significant when aggregated, either a qualitative or quantitative indication of their extent.

- Thus, the reporting entity is expected to apply its judgment to determine the level of details it is required to disclose as per above. To enable the reporting entity to arrive at decision, it shall consider:

  (a) the closeness of the related party relationship;

  (b) whether the transaction is significant in size;

  (c) whether the transaction is carried out on non-market terms;

  (d) whether these are outside the normal day to day business operations, such as purchase and sales of businesses

  (e) whether they are disclosed to regulatory or supervisory authorities;

  (f) whether they are reported to senior management;

  (g) whether they are subject to shareholder approval.

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Following is the extract from the financial statements of the listed entity 'Cochin Shipyard Limited' for the financial year 2021-2022 with respect to 'Related Party disclosure as per Ind AS 24'.

Nature of transaction - Transaction with other related parties

As CSL is a Government company under the control of Ministry of Shipping (MoS), the Company has availed exemption from detailed disclosures prepared under Ind AS 24 with respect to related party transactions with Government and Government related entities. However, as required under Ind AS 24, following are the individually significant transactions:

Transactions/balances with Government and Government related entities by the parent company.

(₹ in Lakhs)

Particulars	As at March 31, 2022	As at March 31, 2021
Secondment to subsidiary - Hooghly Cochin Shipyard Ltd.(HCSL)	0.00	6.15
Secondment to subsidiary - Udupi Cochin Shipyard Limited	0.00	13.05
Investment in NCDs issued by subsidiary - HCSL	7500.00	4400.00
Investment in NCDs issued by subsidiary - UCSL	1000.00	-
Investment in Right Issue in subsidiary - HCSL	2800.00	2800.00

(Source: Annual Report for 2021-2022 of 'Cochin Shipyard Limited')

Disclosure requirements when exemption applies

In Entity A's financial statements, an example of disclosure to comply for **individually** significant transactions could be:

- **Example** of disclosure for individually significant transaction carried out on non-market terms

Example 23

On 15 January, 20X1 Entity A, a utility company in which Government G indirectly owns 75 per cent of outstanding shares, sold a 10-hectare piece of land to another government-related utility company for ₹ 5 million. On 31, December 20X0 a plot of land in a similar location, of a similar size and with similar characteristics, was sold for ₹ 3 million. There had not been any appreciation or depreciation of the land in the intervening period. See note X [of the financial statements] for disclosure of government assistance as required by Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* and notes Y and Z [of the financial statements] for compliance with other relevant Indian Accounting Standards.

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- **Example** of disclosure for individually significant transaction because of **size** of transaction

Example 24

In the year ended December 20X1 Government G provided Entity A, a utility company in which Government G indirectly owns 75 per cent of outstanding shares, with a loan equivalent to 50 percent of its funding requirement, repayable in quarterly instalments over the next five years. Interest is charged on the loan at a rate of 3 per cent, which is comparable to that charged on Entity A's bank loans.* See notes Y and Z [of the financial statements] for compliance with other relevant Indian Accounting Standards.

- **Example** of disclosure of collectively significant transactions in Entity A's financial statements, an example of disclosure to comply with for **collectively** significant transactions could be:

Example 25

Government G, indirectly, owns 75 per cent of Entity A's outstanding shares. Entity A's significant transactions with Government G and other entities controlled, jointly controlled or significantly influenced by Government G are [a large portion of its sales of goods and purchases of raw materials] or [about 50 per cent of its sales of goods and about 35 per cent of its purchases of raw materials]. The company also benefits from guarantees by Government G of the company's bank borrowing. See note X [of the financial statements] for disclosure of government assistance as required by Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* and notes Y and Z [of the financial statements] for compliance with other relevant Indian Accounting Standards.

1.7 SIGNIFICANT DIFFERENCES IN IND AS 24 VIS-A-VIS AS 18

S. No.	Particulars	Ind AS 24	AS 18
1.	*Definition of Relative*	Ind AS 24 uses the term "a close member of the family of a person".	AS 18 uses the term "relatives of an individual"
		Definition of close members of family as per Ind AS 24 includes those family members, who may be expected to influence, or be influenced by, that person in their dealings with the entity, including:	AS 18 covers the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in

*If the reporting entity had concluded that this transaction constituted government assistance it would have needed to consider the disclosure in Ind AS 20.

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S. No.	Particulars	Ind AS 24	AS 18
		(a) that person's children, spouse or domestic partner, brother, sister, father and mother; (b) children of that person's spouse or domestic partner; and (c) dependents of that person or that person's spouse or domestic partner. Hence, the definition as per Ind AS 24 is much wider.	his/her dealings with the reporting enterprise.
2.	*State Controlled Enterprise:*	Ind AS 24, has extended coverage of Government Enterprises, as it defines a government-related entity as "an entity that is controlled, jointly controlled or significantly influenced by a government." Further, "Government refers to government, government agencies and similar bodies whether local, national or international."	AS 18 defines state-controlled enterprise as *"an enterprise which is under the control of the Central Government and/or any State Government(s)"*.
3.	*Key Management Personnel*	Ind AS 24 covers KMP of the parent as well. Ind AS 24 also covers the entity, or any member of a group of which it is a part, providing key management personnel services to the reporting entity or to the parent of the reporting entity. Further definition of KMP under Ind AS 24 specifically includes Directors whether executive or not and also those KMP who control the entity indirectly.	AS 18 covers key management personnel (KMP) of the entity only
4.	*Related Parties in case of Joint*	Under Ind AS 24 there is extended coverage in case of joint	As per AS 18, co-venturers or co-associates

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S. No.	Particulars	Ind AS 24	AS 18
	Venture	ventures. Two entities are related to each other in both their financial statements, if they are either co-venturers or one is a venturer and the other is an associate.	are not related to each other.
5.	*Effect of influences which do not lead to transactions*	Ind AS 24 does not specifically mention this.	AS 18 mentions that where there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, disclosure of such effects is not required. (Paragraph 18 of AS 18)
6.	*Post-employment Benefits*	Ind AS 24 specifically includes post-employment benefit plans for the benefit of employees of an entity or its related entity as related parties.	AS 18 does not specifically cover entities that are post-employment benefit plans, as related parties.
7.	*Next Most Senior Parent*	Ind AS 24 requires an additional disclosure as to the name of the next most senior parent which produces consolidated financial statements for public use. (Paragraph 13 of Ind AS 24)	AS 18 has no such requirement.
8.	*Disclosure for Compensation*	Ind AS 24 requires extended disclosures for compensation of KMP under different categories viz. short-term employee benefits, post-employment benefits, other long-term benefits, termination benefits, share-based payments.	AS 18 does not specifically require
9.	*Disclosure of 'Amount of the Transactions' vs 'Volume of the Transactions*	Ind AS 24 requires "the amount of the transactions" need to be disclosed. (Paragraph 18 (a) of Ind AS 24)	AS 18 gives an option to disclose the "Volume of the transactions either as an amount or as an appropriate proportion".

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S. No.	Particulars	Ind AS 24	AS 18
			(Paragraph 23(iv) of AS 18)
10.	*Government Related Entities:*	Ind AS 24 requires disclosures of certain information by the government related entities.	AS 18 exempts the disclosure of such information.
11.	*Clarification of Control, Substantial Interest and Significant Influence*	Ind AS 24 neither defines these terms nor it includes such clarificatory text and allows respective standards to deal with the same.	AS 18 includes definition and clarificatory text, primarily with regard to control, substantial interest (including 20% threshold), significant influence (including 20% threshold).

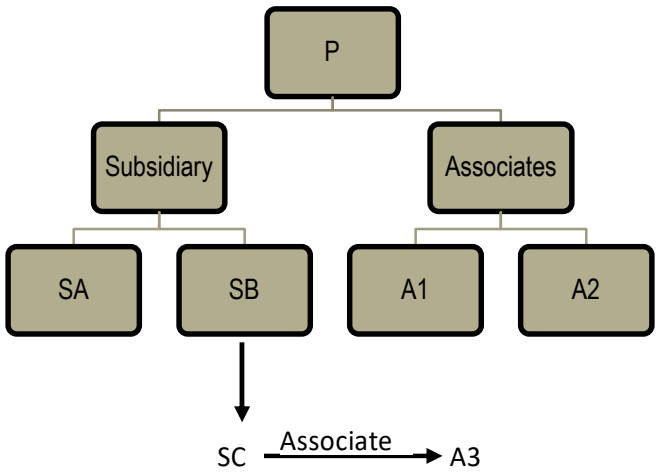
Note: It is strongly advised to draw the diagrams of related party relationships for the following illustrations to test the understanding of the subject matter.

Illustration 1 : Associates and subsidiaries

Entity P Limited has a controlling interest in subsidiaries SA Limited and SB Limited and SC Limited. SC Limited is a subsidiary of SB Limited. P Limited also has significant influence over associates A1 Limited and A2 Limited. Subsidiary SC Limited has significant influence over associate A3 Limited

Examine related party relationships of various entities.

Solution



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- In Separate Financial Statements of P Limited: SA Limited, SB Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SA Limited: P Limited, SB Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SB Limited: P Limited, SA Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SC Limited: P Limited, SA Limited, SB Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of associates A1 Limited, A2 Limited and A3 Limited; P Limited, SA Limited, SB Limited and SC Limited are related parties.
- A1 Limited, A2 Limited and A3 Limited are not related to each other.
- For Parent's consolidated financial statements: A1 Limited, A2 Limited and A3 Limited are related to the Group

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Illustration 2 : Key management personnel

Mr. X has a 100% investment in A Limited. He is also a member of the key management personnel (KMP) of C Limited. B Limited has a 100% investment in C Limited.

Required

(a) Examine related party relationships from the perspective of C Ltd. for A Ltd.

(b) Examine related party relationships from the perspective of C Ltd. for A Ltd. if Mr. X is a KMP of B Ltd. and not C Ltd.

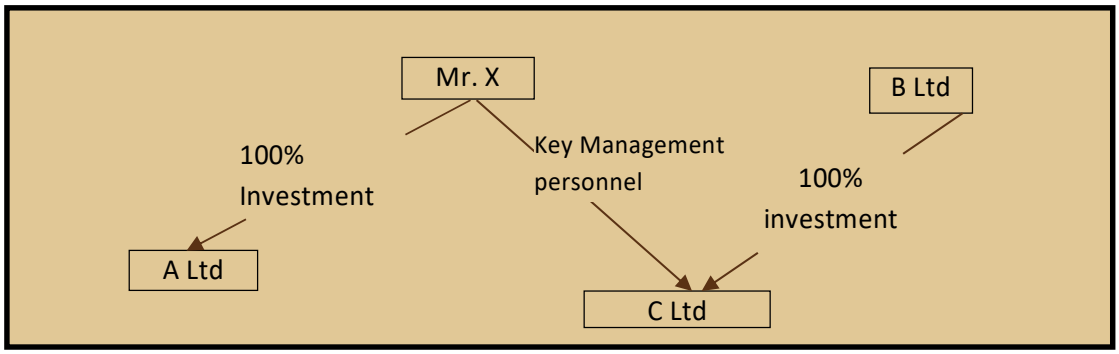
(c) Will the outcome in (a) & (b) would be different if Mr. X has joint control over A Ltd.

(d) Will the outcome in (a) & (b) would be different if Mr. X has significant influence over A Ltd.

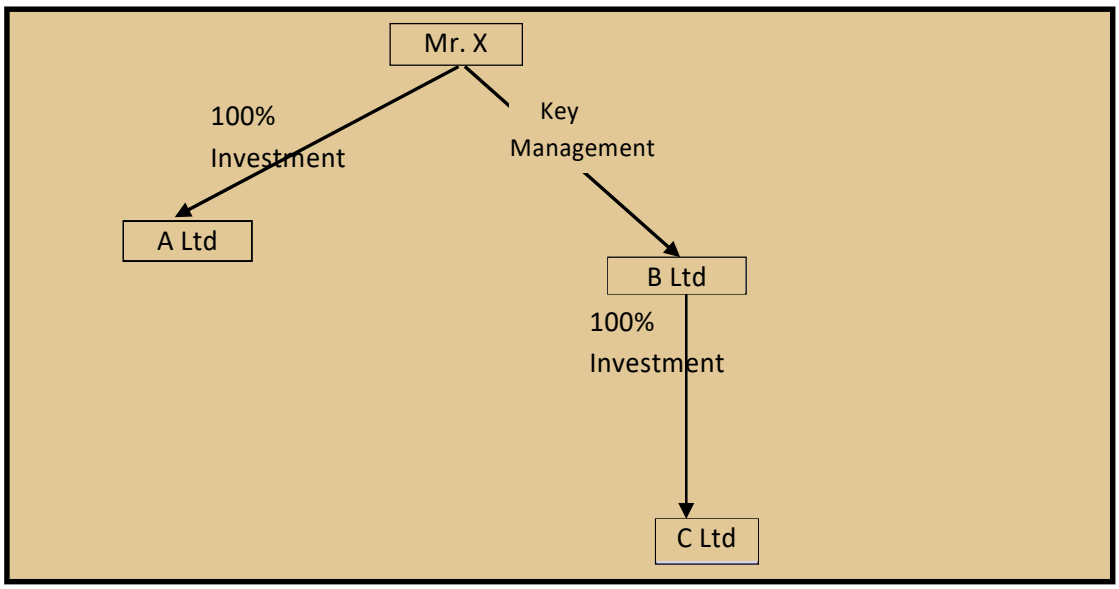
Solution

(a) A Ltd. is related to C Ltd. because Mr. X controls A Ltd. and is a member of KMP of C Ltd.

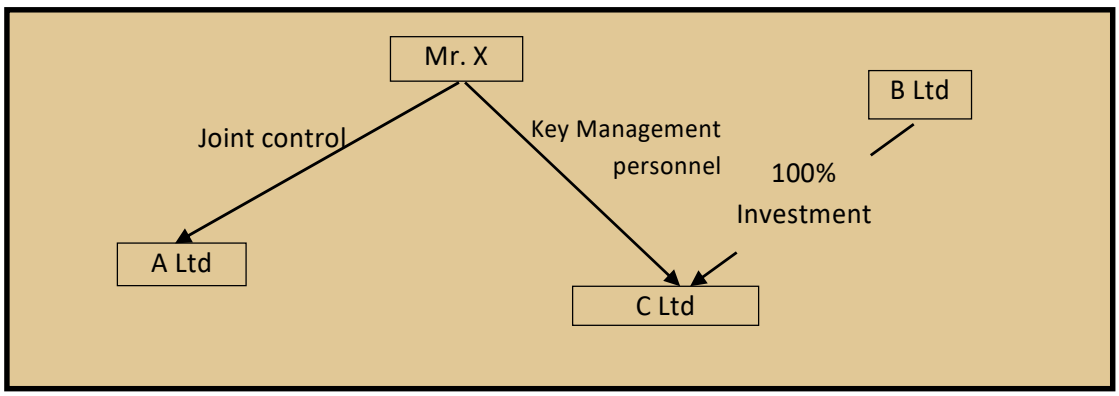
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(b) Still A Ltd. will be related to C Ltd.

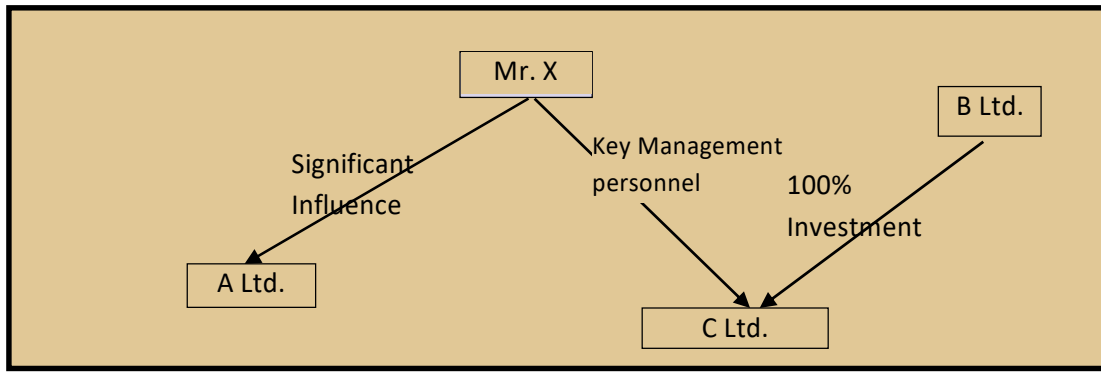


(c) No, Still A Ltd. will be related to C Ltd.



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(d) Yes, A Ltd. is not controlled by Mr. X. Therefore, despite Mr. X being KMP of C Ltd., A Ltd., having significant influence of Mr. X, will not be considered as related party of C Ltd.



*****

Illustration 3 : Person as investor

Mr. X has an investment in A Limited and B Limited.

Required

(i) Examine when can related party relationship be established

(a) from the perspective of A Limited's financial statements:

(b) from the perspective of B Limited's financial statements:

(ii) Will A Limited and B Limited be related parties if Mr. X has only significant influence over both A Limited and B Limited

Solution

(i) (a) If Mr. X controls or jointly controls A Limited, B Limited is related to A Limited when Mr. X has control, joint control or significant influence over Entity B.

(b) If Mr. X controls or jointly controls A Limited, A Limited is related to Entity B when Mr. X has control, joint control or significant influence over Entity B.

(ii) No, A Ltd. & B Ltd., will not be considered as related party since no direct or indirect control is exercised on each other in any of the manner.

*****

Illustration 4 : Partial exemption for government related entities

Government G directly controls Entity 1 and Entity 2. It indirectly controls Entity A and Entity B through Entity 1, and Entity C and Entity D through Entity 2. Person X is a member of the key management personnel in Entity 1.

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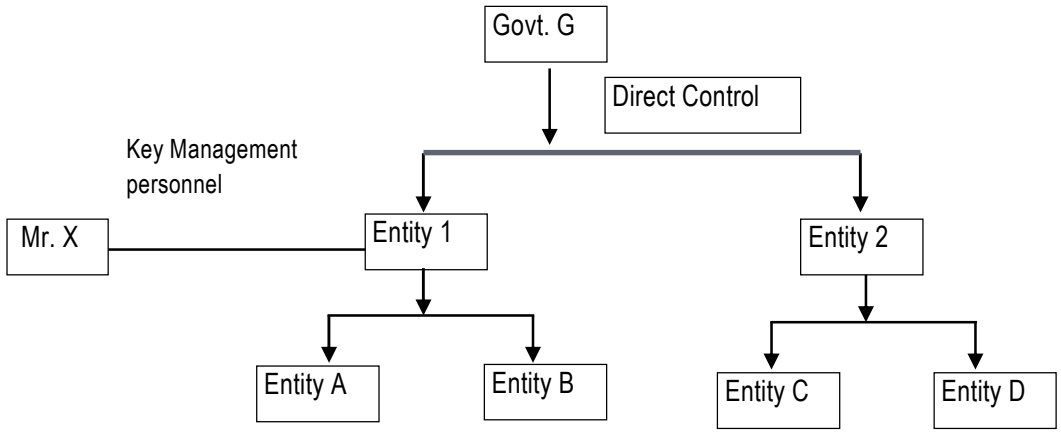
Examine the entity to whom the exemption for disclosure to be given and for transaction with whom.

Solution

For Entity A's financial statements, the exemption of Ind AS 24 applies to:

(a) transactions with Government G; and

(b) transactions with Entities 1 and 2 and Entities B, C and D. However, that exemption does not apply to transactions with Person X.



*****

Illustration 5

Power Limited is a producer of electricity. Transmission Limited regularly purchases electricity from Power Limited. Power Limited whose financial year ends on March 31, 20X2, acquired 100% shareholding of Transmission Limited on July 15, 20X1. However, the entire shareholding is disposed of on March 21, 20X2. Power Limited and Transmission Limited had transactions when Transmission Limited was a subsidiary of Power Limited and also in the period when it was not a subsidiary of Power Limited.

For which period, related party disclosure should Power Limited make in its financial statements for the year ended March 31, 20X2 with respect to transactions with Transmission Limited.

Solution

Power Limited should in its financial statements for the year ended March 31, 20X2 make related party disclosures for the period from July 15, 20X1 to March 21, 20X2 when Transmission Limited was its subsidiary.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Mr. X is a domestic partner of Ms. Y. Mr. X has an investment in A Limited and Ms. Y has an investment in B Limited.

   Required

   (a) Examine when can a related party relationship is established, from the perspective of A Limited's financial statements:

   (b) Examine when can related party relationship is established, from the perspective of B Limited's financial statements:

   (c) Will A Limited and B Limited be related parties if Mr. X has only significant influence over A Limited and Ms. Y also has significant influence over B Limited:

2. A Limited has both (i) joint control over B Limited and (ii) joint control or significant influence over C Limited

   Required

   (a) Examine related party relationship from the perspective of C Limited's financial statements.

   (b) Examine related party relationship from the perspective of B Limited's financial statements.

3. ABC Ltd. is a long-standing customer of XYZ Ltd. Mrs. P whose husband is a director in XYZ Ltd. purchased a controlling interest in entity ABC Ltd. on 1st June, 20X1. Sales of products from XYZ Ltd. to ABC Ltd. in the two-month period from 1st April 20X1 to 31st May 20X1 totalled ₹ 8,00,000. Following the share purchase by Mrs. P, XYZ Ltd. began to supply the products at a discount of 20% to their normal selling price and allowed ABC Ltd. three months' credit (previously ABC Ltd. was only allowed one month's credit,

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XYZ Ltd.'s normal credit policy). Sales of products from XYZ Ltd. to ABC Ltd. in the ten-month period from 1st June 20X1 to 31st March 20X2 totalled ₹ 60,00,000. On 31st March 20X2, the trade receivables of XYZ Ltd. included ₹ 18,00,000 in respect of amounts owing by ABC Ltd.

Analyse and show (where possible by quantifying amounts) how the above event would be reported in the financial statements of XYZ Ltd. for the year ended 31st March 20X2 as per Ind AS. You are required to mention the disclosure requirements as well.

4. Mr. Atul is an independent director of a company X Ltd. He plays a vital role in the Management of X Ltd. and contributes in major decision making process of the organisation. X Ltd. pays sitting fee of ₹ 2,00,000 to him for every Board of Directors' (BOD) meeting he attends. Throughout the year, X Ltd. had 5 such meetings which was attended by Mr. Atul.

   Similarly, a non-executive director, Mr. Naveen also attended 5 BOD meetings and charged ₹ 1,50,000 per meeting. The Accountant of X Ltd. believes that they being not the employees of the organisation, their fee should not be disclosed as per related party transaction in accordance with Ind AS 24.

   Examine whether the sitting fee paid to independent director and non-executive director is required to be disclosed in the financial statements prepared as per Ind AS?

5. Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31st March, 20X2 to the managing director Mr. Y for approval. Mr. Y, who is not an accountant, had raised following query from Mr. X after going through the draft financial statements:

   One of the notes to the financial statements gives details of purchases made by ABC Ltd. from PQR Ltd. during the period 20X1-20X2. Mr. Y owns 100% of the shares in PQR Ltd. However, he feels that there is no requirement for any disclosure to be made in ABC Ltd.'s financial statements since the transaction is carried out on normal commercial terms and is totally insignificant to ABC Ltd., as it represents less than 1% of ABC Ltd.'s purchases.

   Provide answers to the query raised by the Managing Director Mr. Y as per Ind AS.

6. Uttar Pradesh State Government holds 60% shares in PQR Limited and 55% shares in ABC Limited. PQR Limited has two subsidiaries namely P Limited and Q Limited. ABC Limited has two subsidiaries namely A Limited and B Limited. Mr. KM is one of the Key management personnel in PQR Limited.

   (a) Determine the entity to whom exemption from disclosure of related party transactions is to be given. Also examine the transactions and with whom such exemption applies.

   (b) What are the disclosure requirements for the entity which has availed the exemption?

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7. S Ltd., a wholly owned subsidiary of P Ltd is the sole distributor of electricity to consumers in a specified geographical area. A manufacturing facility of P Ltd is located in the said geographical area and, accordingly, P Ltd is also a consumer of electricity supplied by S Ltd. The electricity tariffs for the geographical area are determined by an independent rate-setting authority and are applicable to all consumers of S Ltd, including P Ltd.

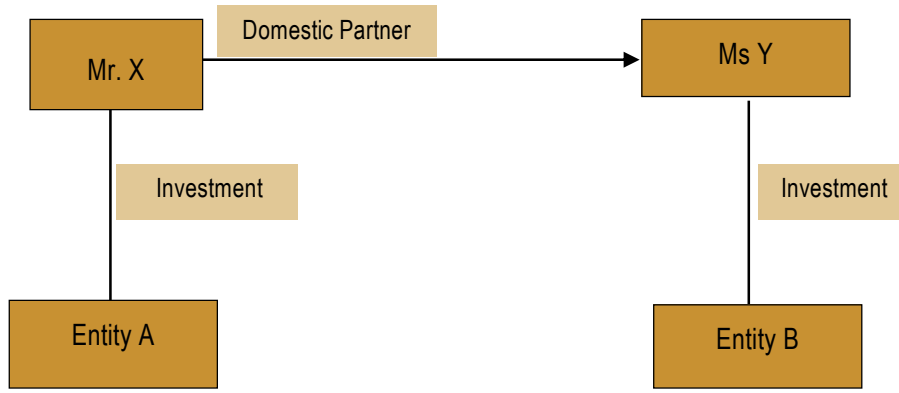
   Whether the above transaction is required to be disclosed as a related party transaction as per Ind AS 24 in the financial statements of S Ltd.? What should be the disclosures in this regard?

Answers

1. (a) If Mr. X controls or jointly controls A Limited, B Limited is related to A Limited when Ms. Y has control, joint control or significant influence over B Limited.

(b) If Mr. X controls or jointly controls A Limited, A Limited is related to B Limited when Ms. Y has control, joint control or significant influence over B Limited.

(c) No, significant influence does not lead to direct/indirect control between the A Ltd. & B Ltd. i.e., if Mr. X has significant influence (but not control or joint control) over Entity A and Ms. Y has significant influence (but not control or joint control) over Entity B, Entities A and B are not related to each other.



If Mr X is a member of the key management personnel of Entity A and Ms Y is a member of the key management personnel of Entity B, Entities A and B are not, in the absence of any other indicator of a related party relationship, related to each other.

2. (a) C Limited is related to B Limited and A Limited

(b) B Limited is related to C Limited and A Limited.

3. XYZ Ltd. would include the total revenue of ₹ 68,00,000 (₹ 60,00,000 + ₹8,00,000) from ABC Ltd. received / receivable in the year ended 31st March 20X2 within its revenue and show ₹ 18,00,000 within trade receivables at 31st March 20X2.

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Mrs. P would be regarded as a related party of XYZ Ltd. because she is a close family member of one of the key management personnel of XYZ Ltd.

From 1st June 20X1, ABC Ltd. would also be regarded as a related party of XYZ Ltd. because from that date ABC Ltd. is an entity controlled by another related party.

Because ABC Ltd. is a related party with whom XYZ Ltd. has transactions, then XYZ Ltd. should disclose:

– The nature of the related party relationship.

– The revenue of ₹ 60,00,000 from ABC Ltd. since 1st June 20X1.

– The outstanding balance of ₹ 18,00,000 at 31st March 20X2.

In the current circumstances it may well be necessary for XYZ Ltd. to also disclose the favourable terms under which the transactions are carried out.

4. As per paragraph 9 of Ind AS 24, Related Party Disclosures, "Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity."

Accordingly, key management personnel (KMP) includes any director of the entity who are having authority and responsibility for planning, directing and controlling the activities of the entity. Hence, independent director Mr. Atul and non-executive director Mr. Naveen are covered under the definition of KMP in accordance with Ind AS.

Also as per paragraph 7 and 9 of Ind AS 19, 'Employee Benefits', an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of the Standard, Employees include directors and other management personnel. So, they should not be reported as related party.

Therefore, contention of the Accountant is wrong that they are not employees of X Ltd.

Paragraph 17 of Ind AS requires disclosure about employee benefits for key management personnel. Therefore, an entity shall disclose key management personnel compensation in total i.e. disclosure of directors' fee of (₹ 10,00,000 + ₹ 7,50,000) ₹ 17,50,000 is to be made as employees benefits (under various categories).

Since short-term employee benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services, the sitting fee paid to directors will fall under it (as per Ind AS 19) and is required to be disclosed in accordance with the paragraph 17 of Ind AS 24.

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

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

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

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

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

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

6. **(a)** As per para 18 of Ind AS 24, 'Related Party Disclosures', if an entity had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements.

However, as per para 25 of the standard a reporting entity is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with:

(i) a government that has control or joint control of, or significant influence over, the reporting entity; and

(ii) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity

According to the above paras, for Entity P's financial statements, the exemption in paragraph 25 applies to:

(i) transactions with Government Uttar Pradesh State Government; and

(ii) transactions with Entities PQR and ABC and Entities Q, A and B.

Similar exemptions are available to Entities PQR, ABC, Q, A and B, with the transactions with UP State Government and other entities controlled directly or indirectly by UP State Government. However, that exemption does not apply to

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transactions with Mr. KM. Hence, the transactions with Mr. KM needs to be disclosed under related party transactions.

(b) It shall disclose the following about the transactions and related outstanding balances referred to in paragraph 25:

(a) the name of the government and the nature of its relationship with the reporting entity (ie control, joint control or significant influence);

(b) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:

(i) the nature and amount of each individually significant transaction; and

(ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

7. As per paragraph 9(b)(i) of Ind AS 24, each parent, subsidiary and fellow subsidiary in a 'group' is related to the other members of the group. Thus, in the case under discussion, P Ltd is a related party of S Ltd from the perspective of financial statements of S Ltd.

Paragraph 11 of Ind AS 24 states as follows:

"In the context of this Standard, the following are not related parties:

(a) two entities simply because they have a director or other member of management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

(b) two joint venturers simply because they share joint control of a joint venture.

(c) (i) providers of finance,(ii) trade unions, (iii) public utilities, and (iv) departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity, simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).

(d) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence."

Being engaged in distribution of electricity, S Ltd is a public utility. Had the only relationship between S Ltd and P Ltd been that of a supplier and a consumer of electricity, P Ltd would not have been regarded as a related party of S Ltd. However, as per the facts of the given case, this is not the only relationship between S Ltd and P Ltd. Apart from being a supplier of electricity to P Ltd., S Ltd is also a subsidiary of P Ltd; this is a relationship that is covered within the related party relationships to which the disclosure

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requirements of the standard apply. In view of the above, the supply of electricity by S Ltd to P Ltd is a related party transaction that attracts the disclosure requirements contained in paragraph 18 and other relevant requirements of the standard. This is notwithstanding the fact that P Ltd is charged the electricity tariffs determined by an independent rate-setting authority (i.e., the terms of supply to P Ltd are at par with those applicable to other consumers)

Ind AS 24 does not exempt an entity from disclosing related party transactions merely because they have been carried out on an arm's length basis.

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UNIT 2 :
INDIAN ACCOUNTING STANDARD 33 : EARNINGS PER SHARE

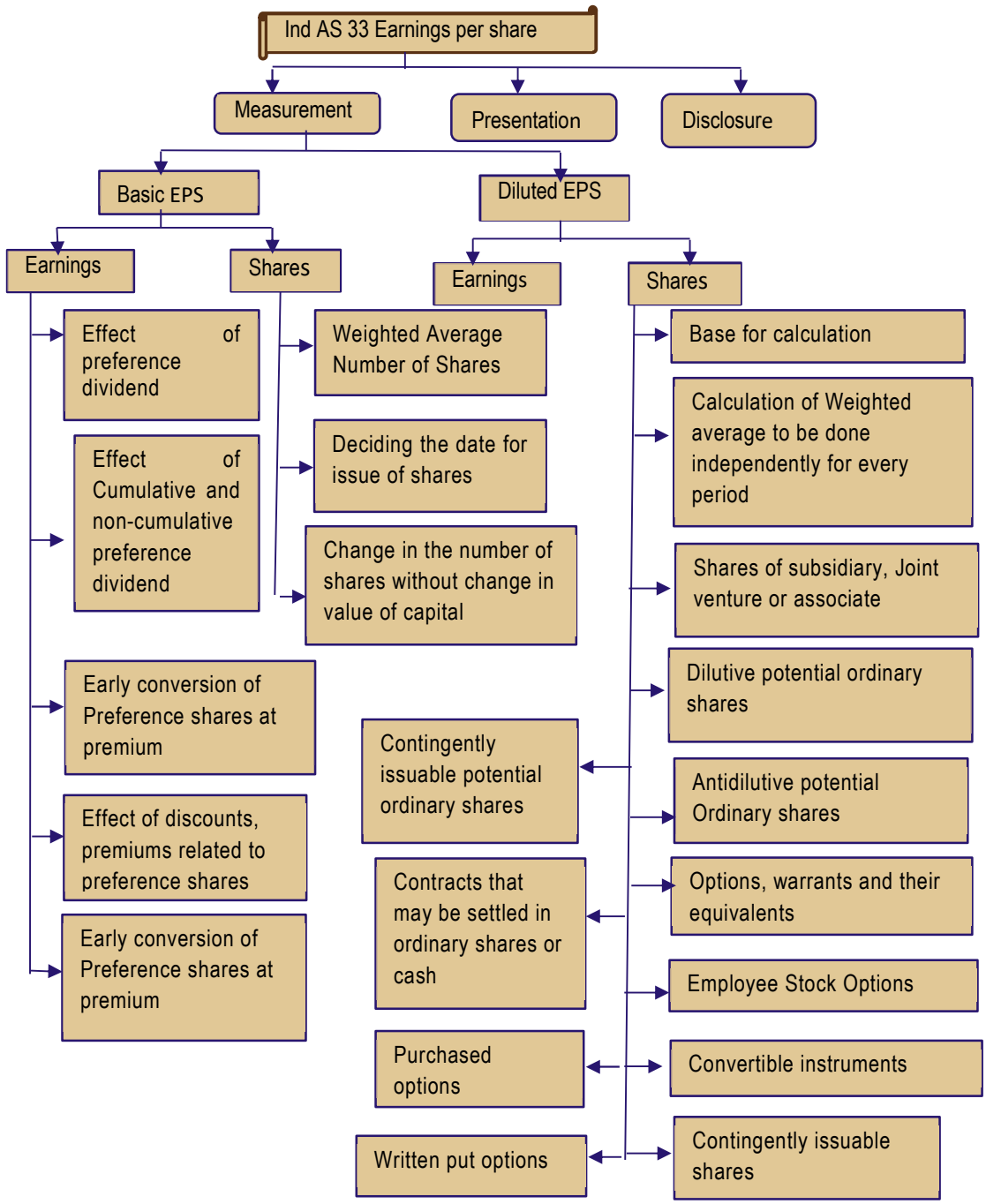
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objectives behind calculation and disclosure of EPS
- Define the terms used in the Standard such as basic EPS, dilution, anti-dilution, contingent share agreement, potential ordinary shares, etc.
- Work out the basic EPS after considering the important points for calculation of earnings and weighted average number of shares
- Determine the diluted EPS after considering the important points for calculation of diluted earnings and weighted average number of shares
- Deal with various peculiar situations of potential ordinary shares, contingently convertible shares, etc.
- Disclose the information regarding EPS in the financial statements

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UNIT OVERVIEW



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2.1 INTRODUCTION

Earnings per share (EPS) is an important measure of the performance of the company. The equity shareholders (ordinary shareholders as per Ind AS 33) invest their money in the entity as owners of the company. They undertake business risks and financial risks along with all allied systematic and non-systematic risks of the company. Generally, they would expect a higher return as compared to a debt-holder considering the risks involved on their investments.

EPS is a ratio that is widely used by financial analysts, investors and other users to gauge an entity's profitability. Its purpose is to indicate how effective an entity has been in using the resources provided by the ordinary shareholders, and to assess the entity's current net earnings. EPS also forms the basis for calculating the price-earnings ratio, which is widely used by investors and analysts to value shares.

2.2 OBJECTIVE

To prescribe principles for the determination and presentation of earnings per share:

Ind AS 33 provides detailed guidelines and lays down the principles about how to calculate earnings, weighted average number of shares and basic and diluted earnings per share, to facilitate performance comparisons between:

(i) **different entities in the same reporting period:**

For example, if one needs to check whether Hero Motocorp Limited is doing better than Baja Auto Limited in terms of profitability, EPS can be considered to be a measure for comparison of performance.

(ii) **different reporting periods for the same entity:**

One can check the performance of a company over last 5 years using EPS as a benchmark.

2.2.1 Limitation of EPS

Earnings per share data may have **limitations** because of different accounting policies that companies might have used for determining 'earnings'.

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2.3 SCOPE

- This Ind AS shall apply to companies (that have issued ordinary shares) to which Ind AS notified under the Companies Act apply. In Indian context, the term 'ordinary shares' is equivalent to 'equity shares'.
- An entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.
- When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with Ind AS 110, *Consolidated Financial Statements*, and Ind AS 27, *Separate Financial Statements,* respectively, the disclosures required by this Standard shall be presented both in the consolidated financial statements and separate financial statements. In consolidated financial statements such disclosures shall be based on consolidated information and in separate financial statements such disclosures shall be based on information given in separate financial statements.

The above mentioned provisions are summarised below in the following table:

Sr. No.	Type of Financial statements	EPS disclosure required	EPS computation should be based on
1	Consolidated	Yes	Information given in consolidated financial statements only
2	Separate	Yes	Information given in separate financial statements only

2.4 DEFINITIONS

1. An ***ordinary share*** is an equity instrument that is subordinate to all other classes of equity instruments. Ordinary shares participate in profit for the period only after other types of shares such as preference shares have participated. An entity may have more than one class of ordinary shares. Ordinary shares of the same class have the same rights to receive dividends.

   In accordance with Ind AS 32, *Financial Instruments: Presentation*, an equity instrument is defined as a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

2. A ***potential ordinary share*** is a financial instrument or other contract that may entitle its holder to ordinary shares.

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Examples of potential ordinary shares are:

(a) financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares;

(b) options and warrants;

(c) shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets.

Contracts that might result in the issue of ordinary shares of the entity to the holder of the contract, at the option of the issuer or the holder, are potential ordinary shares.

Example 1

ABC & Co has issued preference shares with the option to convert these into an equal number of ordinary shares in 2 years' time. They represent potential ordinary shares, even though it is not certain whether the preference shareholders will convert them into equity shares (since it will depend on the prices of each class of shares at that time). If the price of the ordinary share is higher than that of the preference shares, the holders will convert, and will make a profit. If the price is lower, they will not.

3. ***Options, warrants and their equivalents*** are financial instruments that give the holder the right to purchase ordinary shares.

4. ***Put options*** on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.

5. ***Dilution*** is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

6. ***Antidilution*** is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

Example 2

ABC Ltd. has interest paying debt which are convertible into ordinary shares at the option of the entity. On conversion, ABC Ltd. will save on the interest costs and in return will have to issue additional shares. In case the EPS of ABC Ltd. increases on conversion, the convertible debt would be considered as anti-dilutive. However, if the conversion will decrease the EPS, it would be considered as dilutive.

7. ***A contingent share agreement*** is an agreement to issue shares that is dependent on the satisfaction of specified conditions.

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Example 3

ABC Ltd. has provided share options to its employees under a ESOP scheme. As per the scheme, the employees have to provide 3 years' services to the company for being eligible to share options at a discounted price. This is a contingent share agreement.

8. ***Contingently issuable ordinary shares*** are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

Example 4

ABC Ltd. acquires XYZ Ltd.'s business in exchange for ABC Ltd.'s shares. If the share price falls by more than 25% within 6 months of the business combination, ABC Ltd. will issue more shares (for free) to XYZ Ltd., as a compensation.

2.5 MEASUREMENT

Measurement can be divided into following categories:

a. Measurement of basic earnings per share
   - Measurement of earnings
   - Measurement of weighted average number of shares

b. Measurement of diluted earnings per share
   - Measurement of earnings for diluted EPS
   - Measurement of number of shares for diluted EPS

c. Measurement in case of dilutive potential ordinary shares

d. Measurement in case of options, warrants and their equivalents

e. Measurement in case of convertible instruments

f. Measurement in case of contingently issuable shares

g. Measurement in case of contracts that may be settled in ordinary shares or cash

h. Measurement in case of purchased options and written put options

i. Dealing with retrospective adjustments

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2.6 MEASUREMENT OF BASIC EARNINGS PER SHARE

2.6.1 Meaning and Formula

1. Meaning

An entity shall calculate basic earnings per share for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

The objective of basic earnings per share information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

2. Formula

Basic earnings per share shall be calculated by dividing profit or loss for the period attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary (equity) shares outstanding during the period (the denominator). It can be expressed mathematically as follows:

$$\frac{\text{Profit/Loss attributable to Equity share holders}}{\text{Weighted average number of Equity shares outstanding during the period}}$$

2.6.2 Measurement of Earnings

- For the purpose of calculating basic earnings per share, the amounts attributable to ordinary equity holders of the parent entity in respect of:

  (a) profit or loss from continuing operations attributable to the parent entity; and

  (b) profit or loss attributable to the parent entity

  shall be the amounts in (a) and (b) adjusted for the after-tax amounts of preference dividend, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

  An entity that has preference shares in issue, will classify those shares as financial liabilities or equity in accordance with the principles under Ind AS 32. An adjustment is required to the profit or loss for the period, to arrive at the profit or loss attributable to ordinary equity holders for the purpose of calculating EPS, if preference shares are classified as equity. Any dividends and other appropriations would be debited directly to equity under Ind AS 32. Any dividends or other appropriations for preference shares classified as liabilities should be accounted for as finance

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costs in arriving at profit or loss for the period. No adjustment is required for the purpose of calculating EPS.

- Where any item of income or expense, which is otherwise required to be recognised in profit or loss in accordance with Ind AS, is debited or credited to securities premium account/other reserves, the amount in respect thereof shall be deducted from profit or loss from continuing operations for the purpose of calculating basic earnings per share.
- All items of income and expense attributable to ordinary equity holders of the parent entity that are recognised in a period, including tax expense and dividends on preference shares classified as liabilities are included in the determination of profit or loss for the period attributable to ordinary equity holders of the parent entity.
- The amount of dividends declared in respect of the year should be deducted in arriving at the profit attributable to ordinary shareholders for preference dividends that are non-cumulative.
- The dividend for the period should be taken into account, whether or not it has been declared for cumulative preference dividends. If an entity is unable to pay or declare a cumulative preference dividend, the undeclared amount of the cumulative preference dividend (net of tax, if applicable) should still be deducted in arriving at earnings for the purpose of the EPS calculation. The amount paid is not deducted in arriving at earnings for the purpose of the EPS calculation in the period in which arrears of cumulative preference dividends are paid.
- Preference shares that provide for a low initial dividend to compensate an entity for selling the preference shares at a discount, or an above-market dividend in later periods to compensate investors for purchasing preference shares at a premium, are sometimes referred to as increasing rate preference shares. Any original issue discount or premium on increasing rate preference shares is amortised to retained earnings using the effective interest method and treated as a preference dividend for the purposes of calculating earnings per share (irrespective of whether such discount or premium is debited or credited to securities premium account in view of requirements of any law).

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Example 1 Increasing rate preference shares

Reference: Ind AS 33, paragraphs 12 and 15

Entity D issued non-convertible, non-redeemable class A cumulative preference shares of Rs. 100 par value on 1 January 20X1. The class A preference shares are entitled to a cumulative annual dividend of Rs. 7 per share starting in 20X4.

At the time of issue, the market rate dividend yield on the class A preference shares was 7 per cent a year. Thus, Entity D could have expected to receive proceeds of approximately Rs. 100 per class A preference share if the dividend rate of Rs. 7 per share had been in effect at the date of issue.

In consideration of the dividend payment terms, however, the class A preference shares were issued at Rs. 81.63 per share, ie at a discount of Rs. 18.37 per share. The issue price can be calculated by taking the present value of Rs. 100, discounted at 7 per cent over a three-year period.

Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes. To calculate basic earnings per share, the following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity:

Year	Carrying amount of class A preference shares 1 January	Imputed[a] Dividend	Carrying amount[b] of class A preference shares 31 December	*Dividend paid*
	Rs.	Rs.	Rs.	Rs.
20X1	81.63	5.71	87.34	–
20X2	87.34	6.12	93.46	–
20X3	93.46	6.54	100.00	–
Thereafter:	100.00	7.00	107.00	(7.00)

(a) at 7 %
(b) This is before dividend payment.

2.6.2.1 Redemption/Repurchase of preference shares at premium

Preference shares may be repurchased under an entity's tender offer to the holders. The excess of the fair value of the consideration paid to the preference shareholders over the carrying amount of the preference shares represents a return to the holders of the preference shares and a charge to retained earnings for the entity. This amount is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

Example 5

ABC Ltd. had issued preference shares at ₹ 100 each 10 years ago. Now ABC Ltd. buys back the shares for ₹ 120 each. ₹ 20 premium for each share is charged to retained earnings. No amount is recorded in the statement of profit and loss for this transaction. However, for EPS purposes, ₹20 for each share is charged to the statement of profit or loss for the period of the transaction.

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2.6.2.2 Early conversion of Preference shares at premium

Early conversion of convertible preference shares may be induced by an entity through favourable changes to the original conversion terms or the payment of additional consideration. The excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms is a return to the preference shareholders and is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

Illustration 1

ABC Ltd. issues 9% preference shares of fair value of ₹ 10 each on 1.4.20X1. Total value of the issue is ₹ 10,00,000. The shares are issued for a period of 5 years and would be redeemed at the end of 5th year. The shares are to be redeemed at ₹ 11 each.

At the end of the year 3, i.e. on 31.3.20X4, company finds that it has earned good returns than expected over last three years and can make the redemption of preference shares early. To compensate the shareholders for two years of dividend which they need to forego, company decided to redeem the shares at ₹ 12 each instead of original agreement of ₹ 11. Comment on the impact of early conversion of preference shares at a premium on earnings for the year 20X3-20X4 attributable to ordinary equity holders of ABC Ltd. for basic EPS.

Ignore the applicability of the standards on Financial Instruments (i.e., ignore EIR; further, the additional payment to be made can be met from Securities Premium/Reserves as Premium on Redemption) and answer on the basis of Ind AS 33 only.

Solution

In the given situation, ₹ 1 per share is the excess payment made by the company amounting to ₹ 1,00,000 in all. The amount of ₹ 1,00,000 will be deducted from the earnings of the year 20X3-20X4 while calculating the basic EPS of year 20X3-20X4.

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2.6.2.3 Excess payment to Preference share holders

Any excess of the carrying amount of preference shares over the fair value of the consideration paid to settle them is added in calculating profit or loss attributable to ordinary equity holders of the parent entity.

Illustration 2

An entity has following preference shares in issue at the end of 20X4:

- ***5% redeemable, non-cumulative preference shares:*** *These shares are classified as liabilities. During the year, an amount of Rs. 1,00,000 (computed using the coupon rate of 5% - Rs. 20,00,000 x 5%) was paid to the preference shareholders*
- ***Increasing-rate, cumulative, non-redeemable preference shares issued at a discount in 20X0, with a cumulative dividend rate from 20X5 of 10%:*** *The shares were issued at a discount*

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to compensate the holders, because dividend payments will not commence until 20X5. The accrual for the discount in the current year, calculated using the effective interest method amounted to, say, ₹ 18,000. These shares are classified as equity – ₹ 200,000.

- ***8% non-redeemable, non-cumulative preference shares:*** *At the beginning of the year, the entity had ₹ 100,000 8% preference shares outstanding but, at 30 June 20X4, it repurchased ₹ 50,000 of these at a discount of ₹ 1,000 – ₹ 50,000.*
- ***7% cumulative, convertible preference shares (converted in the year):*** *These shares were classified as equity, until their conversion into ordinary shares at the beginning of the year. No dividend was accrued in respect of the year, although the previous year's dividend was paid immediately prior to conversion. To induce conversion, the terms of conversion of the 7% convertible preference shares were also amended, and the revised terms entitled the preference shareholders to an additional 100 ordinary shares on conversion with a fair value of ₹ 300 – Nil.*

The profit after tax for the year 20X4 is ₹ 150,000.

Determine the adjustments for the purpose of calculating EPS.

Solution

Adjustments for the purpose of calculating EPS are made as follows:

Particulars	Amount (₹)	Amount (₹)
Profit after tax		150,000
Amortisation of discount on issue of increasing-rate preference shares (Refer Note 1)	(18,000)	
Discount on repurchase of 8% preference shares (Refer Note 2)	1,000	
Premium to induce Conversion	(30,000)	(47,000)
Profit attributable to ordinary equity holders for basic EPS (Refer Note 3-5)		1,03,000

Notes:

1. The original discount on issue of the increasing-rate preference shares is treated as amortised to retained earnings and treated as preference dividends for EPS purposes and adjusted against profit attributable to the ordinary equity holders. There is no adjustment in respect of dividend, because these do not commence until 20X5. Instead, the finance cost is represented by the amortisation of the discount in the dividend-free period. In future years, the accrual for the dividend of ₹ 20,000 will be deducted from profits.
2. The discount on repurchase of the 8% preference shares has been credited to equity so should be added to profit.

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3. The dividend on the 5% preference shares has been charged to the income statement, because the preference shares are treated as liabilities, so no adjustment is required for it from the profit.

4. No accrual for the dividend on the 8% preference shares is required, because they are non-cumulative. If a dividend had been declared for the year, it would have been deducted from profit for the purpose of calculating basic EPS, because the shares are treated as equity and the dividend would have been charged to equity in the financial statements.

5. The 7% preference shares are convertible and hence correctly classified as equity. Accordingly, the additional amount paid (100 additional shares x fair value ₹ 300 per share = ₹ 30,000) to induce conversion would be taken to Equity Share Capital and Retained Earnings or Securities Premium, as the case may be (transaction with 'owners'). Therefore, this excess amount paid would require to be deducted from the Net Profit to arrive at Net Profit attributable to Equity Shareholders.

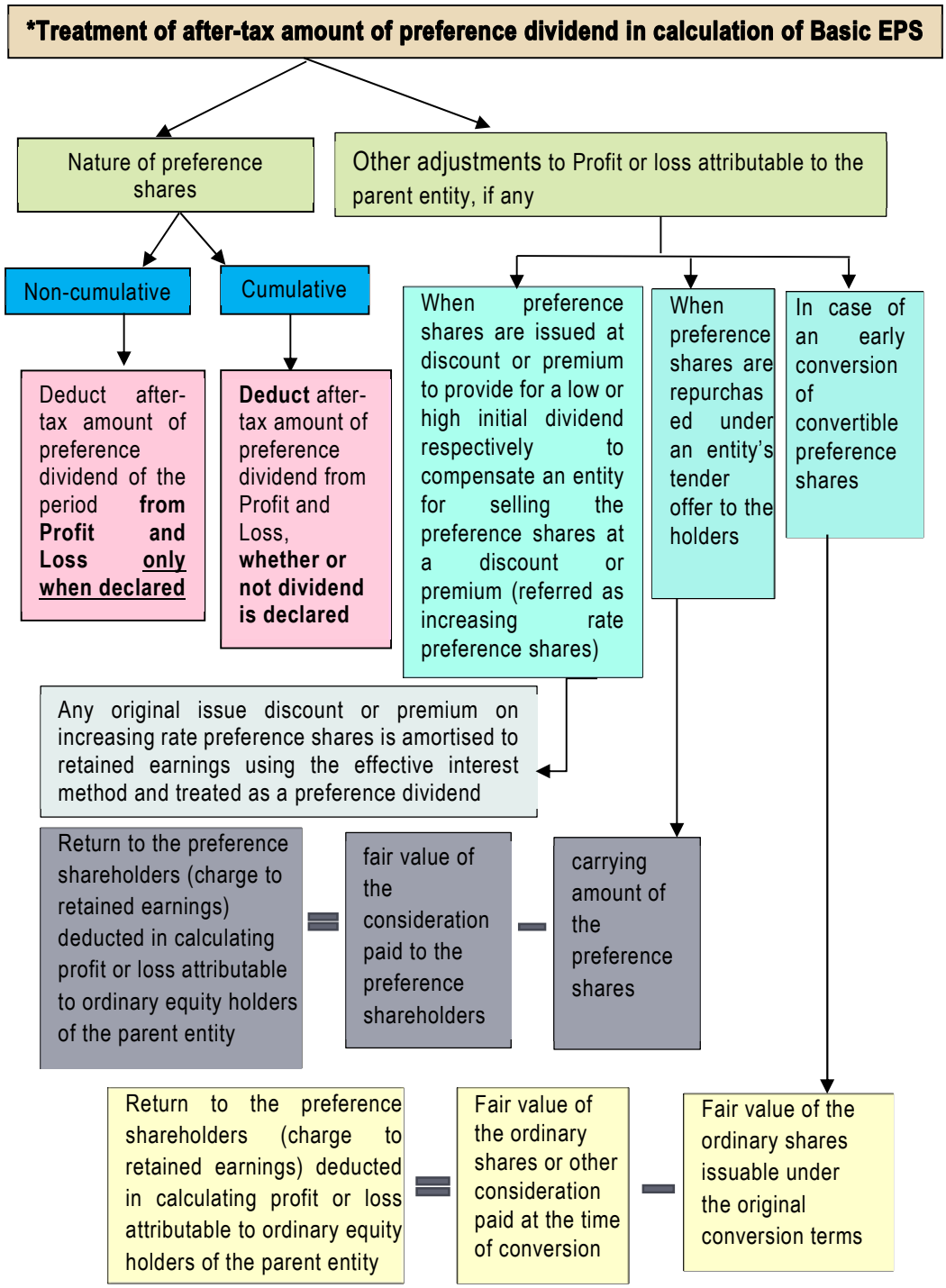
It may be noted that as per Sections 53 and 55 of the Companies Act, 2013, a company cannot issue shares at discount or any irredeemable preference shares. However, the above illustration has been given only to explain the concept given in Ind AS.

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The changes given in the above two questions do not consider the impact of the Companies Act, 2013. Since Ind AS is based on IFRS which ignores country-specific statutory requirements and instead opts for a principle-based approach, solutions are given accordingly. However, the statute gains precedence over Ind AS, and hence the same needs to be followed practically.

Here, in this paper of Financial Reporting, the discussion has been restricted to the concepts of Ind AS provisions.

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Note: The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

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2.6.3 Shares

2.6.3.1 Weighted Average Number of Shares

- For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period.

  The weighted average number of ordinary shares outstanding during the period is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period *multiplied by a time-weighting factor.*

- The time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

  Weighted average number of equity shares:

Ordinary shares outstanding at the beginning	xxxx
Less: Ordinary shares bought back during the period*	xxxx
Add: Ordinary shares issued during the period*	xxxx
Ordinary shares outstanding during the period	**xxxx**

*to be multiplied by time-weighting factor. The time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period.

Illustration 3

Following is the data for company XYZ in respect of number of equity shares during the financial year 20X1-20X2. Find out the number of shares for the purpose of calculation of basic EPS as per Ind AS 33.

S. No.	Date	Particulars	No of shares
1	1-Apr-20X1	Opening balance of outstanding equity shares	100,000
2	15-Jun-20X1	Issue of equity shares	75,000
3	8-Nov-20X1	Conversion of convertible preference shares in Equity	50,000
4	22-Feb-20X2	Buy back of shares	(20,000)
5	31-Mar-20X2	Closing balance of outstanding equity shares	205,000

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Solution

The closing balance of the outstanding shares is 2,05,000 by a normal addition and subtraction. But as per weighted average concept, one need to find out for how many days each type of shares was actually held during the year.

The shares which were there on 1st April 20X1, were held for the whole year. Therefore, weighted average number of such shares will be given by the formula:

No of shares x no of days the shares were held during the year / 365

= 1,00,000 x 365 / 365 = 1,00,000

But the shares which were issued on 15th June 20X1, were held for only 290 days. Therefore, the weighted average number of shares will be 75,000 x 290 / 365 = 59,589.

Following the above formula, the weighted average number of shares for calculation of EPS for the year 20X1-20X2 will be as follows:

Sr. No.	Date	Particulars	No of shares	No of days shares were outstanding	Weighted average no of shares
1	1-Apr-20X1	Opening balance of outstanding equity shares	1,00,000	365	1,00,000
2	15-Jun-20X1	Issue of equity shares	75,000	290	59,589
3	8-Nov-20X1	Conversion of convertible preference shares in Equity	50,000	144	19,726
4	22-Feb-20X2	Buy back of shares	(20,000)	(38)*	(2,082)
5	31-Mar-20X2	Closing balance of outstanding equity shares	2,05,000		1,77,233

* These shares had already been considered in the shares issued. The same has been deducted assuming that the bought back shares have been extinguished immediately.

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From the above illustration, one can notice that the date of issue/ conversion/ repurchase/ transaction affecting the addition or deletion in number of shares is very crucial for calculation of weighted average number of shares.

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2.6.3.2 Deciding the date for issue of shares

- Shares are usually **included** in the weighted average number of shares **from the date consideration is receivable** (which is generally the date of their issue), for example:

  (a) ordinary shares issued in **exchange for cash** are included from the date when **cash is receivable**;

  (b) ordinary shares issued on the **voluntary reinvestment of dividend** on ordinary or preference shares are included from the date when **dividend are reinvested**;

  (c) ordinary shares issued as a result of the **conversion of a debt instrument** to ordinary shares are included from the date that **interest ceases to accrue**;

  (d) ordinary shares issued **in place of interest or principal** on other financial instruments are included from the date that **interest ceases to accrue**;

  (e) ordinary shares issued in **exchange for the settlement of a liability** of the entity are included from the **settlement date**;

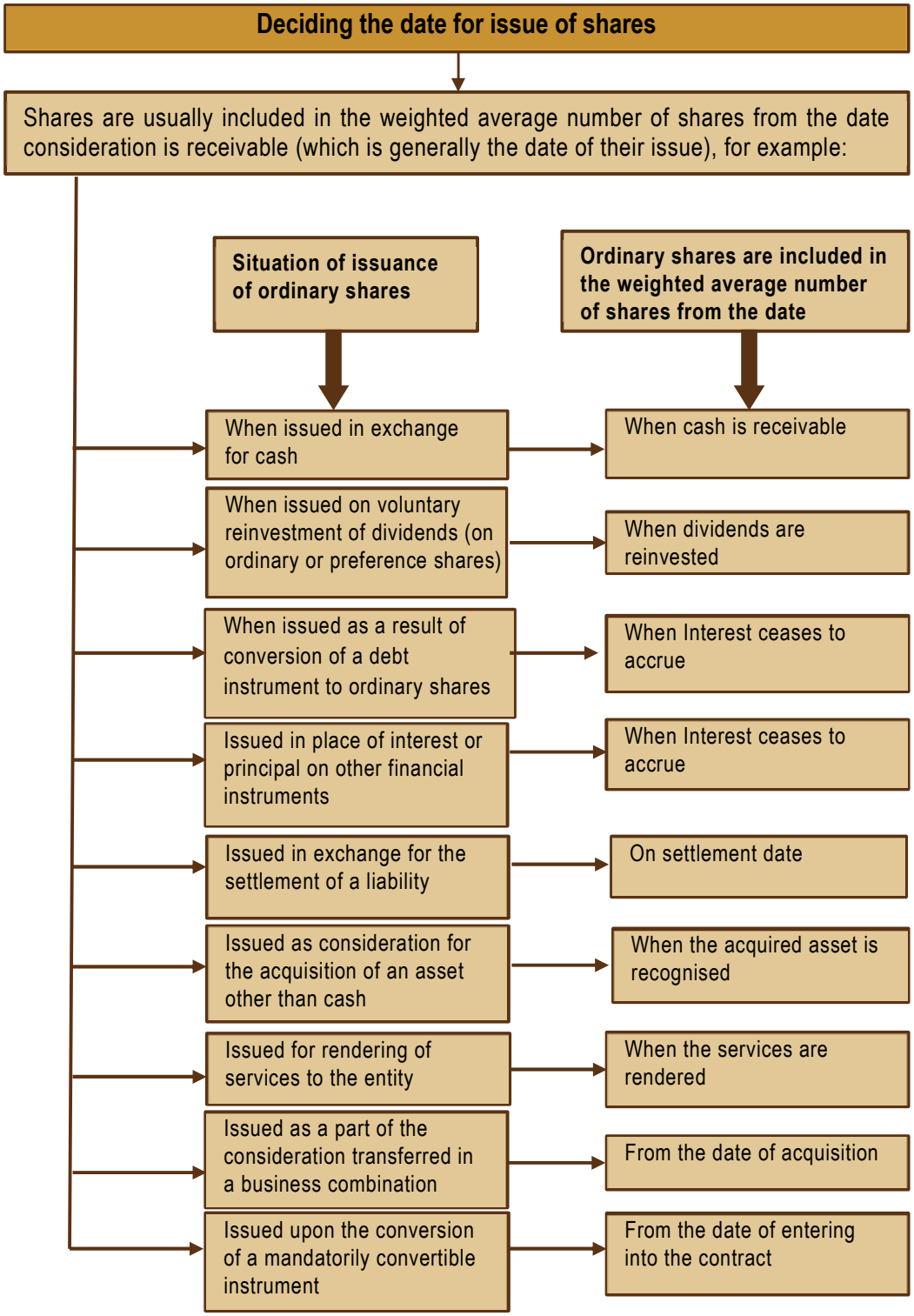
  (f) ordinary shares issued as **consideration for the acquisition** of an asset other than cash are included from the **date on which the acquisition is recognised**; and

  (g) ordinary shares issued for the **rendering of services** to the entity are included from the date on which as the **services are rendered**.

- Ordinary shares issued as part of the consideration transferred in a business combination are included in the weighted average number of shares from the acquisition date of the business. This is because the acquirer incorporates into its statement of profit and loss the acquiree's profits and losses from that date.

- Entities often issue instruments that are convertible into ordinary shares that may be either mandatorily convertible or convertible at the option of the issuer or holder. The issue of ordinary shares is solely dependent on the passage of time for a mandatorily convertible instrument. Ordinary shares that are issuable on the conversion of a mandatorily convertible instrument should be included in basic EPS from the date the contract is entered into.

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2.6.3.3 Contingently issuable shares

- Contingently issuable shares are treated as outstanding and are included in the calculation of basic earnings per share only from the date when all necessary conditions are satisfied (i.e. the events have occurred).
- Shares that are issuable solely after the passage of time are not contingently issuable shares, because the passage of time is a certainty.
- Outstanding ordinary shares that are contingently returnable (ie subject to recall) are not treated as outstanding and are excluded from the calculation of basic earnings per share until the date the shares are no longer subject to recall.

Example 6

ABC Ltd. acquires a company in 20X1 for consideration paid in shares. If the profits for calendar years 20X1 and 20X2 meet budget, ABC Ltd. will issue more shares to the vendor in February 20X3. These additional shares will be included in the weighted-average calculation from 1 January 20X3 (considering reporting date as December end), if the targets are met.

2.6.3.4 Change in the number of shares without change in value of capital

- The weighted average number of ordinary shares outstanding during the period and for all periods presented shall be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of ordinary shares outstanding without a corresponding change in resources.
- There are certain events, which will not change the total equity of the company. Still the number of outstanding equity shares will undergo a change.
- Ordinary shares may be issued, or the number of ordinary shares outstanding may be reduced, without a corresponding change in resources. Examples include:

  (a) a capitalisation or bonus issue (sometimes referred to as a stock dividend);

  (b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

  (c) a share split; and

  (d) a reverse share split (consolidation of shares).

- In a capitalisation or bonus issue or a share split, ordinary shares are issued to existing shareholders for no additional consideration. Therefore, the number of ordinary shares outstanding is increased without an increase in resources. The number of ordinary shares outstanding before the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period presented.

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Example 7

On a two-for-one bonus issue, the number of ordinary shares outstanding before the issue is multiplied by three to obtain the new total number of ordinary shares, or by two to obtain the number of additional ordinary shares.

- We have seen above that for calculation of weighted average number of shares, the date of issue/contract etc. is very important. However, in case of bonus shares where the number of shares change without the change in the resources, the date will be considered from the beginning of the earliest period presented, irrespective of the fact of the date of actual capitalisation of the reserves.

Illustration 4

On 31 March, 20X2, the issued share capital of a company consisted of ₹ 100,000,000 in ordinary shares of ₹ 25 each and ₹ 500,000 in 10% cumulative non-redeemable preference shares (classified as equity) of Re 1 each. On 1 October, 20X2, the company issued 1,000,000 ordinary shares fully paid by way of capitalisation of reserves in the proportion 1:4 for the year ended 31 March, 20X3.

Profit for 20X1-20X2 and 20X2-20X3 is ₹ 450,000 and ₹ 550,000 respectively.

Calculate the basic EPS for 20X1-20X2 and 20X2-20X3.

Solution

	20X2-20X3 ₹'000	20X1-20X2 ₹'000
Calculation of earnings		
Profit for the year	550	450
Less: Preference shares dividend	(50)	(50)
Earnings (A)	500	400

	No. of shares in '000	No. of shares in '000
Number of ordinary shares		
Shares in issue for full year	4,000	4,000
Capitalisation issue at 1 October 20X2	1,000	1,000
Number of shares (B)	5,000	5,000
Earnings per ordinary share (A/B)	10 Paise	8 Paise*

*The comparative EPS for 20X1-20X2 can alternatively be calculated by adjusting the previously disclosed EPS in 20X1-20X2 (in this example, 10 Paise) by the following factor:

Number of shares before the bonus issue/ Number of shares after the bonus issue

*Adjusted EPS for 20X1-20X2 10 Paise x (4,000/ 5,000) = 8 Paise

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Illustration 5

X Ltd.

1 January	*1,000,000 shares in issue*
28 February	*Issued 200,000 shares at fair value*
31 August	*Bonus issue 1 share for 3 shares held*
30 November	*Issued 250,000 shares at fair value*

Calculate the number of shares which would be used in the basic EPS calculation. Consider reporting date as December end.

Solution

Period	Calculations	Weighted average number of shares
1 January - 28 February	1,000,000 × 2 / 12 × 4 / 3	222,222
1 March - 31 August	1,200,000 × 6 / 12 × 4 / 3	800,000
1 September - 30 November	1,600,000 × 3 / 12	400,000
1 December - 31 December	1,850,000 × 1 / 12	154,167
		1,576,389

*****

2.6.3.5 Rights issues

Entities might raise additional capital by issuing shares to existing shareholders, on a pro rata basis to their existing holdings, in the form of a rights issue. The rights shares can either be offered at the current market price or at a price that is below the current market price. Ordinary shares might be issued during the year by way of a rights issue at a discount to the market price. The weighting calculation should reflect the fact that the discount is effectively a bonus (stock dividend) given to the shareholders in the form of shares for no consideration. This bonus element should be factored into the calculation of the weighted average number of shares. A rights issue is equivalent to a capitalisation issue of part of the shares for no consideration and an issue of the remainder of the shares at full market price. The notional capitalisation issue reflects the bonus element inherent in the rights issue and is measured by the following fraction:

$$\frac{\text{Fair value per share immediately before the excersice of rights}}{\text{Theoretical ex-rights fair value per share}}$$

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where,

Theoretical ex-rights fair value per share

Fair value of all outstanding shares before exercise of right + Total amount received from exercise of rights

No of shares outstanding after the exercise of rights

Illustration 6

At 31 December 20X1, the issued share capital of a company consisted of 1.8 million ordinary shares of ₹ 10 each, fully paid. The profits for the year ended 31 December 20X1 and 20X2 amounted to ₹ 630,000 and ₹ 875,000 respectively. On 31 March 20X2, the company made a rights issue on a 1 for 4 basis at ₹ 30. The market price of the shares immediately before the rights issue was ₹ 60.

Calculate EPS.

Solution

Calculation of theoretical ex rights price:

	Number of shares		₹
Initial holding	4	Market Value (4 x 60)	240
Rights taken up	1	Cost (1 x 30)	30
New holding	**5**	**Theoretical price**	**270**

Theoretical ex rights price = 270/5 = ₹ 54

Calculation of bonus element

The bonus element of the rights issue is given by the fraction:

Market price before rights issue/Theoretical ex-rights price =60 / 54 = 10/9

This corresponds to a bonus issue of 1 for 9. The bonus ratio will usually be greater than 1 (that is, the market price of the shares immediately prior to the exercise of rights is greater than the theoretical ex-rights price). If the ratio is less than 1, it might indicate that the market price has fallen significantly during the rights period, which was not anticipated when the rights issue was announced. In this situation, the rights issue should be treated as an issue of shares for cash at full market price.

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It can be demonstrated, using the figures in the illustration, that a rights issue of 1 for 4 at ₹ 30 is equivalent to a bonus issue of 1 for 9 combined with an issue of shares at full market price of ₹ 54 per share. Consider an individual shareholder holding 180 shares:

	Number of shares (in '000s)	Value	₹ (in million)
Original holding	1,800	Value at ₹60 per share	108.00
Rights shares (1:4)	450	Value at ₹30 per share	13.50
Holding after rights issue	2,250	Value at ₹54 per share	121.50

The additional 450 thousand rights shares at ₹30 can be shown to be equivalent to a bonus issue of 1 for 9 on the original holding, followed by an issue of 1:8 at full market price of ₹54 following the bonus issue, as follows:

	Number of shares (in '000s)	Value	₹ (in million)
Original holding	1,800	Value at ₹60 per share	108.00
Bonus issue of 1 for 9	200	Value Nil	nil
	2000	**Value at ₹ 54 per share**	**108.00**
Issue of 1 for 8 at full price (450-200)	250	Value at ₹ 54 per share	13.50
Total holding	**2250**	**Value at ₹54 per share**	**121.50**

The shareholder is therefore indifferent as to whether the entity makes a rights issue of 1 for 4 at ₹ 30 per share, or a combination of a bonus issue of 1 for 9 followed by a rights issue of 1 for 8 at full market price of ₹ 54 per share.

Having calculated the bonus ratio, the ratio should be applied to adjust the number of shares in issue before the rights issue, both for the current year and for the previous year. Therefore, the weighted average number of shares in issue for the current and the previous period, adjusted for the bonus element, would be:

Weighted average number of shares:

	20X2	20X1
No of actual shares in issue before rights	1,800,000	1,800,000
Correction for bonus issue (1:9)	200,000	200,000
Deemed no of shares in issue before right issue	2,000,000	2,000,000

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(1.8 million x 10/9 for the whole year)

The no of shares after the rights issue would be

= 1.8 million x 5/4 = 2,250,000

Therefore, the weighted average number of shares would be

2.0 million for the whole year		2,000,000
1.8 million x 10/9 x 3/12 (before rights issue)	500,000	-
2.25 million x 9/12 (after rights issue)	1,687,500	-
Weighted average number	**2,187,500**	**2,000,000**
	20X2	**20X1**
Calculation of earnings	**(as previously stated)**	
Profits for the year	₹ 875,000	₹ 630,000
Weighted average number	2,187,500	1,800,000
Basic EPS	**40p**	**35p**
Basic EPS for 20X1 (as restated)	₹ 630,000 / 2,000,000	
		= 31.50p

In practice, the restated EPS for 20X1 can also be calculated by adjusting the EPS figure of the previous year by the reciprocal of the bonus element factor:

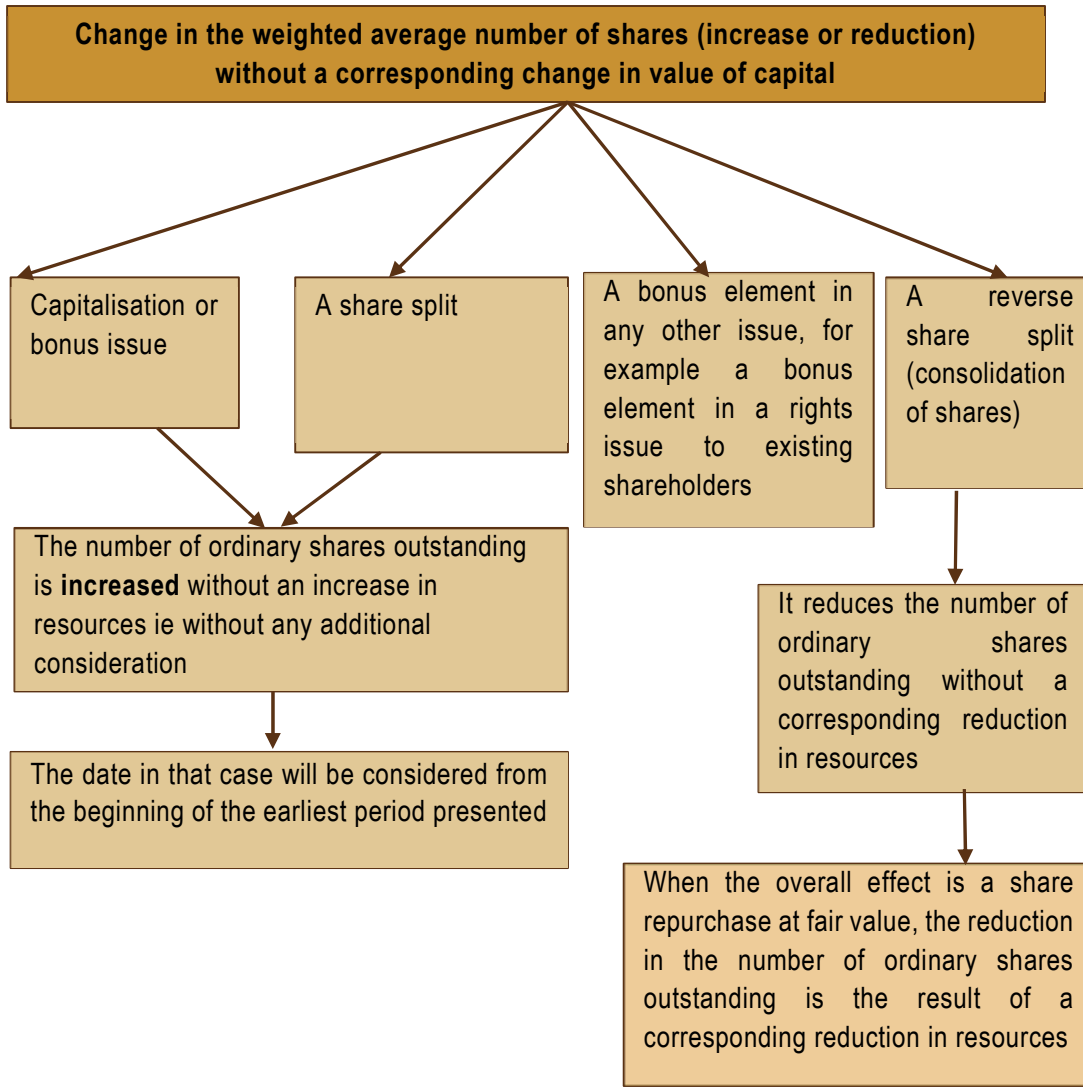
* 35p x 9/10 = 31.50 p

*****

A consolidation of ordinary shares generally reduces the number of ordinary shares outstanding without a corresponding reduction in resources. However, when the overall effect is a share repurchase at fair value, the reduction in the number of ordinary shares outstanding is the result of a corresponding reduction in resources.

An example is a share consolidation combined with a special dividend. The weighted average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognised.

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2.7 DILUTED EARNINGS PER SHARE

2.7.1 Scope, meaning and formula

- An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.
- For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares.

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- The objective of diluted earnings per share is consistent with that of basic earnings per share—to provide a measure of the interest of each ordinary share in the performance of an entity—while giving effect to all dilutive potential ordinary shares outstanding during the period. As a result:
  - ✓ profit or loss attributable to ordinary equity holders of the parent entity is increased by the after-tax amount of dividend and interest recognised in the period in respect of the dilutive potential ordinary shares and is adjusted for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares; and
  - ✓ the weighted average number of ordinary shares outstanding is increased by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

The formula can be mathematically expressed as follows:

$$\frac{\text{Profit/Loss attributable to Equity share holders when dilutive potential shares are converted into ordinary shares}}{\text{Weighted average number of Equity shares + Weighted average number of dilutive potential ordinary shares}}$$

2.7.2 Earnings

- For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, by the after-tax effect of:
  - (a) any dividend or other items related to dilutive potential ordinary shares is deducted in arriving at profit or loss attributable to ordinary equity holders of the parent entity;
  - (b) any interest recognised in the period related to dilutive potential ordinary shares; and
  - (c) any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.
- After the potential ordinary shares are converted into ordinary shares, the new ordinary shares are entitled to participate in profit or loss attributable to ordinary equity holders of the parent entity. Therefore, profit or loss attributable to ordinary equity holders of the parent entity is adjusted for the items in (a)-(c) above and any related taxes. The expenses associated with potential ordinary shares include transaction costs and discounts accounted for in accordance with the effective interest method under Ind AS 109.

Illustration 7

Entity A has in issue 25,000 4% debentures with a nominal value of ₹ 1. The debentures are convertible to ordinary shares at a rate of 1:1 at any time until 20X9. The entity's management receives a bonus based on 1% of profit before tax.

Entity A's results for 20X2 showed a profit before tax of ₹ 80,000 and a profit after tax of ₹ 64,000 (for simplicity, a tax rate of 20% is assumed in this question).

Calculate Earnings for the purpose of diluted EPS.

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Solution

For the purpose of calculating diluted EPS, the earnings should be adjusted for the reduction in the interest charge that would occur if the debentures were converted, and for the increase in the management bonus payment that would arise from the increased profit.

	Amount (₹)
Profit after tax	64,000
Add: Reduction in interest cost (25,000 × 4%) (*Refer Note*)	1,000
Less: Tax expense (1,000 × 20%)	(200)
Less: Increase in management bonus (1,000 × 1%)	(10)
Add: Tax benefit (10 × 20%)	2
Earnings for the purpose of diluted EPS	**64,792**

Note : For simplicity, this illustration does not classify the components of the convertible debenture as liabilities and equity, as required by Ind AS 32.

*****

2.7.3 Shares

2.7.3.1 Base for calculation

For the purpose of calculating diluted earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares ***plus*** the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares.

2.7.3.2 Calculation of Weighted average to be done independently for every period

- Dilutive potential ordinary shares shall be determined independently for each period presented. The number of dilutive potential ordinary shares included in the year-to-date period is not a weighted average of the dilutive potential ordinary shares included in each interim computation.
- Potential ordinary shares are weighted for the period they are outstanding. Potential ordinary shares that are cancelled or allowed to lapse during the period are included in the calculation of diluted earnings per share only for the portion of the period during which they are outstanding. Potential ordinary shares that are converted into ordinary shares during the period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.
- All potential ordinary shares are assumed converted into ordinary shares at the beginning of the period or, if not in existence at the beginning of the period, at the date of issue of the

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potential ordinary shares. The date of issue is the date the financial instrument was issued or the granting of the rights by which they are generated. This is sometimes referred to as the 'if converted' method.

- The conversion into ordinary shares should be determined from the terms of the financial instrument or the rights granted. This determination should assume the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.
- Only potential ordinary shares that are dilutive are considered in the calculation of diluted EPS. Potential ordinary shares should be treated as dilutive only when their conversion to ordinary shares would decrease profit per share or increase loss per share from continuing operations attributable to ordinary equity holders.
- The effects of anti-dilutive potential ordinary shares are ignored in calculating diluted EPS. An entity might have a number of different types of potential ordinary shares in issue. Each one would need to be considered separately rather than in aggregate.
- Convertible preference shares are dilutive where the amount of dividend on such shares, declared or accrued in the period per ordinary share obtainable on conversion, is below basic EPS for continuing operations. If the amount exceeds basic EPS, the convertible preference shares are anti-dilutive.

Illustration 8

ABC Ltd. has 1,000,000 ₹ 1 ordinary shares and 1,000 ₹ 100 10% convertible bonds (issued at par), each convertible into 20 ordinary shares on demand, all of which have been in issue for the whole of the reporting period.

ABC Ltd.'s share price is ₹ 4.50 per share and earnings for the period are ₹ 500,000. The tax rate applicable to the entity is 21%.

Calculate basic EPS, earnings per incremental share for the convertible bonds and diluted EPS.

Ignore the requirements of Financial Instruments (Ind AS 109) for the purpose of this question.

Solution

Basic EPS is ₹ 0.50 per share (ie 500,000/1,000,000)

The earnings per incremental share for the convertible bonds is calculated as follows:

Earnings effect = No. of bonds x nominal value x interest cost x (1 – applicable tax rate)

= 1,000 x 100 x 10% x (1- 0.21) = ₹ 7,900.

Incremental shares calculation

Assume all bonds are converted to shares, even though this converts ₹ 100 worth of bonds into 20 shares worth only ₹ 90 and is therefore not economically rational.

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This gives 1000 x 20 = 20,000 additional shares.

Earnings per incremental share = ₹ 7,900 / 20,000 = ₹ 0.395

Diluted EPS = (₹ 500,000 + ₹ 7,900) / (1,000,000 + 20,000) = ₹ 0.498 per share.

*****

Illustration 9

At 30 June 20X1, the issued share capital of an entity consisted of 1,500,000 ordinary shares of ₹ 1 each. On 1 October 20X1, the entity issued ₹ 1,250,000 of 8% convertible loan stock for cash at par. Each ₹ 100 nominal value of the loan stock may be converted, at any time during the years ended 20X6 to 20X9, into the number of ordinary shares set out below:

30 June 20X6: 135 ordinary shares;

30 June 20X7: 130 ordinary shares;

30 June 20X8: 125 ordinary shares; and

30 June 20X9: 120 ordinary shares.

If the loan stocks are not converted by 20X9, they would be redeemed at par.

The written equity conversion option is accounted for as a derivative liability and marked to market through profit or loss. The change in the options' fair value reported in 20X2 and 20X3 amounted to losses of ₹ 2,500 and ₹ 2,650 respectively. It is assumed that there are no tax consequences arising from these losses.

The profit before interest, fair value movements and taxation for the year ended 30 June 20X2 and 20X3 amounted to ₹ 825,000 and ₹ 895,000 respectively and relate wholly to continuing operations. The rate of tax for both periods is 33%.

Calculate Basic and Diluted EPS.

Solution

	20X3	20X2
Trading results	₹	₹
A. Profit before interest, fair value movements and tax	895,000	825,000
B. Interest on 8% convertible loan stock (20X2: 9/12 × ₹100,000)	(100,000)	(75,000)
C. Change in fair value of embedded option	(2,650)	(2,500)
Profit before tax	792,350	747,500
Taxation @ 33% on (A-B)	(262,350)	(247,500)
Profit after tax	**530,000**	**500,000**

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Calculation of basic EPS		
Number of equity shares outstanding	1,500,000	1,500,000
Earnings	₹ 530,000	₹ 500,000
Basic EPS	35 paise	33 paise

Calculation of diluted EPS

Test whether convertibles are dilutive:

The saving in after-tax earnings, resulting from the conversion of ₹ 100 nominal of loan stock, amounts to ₹ 100 × 8% × 67% + ₹ 2,650/12,500 = ₹ 5.36 + ₹ 0.21 = ₹ 5.57.

There will then be 135 extra shares in issue.

Therefore, the incremental EPS is 4 paise (ie. ₹ 5.57/135). As this incremental EPS is less than the basic EPS at the continuing level, it will have the effect of reducing the basic EPS of 35 paise. Hence the convertibles are dilutive.

	20X3	**20X2**
Adjusted earnings	₹	₹
Profit for basic EPS	530,000	500,000
Add: Interest and other charges on earnings saved	102,650	77,500
as a result of the conversion	(100,000 + 2,650)	(75000+ 2500)
Less: Tax relief thereon	(33,000)	(24,750)
Adjusted earnings for equity	**599,650**	**552,750**

Adjusted number of shares

From the conversion terms, it is clear that the maximum number of shares issuable on conversion of ₹ 1,250,000 loan stock after the end of the financial year would be at the rate of 135 shares per ₹ 100 nominal (that is, 1,687,500 shares).

	20X3	**20X2**
Number of equity shares for basic EPS	1,500,000	1,500,000
Maximum conversion at date of issue 1,687,500 × 9/12		1,265,625
Maximum conversion after balance sheet date	1,687,500	–
Adjusted shares	**3,187,500**	**2,765,625**
Adjusted earnings for equity	₹ 599,650	₹ 552,750
Diluted EPS (approx.)	**19 paise**	**20 paise**

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Note: Since Effective Interest Rate is not given, splitting of the convertible loan into liability and equity components as envisaged under Ind AS 109 cannot be done. However, since fair values of derivatives are given, the same is considered for accounting at FVTPL.

*****

2.7.3.3 Shares of subsidiary, joint venture or associate

A subsidiary, joint venture or associate may issue to parties other than the parent or investors with joint control of, or significant influence over, the investee potential ordinary shares that are convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the parent or investors with joint control of, or significant influence (the reporting entity) over, the investee. If these potential ordinary shares of the subsidiary, joint venture or associate have a dilutive effect on the basic earnings per share of the reporting entity, they are included in the calculation of diluted earnings per share.

2.7.3.4 Options, warrants and their equivalents

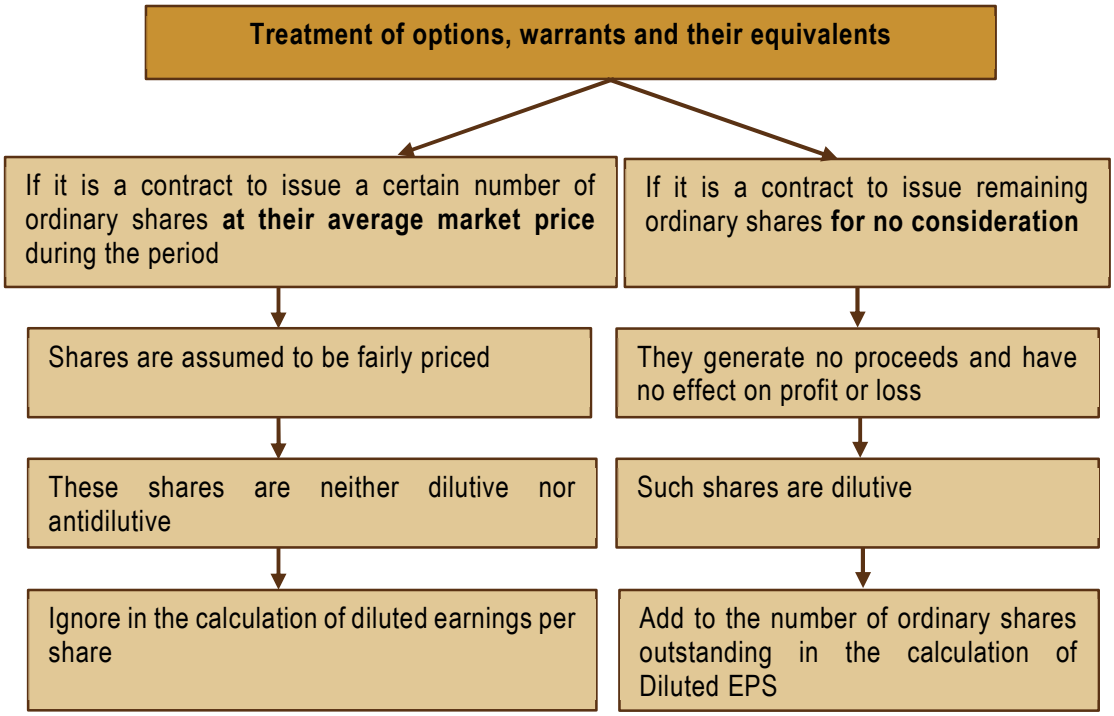
- For the purpose of calculating diluted earnings per share, an entity shall assume the exercise of dilutive options and warrants of the entity. The assumed proceeds from these instruments shall be regarded as having been received from the issue of ordinary shares at the average market price of ordinary shares during the period. The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period shall be treated as an issue of ordinary shares for no consideration.

- Options and warrants are dilutive when they would result in the *issue of ordinary shares for less than the average market price of ordinary shares during the period.* The amount of the dilution is the average market price of ordinary shares during the period minus the issue price. Therefore, to calculate diluted earnings per share, potential ordinary shares are treated as consisting of both the following:

  (a) a contract to issue a certain number of the ordinary shares at their average market price during the period. Such ordinary shares are assumed to be fairly priced and to be neither dilutive nor antidilutive. They are ignored in the calculation of diluted earnings per share.

  (b) a contract to issue the remaining ordinary shares for no consideration. Such ordinary shares generate no proceeds and have no effect on profit or loss attributable to ordinary shares outstanding. Therefore, such shares are dilutive and are added to the number of ordinary shares outstanding in the calculation of diluted earnings per share.

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Examples 8-10

8. ABC Ltd. has issued 20 lacs shares. It has also issued 1 lac warrants convertible into shares at ₹ 45 per share. The average market price of shares during the current period was ₹ 45.

   Such shares are assumed to be fairly priced, and to be neither dilutive, nor anti-dilutive. They are ignored in the calculation of diluted earnings per share.

9. ABC Ltd. has issued 20 lacs shares. It has also issued 1 lac warrants convertible into shares at ₹ 30 per share. The average market price of shares during the current period was ₹ 37. ₹ 7 (i.e. ₹ 37 - ₹ 30) is the dilution per share of the warrants.

   Such shares generate no proceeds and have no effect on profit attributable to the ordinary shares outstanding. They are dilutive and are added to the number of shares outstanding in the calculation of diluted earnings per share.

10. In 20X1, ABC Ltd. issued some staff share options that can be exercised after 3 years' service. They are treated as outstanding on the grant date in 20X1 for diluted earnings per share purposes.

Illustration 10

At 31 December 20X7 and 20X8, the issued share capital of an entity consisted of 4,000,000 ordinary shares of ₹ 25 each. The entity has granted options that give holders the right to subscribe for ordinary shares between 20Y6 and 20Y9 at ₹ 70 per share. Options outstanding at 31 December 20X7 and 20X8 were 630,000. There were no grants, exercises or lapses of options during the year. The profit after tax, attributable to ordinary equity holders for the years ended 31

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December 20X7 and 20X8, amounted to ₹ 500,000 and ₹ 600,000 respectively (wholly relating to continuing operations).

Average market price of share:

Year ended 31 December 20X7 = ₹ 120

Year ended 31 December 20X8 = ₹ 160

Calculate basic and diluted EPS.

Solution

	20X8	20X7
Calculation of basic EPS		
Profit after tax	₹ 600,000	₹ 500,000
Number of share	4,000,000	4,000,000
Basic EPS (approx.)	15 paise	13 paise.
Calculation of diluted EPS		
Adjusted number of shares		
Number of shares under option:		
Issued at full market price:		
(630,000 × 70) ÷ 120		367,500
(630,000 × 70) ÷ 160	275,625	
Issued at nil consideration — dilutive	354,375	262,500
Total number of shares under option	630,000	630,000
Number of equity shares for basic EPS	4,000,000	4,000,000
Number of dilutive shares under option	354,375	262,500
Adjusted number of shares (A)	4,354,375	4,262,500
Profit after tax (B)	₹ 600,000	₹ 500,000
Diluted EPS (B/A)	14 paise	12 paise

Note: *If options had been granted or exercised during the period, the number of 'nil consideration' shares in respect of these options would be included in the diluted EPS calculation on a weighted average basis for the period prior to exercise.*

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- **Options and warrants have a dilutive effect only when the average market price of ordinary shares during the period exceeds the exercise price** of the options or warrants (i.e. they are 'in the money'). Previously reported earnings per share are not retroactively adjusted to reflect changes in prices of ordinary shares.

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- For share options and other share-based payment arrangements to which Ind AS 102, *Share-based Payment,* applies, the issue price and the exercise price shall include the fair value (measured in accordance with Ind AS 102) of any goods or services to be supplied to the entity in the future under the share option or other share-based payment arrangement.

2.7.3.5 Employee Stock Options

Employee share options with fixed or determinable terms and non-vested ordinary shares are treated as options in the calculation of diluted earnings per share, even though they may be contingent on vesting. They are treated as outstanding on the grant date. Performance-based employee share options are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time.

Illustration 11- Effects of share options on diluted earnings per share

Profit attributable to ordinary equity holders of the parent entity for year 20X1	*₹ 1,200,000*
Weighted average number of ordinary shares outstanding during year 20X1	*500,000 shares*
Average market price of one ordinary share during year 20X1	*₹ 20.00*
Weighted average number of shares under option during year 20X1	*100,000 shares*
Exercise price for shares under option during year 20X1	*₹ 15.00*
Calculate basic and diluted EPS.	

Solution

Calculation of earnings per share

	Earnings	*Shares*	*Per share*
Profit attributable to ordinary equity holders of the parent entity for year 20X1	₹ 1,200,000		
Weighted average shares outstanding during year 20X1		500,000	
Basic earnings per share			**₹ 2.40**
Weighted average number of shares under option		100,000	
Weighted average number of shares that would have been issued at average market price: (100,000 × ₹ 15.00) ÷ ₹ 20.00	Refer Note	(75,000)	
Diluted earnings per share	**₹ 1,200,000**	**525,000**	**₹ 2.29**

Note: Earnings have not increased because the total number of shares has increased only by the number of shares (25,000) deemed to have been issued for no consideration.

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2.7.3.6 Convertible instruments

- The dilutive effect of convertible instruments shall be reflected in diluted earnings per share.
- Convertible preference shares are antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per ordinary share obtainable on conversion exceeds basic earnings per share. Similarly, convertible debt is antidilutive whenever its interest (net of tax and other changes in income or expense) per ordinary share obtainable on conversion exceeds basic earnings per share.
- The redemption or induced conversion of convertible preference shares may affect only a portion of the previously outstanding convertible preference shares. In such cases, any excess consideration is attributed to those shares that are redeemed or converted for the purpose of determining whether the remaining outstanding preference shares are dilutive. The shares redeemed or converted are considered separately from those shares that are not redeemed or converted.

2.7.3.7 Contingently issuable shares

- As in the calculation of basic earnings per share, contingently issuable ordinary shares are treated as outstanding and included in the calculation of diluted earnings per share if the conditions are satisfied (i.e. the events have occurred). Contingently issuable shares are included from the beginning of the period (or from the date of the contingent share agreement, if later). If the conditions are not satisfied, the number of contingently issuable shares included in the diluted earnings per share calculation is based on the number of shares that would be issuable if the end of the period were the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period expires.
- If attainment or maintenance of a specified amount of earnings for a period is the condition for contingent issue and if that amount has been attained at the end of the reporting period but must be maintained beyond the end of the reporting period for an additional period, then the additional ordinary shares are treated as outstanding, if the effect is dilutive, when calculating diluted earnings per share. In that case, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period. Because earnings may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied.
- The number of ordinary shares contingently issuable may depend on the future market price of the ordinary shares. In that case, if the effect is dilutive, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period.

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If the condition is based on an average of market prices over a period of time that extends beyond the end of the reporting period, the average for the period of time that has lapsed is used. Because the market price may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied.

- The number of ordinary shares contingently issuable may depend on future earnings and future prices of the ordinary shares. In such cases, the number of ordinary shares included in the diluted earnings per share calculation is based on both conditions (ie earnings to date and the current market price at the end of the reporting period). Contingently issuable ordinary shares are not included in the diluted earnings per share calculation unless both conditions are met.
- In other cases, the number of ordinary shares contingently issuable depends on a condition other than earnings or market price (for example, the opening of a specific number of retail stores). In such cases, assuming that the present status of the condition remains unchanged until the end of the contingency period, the contingently issuable ordinary shares are included in the calculation of diluted earnings per share according to the status at the end of the reporting period.
- Contingently issuable potential ordinary shares (other than those covered by a contingent share agreement, such as contingently issuable convertible instruments) are included in the calculation of diluted earnings per share as follows:
  - ✓ An entity determines whether the potential ordinary shares may be assumed to be issuable on the basis of the conditions specified for their issue in accordance with the contingent ordinary share provisions; and
  - ✓ if those potential ordinary shares are to be reflected in diluted earnings per share, an entity determines their impact on the calculation of diluted earnings per share by following the provisions for options and warrants, the provisions for convertible instruments, the provisions for contracts that may be settled in ordinary shares or cash, or other provisions, as appropriate.
- However, exercise or conversion is not assumed for the purpose of calculating diluted earnings per share unless exercise or conversion of similar outstanding potential ordinary shares that are not contingently issuable is assumed.

Illustration 12- Contingently issuable shares

Ordinary shares outstanding during 20X1	*1,000,000 (there were no options, warrants or convertible instruments outstanding during the period)*

An agreement related to a recent business combination provides for the issue of additional ordinary shares based on the following conditions:

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	5,000 additional ordinary shares for each new retail site opened during 20X1
	1,000 additional ordinary shares for each ₹ 1,000 of consolidated profit in excess of ₹ 2,000,000 for the year ended 31 December 20X1
Retail sites opened during the year:	*one on 1 May 20X1*
	one on 1 September 20X1
Consolidated year-to-date profit attributable to ordinary equity holders of the parent entity:	*₹ 1,100,000 as of 31 March 20X1*
	₹ 2,300,000 as of 30 June 20X1
	₹ 1,900,000 as of 30 September 20X1 (including a ₹ 450,000 loss from a discontinued operation)
	₹ 2,900,000 as of 31 December 20X1

Calculate basic and diluted EPS on quarterly as well as annual basis.

Solution

	Basic earnings per share				
	First quarter	***Second quarter***	***Third quarter***	***Fourth quarter***	***Full year***
Numerator (₹)	1,100,000	1,200,000	(400,000)	1,000,000	2,900,000
Denominator:					
Ordinary shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retail site contingency	–	3,333[6]	6,667[7]	10,000	5,000[8]
Earnings contingency[9]	–	–	–	–	–
Total shares	1,000,000	1,003,333	1,006,667	1,010,000	1,005,000
Basic earnings per share (₹)	1.10	1.20	(0.40)	0.99	2.89

6 5,000 shares × $^{2}/_{3}$

7 5,000 shares + (5,000 shares × $^{1}/_{3}$)

8 (5,000 shares × $^{8}/_{12}$) + (5,000 shares × $^{4}/_{12}$)

9 The earnings contingency has no effect on basic earnings per share because it is not certain that the condition is satisfied until the end of the contingency period. Profits for the year are determined /

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finalized on after Q4 / year is completed, i.e. in the year 20X2. Thus, the earliest when these shares can be actually issued is on 1 Jan 20X2.

	Diluted earnings per share				
	First quarter	*Second quarter*	*Third quarter*	*Fourth quarter*	*Full year*
Numerator (₹)	1,100,000	1,200,000	(400,000)	1,000,000	2,900,000
Denominator:					
Ordinary shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retail site contingency	–	5,000	10,000	10,000	10,000
Earnings contingency	–[10]	300,000[11]	–[12]	900,000[13]	900,000
Total shares	1,000,000	1,305,000	1,010,000	1,910,000	1,910,000
Diluted earnings per share (₹)	1.10	0.92	(0.40)[14]	0.52	1.52

10 Company A does not have year-to-date profit exceeding ₹ 2,000,000 at 31 March 20X1. The Standard does not permit projecting future earnings levels and including the related contingent shares.

11 Each quarter is treated as an independent reporting period and hence if the conditions are fulfilled during the quarter, the contingent shares are considered for Diluted EPS right from the beginning of the reporting period i.e., the quarter in the said case. [(₹ 2,300,000 – ₹ 2,000,000) ÷ 1,000] × 1,000 shares = 300,000 shares.

12 Year-to-date profit is less than ₹ 2,000,000.

13 [(₹ 2,900,000 – ₹ 2,000,000) ÷ 1,000] × 1,000 shares = 900,000 shares.

14 Because the loss during the third quarter is attributable to a loss from a discontinued operation, the antidilution rules do not apply. The control number (ie profit or loss from, continuing operations attributable to the equity holders of the parent entity) is positive. Accordingly, the effect of potential ordinary shares is included in the calculation of diluted earnings per share.

*****

2.7.3.8 Entity with discontinued operations

An entity that reports a discontinued operation should use income from continuing operations, adjusted for preferred dividends and similar adjustments, if any, as the "control number" in determining whether potential common shares are dilutive. That is, the same number of potential common shares used in computing the diluted per-share amount of income from continuing operations should be used in computing all other reported diluted per-share amounts even if the effect will be anti-dilutive compared to their respective basic per-share amounts.

Illustration 13

Assume the following facts for Company XY:

- *Income from continuing operations:* *INR 30,00,000*
- *Loss from discontinued operations:* *(INR 36,00,000)*
- *Net loss:* *(INR 6,00,000)*

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- *Weighted average Number of shares outstanding* *10,00,000*
- *Incremental common shares outstanding relating to stock options* *2,00,000*

(a) You are required to calculate the basic and diluted EPS for Company XY from the above information.

(b) Assume, if in above case, Loss from continued operations is ₹ 10,00,000 and income from discontinued operations is ₹ 36,00,000 calculate the diluted EPS.

Solution:

(a) Step 1:

Basic EPS = Profit for the year / Weighted average Number of shares outstanding

Basic EPS (Continued Operations) = Profit from continued operations / Weighted average Number of shares outstanding

= ₹ 30,00,000 / 10,00,000 = ₹ 3.00

Basic Loss per share (Discontinued operations) = Loss from discontinued operations / Weighted average Number of shares outstanding

= ₹ (36,00,000) / 10,00,000 = (₹ 3.60)

Overall Basic Loss per share = (₹ 6,00,000) / 10,00,000 = ₹ (0.60) (i)

Step 2: Calculation of Diluted EPS

Diluted EPS = Profit for the year / Adjusted Weighted average Number of shares outstanding

EPS (Continued Operations) = Profit from continued operations / Adjusted Weighted average Number of shares outstanding

= ₹ 30,00,000 / 12,00,000 = ₹ 2.50

Loss per share (Discontinued operations) = Loss from discontinued operations / Adjusted weighted average number of shares outstanding

= ₹ (36,00,000) / 12,00,000 = (₹ 3.00)

Overall Diluted Loss per share = ₹ 6,00,000 / 12,00,000 = ₹ (0.50) (ii)

The income from continuing operations is the control number, there is a dilution in basic EPS for income from continuing operations (reduction of EPS from ₹ 3.00 to ₹ 2.50). Therefore, even though there is an anti-dilution [Loss per share reduced from ₹ 0.60 (i) to ₹ 0.50 (ii) above], diluted loss per share of ₹ 0.50 is reported.

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(b) In case of loss from continuing operations, the potential shares are excluded since including those shares would result into anti-dilution effect on the **control number** (loss from continuing operations). Therefore, the diluted EPS will be calculated as under:

Diluted EPS = Profit for the year / Adjusted weighted average number of shares outstanding

Overall Profit = Loss from continuing operations + Gain from discontinued operations

= ₹ (10,00,000) + ₹ 36,00,000

= ₹ 26,00,000

Weighted average number of shares outstanding = 10,00,000

Diluted EPS = ₹ 2.60

The dilutive effect of the potential common shares on EPS for income from discontinued operations and net income would not be reported because of the loss from continuing operations.

*****

2.7.3.9 Contracts that may be settled in ordinary shares or cash

- When an entity has issued a contract that may be settled in ordinary shares or cash at the entity's option, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is dilutive.
- When an issued contract that may be settled in ordinary shares or cash at the entity's option may give rise to an asset or a liability, or a hybrid instrument with both an equity and a liability component under Ind AS 32, the entity should adjust the numerator (profit or loss attributable to ordinary equity holders) for any changes in the profit or loss that would have resulted during the period if the contract had been classified wholly as an equity instrument.
- For contracts that may be settled in ordinary shares or cash at the holder's option, the more dilutive of cash settlement and share settlement shall be used in calculating diluted earnings per share.

An example of a contract that may be settled in ordinary shares or cash is a debt instrument that, on maturity, gives the entity the unrestricted right to settle the principal amount in cash or in its own ordinary shares.

Another example is a written put option that gives the holder a choice of settling in ordinary shares or cash.

Illustration 14

An entity issues 2,000 convertible bonds at the beginning of Year 1. The bonds have a three-year term and are issued at par with a face value of ₹ 1,000 per bond, giving total proceeds of ₹ 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per

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cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. The entity has an option to settle the principal amount of the convertible bonds in ordinary shares or in cash.

When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9 per cent. At the issue date, the market price of one ordinary share is ₹ 3. Income tax is ignored. Entity has accounted for the convertible instrument using the principles of Financial Instruments.

Interest @ 6% for the year has already been adjusted in the profit attributable to shareholders.

Calculate basic and diluted EPS when

Profit attributable to ordinary equity holders of the parent entity Year 1	*₹ 1,000,000*
Ordinary shares outstanding	*1,200,000*
Convertible bonds outstanding	*2,000*

Solution

Assumption: Entity intends to settle only interest in cash

Allocation of proceeds of the bond issue:	
Liability component (Refer Note 1)	₹ 303,755
Equity component	₹ 1,696,245
	₹ 2,000,000

The liability and equity components would be determined in accordance with Ind AS 32. These amounts are recognised as the initial carrying amounts of the liability and equity components. The amount assigned to the issuer conversion option equity element is an addition to equity and is not adjusted.

Basic earnings per share Year 1:

$\frac{₹1,000,000}{1,200,000}$ = ₹ 0.83 per ordinary share

Diluted earnings per share Year 1:

It is presumed that the issuer will settle the contract by the issue of ordinary shares. The dilutive effect is therefore calculated in accordance with the Standard.

$\frac{₹1,000,000 + ₹27,338}{1,200,000 + 500,000}$ = ₹ 0.60 per ordinary share

Notes:

1. This represents the present value of the interest discounted at 9% – ₹ 120,000 payable annually in arrears for three years. ₹ 2,000,000 assumed to be settled in equity since option is with the entity will not form part of liability.

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2. Profit is adjusted for the accretion of ₹ 27,338 (₹303,755 x 9%) of the liability because of the passage of time.

3. 500,000 ordinary shares = 250 ordinary shares x 2,000 convertible bonds.

*****

2.7.3.10 Purchased options

- Contracts such as purchased put options and purchased call options (ie options held by the entity on its own ordinary shares) are not included in the calculation of diluted earnings per share because including them would be antidilutive. The put option would be exercised only if the exercise price were higher than the market price and the call option would be exercised only if the exercise price were lower than the market price.

2.7.3.11 Written put options

- Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of diluted earnings per share if the effect is dilutive. If these contracts are 'in the money' during the period (ie the exercise or settlement price is above the average market price for that period), the potential dilutive effect on earnings per share shall be calculated as follows:

  (a) it shall be assumed that at the beginning of the period sufficient ordinary shares will be issued (at the average market price during the period) to raise proceeds to satisfy the contract;

  (b) it shall be assumed that the proceeds from the issue are used to satisfy the contract (ie to buy back ordinary shares); and

  (c) the incremental ordinary shares (the difference between the number of ordinary shares assumed issued and the number of ordinary shares received from satisfying the contract) shall be included in the calculation of diluted earnings per share.

Written put options

Example 11

Assume that an entity has 160 written put options outstanding on 160 of its ordinary shares, with an exercise price of ₹ 10 per option. The put obligation is therefore ₹ 1,600. The average market price of the entity's ordinary shares is ₹ 8 for the period. In calculating diluted EPS, the entity assumes that it issues 200 ordinary shares at ₹ 8 per share to raise the proceeds necessary to satisfy the put option. The difference between the 200 ordinary shares assumed to be issued and the 160 ordinary shares that would have been received on exercise of the option (that is, 40 shares) is added to the denominator (number of shares) in calculating the diluted EPS. No adjustments are made to the numerator (profit attributable to ordinary shareholders), because the shares are deemed issued for nil proceeds.

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2.8 RETROSPECTIVE ADJUSTMENTS

- Diluted EPS of any prior period presented should not be restated for changes in the assumptions used (such as for contingently issuable shares) or for the conversion of potential ordinary shares (such as convertible debt) outstanding at the end of the previous period. These factors are already taken into account in calculating the basic and, where applicable, the diluted EPS for the current period. Prior period's EPS data should be restated for the effects of errors and adjustments resulting from changes to accounting policies accounted for retrospectively.
- Basic and diluted EPS figures for the current period and for prior periods should include bonus issues, share splits, share consolidations and other similar events occurring during the period that change the number of shares in issue without a corresponding change in the resources of the entity (that is, retrospective application).

2.9 PRESENTATION

- An entity shall present in the statement of profit and loss basic and diluted earnings per share for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period. An entity shall present basic and diluted earnings per share with equal prominence for all periods presented.
- Earnings per share is presented for every period for which a statement of profit and loss is presented. If diluted earnings per share is reported for at least one period, it shall be reported for all periods presented, even if it equals basic earnings per share. If basic and diluted earnings per share are equal, dual presentation can be accomplished in one line in the statement of profit and loss.
- If a company does not have any potential ordinary shares, then the company's basic and diluted EPS will be same. In such a case, the company need not disclose Basic EPS and Diluted EPS separately. It may disclose basic and diluted EPS as follows (illustrative numbers only):

	20X1	20X0
Basic and Diluted EPS	3.60	2.45

- An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either in the statement of profit and loss or in the notes.

An entity shall present basic and diluted earnings per share, even if the amounts are negative (ie a loss per share).

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2.10 DISCLOSURE

- An entity shall disclose the following:

  (a) The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

  (b) the weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

  (c) instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future but were not included in the calculation of diluted earnings per share because they are antidilutive for the period(s) presented.

  (d) a description of ordinary share transactions or potential ordinary share transactions (other than those arising from capitalisation, bonus issue, share split or reverse share split), that occur after the reporting period and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

  Examples of transactions in this para include:

  (a) an issue of shares for cash;

  (b) an issue of shares when the proceeds are used to repay debt or preference shares outstanding at the end of the reporting period;

  (c) the redemption of ordinary shares outstanding;

  (d) the conversion or exercise of potential ordinary shares outstanding at the end of the reporting period into ordinary shares;

  (e) an issue of options, warrants, or convertible instruments; and

  (f) the achievement of conditions that would result in the issue of contingently issuable shares. Earnings per share amounts are not adjusted for such transactions occurring after the reporting period because such transactions do not affect the amount of capital used to produce profit or loss for the period.

- Financial instruments and other contracts generating potential ordinary shares may incorporate terms and conditions that affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether any potential ordinary shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to profit or loss attributable to ordinary equity holders. The

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disclosure of the terms and conditions of such financial instruments and other contracts is encouraged, if not otherwise required.

- If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the statement of profit and loss other than one required by this Standard, such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard.
- Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes. An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax. If a component of the statement of profit and loss is used that is not reported as a line item in the statement of profit and loss, a reconciliation shall be provided between the component used and a line item that is reported in the statement of profit and loss.

2.11 ADDITIONAL TOPICS

2.11.1 Participating equity instruments and two-class ordinary shares

- The equity of some entities includes:

  (a) instruments that participate in dividend with ordinary shares according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).

  (b) a class of ordinary shares with a different dividend rate from that of another class of ordinary shares but without prior or senior rights.

- For the purpose of calculating diluted earnings per share, conversion is assumed for those instruments that are convertible into ordinary shares if the effect is dilutive. For those instruments that are not convertible into a class of ordinary shares, profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights to participate in undistributed earnings. To calculate basic and diluted earnings per share:

  (a) profit or loss attributable to ordinary equity holders of the parent entity is adjusted (a profit reduced and a loss increased) by the amount of dividend declared in the period for each class of shares and by the contractual amount of dividend (or interest on participating bonds) that must be paid for the period (for example, unpaid cumulative dividend).

  (b) the remaining profit or loss is allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed. The total profit or loss allocated to each class of equity instrument is determined by adding together the amount allocated for dividend and the amount allocated for a participation feature.

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(c) the total amount of profit or loss allocated to each class of equity instrument is divided by the number of outstanding instruments to which the earnings are allocated to determine the earnings per share for the instrument.

- For the calculation of diluted earnings per share, all potential ordinary shares assumed to have been issued are included in outstanding ordinary shares.

Illustration 15

An entity has two classes of shares in issue:

- *5,000 non-convertible preference shares*
- *10,000 ordinary shares*

The preference shares are entitled to a fixed dividend of ₹ 5 per share before any dividends are paid on the ordinary shares. Ordinary dividends are then paid in which the preference shareholders do not participate. Each preference share then participates in any additional ordinary dividend above ₹ 2 at a rate of 50% of any additional dividend payable on an ordinary share.

The entity's profit for the year is ₹ 100,000, and dividends of ₹ 2 per share are declared on the ordinary shares.

Compute the allocation of earnings for the purpose of calculation of Basic EPS when an entity has ordinary shares & participating equity instruments that are not convertible into ordinary shares.

Solution

The calculation of basic EPS is as follows:

	₹	₹
Profit		100,000
Less: Dividends payable for the period:		
Preference (5,000 × ₹ 5)	25,000	
Ordinary (10,000 × ₹ 2)	20,000	(45,000)
Undistributed earnings		55,000

Allocation of undistributed earnings:

Allocation per ordinary share = A

Allocation per preference share = B where B = 50% of A

(A × 10,000) + (50% × A × 5,000) = ₹ 55,000

A = 55,000 / (10,000 + 2,500) = ₹ 4.4

B = 50% of A i.e. B = ₹ 2.2

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Dividend per share are:	Preference shares ₹ per share	Ordinary shares ₹ per share
Distributed earnings	5.00	2.00
Undistributed earnings	2.20	4.40
Totals	**7.20**	**6.40**

Proof: (5,000 × ₹ 7.2) + (10,000 × ₹ 6.4) = ₹100,000

*****

Illustration 16

(This illustration does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by Ind AS 32).

Profit for the year	*₹ 100,000*
Ordinary shares outstanding	*10,000*
Non-convertible preference shares	*6,000*
Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares)	*₹ 5.50 per share*
After ordinary shares have been paid a dividend of ₹ 2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares.	

Compute the allocation of earnings for the purpose of calculation of Basic EPS when an entity has ordinary shares & participating equity instruments that are not convertible into ordinary shares.

Solution

Dividends on preference shares paid (6000 x ₹ 5.50 per share)	₹ 33,000
Dividends on ordinary shares paid (10,000 x ₹ 2.10 per share)	₹ 21,000

Basic earnings per share is calculated as follows:	₹	₹
Profit attributable to equity holders of the parent entity		100,000
Less: Dividend paid:		
Preference	33,000	
Ordinary	21,000	(54,000)
Undistributed earnings		46,000

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Allocation of undistributed earnings:	
Allocation per ordinary share = A	
Allocation per preference share = B; B = 1/4 A	
	(A x 10,000) + (1/4 x A x 6,000) = ₹ 46,000
	A = ₹ 46,000 ÷ (10,000 + 1,500)
	A = ₹ 4.00
	B = 1/4 A
	B = Re. 1.00

Dividend per share:		
	Preference shares	**Ordinary shares**
Distributed earnings	₹ 5.50	₹ 2.10
Undistributed earnings	₹ 1.00	₹ 4.00
Totals	**₹ 6.50**	**₹ 6.10**

*****

2.11.2 Partly paid shares

- Where ordinary shares are issued but not fully paid, they are treated in the calculation of basic earnings per share as a fraction of an ordinary share to the extent that they were entitled to participate in dividend during the period relative to a fully paid ordinary share.
- To the extent that partly paid shares are not entitled to participate in dividend during the period they are treated as the equivalent of warrants or options in the calculation of diluted earnings per share. The unpaid balance is assumed to represent proceeds used to purchase ordinary shares. The number of shares included in diluted earnings per share is the difference between the number of shares subscribed and the number of shares assumed to be purchased.

Illustration 17

An entity issues 100,000 ordinary shares of Re 1 each for a consideration of ₹ 2.50 per share. Cash of ₹ 1.75 per share was received by the balance sheet date. The partly paid shares are entitled to participate in dividends for the period in proportion to the amount paid.

Calculate number of shares for calculation of Basic EPS.

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Solution

The number of ordinary share equivalents that would be included in the basic EPS calculation on a weighted basis is as follows:

(100,000 × ₹ 1.75) / ₹ 2.50 = 70,000 shares.

*****

2.12 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Extracts from Annual reports of Hindustan Unilever Ltd.

(All amounts in ₹ crores, unless otherwise stated)

Particulars	Note	Year ended 31st March, 2022	Year ended 31st March, 2021
OTHER COMPREHENSIVE INCOME			
Items that will not be reclassified subsequently to profit or loss			
Remeasurements of the net defined benefit plans	39C	41	(3)
Income tax relating to items that will not be reclassified subsequently to profit or loss			
Remeasurements of the net defined benefit plans	9A	(10)	1
Items that will be reclassified subsequently to profit or loss			
Fair value of debt instruments through other comprehensive income	18C	(1)	(0)
Fair value of cash flow hedges through other comprehensive income	18C	85	70
Income tax relating to items that will be reclassified subsequently to profit or loss			
Fair value of debt instruments through other comprehensive income	9A	0	0
Fair value of cash flow hedges through other comprehensive income	9A	(0)	(47)
OTHER COMPREHENSIVE INCOME FOR THE YEAR (B)		**115**	**21**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR (A+B)		**8,933**	**7,975**
Earnings per equity share			
Basic (Face value of ₹1 each)	35	₹37.53	₹33.85
Diluted (Face value of ₹1 each)	35	₹37.53	₹33.85
Basis of preparation, measurement and significant accounting policies	2		

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NOTE 35 EARNINGS PER EQUITY SHARE

Basic earnings per share is computed by dividing the net profit for the period attributable to the equity shareholders of the Company by the weighted average number of equity shares outstanding during the period. The weighted average number of equity shares outstanding during the period and for all periods presented is adjusted for events, such as bonus shares, other than the conversion of potential equity shares that have changed the number of equity shares outstanding, without a corresponding change in resources.

For the purpose of calculating diluted earnings per share, the net profit for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period is adjusted for the effects of all dilutive potential equity shares.

	Year ended 31st March, 2022	Year ended 31st March, 2021
Earnings Per Share has been computed as under:		
Profit for the year	8,818	7,954
Weighted average number of equity shares outstanding during the year	2,34,95,87,637	2,34,95,42,101
Earnings Per Share (₹) - Basic (Face value of ₹1 per share)	₹37.53	₹33.85
Add: Weighted average number of potential equity shares on account of employee stock options/performance share schemes *	3,625	50,297
Weighted average number of Equity shares (including dilutive shares) outstanding during the year	2,34,95,91,262	2,34,95,92,398
Earnings Per Share (₹) - Diluted (Face value of ₹1 per share)	₹37.53	₹33.85

* Pertains to ESOP shares vested during the year, no outstanding share options as at 31st March, 2022

(Source: Annual Report for 2021-2022 of Hindustan Unilever Ltd.)

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Larsen and Toubro Ltd. (Extract of Statement of Profit and Loss)

Statement of Profit and Loss for the year ended March 31, 2022 (contd.)

₹ crore

	Note	2021-22		2020-21	
Brought forward - other comprehensive income			58.02		39.36
B Items that will be reclassified to Profit or Loss:					
Debt instruments through other comprehensive income		(177.90)		239.46	
Income tax (expenses)/income on debt instruments through other comprehensive income		40.70		(54.79)	
			(137.20)		184.67
Exchange differences in translating the financial statements of foreign operations		(26.59)		17.56	
Income tax (expenses)/income on exchange differences in translating the financial statements of foreign operations		6.69		(4.42)	
			(19.90)		13.14
Effective portion of gains/(losses) on hedging instruments in a cash flow hedge		69.17		218.43	
Income tax (expenses)/income on effective portion of gains/(losses) on hedging instruments in a cash flow hedge		(8.59)		(69.74)	
			60.58		148.69
Cost of hedging reserve		3.06		11.80	
Income tax (expenses)/income on cost of hedging reserve		(0.77)		(2.97)	
			2.29		8.83
Other comprehensive income for the year (net of tax)			(36.21)		394.69
Total comprehensive income for the year			7843.24		12192.48
Earnings per share (EPS) of ₹ 2 each from continuing operations:					
Basic earnings per equity share (₹)	49		56.09		22.41
Diluted earnings per equity share (₹)	49		56.03		22.39
Earnings per share (EPS) of ₹ 2 each from discontinued operations:					
Basic earnings per equity share (₹)	49		–		61.61
Diluted earnings per equity share (₹)	49		–		61.54
Earnings per share (EPS) of ₹ 2 each from continuing operations & discontinued operations:					
Basic earnings per equity share (₹)	49		56.09		84.02
Diluted earnings per equity share (₹)	49		56.03		83.93
Face value per equity share (₹)			2.00		2.00
NOTES FORMING PART OF THE FINANCIAL STATEMENTS	1 to 65				

NOTE [49]

Basic and diluted Earnings per Share [EPS] computed in accordance with Ind AS 33 "Earnings per Share":

Particulars		2021-22	2020-21
Basic earnings per share			
Profit after tax from continuing operations as per accounts (₹ crore)	A	7879.45	3147.31
Profit after tax from discontinued operations as per accounts (₹ crore)	B	–	8650.48
Profit after tax from continuing and discontinued operations as per accounts (₹ crore)	C=A+B	7879.45	11797.79
Weighted average number of equity shares outstanding	D	1,40,47,47,700	1,40,41,46,937
Basic EPS from continuing operations(₹)	A/D	56.09	22.41
Basic EPS from discontinued operations(₹)	B/D	–	61.61
Basic EPS from continuing discontinued operations(₹)	C/D	56.09	84.02
Diluted earnings per share			
Profit after tax from continuing operations as per accounts (₹ crore)	A	7879.45	3147.31
Profit after tax from discontinued operations as per accounts (₹ crore)	B	–	8650.48
Profit after tax from continuing and discontinued operations as per accounts (₹ crore)	C=A+B	7879.45	11797.79
Weighted average number of equity shares outstanding	D	1,40,47,47,700	1,40,41,46,937
Add: Weighted average number of potential equity shares on account of employee stock options	E	15,40,580	14,20,264
Weighted average number of equity shares outstanding for diluted EPS	F=D+E	1,40,62,88,280	1,40,55,67,202
Diluted EPS from continuing operations(₹)	A/F	56.03	22.39
Diluted EPS from discontinued operations(₹)	B/F	–	61.54
Diluted EPS from continuing discontinued operations(₹)	C/F	56.03	83.93
Face value per share (₹)		2	2

(Source: Annual Report for 2021-2022 of Larsen and Toubro Ltd.)

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Reliance Industries Ltd. (Statement of Profit and Loss)

Statement of Profit and Loss

For the year ended 31st March, 2022

(₹ in crore)

	Notes	2021-22	2020-21
Income			
Value of Sales		4,63,067	2,76,181
Income from Services		3,358	2,759
Value of Sales & Services (Revenue)		**4,66,425**	**2,78,940**
Less: GST Recovered		21,050	13,871
Revenue from Operations	26	**4,45,375**	**2,65,069**
Other Income	27	13,872	14,818
Total Income		**4,59,247**	**2,79,887**
Expenses			
Cost of Material Consumed		3,20,852	1,68,262
Purchase of Stock-in-Trade		10,691	7,301
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade	28	(7,962)	610
Excise Duty		21,672	19,402
Employee Benefits Expense	29	5,426	5,024
Finance Costs	30	9,123	16,211
Depreciation / Amortisation and Depletion Expense	1	10,276	9,199
Other Expenses	31	42,383	30,970
Total Expenses		**4,12,461**	**2,56,979**
Profit Before Exceptional Item and Tax		**46,786**	**22,908**
Exceptional Item (Net of Tax)	32	-	4,304
Profit Before Tax *		**46,786**	**27,212**
Tax Expenses *			
Current Tax	12	787	-
Deferred Tax	19	6,915	(4,732)
Profit for the Year		**39,084**	**31,944**
Other Comprehensive Income			
i. Items that will not be reclassified to Profit or Loss	27.1	241	350
ii. Income tax relating to items that will not be reclassified to Profit or Loss		(58)	(79)
iii. Items that will be reclassified to Profit or Loss	27.2	(2,705)	2,755
iv. Income tax relating to items that will be reclassified to Profit or Loss		543	(456)
Total Other Comprehensive Income/ (Loss) for the Year (Net of Tax)		**(1,979)**	**2,570**
Total Comprehensive Income for the Year		**37,105**	**34,514**
Earnings per Equity Share of Face Value of ₹ 10 Each			
Basic (in ₹) - After Exceptional Item	33	59.24	49.66
Basic (in ₹) - Before Exceptional Item	33	59.24	42.97
Diluted (in ₹) - After Exceptional Item	33	58.49	48.90
Diluted (in ₹) - Before Exceptional Item	33	58.49	42.31
Significant Accounting Policies See accompanying Notes to the Financial Statements	1 to 47		

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(₹ in crore)

	2021-22	2020-21
33. Earnings Per Share (EPS)		
Face Value per Equity Share (₹)	10	10
Basic Earnings per Share (₹) - After Exceptional Item	59.24	49.66
Basic Earnings per Share (₹) - Before Exceptional Item	59.24	42.97
Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - After Exceptional Item	39,084	31,944
Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - Before Exceptional Item	39,084	27,640
Weighted Average number of Equity Shares used as denominator for calculating Basic EPS	6,59,81,11,978	6,43,28,74,848
Diluted Earnings per Share (₹) - After Exceptional Item	58.49	48.90
Diluted Earnings per Share (₹) - Before Exceptional Item	58.49	42.31
Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - After Exceptional Item	39,084	31,944
Net Profit after Tax as per Statement of Profit and Loss attributable to Equity Shareholders (₹ in crore) - Before Exceptional Item	39,084	27,640
Weighted Average number of Equity Shares used as denominator for calculating Diluted EPS	6,68,16,52,444	6,53,21,38,901
Reconciliation of Weighted Average Number of Shares Outstanding		
Weighted Average number of Equity Shares used as denominator for calculating Basic EPS *	6,59,81,11,978	6,43,28,74,848
Total Weighted Average Potential Equity Shares *	8,35,40,466	9,92,64,053
Weighted Average number of Equity Shares used as denominator for calculating Diluted EPS	6,68,16,52,444	6,53,21,38,901

* Dilutive impact of Employee Stock Option Scheme and Partly paid Rights Issue Shares
* Refer Note 14.9

(Source: Annual Report for 2021-2022 of Reliance Industries Ltd.)

2.13 SIGNIFICANT DIFFERENCES BETWEEN IND AS 33 AND AS 20

S. No.	Particulars	Ind AS 33	AS 20
1.	*Additional disclosures*	Disclosure is required for instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future but were not included in the calculation of diluted earnings per share because	Certain additional disclosures required under Ind AS not required here.

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		they are anti-dilutive for the periods presented.	
2.	*Mandatorily convertible instrument*	Ordinary shares to be issued upon conversion of a mandatorily convertible instrument are included in the calculation of basic EPS from the date the contract is entered into.	No specific requirement as in Ind AS.
3.	*Shares issuable after a passage of time*	Ordinary shares that are issuable solely after a passage of time are not treated as contingently issuable shares because passage of time is a certainty.	No specific guidance.
4.	*Contingently returnable shares*	Outstanding ordinary shares that are contingently returnable are not treated as outstanding and are ignored in the calculation of basic EPS until the shares are no longer subject to recall.	No guidance on contingently returnable shares.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. ABC Ltd — 1 January 20X1 — Shares in issue 1,000,000

   31 March 20X1 — (a) Rights issue 1 for 5 at 90 paise

   (b) Fair value of shares ₹ 1 (cum-rights price)

   Calculate the number of shares for use in the EPS calculation for the calendar year.

2. 1 January — Shares in issue — 1,000,000

   5% Convertible bonds — ₹ 100,000

   (terms of conversion 120 ordinary shares for ₹ 100)

   31 March Holders of ₹ 25,000 bonds converted to ordinary shares.

   Profit for the year ended 31 December — ₹ 200,000

   Tax rate 30%.

   Calculate basic and diluted EPS. Ignore the need to split the convertible bonds into liability and equity elements.

3. 1 January — Shares in issue — 1,000,000

   Profit for the year ended 31 December — ₹ 100,000

   Average fair value during period — ₹ 8

   The company has in issue 200,000 options to purchase equal ordinary shares

   Exercise price — ₹ 6

   Calculate the diluted EPS for the period.

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4. Calculate Basic EPS for period ending 20X0, 20X1 and 20X2, when

	20X0	20X1	20X2
Profit attributable to ordinary equity holders of the parent entity	₹ 1,100	₹ 1,500	₹ 1,800

Shares outstanding before rights issue	500 shares
Rights issue	One new share for each five outstanding shares
Exercise price	₹ 5.00
Date of rights issue	1 January 20X1
Last date to exercise rights	1 March 20X1
Market price of one ordinary share immediately before exercise on 1st March 20X1:	₹ 11.00
Reporting date	31 December

5. Calculate Subsidiary's and Group's Basic EPS and Diluted EPS, when

Parent:	
Profit attributable to ordinary equity holders of the parent entity	₹ 12,000 (excluding any earnings of, or dividends paid by, the subsidiary)
Ordinary shares outstanding	10,000
Instruments of subsidiary owned by the parent	800 ordinary shares
	30 warrants exercisable to purchase ordinary shares of subsidiary
	300 convertible preference shares
Subsidiary:	
Profit	₹ 5,400
Ordinary shares outstanding	1,000
Warrants	150, exercisable to purchase ordinary shares of the subsidiary
Exercise price	₹ 10
Average market price of one ordinary share	₹ 20
Convertible preference shares	400, each convertible into one ordinary share
Dividends on preference shares	₹ 1 per share
No inter-company eliminations or adjustments were necessary except for dividends.	

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Ignore income taxes. Also, ignore classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by Ind AS 32.

6. CAB Limited is in the process of preparation of the consolidated financial statements of the group for the year ending 31st March, 20X3 and the extract of the same is as follows:

Particulars	Attributable to CAB Limited	Non-controlling interest	Total (₹ in '000)
Profit for the year	39,000	3,000	42,000
Other Comprehensive Income	5,000	Nil	5,000
Total Comprehensive Income	44,000	3,000	47,000

The long-term finance of the company comprises of the following:

(i) 20,00,00,000 equity shares at the beginning of the year and the company has issued 5,00,00,000 shares on 1st July, 20X2 at full market value.

(ii) 8,00,00,000 irredeemable preference shares. These shares were in issue for the whole of the year ended 31st March, 20X3. The dividend on these preference shares is discretionary.

(iii) ₹ 18 crores of 6% convertible debentures issued on 1st April, 20X1 and repayable on 31st March, 20X5 at par. Interest is payable annually. As an alternative to repayment at par, the holder on maturity can elect to exchange their convertible debentures for 10 crores ordinary shares in the company. On 1st April, 20X1, the prevailing market interest rate for four-year convertible debentures which had no right of conversion was 8%. Using an annual discount rate of 8%, the present value of ₹ 1 payable in four years is 0.74 and the cumulative present value of ₹ 1 payable at the end of years one to four is 3.31.

In the year ended 31st March, 20X3, CAB Limited declared an ordinary dividend of 0.10 paise per share and a dividend of 0.05 paise per share on the irredeemable preference shares.

Compute the following:

- the finance cost of convertible debentures and its closing balance as on 31st March, 20X3 to be presented in the consolidated financial statements.
- the basic and diluted earnings per share for the year ended 31st March, 20X3.

Assume that income tax is applicable to CAB Limited and its subsidiaries at 25%.

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Answers

1. Rights issue bonus fraction

	Shares	₹ per share	₹
Cum-rights	5	1	5.0
Rights	1	0.9	0.9
Ex-rights	**6**		**5.9**

Theoretical ex-rights price (5.9 / 6) = 0.9833

Bonus fraction = Cum-rights price / Theoretical ex-rights price

= 1/0.9833

	Number of shares
1 January - 31 March (1,000,000 × 3/12 × 1/.9833)	254,237
1 April - 31 December (1,200,000 × 9/12)	900,000
	1,154,237

2.

	Number of shares	Profit ₹
Profit		200,000
Ourdinary shares	1,000,000	
New shares on conversion (weighted average)		
9/12 × ₹ 25,000 / 100 × 120	22,500	-
Figures for basic EPS	1,022,500	200,000

Basic EPS is (₹ 200,000 / 1,022,500) = 0.196 per share

Dilution adjustments

Unconverted shares ₹ 75,000 / 100 × 120	90,000	
Interest: ₹ 75,000 × 5% × 0.7 (net of tax)		2,625
Converted shares pre conversion adjustment		
3/12 × ₹ 25,000 / 100 × 120	7,500	
Interest: [3/12 × ₹ 25,000 × 5% × 0.7]		219
	1,120,000	**202,844**

Diluted EPS is (₹ 202,844 / 1,120,000) = 0.181

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3. Diluted EPS

	Number of Shares	Profit (₹)	EPS
Basic	1,000,000	100,000	0.10
Dilution (Refer W.N.)	50,000	–	–
	1,050,000	100,000	0.095

Working Notes:

Proceeds of issue	(200,000 × ₹ 6)	=	1,200,000
Number that would have been issued at Fair value (1,200,000 / ₹ 8)=			150,000
Number actually issued			200,000
Number for "free" (200,000 – 150,000)			50,000

4. Calculation of theoretical ex-rights value per share

$$\frac{\text{Fair value of all outstanding shares before the exercise of rights + total amount received from exercise of rights}}{\text{Number of shares outstanding before exercise + number of shares issued in the exercise}}$$

$$\frac{(₹11.00 \times 500 \text{ shares}) + (₹5.00 \times 100 \text{ shares})}{500 \text{ shares} + 100 \text{ shares}}$$

Theoretical ex-rights value per share = ₹10.00

Calculation of adjustment factor

$$\frac{\text{Fair value per share before exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{₹\ 11.00}{₹\ 10.00} = 1.10$$

Calculation of basic earnings per share

	20X0	20X1	20X2
20X0 Basic EPS as originally reported: ₹1,100 / 500 shares	₹ 2.20		
20X0 Basic EPS restated for rights: ₹1,100 / (500 shares x 1.1)	₹ 2.00		
20X1 Basic EPS including effects of rights issue: {₹1,500 / [(500 x 1.1 x 2/12) + (600x10/12)]}		₹ 2.54	
20X2 Basic EPS: ₹ 1,800 / 600 shares		₹ 3.00	

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5. Subsidiary's earnings per share

Basic EPS ₹ 5.00 calculated: $\frac{₹ 5,400 \text{ (a)} - ₹400 \text{ (b)}}{1,000 \text{ (c)}}$

Diluted EPS ₹ 3.66 calculated: $\frac{₹ 5,400 \text{ (d)}}{(1,000 + 75 \text{ (e)} + 400(f))}$

Notes:

(a) Subsidiary's profit attributable to ordinary equity holders.

(b) Dividends paid by subsidiary on convertible preference shares.

(c) Subsidiary's ordinary shares outstanding.

(d) Subsidiary's profit attributable to ordinary equity holders (₹ 5,000) increased by ₹ 400 preference dividends for the purpose of calculating diluted earnings per share.

(e) Incremental shares from warrants, calculated: [(₹ 20 – ₹ 10) ÷ ₹ 20] × 150.

(f) Subsidiary's ordinary shares assumed outstanding from conversion of convertible preference shares, calculated: 400 convertible preference shares × conversion factor of 1.

Consolidated earnings per share

Basic EPS ₹ 1.63 calculated: $\frac{₹ 12,000(a) + ₹ 4,300(b)}{10,000(c)}$

Diluted EPS ₹ 1.61 calculated: $\frac{₹ 12,000 + ₹ 2,928(d) + ₹ 55(e) + ₹ 1,098(f)}{10,000}$

(a) Parent's profit attributable to ordinary equity holders of the parent entity.

(b) Portion of subsidiary's profit to be included in consolidated basic earnings per share, calculated: (800 × ₹ 5.00) + (300 × Re 1.00).

(c) Parent's ordinary shares outstanding.

(d) Parent's proportionate interest in subsidiary's earnings attributable to ordinary shares, calculated: (800 ÷ 1,000) × (1,000 shares × ₹ 3.66 per share).

(e) Parent's proportionate interest in subsidiary's earnings attributable to warrants, calculated: (30 ÷ 150) × (75 incremental shares × ₹ 3.66 per share).

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(f) Parent's proportionate interest in subsidiary's earnings attributable to convertible preference shares, calculated: (300 ÷ 400) × (400 shares from conversion × ₹ 3.66 per share).

6. Calculation of the liability and equity components on 6% Convertible debentures:

Present value of principal payable at the end of 4th year (₹ 1,80,000 thousand x 0.74)

= ₹ 1,33,200 thousand

Present value of interest payable annually for 4 years (₹ 1,80,000 thousand x 6% x 3.31)

= ₹ 35,748 thousand

Total liability component = ₹ 1,68,948 thousand

Therefore, equity component = ₹ 1,80,000 thousand – ₹ 1,68,948 thousand = ₹ 11,052 thousand

Calculation of finance cost and closing balance of 6% convertible debentures

Year	Opening balance ₹ in '000	Finance cost @ 8% ₹ in '000	Interest paid @ 6% ₹ in '000	Closing balance ₹ in '000
	a	b = a x 8%	c	d = a + b - c
31.3.20X2	1,68,948	13,515.84	10,800	1,71,663.84
31.3.20X3	1,71,663.84	13,733.11	10,800	1,74,596.95

Finance cost of convertible debentures for the year ended 31.3. 20X3 is ₹ **13,733.11 thousand** and closing balance as on 31.3. 20X3 is ₹ **1,74,596.95** thousand.

Calculation of Basic EPS **₹ in '000**

Profit for the year	39,000
Less: Dividend on preference shares (80,000 thousand x ₹ 0.05)	(4,000)
Profit attributable to equity shareholders	35,000

Weighted average number of shares = 20,00,00,000 + {5,00,00,000 x (9/12)}

= 23,75,00,000 shares or 2,37,500 thousand shares

Basic EPS = ₹ 35,000 thousand / 2,37,500 thousand shares

= ₹ 0.147

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Calculation of Diluted EPS **₹ in '000**

Profit for the year		39,000
Less: Dividend on preference shares (80,000 x 0.05)		(4,000)
		35,000
Add: Finance cost (as given in the above table)	13,733.11	
Less: Tax @ 25%	(3,433.28)	10,299.83
		45,299.83

Weighted average number of shares

= 20,00,00,000 + {5,00,00,000 x (9/12)} + 10,00,00,000

= 33,75,00,000 shares or 3,37,500 thousand shares

Diluted EPS = ₹ 45,299.83 thousand / 3,37,500 thousand shares

= ₹ 0.134

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UNIT 3
INDIAN ACCOUNTING STANDARD 108 : OPERATING SEGMENTS

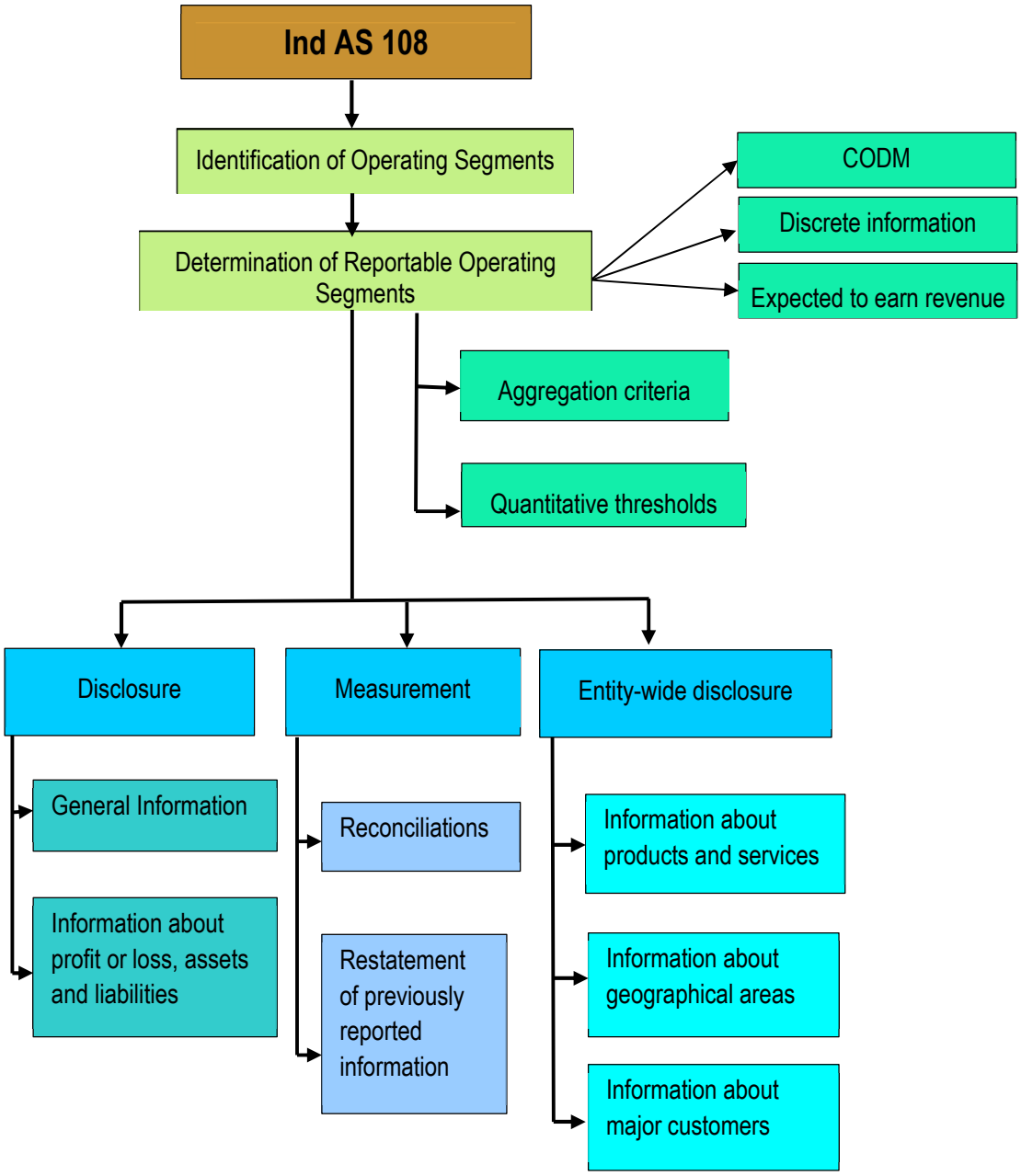
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Explain the meaning of 'operating segments'
- Define the 'chief operating decision maker' (CODM)
- Identify the reportable segments and the application of aggregation criteria
- Comply with the disclosure requirement under Ind AS 108 with regard to operating segments
- Differentiate between Ind AS 108 and AS 17

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UNIT OVERVIEW



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3.1 CORE PRINCIPLE

An entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Ind AS 108 requires an entity to disclose information to enable the stakeholders to have insight into the entity's operations from the same perspective as that of its management. For instance, in case of an entity engaged in multiple lines of business / business activities (e.g., engineering, financial services and IT), the users of financial statements must have the information about the performance of each of its 'business activities' as perceived by management in order to make better and more informed decisions about their investments in the entity as a whole.

Similarly, an entity may be operating across multiple economic environments. 'Economic Environments' in general, are those factors which have an impact on the working of any business. These factors could include political and economic macro-systems, trade cycles, economic resources, statutory environment, income levels, industrial growth rates and many other such factors. These are dynamic in nature and are in a continuous state of change.

In view of these complexities, Ind AS 108 requires disclosure of information in a manner which enables users to make informed decisions based on their assessment of the economic environments in which the different businesses of an entity operate.

3.2 SCOPE

Ind AS 108 should apply to companies to which Indian Accounting Standards notified under the Companies Act, 2013 apply.

If an entity that is not required to apply Ind AS 108 but chooses to disclose information about segments that does not comply with Ind AS 108, it should not describe the information as segment information.

If a financial report contains both the consolidated financial statements of a parent that is within the scope of Ind AS 108 as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

Extract from: Hindustan Unilever Limited's Annual Report for 2021-2022

NOTE 46

The Company has presented segment information in the consolidated financial statements which are presented in the same annual report. Accordingly, in terms of Paragraph 4 of Ind AS 108 'Operating Segments', no disclosures related to segments are presented in these standalone financial statements.

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3.3 OPERATING SEGMENTS

An operating segment is a component of an entity:

(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);

(b) whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance; and

(c) for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

A perusal of the above requirements for identifying an operating segment differs with requirements contained in Accounting Standard (AS) 17, *Segment Reporting*. According to AS 17, identification of business segment is determined by considering risk and returns derived from an identical product or service or group of related products and services. Similarly, identification of geographical segment is determined by considering the risk and returns from products and services within a particular economic environment.

Ind AS 108, however, requires the consideration of earning of revenues and incurring of expenses from a business activity, the operating results of which are regularly reviewed by entity's CODM and discrete financial information is available. It may be noted that AS 17 follows the approach of risk and return for determination of a business and geographical segment. Ind AS 108, however, follows the management approach meaning thereby that whichever business activity is considered by the management as a separate source of revenue will be considered as an operating segment, the operating results of which are regularly reviewed by CODM to make decision about resources allocation and performance measurement.

Under this approach, not only would enterprises be likely to report more detailed information but the knowledge obtained of the structure of an enterprise's internal organisation is valuable in itself because it highlights segments based on such structure. This approach results in the following significant advantages:

- An ability to see an enterprise "through the eyes of management" enhances a user's ability to predict actions or reactions of management that can significantly affect the enterprise's prospects for future cash flows.
- Information about those segments is generated for management's use and hence the incremental cost of providing information for external reporting would be relatively low.

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Illustration 1

ABC Ltd. manufactures and sells healthcare products, and food and grocery products. Three products namely A, B & C are manufactured. Product A is classified as healthcare product and product B & C are classified as food and grocery products. Products B & C are similar products. Discrete financial information is available for each manufacturing locations and for the selling activity of each product. There are two-line managers responsible for manufacturing activities of products A, B & C. Manager X manages product A and Manager B manages products B & C. The operating results of health care products (product A) and food and grocery products (products B & C) are regularly reviewed by the CODM.

Identify reportable segments of ABC Ltd.

Solution

In this situation both the healthcare, and food and grocery product line meet the criteria for operating segments set out above. Therefore, it is likely that ABC Ltd.'s operating segments would be classified as being (i) healthcare and (ii) food and grocery segments.

Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments. For the purposes of Ind AS 108, an entity's post-employment benefit plans are not operating segments.

*****

3.3.1 Functions that are integral to business

In case of a company, where the activities of a function are an integral part of company's business (for example, research and development function for a pharmaceuticals or software company), this can be considered as an operating function provided that there is discrete information available that is regularly reviewed by the CODM.

3.3.2 Discontinued operations – whether an operating segment

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.

The term 'chief operating decision maker' (CODM) identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the

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performance of the operating segments of an entity. Often the CODM of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.

For many entities, the three characteristics of operating segments clearly identify its operating segments. However, an entity may produce reports in which its business activities are presented in a variety of ways. If the CODM uses more than one set of segment information, other factors may identify a single set of components as constituting an entity's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

Illustration 2

The CEO along with other Board members do a review of financial information about various business segments and take decisions on the basis of discrete information available for these segments and are correctly identified as ***Chief Operating Decision Maker (CODM).*** *Review of only revenue information is done for decision making about those segments by the CODM. As per CODM, many segments require minimal costs due to centralization of costs.*

Analyse whether the review of only the revenue related information is sufficient for these segments to be considered as operating segments for the purposes of Ind AS 108 'Operating Segments'.

Solution

Many entities would be considering the decision making for segments on the basis of revenue growth – especially the ones aggressively trying to build a market share. Common examples would be businesses in the technology sector or those creating or launching new products from time to time. For them, the decision making for different regional segments would need revenue growth and related information for further investment decisions.

Merely examining revenue data by CODM without taking into account the corresponding expenses involved in generating that revenue may not provide adequate insights for determining how to allocate resources and measure the performance of a segment.

However, in the instant case, the logic given by the CODM is that since many segments require minimal costs (due to centralization of costs), therefore, revenue-only data is a fair representation of the operating results.

In the above case, review of the information that is based only on revenue data may be appropriate to consider that the segment meets the definition of an operating segment.

*****

Whether a committee of non-executive directors (NEDs) is likely to be the CODM.

NEDs are not usually involved in resource allocation decisions, other than at a very high level. Their role is primarily related to governance than a management role. Accordingly, it may be difficult to establish if they would meet the definition of the CODM.

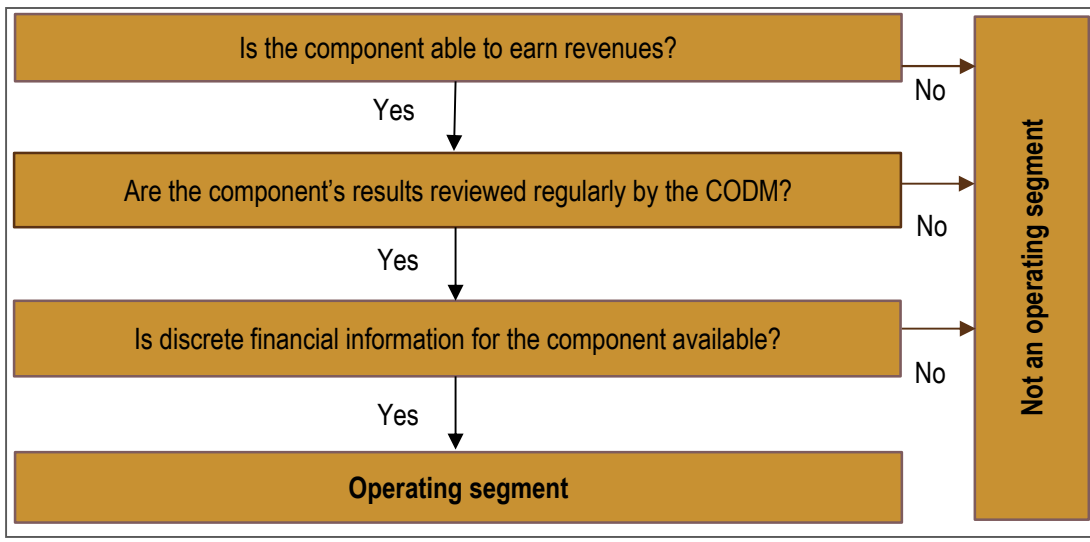
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However, a function (Board of directors), might include non-executive directors whose sole responsibility is governance. Such a function would be a CODM if the most significant operating, as well as strategic, decisions are made by that function, even if those non-executive directors do not participate in implementing such decisions.

Overlapping sets of components

Generally, an operating segment has a segment manager who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment. The term 'segment manager' identifies a function, not necessarily a manager with a specific title. The chief operating decision maker also may be the segment manager for some operating segments. A single manager may be the segment manager for more than one operating segment. If the characteristics apply to more than one set of components of an organisation but there is only one set for which segment managers are held responsible, that set of components constitutes the operating segments.

The characteristics may apply to two or more overlapping sets of components for which managers are held responsible. That structure is sometimes referred to as a matrix form of organisation. For example, in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. The CODM regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity should determine which set of components constitutes the operating segments by reference to the core principle.



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Illustration 3

X Ltd. is engaged in the manufacture and sale of two distinct type of products A & B. X Ltd. supplies the product in the domestic market in India as well as in Singapore. There are two regional managers responsible for manufacturing activities of product A & B worldwide and also two other managers responsible for different geographical areas. For internal reporting purposes, X Ltd. provides information product-wise and as per the geographical location of the company. The CODM regularly reviews the operating results of both sets of components.

Comment, how should X Ltd. identify its operating segments.

Solution

In this situation, both the geographical sales areas and product areas may meet the criteria for operating segment. However, in such situation, it is more difficult to determine clearly which set of components should be identified as the entity's operating segments. In such situation the entity should determine which set of components constitutes the operating segments by reference to the core principle. The core principle is that the entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. The entity should also assess whether the identified operating segments could realistically represent the level at which the CODM is assessing performance and allocating resources.

Therefore, X Ltd. should consider all the above factors and apply judgement to determine which component should be disclosed as operating segment.

*****

Illustration 4

CODM of XY Ltd. receives and reviews multiple sets of information when assessing the businesses' overall performance to take a decision on resources allocation. It receives the information as under:

- *Level 1 Report: Summary report for all 4 regions*
- *Level 2 Report: Summary report for 20 Sub-regions within those regions*
- *Level 3 Report: Detailed report for 50 Branches within the sub-regions*

State what factors and level should be considered for determining an operating segment.

Solution

We need to consider multiple factors (including but not limited to below):

— The process that CODM may use to assess the performance (Key Financial Matrix, KPIs, Ratio etc.);

— Identify the segment managers and their responsibility areas;

— The process of budgeting for resource allocations.

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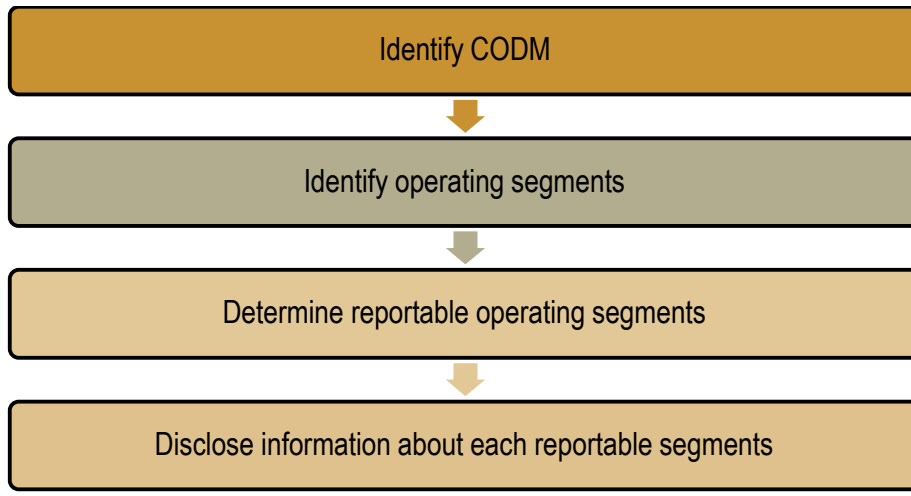
3.4 REPORTABLE SEGMENTS

An entity should report separately information about each operating segment that:

(a) has been identified or results from aggregating two or more of those segments; and

(b) exceeds the quantitative thresholds.

Standard specifies other situations in which separate information about an operating segment should be reported.



3.5 AGGREGATION CRITERIA

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of Ind AS 108, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

(a) the nature of the products and services;

(b) the nature of the production processes;

(c) the type or class of customer for their products and services;

(d) the methods used to distribute their products or provide their services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

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Illustration 5

XY Ltd. has operations in France, Italy, Germany, UK and India. It wishes to apply aggregation criteria on geographical basis.

State, how will the aggregation criteria apply for reporting segments in the given scenario.

Solution

XY Ltd. needs to assess and prove that each country possesses the same economic characteristics. Factors including exchange control regulations, currency risks and economic conditions are required to be considered.

Considering above factors, it may be possible to aggregate the results of France, Italy and Germany (falling within EU region) and results of UK and India may be separately reported (no aggregation is permitted).

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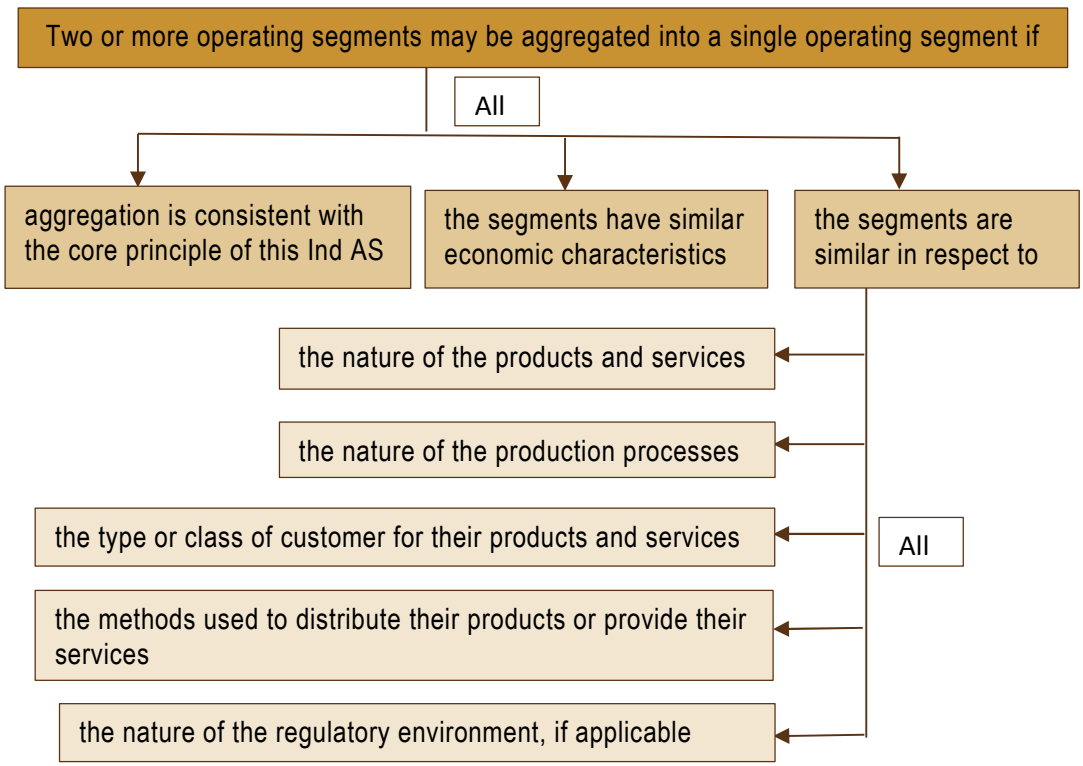


Illustration 6

X Ltd. is engaged in the business of manufacturing and selling papers. Varieties of paper like adhesive paper, anti-rust paper, antique paper, art paper etc., are manufactured and sold by X Ltd.

State whether X Ltd. should classify these papers into different segments.

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Solution

Two or more operating segments may be aggregated into a single operating segment if the segments have similar economic characteristics, and the segments are similar with respect to various factors like nature of the product and production process, type of customers, method of distribution and regulatory requirement.

In case of X Ltd., so far as varieties of paper concerned, if all factors such as nature of the product and production process, type of customers, method of distribution and regulatory requirement are common, there is no need to create different segments for each type of paper.

*****

Illustration 7

T Ltd is engaged in transport sector, running a fleet of buses at different routes. T Ltd has identified 3 operating segments:

- *Segment 1: Local Route*
- *Segment 2: Inter-city Route*
- *Segment 3: Contract Hiring*

The characteristics of each segment are as under:

Segment 1: *The local transport authority awards the contract to ply the buses at different routes for passengers. These contracts are awarded following a competitive tender process; the ticket price paid by passengers are controlled by the local transport authority. T Ltd would charge the local transport authority on a per kilometer basis.*

Segment 2: *T Ltd operates buses from one city to another, prices are set by T Ltd on the basis of services provided (Deluxe, Luxury or Superior).*

Segment 3: *T Ltd also leases buses to schools under a long-term arrangement.*

*While Segment 1 has been showing significant decline in profitability, Segment 2 is performing well in respect of higher revenues and improved margins. The management of the company is not sure why is the segment information relevant for users when they should only be concerned about the returns from overall business. They would like to aggregate the Segment 1 and Segment 2 for reporting under '**Operating Segment'***

Required:

State whether it is appropriate to aggregate Segments 1 and 2 with reference to Ind AS 108 'Operating Segments'; and also discuss, in the above context, whether disclosure of segment information is relevant to an investor's appraisal of financial statements.

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Solution

Ind AS 108 '**Operating Segments'** requires operating segments to be aggregated to present a reportable segment if the segments have similar economic characteristics, and the segments are similar in each of the following aggregation criteria:

(a) The nature of the products and services

(b) The nature of the production process

(c) The type or class of customer for their products and services

(d) The methods used to distribute their products or provide their services

(e) If applicable, the nature of the regulatory environment

While the products and services are similar, the customers for those products and services are different.

In Segment 1, the decision to award the contract is in the hands of the local authority, which also sets prices and pays for the services. The company is not exposed to passenger revenue risk, since a contract is awarded by competitive tender.

On the other hand, in the inter-city segment, the customer determines whether a bus route is economically viable by choosing whether or not to buy tickets. T Ltd sets the ticket prices but will be affected by customer behavior or feedback. T Ltd is exposed to passenger revenue-risk, as it sets prices which customers may or may not choose to pay.

Operating Segment provides information that makes the financial statements more useful to investors. In making the investment decisions, investors and creditors consider the returns they are likely to make on their investment. This requires assessment of the amount, timing and uncertainty of the future cash flows of T Ltd as well as of management's stewardship of T Ltd's resources. How management derives profit is therefore relevant information to an investor.

Inappropriately aggregating segments reduces the usefulness of segment disclosures to investors. Ind AS 108 requires information to be disclosed that is not readily available elsewhere in the financial statements, therefore it provides additional information which aids an investor's understanding of how the business operates and is managed.

In T Ltd.'s case, if the segments are aggregated, then the increased profits in segment 2 will hide the decreased profits in segment 1. However, the fact that profits have sharply declined in segment 1 would be of interest to investors as it may suggest that future cash flows from this segment are at risk.

It is not mandatory to aggregate segments. An entity, if desires, can disclose separately information about segments that meet all the criteria. However, with regard to upper limit on number of segments to be reported, the entity should consider whether a practical limit has been reached.

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3.6 QUANTITATIVE THRESHOLDS

An entity should report separately information about an operating segment that meets any of the following quantitative thresholds:

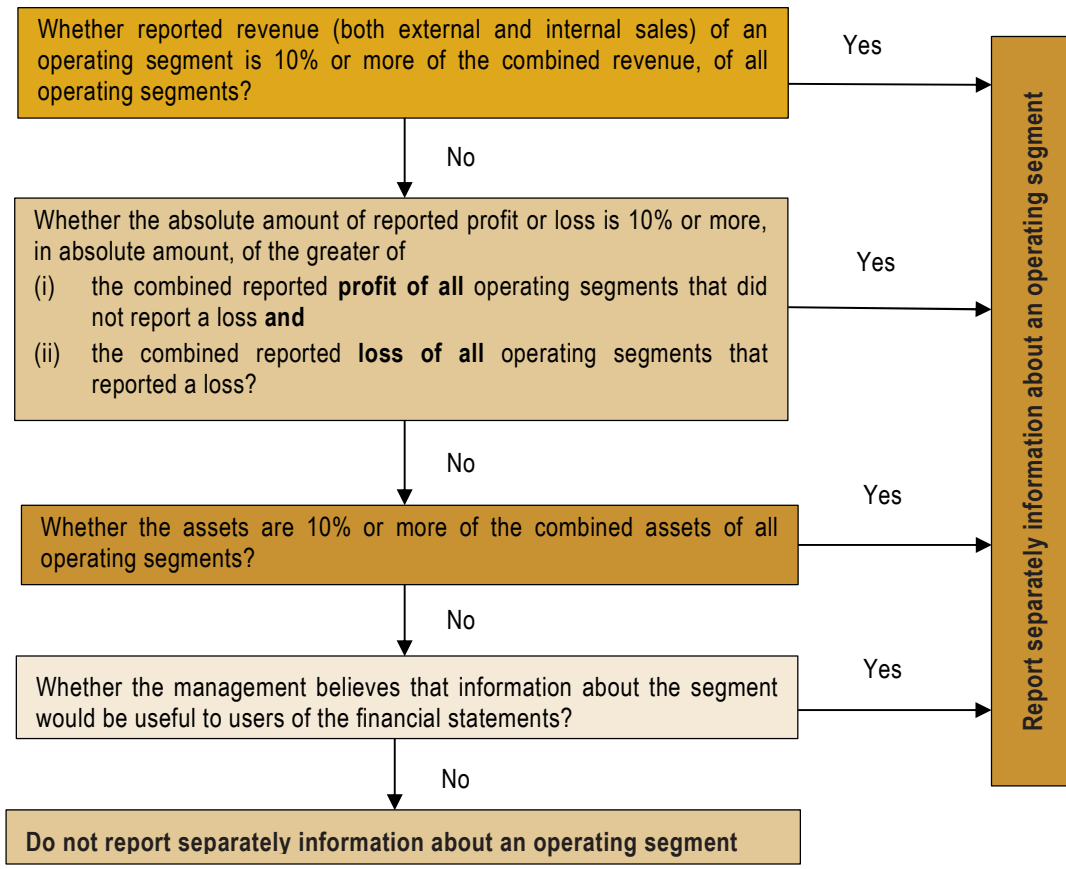
(a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.

(b) Its reported profit or loss is 10% or more, in absolute amount, of the greater, in absolute amount, of

(i) the combined reported profit of all operating segments that did not report a loss and

(ii) the combined reported loss of all operating segments that reported a loss.

(c) Its assets are 10% or more of the combined assets of all operating segments. Operating segments that do not meet any of the quantitative thresholds may be considered reportable and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.



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Illustration 8

X Ltd. has identified the following business components.

Segment	Revenue (₹)		Profit (₹)	Assets (₹)
	External	Internal		
Pharma	97,00,000	Nil	20,00,000	55,00,000
FMCG	Nil	4,00,000	2,50,000	25,00,000
Ayurveda	3,00,000	Nil	2,00,000	4,00,000
Others	8,00,000	41,00,000	5,50,000	6,00,000
Total for the entity	1,08,00,000	45,00,000	30,00,000	90,00,000

Which of the segments would be reportable as per the criteria prescribed in Ind AS108?

Solution

Quantitative thresholds are calculated below:

Segments	Pharma	FMCG	Ayurveda	Others
% segment sales to total sales	63.40	2.61	1.96	32.03
% segment profit to total profits	66.67	8.33	6.67	18.33
% segment assets to total assets	61.11	27.78	4.44	6.67

Segment Pharma would separately reportable since they meet all three size criteria, though any one criteria is required. FMCG segment does not satisfy the revenue and profit test but does satisfy the asset test. So it would be separately reportable. Ayurveda segment does not meet any threshold. It may not be classified as reportable segment.

*****

An entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments should be identified as reportable segments (even if they do not meet the criteria) until at least 75% of the entity's revenue is included in reportable segments.

Note

- External revenue of reportable segments must be ≥ 75% of total revenue of the entity.
- Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if information about the segment is useful to users.

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Non-reportable segments – After the appropriate aggregation and requisite tests are done (i.e. 10% tests done and 75% test met), information about other business activities and operating segments that are not reportable should be combined and disclosed in an 'all other segments' category separately from other reconciling items in the reconciliations. The sources of the revenue included in the 'all other segments' category should be described.

If management judges that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment should continue to be reported separately in the current period even if it no longer meets the criteria for reputability.

If an operating segment is identified as a reportable segment in the current period in accordance with the quantitative thresholds, segment data for a prior period presented for comparative purposes should be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the criteria for reportability in the prior period, unless the necessary information is not available and the cost to develop it would be excessive.

There may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed. Although no precise limit has been determined, as the number of segments that are reportable increases above ten, the entity should consider whether a practical limit has been reached.

Illustration 9

An entity has branches in different parts of the country – catering to different customers and selling local made products (a product of one region is not sold in any other region). No region or product contributes more than 5% to total revenue of the entity.

Discuss how many segments are reportable.

Solution

Under the quantitative threshold, external revenue of reportable segments must be ≥ 75% of total revenue of the entity. Considering above case, minimum 15 operating segments need to be reportable (75% [threshold] / 5% {revenue}).

*****

3.7 DISCLOSURE

An entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

An entity should disclose the following for each period for which a statement of profit and loss is presented:

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(a) general information;

(b) information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement; and

(c) reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts.

Reconciliations of the amounts in the balance sheet for reportable segments to the amounts in the entity's balance sheet are required for each date at which a balance sheet is presented. Information for prior periods should be restated.

3.7.1 General Information

An entity should disclose the following general information:

(a) factors used to identify the entity's reportable segments, including the basis of organisation (for example, whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated); and

(b) the judgements made by management in applying the aggregation criteria. This includes a brief description of the operating segments that have been aggregated in this way and the economic indicators that have been assessed in determining that the aggregated operating segments share similar economic characteristics; and

(c) types of products and services from which each reportable segment derives its revenues.

3.7.1.1 Factors that management used to identify the entity's reportable segments

Diversified Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. Most of the businesses were acquired as individual units, and the management at the time of the acquisition was retained.

3.7.1.2 Description of the types of products and services from which each reportable segment derives its revenues

Diversified Company has five reportable segments: car parts, motor vessels, software, electronics and finance. The car parts segment produces replacement parts for sale to car parts retailers. The motor vessels segment produces small motor vessels to serve the offshore oil industry and similar businesses. The software segment produces application software for sale to computer manufacturers and retailers. The electronics segment produces integrated circuits and related products for sale to computer manufacturers. The finance segment is responsible for portions of the company's financial operations including financing customer purchases of

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products from other segments and property lending operations.

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NOTE 46 SEGMENT INFORMATION

The Operating Segment is the level at which discrete financial information is available. Business segments are identified considering:

a) the nature of products and services
b) the differing risks and returns
c) the internal organisation and management structure, and
d) the internal financial reporting systems.

3.7.2 Information about profit or loss, assets and liabilities

An entity should report a measure of profit or loss for each reportable segment. An entity should report a measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to CODM. An entity should also disclose the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the CODM, or are otherwise regularly provided to the CODM, even if not included in that measure of segment profit or loss:

(a) revenues from external customers;

(b) revenues from transactions with other operating segments of the same entity;

(c) interest revenue;

(d) interest expense;

(e) depreciation and amortisation;

(f) material items of income and expense disclosed in accordance with Ind AS 1, *Presentation of Financial Statements*;

(g) the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;

(h) income tax expense or income; and

(i) material non-cash items other than depreciation and amortisation.

An entity should report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the CODM relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, an entity may report that segment's interest revenue net of its interest expense and disclose that it has done so.

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An entity should disclose the following about each reportable segment if the specified amounts are included in the measure of segment assets reviewed by the CODM or are otherwise regularly provided to the CODM, even if not included in the measure of segment assets:

(a) the amount of investment in associates and joint ventures accounted for by the equity method; and

(b) the amounts of additions to non-current assets (For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the reporting period) other than financial instruments, deferred tax assets, net defined benefit assets (in accordance with Ind AS 19, *Employee Benefits*) and rights arising under insurance contracts.

The following table illustrates a suggested format for disclosing information about segment profit or loss, assets and liabilities. The same type of information is required for each year for which a statement of profit and loss is presented. Diversified Company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration are assumed to be the amounts in reports used by the CODM.

Information about reportable segment profit or loss, assets and liabilities

	Car parts ₹	Motor vessels ₹	Software ₹	Electronics ₹	Finance ₹	All others ₹	Total ₹
Revenue from external customers	3,000	5,000	9,500	12,000	5,000	1,000[(a)]	35,500
Inter-segment revenues	-	-	3,000	1,500	-	-	4,500
Interest revenue	450	800	1,000	1,500	-	-	3,750
Interest expense	350	600	700	1,100	-	-	2,750
Net interest revenue[(b)]	-	-	-				1,000
Depreciation and amortisation	200	100	50	1,500	1,100	-	2,950
Reportable Segment profit	200	70	900	2,300	500	100	4,070
Other material Non-cash item:							
Impairment of assets	-	200	-	-	-	-	200
Reportable segment assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000

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Expenditures for reportable segment non- current assets	300	700	500	800	600	-	2,900
Reportable segment liabilities	1,050	3,000	1,800	8,000	30,000		43,850

[a]Revenues from segments below the quantitative thresholds are attributable to four operating segments of Diversified Company. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.

[b]The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, only the net amount is disclosed.

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Segment revenue relating to each of the above domestic business segments includes Income from Services provided to group companies, where applicable. Segment results relate to profit from continuing operations before other income, finance costs, exceptional items and tax

	Year ended 31st March, 2022			Year ended 31st March, 2021		
	External	Intersegment	Total	External	Intersegment	Total
Revenue						
Home care	16,570	-	16,570	13,957	-	13,957
Beauty & Personal care	19,567	-	19,567	18,038	-	18,038
Foods & Refreshment	14,105	-	14,105	13,204	-	13,204
Others (includes Exports, Consignment, etc.)	2,204	-	2,204	1,829	-	1,829
Total Revenue	**52,446**	**-**	**52,446**	**47,028**	**-**	**47,028**

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	Year ended 31st March, 2022			Year ended 31st March, 2021		
	External	Intersegment	Total	External	Intersegment	Total
Result						
Home care	3,183	-	3,183	2,773	-	2,773
Beauty & Personal care	5,392	-	5,392	5,134	-	5,134
Foods & Refreshment	2,623	-	2,623	2,189	-	2,189
Others (includes Exports, Consignment, etc.)	568	-	568	456	-	456
Total Segment Results	**11,766**	**-**	**11,766**	**10,552**	**-**	**10,552**
Finance costs			(106)			(117)
Other Income			258			410
Profit from continuing operations before exceptional items and tax			**11,918**			**10,845**
Exceptional items - income/ (expenditure)			(44)			(239)
Profit before tax from continuing operations			**11,874**			**10,606**
Tax expense						
Current tax			(2,840)			(2,520)
Deferred tax charge/ (credit)			(147)			(86)
Profit for the year from Continuing Operations (A)			**8,887**			**8,000**
Profit for the year from Discontinued Operations (B)			5			(1)
Profit For the Year (A+B)			**8,892**			**7,999**
Less: Non Controlling Interest			(13)			(4)
Profit for the Year			**8,879**			**7,995**

Other Information

	Segment Assets		Segment Liabilities	
	As at 31st March, 2022	As at 31st March, 2021	As at 31st March, 2022	As at 31st March, 2021
Home care	3,999	3,175	3,755	3,404
Beauty & Personal care	6,239	5,910	5,670	5,636
Foods and Refreshment	49,669	49,510	3,140	3,358
Others (includes Exports, Consignment, etc.)	1,413	1,068	682	608
Total	**61,320**	**59,663**	**13,247**	**13,006**
Unallocated Corporate Assets / (Liabilities)	9,197	9,094	8,183	8,057
Total Assets / (Liabilities)	**70,517**	**68,757**	**21,430**	**21,063**

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	Year ended 31st March, 2022			Year ended 31st March, 2021		
	Capital expenditure	Depreciation/ Amortisation	Non-cash expenses other than depreciation	Capital expenditure	Depreciation/ Amortisation*	Non-cash expenses other than depreciation
Home care	280	213	38	366	245	89
Beauty & Personal care	512	544	44	407	472	105
Foods & Refreshment	361	300	34	1,684	324	73
Others (includes Exports, Consignment, etc.)	59	34	12	48	33	3

*In addition to the above, ₹15 crores (2020-21: ₹60 crores) of accelerated depreciation has been charged to exceptional items under a restructuring project.

3.8 MEASUREMENT

The amount of each segment item reported should be the measure reported to the CODM for the purposes of making decisions about allocating resources to the segment and assessing its performance. Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses should be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Similarly, only those assets and liabilities that are included in the measures of the segment's assets and segment's liabilities that are used by the chief operating decision maker should be reported for that segment. If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts should be allocated on a reasonable basis.

If the CODM uses only one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities in assessing segment performance and deciding how to allocate resources, segment profit or loss, assets and liabilities should be reported at those measures. If the CODM uses more than one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities, the reported measures should be those that management believes are determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements.

An entity should provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity should disclose the following:

(a) the basis of accounting for any transactions between reportable segments;

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(b) the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income and discontinued operations (if not apparent from the reconciliations). Those differences could include accounting policies and policies or allocation of centrally incurred costs that are necessary for an understanding of the reported segment information;

(c) the nature of any differences between the measurements of the reportable segments' assets and the entity's assets (if not apparent from the reconciliations. Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information;

(d) the nature of any differences between the measurements of the reportable segments' liabilities and the entity's liabilities (if not apparent from the reconciliations. Those differences could include accounting policies and policies for allocation of jointly utilised liabilities that are necessary for an understanding of the reported segment information;

(e) the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss; and

(f) the nature and effect of any asymmetrical allocations to reportable segments. For example, an entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.

Illustration 10

GH Ltd. has four distinct operating segments. The management of GH is concerned as it is unsure on how common costs be reasonably allocated to different operating segments. They intend to allocate management charges, interest costs of internal funding, cost of management of properties and pension costs.

Analyse, whether such costs need to conform to the accounting policies as used to prepare the financial statements.

Solution

Ind AS 108 does not prescribe any specific basis but suggests that a reasonable basis to be used in allocation of common costs. Here, it may not be reasonable to allocate management charges to most profitable segment. However, it may be reasonable to charge interest costs of internal funding on the basis of actual usage over time, even if majority of funds are used for running a loss-making segment.

A reasonable manner of allocation of above costs could be:

Management Charges: These may be allocated based on Net Assets invested or Revenue earned by the segments. It needs to be understood if there is an operating segment which is yet

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to earn revenue, it would fail to have any costs being allocated.

Interest costs: As mentioned above, these may be allocated on the basis of actual usage and time.

Cost of management of properties: Based on value of property used at each segment.

Pension costs: Based on salary expenses of each segment.

*****

Measurement of operating segment profit or loss, assets and liabilities

The accounting policies of the operating segments are the same as those described in the significant accounting policies except that pension expense for each operating segment is recognised and measured based on cash payments to the pension plan. Diversified Company evaluates performance based on profit or loss from operations before tax expense not including non-recurring gains and losses and foreign exchange gains and losses.

Diversified Company accounts for inter-segment sales and transfers as if the sales or transfers were to third parties, i.e., at current market prices.

3.8.1 Reconciliations

An entity should provide reconciliations of all of the following:

(a) the total of the reportable segments' revenues to the entity's revenue;

(b) the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to the entity's profit or loss after those items;

(c) the total of the reportable segments' assets to the entity's assets if the segment assets are reported;

(d) the total of the reportable segments' liabilities to the entity's liabilities if segment liabilities are reported; and

(e) the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.

All material reconciling items should be separately identified and described. For example, the amount of each material adjustment needed to reconcile reportable segment profit or loss to the entity's profit or loss arising from different accounting policies should be separately identified and described.

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The following illustrate reconciliations of reportable segment revenues, profit or loss, assets and liabilities to the entity's corresponding amounts. Reconciliations also are required to be shown for every other material item of information disclosed. The entity's financial statements are assumed not to include discontinued operations. The entity recognises and measures pension expense of its reportable segments on the basis of cash payments to the pension plan, and it does not allocate certain items to its reportable segments.

Reconciliation of reportable segment revenues, profit or loss, assets and liabilities

Revenues	₹
Total revenues for reportable segments	39,000
Other revenues	1,000
Elimination of intersegment revenues	(4,500)
Entity's revenues	35,500
Profit or Loss	₹
Total profit or loss for reportable segments	3,970
Other profit or loss	100
Elimination of intersegment profits	(500)
Unallocated amounts:	
Litigation settlement received	500
Other corporate expenses	(750)
Adjustment to pension expense in consolidation	(250)
Income before income tax expense	3,070
Assets	₹
Total assets for reportable segments	79,000
Other assets	2,000
Elimination of receivable from corporate headquarters	(1,000)
Other unallocated amounts	1,500
Entity's assets	81,500
Liabilities	₹
Total liabilities for reportable segments	43,850
Unallocated defined benefit pension liabilities	25,000
Entity's liabilities	68,850

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Other material items	Reportable Segment totals ₹	Adjustments ₹	Entity totals ₹
Interest revenue	3,750	75	3,825
Interest expenses	2,750	(50)	2,700
Net interest revenue (finance segment only)	1,000	-	1,000
Expenditure for assets	2,900	1,000	3,900
Depreciation and amortisation	2,950	-	2,950
Impairment of assets	200	-	200

The reconciling item to adjust expenditures for assets is the amount incurred for the corporate headquarters building, which is not included in segment information. None of the other adjustments are material.

3.9 RESTATEMENT OF PREVIOUSLY REPORTED INFORMATION

If an entity changes the structure of its internal organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, should be restated unless the information is not available and the cost to develop it would be excessive. The determination of whether the information is not available and the cost to develop it would be excessive should be made for each individual item of disclosure. Following a change in the composition of its reportable segments, an entity should disclose whether it has restated the corresponding items of segment information for earlier periods.

If an entity has changed the structure of its internal organisation in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is not restated to reflect the change, the entity should disclose in the year in which the change occurs segment information for the current period on both the old basis and the new basis of segmentation, unless the necessary information is not available and the cost to develop it would be excessive.

3.10 ENTITY-WIDE DISCLOSURES

Some entities' business activities are not organised on the basis of differences in related products and services or differences in geographical areas of operations. Such an entity's reportable segments may report revenues from a broad range of essentially different products

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and services, or more than one of its reportable segments may provide essentially the same products and services. Similarly, an entity's reportable segments may hold assets in different geographical areas and report revenues from customers in different geographical areas, or more than one of its reportable segments may operate in the same geographical area. Certain information required should be provided only if it is not provided as part of the reportable segment information required by Ind AS 108.

3.10.1 Information about products and services

An entity should report the revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact should be disclosed. The amounts of revenues reported should be based on the financial information used to produce the entity's financial statements.

Extract from Annual Report for 2021-2022 of Hindustan Unilever Limited

Segment-wise Revenue from operations

The Company has following major segments:-

(a) Home Care include Fabric Solutions, Home and Hygiene, etc
(b) Beauty & Personal Care include Skin Cleansing, Skin Care, Hair Care, etc
(c) Foods & Refreshment include Tea, Health Food Drinks and Coffee, etc
(d) Others include Exports, Consignment, etc.

	Year ended 31st March, 2022	Year ended 31st March, 2021
Home Care	16,578	13,959
Beauty & Personal Care	19,460	17,964
Foods & Refreshment	14,105	13,204
Others (includes Exports, Consignment, etc.)	1,050	869
Total	51,193	45,996

3.10.2 Information about geographical areas

An entity should report the following geographical information, unless the necessary information is not available and the cost to develop it would be excessive:

(a) revenues from external customers

(i) attributed to the entity's country of domicile and

(ii) attributed to all foreign countries in total from which the entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues should be disclosed separately. An entity should disclose the basis for attributing revenues from external customers to individual countries; and

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(b) non-current assets (For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the reporting period) other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts (i) located in the entity's country of domicile and (ii) located in all foreign countries in total in which the entity holds assets. If assets in an individual foreign country are material, those assets should be disclosed separately.

The amounts reported should be based on the financial information that is used to produce the entity's financial statements. If the necessary information is not available and the cost to develop it would be excessive, that fact should be disclosed. An entity may provide, in addition to the information required by this paragraph, subtotals of geographical information about groups of countries.

The following illustrates the geographical information required (Because Diversified Company's reportable segments are based on differences in products and services, no additional disclosures of revenue information about products and services are required.)

Geographical Information	Revenue(a) ₹	Non-Current Assets ₹
United States	19,000	11,000
Canada	4,200	-
China	3,400	6,500
Japan	2,900	3,500
Other countries	6,000	3,000
Total	35,500	24,000

Revenue are attributed to countries on the basis of the customer's location.

Extract from Annual Report for 2021-2022 of Hindustan Unilever Limited

Additional Information by Geographies

Although the Group's operations are managed by product area, we provide additional information based on geographies.

	Year ended 31st March, 2022	Year ended 31st March, 2021
Revenue by Geographical Market		
India	50,327	45,283
Outside India	2,119	1,745
	52,446	**47,028**
Carrying Amount of Segment Assets		
India	60,771	59,256
Outside India	549	407
	61,320	**59,663**

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3.10.3 Information about major customers

An entity should provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10% or more of an entity's revenues, the entity should disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer. For the purposes of Ind AS 108, a group of entities known to a reporting entity to be under common control should be considered a single customer. However, judgement is required to assess whether a government (including government agencies and similar bodies whether local, national or international) and entities known to the reporting entity to be under the control of that government are considered a single customer. In assessing this, the reporting entity should consider the extent of economic integration between those entities.

The following illustrates the information about major customers. Neither the identity of the customer nor the amount of revenues for each operating segment is required.

Revenues from one customer of Diversified Company's software and electronics segments represent approximately ₹ 5,000 of the Company's total revenues.

Extract from Annual Report for 2021-22 of Hindustan Unilever Limited

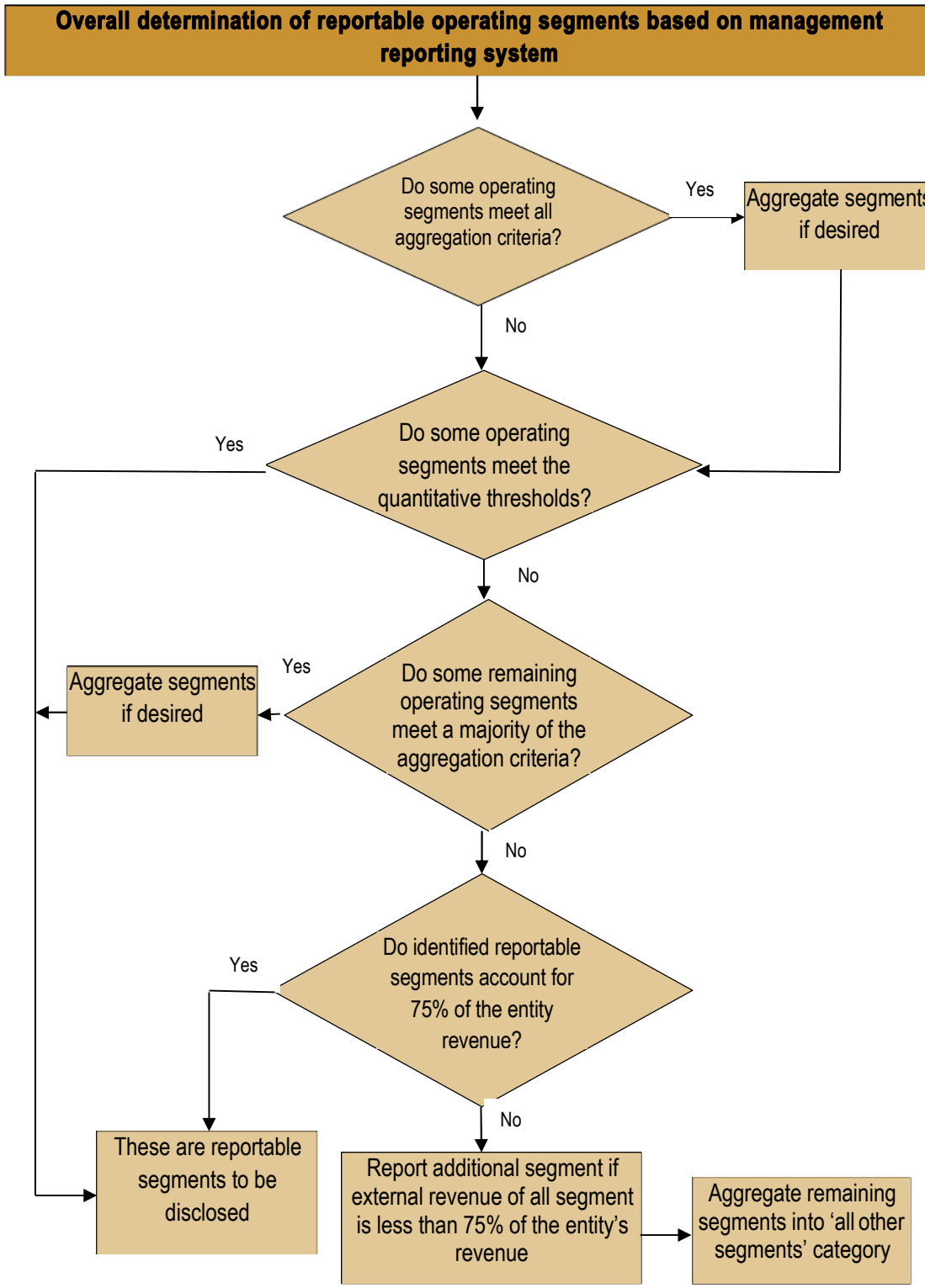
Revenue from major customers

The Group is not reliant on revenues from transactions with any single external customer and does not receive 10% or more of its revenues from transactions with any single external customer.

Diagram to assist in identifying reportable segments

The following diagram illustrates how to apply the main provisions for identifying reportable segments as defined in Ind AS 108.

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3.11 SIGNIFICANT DIFFERENCES IN IND AS 108 *VIS-A-VIS* AS 17

S. No.	Particulars	Ind AS 108	AS 17
1.	*Approach for identification of segments*	Identification of segments under Ind AS 108 is based on 'management approach' i.e., operating segments are identified based on the internal reports regularly reviewed by the entity's chief operating decision maker.	AS 17 requires identification of two sets of segments; one based on related products and services, and the other on geographical areas based on the risks and returns approach. One set is regarded as primary segments and the other as secondary segments.
2.	*Basis for reporting the segments*	Ind AS 108 requires that the amounts reported for each operating segment should be measured on the same basis as that used by the chief operating decision maker for the purposes of allocating resources to the segments and assessing its performance. It does not define the terms segment revenue, segment expense, segment result, segment assets and segment liabilities.	AS 17 requires segment information to be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements. Accordingly, AS 17 defines segment revenue, segment expense, segment result, segment assets and segment liabilities.
3.	*Aggregation criteria*	Ind AS 108 specifies aggregation criteria for aggregation of two or more segments and also requires the related disclosures in this regard.	AS 17 does not deal specifically with this aspect.
4.	*Disclosure in case of single reporting segment*	Ind AS 108 requires certain disclosures even in case of entities having single reportable segment.	AS 17 states that in case there is neither more than one business segment nor more than one geographical segment,

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			segment information as per this standard is not required to be disclosed. However, this fact shall be disclosed by way of footnote.
5.	*Disclosure of Interest*	Ind AS 108 requires separate disclosures about interest revenue and interest expense of each reportable segment, therefore, these aspects have not been specifically dealt with.	As per AS 17, interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense. It also provides that in case interest is included as a part of the cost of inventories and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. These aspects are specifically dealt with keeping in view that the definition of 'segment expense' given in AS 17 excludes interest.
6.	*Disclosure basis*	Ind AS 108 requires disclosures of revenues from external customers for each product and service. Regarding geographical information, it requires the disclosure of revenues from customers in the country of domicile and in all foreign countries, non-current assets in the country of domicile and all foreign countries. It also requires disclosure of information about major customers.	Disclosures in AS 17 are based on the classification of the segments as primary or secondary segments. Disclosure requirements for primary segments are more detailed as compared to secondary segments.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. X Ltd. has identified 4 operating segments for which revenue data is given below:

	External Revenue (₹)	Internal Revenue (₹)	Total (₹)
Segment A	30,00,000	Nil	30,00,000
Segment B	6,50,000	Nil	6,50,000
Segment C	8,50,000	1,00,000	9,50,000
Segment D	5,00,000	49,00,000	54,00,000
Total Revenue	**50,00,000**	**50,00,000**	**1,00,00,000**

Additional information:

Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years.

Which of the segments would be reportable under the criteria identified in Ind AS 108?

2. X Ltd. operates in coating industry. Its business segments comprise **Coating** (consisting of decorative, automotive, industrial paints and related activities) and **Others** (consisting of chemicals, polymers and related activities). Certain information for financial year 20X1-20X2 is given below: **(₹ in lakhs)**

Segments	External Revenue (including GST)	GST	Other operating income	Result	Asset	Liabilities
Coating	2,00,000	5,000	40,000	10,000	50,000	30,000
Others	70,000	3,000	15,000	4,000	30,000	10,000

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Additional information:

1. Unallocated income net of expenses is ₹ 30,00,00,000
2. Interest and bank charges is ₹ 20,00,00,000
3. Income tax expenses is ₹ 20,00,00,000 (current tax ₹ 19,50,00,000 and deferred tax ₹ 50,00,000)
4. Unallocated Investments are ₹ 1,00,00,00,000 and other assets are ₹ 1,00,00,00,000.
5. Unallocated liabilities, Reserves & surplus and share capital are ₹ 2,00,00,00,000, ₹ 3,00,00,00,000 & ₹ 1,00,00,00,000 respectively.
6. Depreciation amounts for coating & others are ₹ 10,00,00,000 and ₹ 3,00,00,000 respectively.
7. Capital expenditure for coating and others are ₹ 50,00,00,000 and ₹ 20,00,00,000 respectively.
8. Revenue from outside India is ₹ 6,20,00,00,000 and segment asset outside India ₹ 1,00,00,00,000.

Based on the above information, comment how X Ltd. would disclose information about reportable segment revenue, profit or loss, assets and liabilities for financial year 20X1-20X2.

3. 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.

   State the cost formula to be used for Ind AS 108 disclosure purposes.

4. ABC Limited has 5 operating segments namely A, B, C, D and E. The profit / loss of respective segments for the year ended 31st March, 20X1 are as follows:

Segment	Profit/(Loss) (₹ in crore)
A	780
B	1,500
C	(2,300)
D	(4,500)
E	6,000
Total	**1,480**

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Based on the quantitative thresholds, state which of the above segments A to E would be considered as reportable segments for the year ending 31st March, 20X1.

Answers

1. Threshold amount is ₹ 10,00,000 (₹ 1,00,00,000 × 10%).

Segment A exceeds the quantitative threshold (₹ 30,00,000 > ₹ 10,00,000) and hence reportable segment.

Segment D exceeds the quantitative threshold (₹ 54,00,000 > ₹ 10,00,000) and hence reportable segment.

Segment B & C do not meet the quantitative threshold amount and may not be classified as reportable segment.

However, the total external revenue generated by these two segments A & D represent only 70% [(₹ 35,00,000 / 50,00,000) x 100] of the entity's total external revenue. If the total external revenue reported by operating segments constitutes less than 75% of the entity total revenue, additional operating segments should be identified as reportable segments until at least 75% of the revenue is included in reportable segments.

In case of X Ltd., it is given that Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years. In accordance with the requirement of Ind AS 108, X Ltd. designates this start-up segment C as a reportable segment, making the total external revenue attributable to reportable segments 87% [(₹ 43,50,000/ 50,00,000) x 100] of total entity revenues.

In this situation, Segments A, C and D will be reportable segments and Segment B will be shown as other segment.

Alternatively, segment B can be considered as a reportable segment as well as it meets the definition of operating segment. If Segment B is considered as reportable segment:

External revenue reported: ₹ 30,00,000 + ₹ 6,50,000 + ₹ 5,00,000 = ₹ 41,50,000

% of Total External Revenue = ₹ 41,50,000 / ₹ 50,00,000 = 83%

Accordingly, Segments A, B and D will be reportable segments and Segment C will be shown as other segment.

2. Segment information

(A) Information about operating segment

(1) the company's operating segments comprise:

Coatings: consisting of decorative, automotive, industrial paints and related activities.

Others: consisting of chemicals, polymers and related activities.

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(2) Segment revenues, results and other information. (₹ in Lakhs)

	Revenue	Coating	Others	Total
1.	**External Revenue (gross)**	**2,00,000**	**70,000**	**2,70,000**
	GST	(5,000)	(3,000)	(8,000)
	Total Revenue (net)	1,95,000	67,000	2,62,000
	Other Operating Income	40,000	15,000	55,000
	Total Revenue	2,35,000	82,000	3,17,000
2.	**Results**			
	Segment results	10,000	4,000	14,000
	Unallocated income (net of unallocated expenses)			3,000
	Profit from operation before interest, taxation and exceptional items			**17,000**
	Interest and bank charges			(2,000)
	Profit before exceptional items			**15,000**
	Exceptional items			Nil
	Profit before taxation			**15,000**
	Income Taxes			
	-Current taxes			(1,950)
	-Deferred taxes			(50)
	Profit after taxation			**13,000**
3.	**Other Information**			
(a)	**Assets**			
	Segment Assets	50,000	30,000	80,000
	Investments			10,000
	Unallocated assets			10,000
	Total Assets			**1,00,000**
(b)	**Liabilities and Shareholder's funds**			
	Segment liabilities	30,000	10,000	40,000
	Unallocated liabilities			20,000
	Share capital			10,000

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	Reserves and surplus			30,000
	Total liabilities and shareholder's funds			**1,00,000**
(c)	**Others**			
	Capital Expenditure	(5,000)	(2,000)	(7,000)
	Depreciation	(1,000)	(300)	(1,300)

Geographical Information				**(₹ in lakhs)**
		India (₹)	**Outside India (₹)**	**Total (₹)**
	Revenue	2,55,000	62,000	3,17,000
	Segment assets	90,000	10,000	1,00,000
	Capital expenditure	7,000		7,000

Notes:

(i) The operating segments have been identified in line with the Ind AS 108, taking into account the nature of product, organisation structure, economic environment and internal reporting system.

(ii) Segment revenue, results, assets and liabilities include the respective amounts identifiable to each of the segments. Unallocable assets include unallocable non-current assets and other current assets. Unallocable liabilities include unallocable current liabilities and net deferred tax liability.

(iii) Corresponding figures for previous year have not been provided. However, in a practical scenario the corresponding figures would need to be given.

3. 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.

4. With regard to quantitative thresholds to determine reportable segment relevant in context of instant case, paragraph 13(b) of Ind AS 108 may be noted which provides as follows:

"The absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not

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report a loss and (ii) the combined reported loss of all operating segments that reported a loss."

In compliance with Ind AS 108, the segment profit/loss of respective segment will be compared with the greater of the following:

(i) All segments in profit, i.e., A, B and E – Total profit ₹ 8,280 crores.

(ii) All segments in loss, i.e., C and D – Total loss ₹ 6,800 crores.

Greater of the above – ₹ 8,280 crores.

Based on the above, reportable segments will be determined as follows:

Segment	Profit/(Loss) (₹ in crore)	As absolute % of ₹ 8,280 crore	Reportable segment
A	780	9%	No
B	1,500	18%	Yes
C	(2,300)	28%	Yes
D	(4,500)	54%	Yes
E	6,000	72%	Yes
Total	**1,480**		

Hence B, C, D, E are reportable segments.

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NOTES

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CHAPTER 11

ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Define financial asset, financial liability and equity
- Examine the scope of financial instruments and items excluded from scope of financial instruments
- Understand the application of these definitions and scope to different forms of instruments
- Determine whether the financial instruments such as preference shares, debentures and bonds will be classified under "equity" or "financial liabilities" or components thereof will be classified under both
- Apply necessary accounting principles for determining when a financial liability can be offset with a financial asset
- Apply accounting principles for recognition of financial assets and financial liabilities
- Classify financial asset and financial liability
- Determine the accounting treatment for regular way purchase or sale of financial assets

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- Measure financial assets initially and subsequently
- Measure financial liability initially and subsequently
- Reclassify the financial instrument and deal with the accounting aspect upon reclassification
- Acquire the conceptual understanding of “derivatives” and “embedded derivatives”,
- Identify the situations in which embedded derivatives need to be separated and
- Deal with the Accounting principles in the situations in which embedded derivatives are so separated
- Identify the hedged items
- Designate the items as hedged items/instruments
- Qualify instruments for hedge accounting
- Determine the criteria for qualifying the items as hedge items and its accounting.
- Determine whether or not a transfer qualifies for derecognition and accounting treatment in various situations
- Apply accounting principles for derecognition of financial liabilities, including evaluating practical complexities involved in exchange of financial instruments or parts thereof
- Disclose necessary details regarding financial instruments as per the standards

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CHAPTER OVERVIEW

The chapter is divided into 7 units-

a) **Unit 1 'Financial Instruments: Scope and Definitions'** deals with a brief introduction of financial instruments, definitions of financial instrument, financial asset, financial liability and equity instrument. It also discusses the contracts which are included and excluded from the scope of the standards on Financial Instruments.

b) **Unit 2 'Classification and Measurement of Financial Assets and Financial Liabilities'**, deals with criterias for classification, measurement (initially and subsequently), reclassification of financial assets and financial liabilities. It further discusses impairment of financial assets.

c) **Unit 3 'Financial Instruments: Equity and Financial Liabilities'** covers the analysis of the definition of financial liabilities and equity. It also deliberates critical features in differentiating a financial liability from an equity instrument and delves into various aspects which help in determining the liability as financial liability. The unit also explains when an instrument is a compound financial instrument. It also analyses treasury shares, interest, dividends, losses and gains. Finally, it elucidates offsetting a financial asset and financial liability.

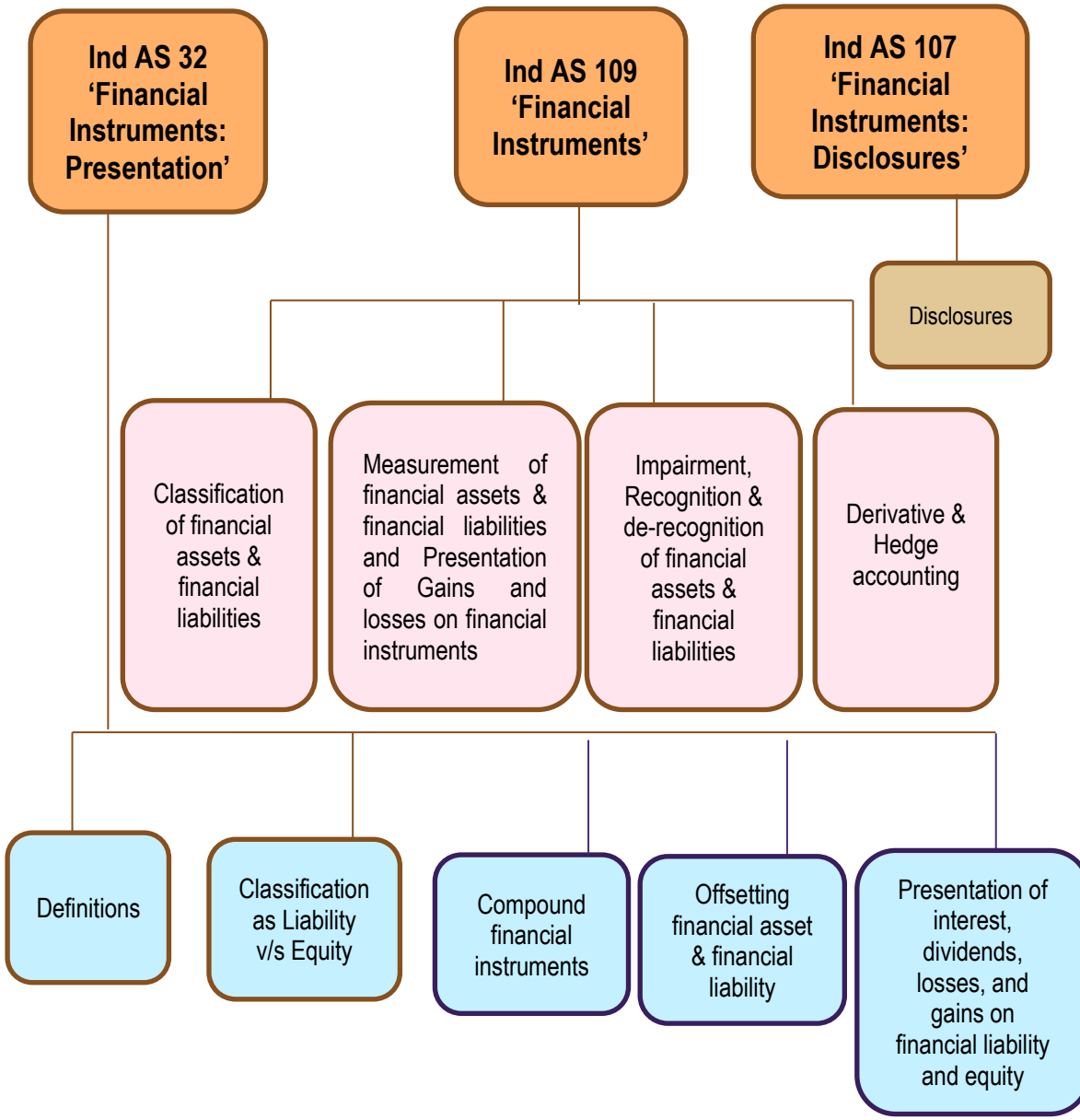
d) **Unit 4 'Derivatives and Embedded Derivatives'** defines the two derivatives with examples and the manner of separating the embedded derivatives from the host contract alongwith the characteristics differences and deals with the accounting thereof.

e) **Unit 5 'Recognition and Derecognition of Financial Instruments'** covers guidance prescribed in the standard on initial recognition of financial instruments. It also takes into account, the timings of recognition and accounting treatment under various situations. Later on, it discusses the derecognition of financial instruments and situations under which derecognition will be considered or not. The unit also covers the extinguishment and modification of financial liabilities and accounting of debt for equity swaps.

f) **Unit 6 'Hedge Accounting'** covers identification and designation of hedge items, criteria qualifying an item as hedge item and accounting thereof.

g) **Unit 7 'Disclosures'** covers disclosure requirements as stated in the standard.

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UNIT 1:
FINANCIAL INSTRUMENTS: SCOPE AND DEFINITIONS

1.1 INTRODUCTION

With the changing landscape of Indian economy and more liberalisation, raising funds in national and international markets through different forms of instruments has gathered momentum. As companies expand their horizon, investors at the same time are getting cautious to invest through different means to achieve their intended objective, which could have fixed return like a debt instrument or a residual share in net assets like equity or both. Several type of instruments are issued like convertible preference shares, FCCBs, foreign currency loans, debt syndication arrangements, loans from group companies, etc. by borrowing entities for raising funds. Accounting treatment of these instruments in the books, with introduction of Indian Accounting Standards (Ind AS) is important for us to understand to reflect proper financial reporting for users of financial statements that provides relevant and faithful representation of the financial performance, financial position, and cash flows of the reporting entity.

MCA notified following Ind AS to deal with accounting of financial instruments:

- Ind AS 109 – Financial instruments
- Ind AS 32 – Financial instruments: Presentation
- Ind AS 107 – Financial Instruments: Disclosures

These Ind AS are largely aligned with the prevailing guidance in IFRS which require classification of a financial instrument based on substance of the arrangement between the parties rather than their legal form and the definition of financial asset, financial liability and equity. Further, recognition and measurement criteria are also driven based on classification of such instruments.

1.2 WHAT ARE FINANCIAL INSTRUMENTS?

A **financial instrument** is any **contract** that gives rise to a **financial asset** of one entity and a **financial liability** or **equity instrument** of another entity.

- Here, a ***contract*** refers to an agreement between two or more parties that has clear economic consequences and which parties usually are bound to adhere, usually because the agreement is enforceable by law.
- Contracts need not be in writing and may take a variety of forms.
- An important point to note is any assets or liabilities that are not contractual are not financial liabilities or financial assets. For eg.: income taxes are a statutory obligation and not arising from contract, constructive obligations as defined in Ind AS 37 – Provisions,

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Contingent Liabilities and Contingent Assets do not arise from contracts and hence, are not financial liabilities, etc.

- Financial instruments include:
  (a) Primary instruments (such as receivables, payables and equity instruments) and
  (b) Derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps).

While the examples above provide an indication of what financial instruments comprise, let's understand the definition of each of these type of financial instruments in greater detail.

1.3 WHAT IS A FINANCIAL ASSET?

A **'financial asset'** is any asset that is:

(a) **Cash**;

(b) An equity instrument of another entity;

(c) A **contractual right**:

  (i) to receive cash or another financial asset from another entity; or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

(d) a contract that will or may be settled in **entity's own equity instruments** and is:

  (i) a non-derivative for which the entity is or may be obliged to receive a variable number of entity's own equity instruments; or

  (ii) a derivative that will or may be settled other than by exchange of fixed amount of cash or another financial asset for a fixed number of entity's own equity instruments. For this purpose, entity's own equity instruments do not include puttable financial instruments classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a pro-rata share of net assets of the entity on liquidation and are classified as equity instruments, or instruments that are themselves contracts for future receipt or delivery of entity's own equity instruments.

On the basis of the above definition, a financial asset can be either of the following –

Financial asset

Common examples
- ❖ Cash
- ❖ Trade receivables
- ❖ Investments in bonds and deposits
- ❖ Investment in equity instruments
- ❖ Loans receivable, etc.

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- On the basis of the above definition, some of the key elements to understand:

Cash	❖ Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. ❖ A deposit of cash with bank or other financial institution represents a contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.
Contractual right to receive cash or other financial asset	❖ A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument. Common examples of contractual right to receive cash and corresponding financial liability representing other party's contractual obligation to deliver cash in future are: 1. Trade receivables; 2. Loans and Notes receivable 3. Deposits made; 4. Investment in bonds, etc. ❖ The ability to exercise a contractual right or to satisfy a contractual obligation may be absolute or it may be contingent on occurrence of one or more future events, not wholly within the control of either party to the contractual arrangement. ❖ A contingent right and obligation meets the definition of financial asset and financial liability, even though such assets and liabilities are not always recognized in the financial statements. For eg.: A lender may be provided with a financial guarantee by a party ('guarantor') on behalf of borrower, entitling to recover the outstanding dues from the guarantor if the borrower were to default, etc. It may be noted that paragraph 2 of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' excludes from its scope financial instruments within the scope of Ind AS 109. Therefore, financial guarantee contracts cannot be disclosed as contingent liability.

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- **Physical assets, right-of-use assets and intangible assets**
  - Physical assets (such as inventories, property, plant and equipment), right-of-use assets and intangible assets (such as patents and trademarks) are not financial assets.
  - Control of such physical assets, right-of-use assets and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.
- **Prepaid expenses**
  - Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
  - Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.
- **'Perpetual' debt instruments**

  Perpetual debt instruments such as 'perpetual' bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future.

Example 1

Evaluate the financial assets.

S. No.	Particulars	Whether FA or not	Remarks
1	Investment in bonds debentures	FA	• Contractual right to receive cash.
2	Loans and receivables	FA	• Contractual right to receive cash.
3	Deposits given	FA	• Contractual right to receive cash.
4	Trade & other receivables	FA	• Contractual right to receive cash.
5	Cash and cash equivalents	FA	• Specifically covered in the definition.
6	Bank balance	FA	• Contractual right to receive cash.

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S. No.	Particulars	Whether FA or not	Remarks
7	Investments in equity shares	FA	• Equity instrument of another entity.
8	Perpetual debt instruments Eg. perpetual bonds, debentures and capital notes.	FA	• Such instruments provide the contractual right to receive interest for indefinite future or a right to return of principal under terms that make it very unlikely or very far in the future.
9	Physical assets Eg. inventories, property, plant and equipment etc.	No	• Control of such assets does not create a present right to receive cash or another financial asset.
10	Right to use assets Eg. Lease vehicle etc.	No	• Control of such assets does not create a present right to receive cash or another financial asset.
11	Intangibles Eg. Patents, trademark etc.	No	• Control of such assets does not create a present right to receive cash or another financial asset.
12	Prepaid expenses Eg. Prepaid insurance, prepaid rent etc.	No	• These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.
13	Advance given for goods and services	No	• These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.

Illustration 1: Trade receivables

A Ltd. makes sale of goods to customers on credit of 45 days. The customers are entitled to earn a cash discount @ 2% per annum if payment is made before 45 days and an interest @ 10% per annum is charged for any payments made after 45 days.

Evaluate whether such trade receivable are financial assets or not.

Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

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In the above case, A Ltd. has the contractual right to receive cash /bank from its trade receivable recorded in its books of accounts, after the expiry of credit period of 45 days or earlier after passing discounts of 2 % per annum.

Hence, trade receivables would meet the definition of financial assets.

It may be noted that contractual right to receive cash includes contractual right to receipt of money in bank account or any wallet account.

*****

Illustration 2: Deposits

Z Ltd. (the 'Company') makes sale of goods to customers on credit. Goods are carried in large containers for delivery to the dealers' destinations. All dealers are required to deposit a fixed amount of ₹ 10,000 as security for the containers, which is returned only when the contract with Company terminates. The deposits carry 8% per annum which is payable only when the contract terminates.

If the containers are returned by the dealers in broken condition or any damage caused, then appropriate adjustments shall be made from the deposits at the time of settlement.

How would such deposits be treated in books of the dealers?

Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

In the above case, such security deposits are receivable in cash at the end of contract period between the dealer and the Company.

Hence, they meet the definition of financial assets.

*****

1.4 WHAT IS A FINANCIAL LIABILITY?

- A **financial liability** is any liability that is:

  (a) A **contractual obligation**:

  (i) To deliver cash or other financial asset to another entity; or

  (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity;

  Or

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(b) A contract that will or may be settled in entity's **own equity instruments** and is:

(i) A **non-derivative** for which the entity is or may be obliged to deliver a **variable** number of entity's own equity instruments; or

(ii) a **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, following type of instruments that meets the definition of a financial liability may still be classified as an equity instrument if they have certain features and meets specific conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32. The definition of financial liability includes a carve-out from IAS 32 that the variablilty due to foreign currency shall be ignored while classifying a foreign currency convertible bond as equity or liability or compound financial instrument.

For details, refer Unit 3 – Equity and Financial Liabilities.

Financial liability

Common examples

- Loans and borrowings
- Payables for purchase of goods & services
- Finance lease liabilities
- Redeemable instruments like preference shares, debentures, etc.
- Guarantee given for repayment of debt upon borrower's default

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Example 2

Evaluate the financial Liability.

S. No.	Particulars	Whether FL or not	Remarks
1	Loans payable or bank loan	FL	• Contractual obligation to pay cash.
2	Trade and other payables	FL	• Contractual obligation to pay cash
3	Bills payable / acceptance	FL	• Contractual obligation to pay cash.
4	Deposits received	FL	• Contractual obligation to pay cash.
5	Mandatory redeemable preferences shares	FL	Contractual obligation to pay cash.
6	Financial guarantee given (Also see the scope section to understand when financial guarantee contract can be regarded as insurance contract)	FL	• Contractual obligation to pay cash, due to the occurrence of certain events.

Illustration 3: Perpetual debt instruments

A Ltd. issues a bond at principal amount of CU 1000 per bond. The terms of bond require annual payments in perpetuity at a stated interest rate of 8 per cent applied to the principal amount of CU 1,000. Assuming 8 per cent to be the market rate of interest for the instrument when it was issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition.

Evaluate the financial instrument in the hands of both the holder and the issuer.

Solution

A financial asset is an asset where there is a contractual right to receive cash or another financial asset from another entity.

- For the Holder – There is right to receive cash in future. Hence, it will be classified as a financial asset
- For the Issuer – There is contractual obligation to pay cash in future. However, the instrument is redeemed at the option of A Ltd. or on liquidation of A Ltd. Therefore, the instrument has characteristics of both equity and financial liability. Such an

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instrument is regarded as compound financial instrument (Ref. para 28 of Ind AS 32). See Unit 3 to understand accounting for compound financial instrument.

*****

Illustration 4: Creditors for sale of goods

A Ltd. (the 'Company') makes purchase of steel for its consumption in normal course of business. The purchase terms provide for payment of goods at 30 days credit and interest payable @ 12% per annum for any delays beyond the credit period.

Analyse whether the transaction leads to any financial instruments and if yes, then what is the nature of that financial instrument?

Solution

A financial liability is any liability where there is a contractual obligation to deliver cash or other financial asset to another entity.

In the above case, A Ltd. has entered into a contractual arrangement for purchase of goods at a fixed consideration payable to the creditor. A contractual arrangement that provides for payment in fixed amount of cash to another entity meets the definition of financial liability.

*****

Illustration 5: Contract for exchange on unfavorable conditions

A Ltd. (the 'Company') makes a borrowing for INR 10 lacs from RBC Bank, with bullet repayment of INR 10 lacs and an annual interest rate of 12% per annum. Now, Company defaults at the end of 5th year and consequently, a rescheduling of the payment schedule is made beginning 6th year onwards. The Company is required to pay INR 1,300,000 at the end of 6th year for one time settlement, in lieu of defaults in payments made earlier.

(a) Does the above instrument meet definition of financial liability? Please explain.

(b) Analyse the differential amount to be exchanged for one-time settlement.

Solution

(a) A Ltd. has entered into an arrangement wherein against the borrowing, A Ltd. has contractual obligation to make stream of payments (including interest and principal). This meets definition of financial liability.

(b) Let's compute the amount required to be settled and any differential arising upon one time settlement at the end of 6th year –

- Loan principal amount = ₹ 10,00,000
- Amount payable at the end of 6th year = ₹ 12,54,400 [10,00,000 x 1.12 x 1.12 (Interest for 5th & 6th year in default plus principal amount)]
- One time settlement = INR 13,00,000
- Additional amount payable = ₹ 45,600

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The above represents a contractual obligation to pay cash against settlement of a financial liability under conditions that are unfavorable to A Ltd. (owing to additional amount payable in comparison to amount that would have been paid without one time settlement). Hence the rescheduled arrangement meets definition of 'financial liability'.

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1.5 WHAT IS AN EQUITY INSTRUMENT?

- As per Ind AS 32.11 – An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
- As per Ind AS 32.16 – An instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:

  (a) The instrument includes **no contractual obligation**:

  (i) to deliver cash or another financial asset to another entity; or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

  (b) If the instrument will or may be settled in the **issuer's own equity instruments**, it is:

  (i) a **non-derivative** that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

  (ii) a **derivative** that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

  A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

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Equity

- ❖ Equity instruments issued
- ❖ Warrants to issue fixed number of shares at fixed price against each warrant
- ❖ Other instruments convertible into fixed number of equity shares for fixed amount per share, etc.

- The **key characteristics** of an equity instrument have been further explained as follows:

No contractual obligation	❖ A key characteristic of equity instruments is that they carry no contractual obligation throughout for any payment or distribution towards the holders of such instruments. ❖ However, following type of instruments as an exception are 'equity' classified even if they contain an obligation to deliver cash or other financial asset, provided certain requisite criteria are met – 1. puttable financial instruments that meet certain conditions 2. an instrument, or a component of an instrument, that contains an obligation for the issuing entity to deliver to the holder a pro rata share of the net assets of the issuing entity only on its liquidation. The nature of these instruments and the criteria to be met for equity classification are explained in greater detail in Unit 3 – Financial Instruments : Equity and Financial Liabilities.
Settlement in own equity instruments	❖ Settlement in own equity instruments is equity classified only if it's a fixed-for-fixed transaction, ie, issue of fixed number of shares and involves a fixed amount of cash or other financial asset. ❖ Where an entity enters into a non-derivative contract to issue a fixed number of its own equity instruments in exchange for a fixed amount of cash (or another financial asset), it is an equity instrument of the entity. But this does not apply for instruments that are equity classified being a puttable instrument or other instrument entitling the holder to pro-rata share in net assets that meet specified criteria (refer Unit 3 – Equity and Financial Liabilities). ❖ However, if such a contract contains an obligation for the entity to pay cash (or another financial asset), it also gives rise to a liability for the present value of the redemption amount. For example: a forward contract entered into by an entity to repurchase fixed number of its own shares for a fixed amount of cash gives rise to a financial liability to be recorded at present value of redemption amount.

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- An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obliged to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

Example 3

When a Company proposes dividend in its board meeting, no obligation arises because it becomes payable only post approval by shareholders in the annual general meeting. However, when the dividend is approved by shareholders in annual general meeting, the Company has taken an obligation to distribute dividend to its shareholders and hence it's a contractual obligation meeting the definition of financial liability.

- **Examples** of equity instruments include:
  - Non-puttable ordinary shares, for eg.: equity shares issued by companies
  - Some puttable instruments (if they meet requisite criteria and are not classified as financial liabilities);
  - Some instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (if they meet requisite criteria and are not classified as financial liabilities);
  - Some types of preference shares (where repayment and distribution is at the discretion of the Issuer);
  - Warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.
- Basis the above definition of equity and characteristics of such instruments, let's evaluate some typical form of instruments that may be issued and how are they classified –
  - **Preference shares**

    Preference shares is a class of shares issued by Indian companies, whose terms may provide for redemption at a pre-determined amount with a fixed return which may be cumulative or discretionary. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attached to the share to determine whether it exhibits the fundamental characteristic of a financial liability or an equity instrument, as explained below:

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(A) Redeemable preference shares:

Redemption terms	Evaluation under Ind AS 32
Redemption at a specified date	This contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. **Hence, classified as 'financial liability'.**
Redemption at option of Holder	
Redemption at option of Issuer	An option of the issuer to redeem shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. **Hence, classified as 'equity instrument'**. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares, at which time this instrument shall be reclassified from 'equity' to 'financial liability'.

(B) Non-redeemable preference shares

Non-redeemable preference shares may be issued by foreign subsidiaries or foreign branches or foreign associates or foreign joint operations or foreign joint ventures. In this case, appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

- When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments.
- The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
  - (a) a history of making distributions;
  - (b) an intention to make distributions in the future
  - (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends

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on the ordinary shares if dividends are not paid on the preference shares)

(d) the amount of the issuer's reserves

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Hence, the contractual terms determine the nature of instrument. Any historical trend or ability of the Issuer does not affect the classification of an instrument as 'equity' or 'financial liability'.

(C) Distributions on preference shares

Other than the terms for redemption of financial instrument, another important point for consideration is whether the Company has an obligation to make payments of dividend ie, whether dividend on such preference shares are cumulative or non-cumulative.

- **Where dividends are at the discretion of the issuer –**this is akin to an equity instrument. However, where the instrument itself is redeemable, the obligation to pay still exists but only to the extent of the redemption value and not dividends on such shares unless they are declared.

- **Where dividends are cumulative but payable only on liquidation**–One needs to assess the key terms of the instrument to check if the entity has a contractual obligation:

  (a) Where no contractual obligation exists to pay– such preference shares may themselves be irredeemable and the dividend on such shares even if cumulative, the entity may be under no obligation to pay unless upon liquidation – then such preference shares may be classified as equity.

  (b) Where contractual obligation exists – In cases where the preference shares are not redeemable, it is like an equity instrument. But if they are entitled to dividend which is payable such that entity does not have an unconditional right to defer payment, then this provides the shareholders with a lender's return on the amount invested. This obligation is also not negated if the entity is unable to pay such dividend for lack of funds or insufficient distributable profits. Therefore, the obligation to pay dividend meets the definition of financial liability. The instrument in such cases shall have two components – financial

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liability represented by dividend and equity component represented by the issue price, such instruments are overall classified as 'compound financial instruments' and each of the components as mentioned above are accounted separately.

Illustration 6: Preference shares with non-cumulative dividend

Silver Ltd. issued irredeemable preference shares with face value of ₹ 10 each and premium of ₹ 90. These shares carry dividend @ 8% per annum, however dividend is paid only when Silver Ltd declares dividend on equity shares. Analyse the nature of this instrument.

Solution

In the above case, two main characteristics of the preference shares are:

(i) Preference shares carry dividend, which is payable only when Company declares dividend on equity shares

(ii) Preference share are irredeemable.

Analysing the definition of equity, an instrument meets definition of equity if:

(a) It contains no contractual obligation to pay cash; and

(b) Where an instrument shall be settled in own equity instruments, it's a non-derivative contract that will be settled only by issue of fixed number of shares or a derivative contract that will be settled by issue of fixed number of shares for a fixed amount of cash.

In the above instrument, there is no contractual obligation on the Company to pay cash since –

(i) Face value is not redeemable (except in case of liquidation); and

(ii) Dividend is payable only if Company declares dividend on equity shares. Since dividend on equity shares is discretionary and the Company can choose not to pay, Company has an unconditional right to avoid payment of cash on preference shares also.

Hence preference shares meet definition of equity instrument.

*****

- **Contracts settled in own equity instruments but classified as 'financial liability' (where equity instrument is treated as currency) –**

Terms	Evaluation under Ind AS 32
Non derivative contract	• A contract that will be settled in a variable number of entity's own shares whose value equals a fixed amount is a financial liability, because the entity is under an obligation to pay a fixed amount, that is settled through equity instruments (similar to settlement in currency).

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	• Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.
Derivative contract	• A contract that will be settled in a variable number of the entity's own shares whose value equals an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. • An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract.

Illustration 7: Non-derivative contract to be settled in own equity instruments

A Ltd. invests in compulsorily convertible preference shares (CCPS) issued by its subsidiary – B Ltd. at ₹ 1,000 each (₹ 10 face value + ₹ 990 premium). Under the terms of the instrument, each CCPS is compulsorily convertible into one equity share of B Ltd at the end of 5 years. Such CCPS carry dividend @ 12% per annum, payable only when declared at the discretion of B Ltd. Evaluate this under definition of financial instrument.

Solution

B Ltd. has issued CCPS which provide for –

(a) Conversion into fixed number of equity shares, ie, one equity share for every CCPS

(b) Non-cumulative dividends.

Applying the definition of 'equity' under Ind AS 32 –

(a) There is no contractual obligation to deliver cash or other financial asset. Dividends are payable only when declared and hence, at the discretion of the Issuer – B Ltd., thereby resulting in no contractual obligation over B Ltd.

(b) Conversion is into a fixed number of equity shares.

Hence it meets definition of equity instrument and shall be classified as such in books of B Ltd.

*****

Illustration 8: Settlement in variable number of shares

Target Ltd. took a borrowing from Z Ltd. for ₹ 10,00,000. Z Ltd. enters into an arrangement with Target Ltd. for settlement of the loan against issue of a certain number of equity shares of Target Ltd. whose value equals ₹ 10,00,000. For this purpose, fair value per share (to determine

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total number of equity shares to be issued) shall be determined based on the market price of the shares of Target Ltd. at a future date, upon settlement of the contract. Evaluate this under definition of financial instrument.

Solution

In the above scenario, Target Ltd. is under an obligation to issue variable number of equity shares equal to a total consideration of ₹ 10,00,000. Hence equity shares are used as currency for purpose of settlement of an amount payable by Target Ltd.

Since this is variable number of shares to be issued in a non-derivative contract for fixed amount of cash, it tantamounts to use of equity shares as 'currency' and hence this contract meets the definition of financial liability in books of Target Ltd.

*****

1.6 COMPARISON OF FINANCIAL ASSETS, FINANCIAL LIABILITIES AND EQUITY

Sl. No.	Financial Assets	Financial liabilities	Equity
1	Cash	-	-
2	An equity instrument of another entity.	-	-
3.	**A contractual right** To receive cash or another financial asset from another entity Or	**A contractual obligation** To deliver cash or another financial asset to another entity Or	**No contractual obligation** To deliver cash or another financial asset to another entity. Or
3	To exchange financial assets or financial liabilities with another entity under conditions that are **potentially favourable** to the entity.	To exchange financial assets or financial liabilities with another entity under conditions that are **potentially unfavourable** to the entity.	To exchange financial assets or financial liabilities with another entity.
4	A contract that will or may be settled in the entity's own equity instruments.	A contract that will or may be settled in the entity's own equity instruments including derivative and non-derivative **(Variable no. of shares. and Fixed for Fixed criterion not met).**	A contract that will or may be settled in the entity's own equity **instruments (Fixed for Fixed criterion met).**

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1.7 SCOPE OF FINANCIAL INSTRUMENTS

Scope of financial instruments excludes the following:

(a) Interests in subsidiaries, associates and joint ventures that are accounted for in accordance with Ind AS 110 *Consolidated Financial Statements*, Ind AS 27 *Separate Financial Statements* or Ind AS 28 *Investments in Associates and Joint Ventures*. However, in some cases, Ind AS 110, Ind AS 27 or Ind AS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in Ind AS 32 *Financial Instruments: Presentation*.

(b) Rights and obligations under leases to which Ind AS 116 Leases applies. However,

  (i) finance lease receivables (i.e. net investments in finance leases) and operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of Ind AS 109;

  (ii) lease liabilities recognised by a lessee are subject to the derecognition requirements in paragraph 3.3.1 of Ind AS 109; and

  (iii) derivatives that are embedded in leases are subject to the embedded derivatives requirements of Ind AS 109.

(c) employers' rights and obligations under employee benefit plans, to which Ind AS 19 *Employee Benefits* applies.

(d) rights and obligations arising under (i) an insurance contract as defined in Ind AS 104 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, or (ii) a contract that is within the scope of Ind AS 104 because it contains a discretionary participation feature.

  - However, this Standard applies to a derivative that is embedded in a contract within the scope of Ind AS 104 if the derivative is not itself a contract within the scope of Ind AS 104.
  - Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 104 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

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(e) Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of Ind AS 103 *Business Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.

(f) Loan commitments other than those loan commitments described below –

- loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.
- loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).
- commitments to provide a loan at a below-market interest rate

However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan commitments are subject to the derecognition requirements of this Standard.

(g) Financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 102 *Share-based Payment* applies, except for contracts to buy non-financial items as described below.

(h) Rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it recognised a provision in accordance with Ind AS 37.

(i) Rights and obligations within the scope of Ind AS 115 *Revenue from Contracts with Customers* that are financial instruments, except for those that Ind AS 115 specifies are accounted for in accordance with this Standard.

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Summary of the transaction outside the scope Financial Instruments:

Sl. No.	Particulars	Covered under Ind AS 109	Covered under Ind AS 32	Under Ind AS 107	Applicable Ind AS
1	Interest in subsidiaries (At Costs)	No	No	No	Ind AS 27
2	Interests in associates (At Costs)	No	No	No	Ind AS 27
3	Interest in joint ventures (At Costs)	No	No	No	Ind AS 27
4	Rights and obligations under leases	No	No	Yes	Ind AS 116
5	Employers' rights and obligations under employee benefit plans	No	No	No	Ind AS 19
6	Rights and obligations under an insurance contract	No	No	No	Ind AS 104
7	Forward contract arising within the scope of business combination	No	No	Yes	Ind AS 107
8	Loan commitment other than covered under Ind AS 109 and Ind AS 32	No	No	Yes	Ind AS 107
9	Shared based payments	No	No	No	Ind AS 102
10	Reimbursement right in respect of provision	No	No	Yes	Ind AS 37 and Ind AS 107
11	Rights and obligations under revenue for contracts with customers	No	No	Yes	Ind AS 115 and Ind AS 107

1.8 CONTRACTS TO BUY OR SELL NON-FINANCIAL ITEMS ('OWN USE EXEMPTION')

- Contracts to buy or sell non-financial items are outside the scope of 'financial instruments', except for the following:

  (a) Contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

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(b) A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments that are irrevocably designated as measured at fair value through profit or loss (even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements). This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard applying the scope exclusion in (a) above.

(c) A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, where such a contract was not entered into for the purpose of receipt or delivery of the non-financial item in accordance with entity's expected purchase, sale or usage requirements.

- There are various ways in which a contract to buy or sell non-financial items can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

Example 4

ABC Ltd. enters into a contract to buy 100 tonnes of cocoa beans at 1,000 per tonne for delivery in 12 months. On the settlement date, the market price for cocoa beans is 1,500 per tonne. If the contract cannot be settled net in cash and this contract is entered for delivery of cocoa beans in line with ABC Ltd.'s expected purchase/ usage requirements, then own-use exemption applies.

In such case, the contract is considered to be an executory contract outside the scope of Ind AS 109 and hence shall not be accounted as a derivative.

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UNIT 2: CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

2.1 RECOGNITION AND SUBSEQUENT MEASUREMENT

All financial assets and financial liabilities are measured at their fair values upon initial recognition. Classification of the financial assets and financial liabilities drives their initial and subsequent measurement.

2.2 FINANCIAL ASSETS: KEY ELEMENTS TO DETERMINE CLASSIFICATION

Key essential elements that determine classification of financial assets are:

(A) Business model (BM) test:

- An entity's business model refers to how an entity manages its financial assets in order to generate cash flows.

Factors determining BM

- ❖ An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model and an entity will need to use judgement when it assesses its business model for managing financial assets.
- ❖ This assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available. Such relevant evidence includes, but is not limited to:
  - (a) how the performance of business model and the financial assets held within that business model are evaluated & reported to the entity's key management personnel;
  - (b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
  - (c) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

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Level of aggregation of assets for determining BM	❖ An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective and not based on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined at a higher level of aggregation. ❖ However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.
Determining basis of realisation of contractual cash flows	❖ Entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. ❖ For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur.
Difference in actual realisation from BM	If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements nor does it change the classification of the remaining financial assets held in that business model (ie those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment.

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- **Financial assets held for trading:**

  Financial assets held for trading are defined as those that:

  (a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;

  (b) on initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

  (c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

  Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin.

Illustration 1

An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs.

The entity performs credit risk management activities with the objective of minimising credit losses. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.

Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.

Evaluate the business model.

Solution

- Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows.

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- Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy. Infrequent sales resulting from unanticipated funding needs (eg in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.

Hence the business model of the company is to collect contractual cash flows and not realisation from sale of financial assets.

*****

Illustration 2

An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired.

If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them.

In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

Evaluate the business model.

Solution

The objective of the entity's business model is to hold the financial assets in order to collect the contractual cash flows. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets are credit impaired at initial recognition).

Moreover, the fact that the entity enters into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model.

*****

Illustration 3

Entity B sells goods to customers on credit. Entity B typically offers customers up to 60 days following the delivery of goods to make payment in full. Entity B collects cash in

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accordance with the contractual cash flows of trade receivables and has no intention to dispose of the receivables.

Evaluate the business model.

Solution

Entity's B objective is to collect contractual cash flows from trade receivables and therefore, trade receivables meet the business model test for the purpose of classifying the financial assets at amortised cost.

*****

Illustration 4

An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period.

The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.

Evaluate the business model.

Solution

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk). The objective of this contrasting business model is to hold financial assets to collect contractual cash flows.

*****

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Illustration 5

An entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it.

The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. In the consolidated balance sheet, loans continue to be recognised because they are not derecognised by the securitisation vehicle.

Evaluate the business model.

Solution

The entity originating loans to customers has the objective of realising contractual cash flows on the loan portfolio only through sale to securitisation vehicle. However, the consolidated group originates loans with the objective of holding them to collect the contractual cash flows.

- Hence, the consolidated financial statements provide for a business model with the objective of collecting contractual cash flows by holding to maturity.
- And in separate financial statements of the entity originating loans to customers, business model is to collect cash flows through sale only.

*****

Illustration 6

A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (eg, a run on the bank's deposits). The entity does not anticipate selling these assets except in such scenarios. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised.

However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.

Evaluate the business model.

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Solution

The objective of the entity's business model is to hold the financial assets to collect contractual cash flows. The analysis would not change –

- If during a previous stress case scenario the entity had sales that were significant in value in order to meet its liquidity needs; or
- Recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows.

If the entity is required by its regulator to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's business model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.

In contrast, if an entity holds financial assets to meet its everyday liquidity needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows.

*****

(B) Contractual cash flows characteristics test:

Ind AS 109 requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held –

i. within a business model whose objective is to hold assets to collect contractual cash flows; or

ii. within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

To do so, an entity is required to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

- The key characteristics of cash flows to test if they are solely payments of principal and interest are as follows:

What is principal?	❖ Principal is the fair value of the financial asset at initial recognition. ❖ However, that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

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Components of 'interest element'	**Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement**. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form. ❖ In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. ❖ However, in such an arrangement, interest can also include – ❖ consideration for other basic lending risks (for example, liquidity risk); ❖ costs (for example, administrative costs) associated with holding the financial asset for a particular period of time; and ❖ profit margin that is consistent with a basic lending arrangement. ❖ In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). ❖ However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal & interest. ❖ Leverage is a contractual cash flow characteristic of some financial assets, that increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts cannot be said to have contractual cash flows that are only payments of principal & interest and hence, cannot be subsequently measured at amortised cost or fair value through other comprehensive income.

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- Following are **examples** of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

  (a) a variable interest rate on a financial instrument, where this rate consists of consideration for –

  - time value of money,
  - credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed); and
  - other basic lending risks and costs, as well as a profit margin.

  This is because this variable interest rate is only to provide the lender with a return through 'interest' based on present market factors and no other form of return on the principal amount of the financial instrument. So, it has characteristics of return similar to one on a basic lending arrangement and thus, meets definition of contractual cash flows that are solely payments of principal and interest.

  (b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract;

  Reasonable additional compensation' implies that the party choosing to exercise its option to terminate the contract compensates the other party.

  Exception

  Some prepayment options could result in other party being forced to accept negative compensation – e.g. the lender receives an amount less than the unpaid amounts of principal and interest if the borrower chooses to prepay.

  Earlier, these instruments were measured at FVTPL. However, now after amendment, such financial assets could be measured at amortised cost or at FVOCI if they meet the other relevant requirements of Ind AS 109.

  To be eligible for the exception, the fair value of the prepayment feature would have to be insignificant on initial recognition of the asset. If this is impracticable to assess based on the facts and circumstances that existed on initial recognition of the asset, then the exception would not be available. Also, financial assets prepayable at current fair value would be measured at FVTPL. The same would apply if the prepayment amount includes the fair value cost to terminate a

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hedging instrument if the amount is inconsistent with the current Ind AS 109 prepayment rules. (The measurement principles given here have been explained in detail in the subsequent sections).

(c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (ie an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

Illustration 7

Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.

Evaluate the Contractual cash flows characteristics test

Solution

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

However, if the interest payments were indexed to another variable such as the debtor's performance (eg the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement.

*****

Illustration 8

Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer. Analyse the nature of cash flows.

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Solution

The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement; ie the return is linked to the value of the equity of the issuer.

*****

Illustration 9

Instrument H is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.

Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest. Analyse the nature of cash flows.

Solution

The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.

If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.

*****

Illustration 10

Instrument D is loan with recourse and is secured by collateral. Does the collateral affect the nature of contractual cash flows?

Solution

The fact that a loan is collateralised (since with recourse) does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The collateral is only a security to recover dues.

*****

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Illustration 11

Instrument G is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates). Analyse the nature of cash flows.

Solution

Here, interest on the instrument has an inverse relationship to the market rate of interest. Hence, it is unlike a basic lending arrangement which normally comprises of interest payable on any funds lent, as a consideration for the time value of money, credit risk and profit margin normally existing in such arrangements. This arrangement with an inverse floating interest rate provides the lender with a return which may be higher or lower to the market rate of interest and hence, is not necessarily a consideration for the time value of money on the principal amount outstanding.

Thus, these do not represent contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

*****

2.3 FINANCIAL ASSETS: CLASSIFICATION – OVERALL CONCEPT

Categorisation of financial assets (FA) is determined based on the business model that determines how cash flows of the financial asset are collected and the contractual cash flow characteristics; and can be:

(a) Measured at **Amortised cost**

(b) Measured at fair value through comprehensive income (**FVOCI**)

(c) Measured at fair value through profit or loss (**FVTPL**).

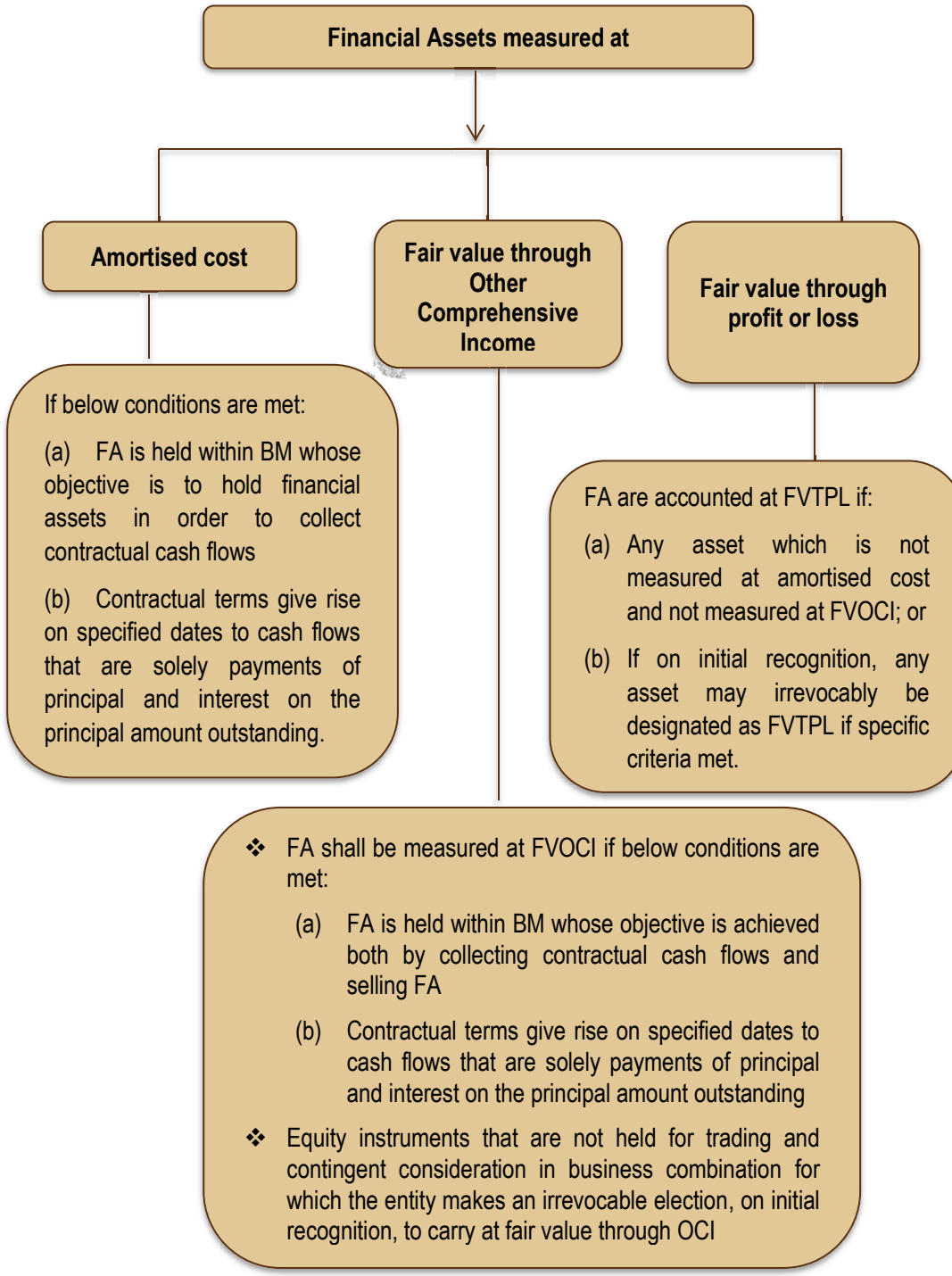
- As per Ind AS 109.4.1.1 – Except for financial assets designated as fair value through profit or loss (refer Ind AS 109.4.1.5), an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

  (a) Entity's **business model** (BM) for managing the financial assets and

  (b) **Contractual cash flow** characteristics of the financial asset.

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- Categorisation of financial assets has been broadly laid out in the below flow chart:

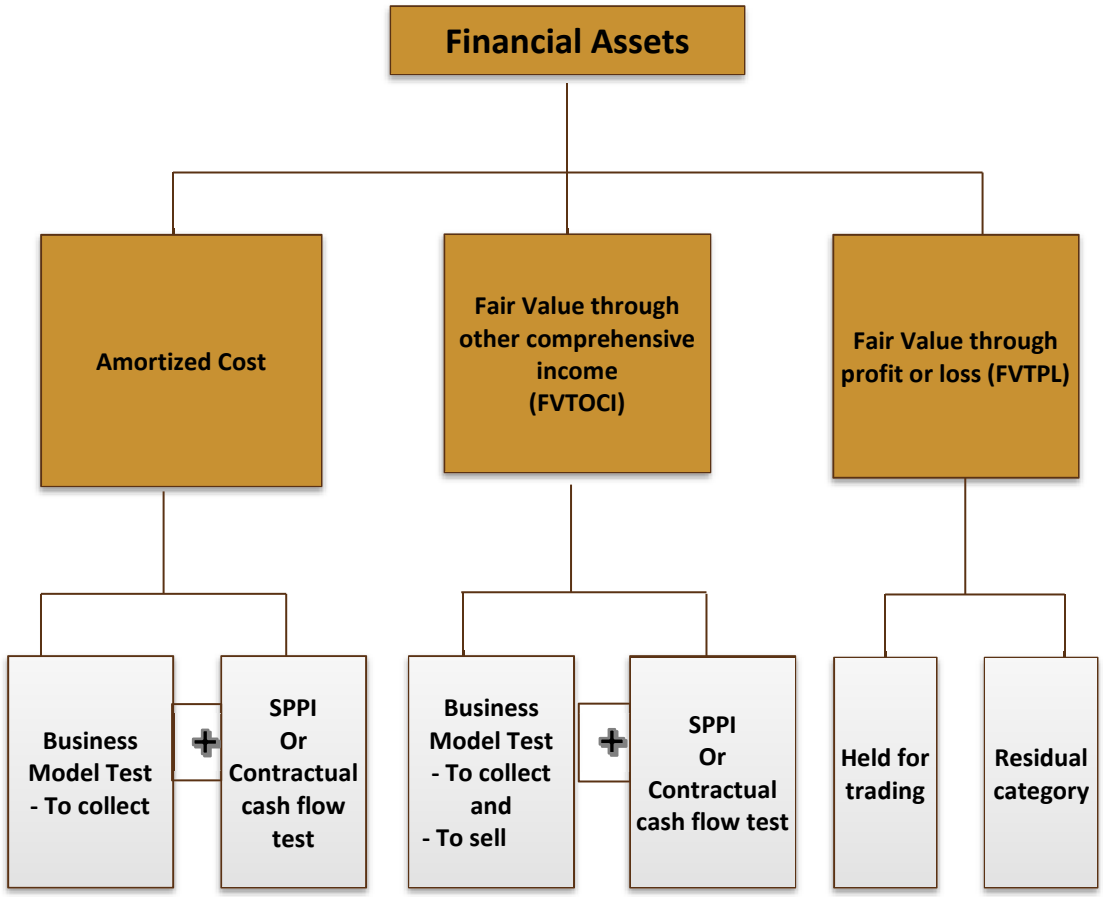


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- **Exception to classification based on above criteria mentioned in para 109.4.1.1 – Option to designate at fair value through profit or loss:**

  An entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an **'accounting mismatch'**) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases

  The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows.



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1. Financial Assets at Amortised cost

- **What is Amortised cost**
  - **Amortised cost** is the amount at which the financial asset is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.
  - **In applying effective interest method –**
    (a) Entity identifies fees that are an integral part of the effective interest rate of a financial instrument. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

    (b) Such fees adjusted in effective interest rate are then amortised over then expected life of the instrument. However, a shorter period may be used if such fee adjusted in effective interest rate pertains to such shorter period.

- **Financial asset (FA) shall be classified at amortised cost if it meets both of following criteria:**

1. **'Hold-to-collect' business model test -** Objective is to hold the financial asset in order to collect contractual cash flows;

   AND

2. **'SPPI' contractual cash flow characteristics test -** Contractual terms give rise to cash flows that are **Solely Payments of Principal and Interest (SPPI)** on the principal amount outstanding.

- **Examples of Financial assets classified and accounted for at amortised cost:**
  - Trade receivables
  - Investments in government bonds (not held for trading)
  - Investments in term deposits (at standard interest rates)
  - Loan receivables with 'basic' features

Investment in Equity instrument can never be classified at amortized cost.

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Illustration 12 : Hold-to-collect' business model test

An entity purchased a debt instrument for 1,00,000.

The instrument pays interest of 6,000 annually and has 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows.

Evaluate the business model test.

Solution

Entity's objective is to hold the asset to collect the contractual cash flows and not to sell the assets before the maturity period.

Thus, the debt instrument would meet the 'hold-to-collect' business model test.

*****

Illustration 13 : Hold-to-collect' business model test

An entity purchased a debt instrument for 1,00,000.

The instrument pays interest of 6,000 annually and has 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows.

Six years have passed and the entity is suffering a liquidity crisis and needs to sell the asset to raise funds.

Evaluate the business model test.

Solution

Since the sale of financial assets was not expected on initial classification and therefore, does not affect the classification (i.e. there is no retrospective reclassification).

Thus, the debt instrument would still meet the 'hold-to-collect' business model test.

*****

Illustration 14 : SPPI or contractual cash flow test

SPPI test for loan with zero interest and no fixed repayment terms

Parent H Ltd. provides a loan to its Subsidiary S Ltd. The loan is classified as a current liability in Subsidiary S's financial statements and has the following terms:

– Interest free loan.

– No fixed repayment terms

– Repayable on demand of Parent H Ltd.

Does the loan meet the 'SPPI' or contractual cash flows characteristic test?

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Solution

Yes. The terms for the repayment of the principal amount of the loan on demand satisfies the criterion of SPPI.

*****

Illustration 15 : SPPI Test for loan with zero interest repayable in ten years

Parent H Ltd. provides a loan of INR 100 million to Subsidiary B. The loan has the following terms:

– No interest

– Repayable in ten years.

Does the loan meet the 'SPPI' or contractual cash flows characteristic test?

Solution

Yes. The terms for the repayment of the principal amount of the loan in 10 years satisfies the criterion of SPPI.

*****

Illustration 16 : SPPI Test for loan with interest rate

Entity A Ltd. lends Entity B Ltd. INR 5 million for ten years, subject to the following terms:

– Interest is based on the prevailing variable market interest rate.

– Variable interest rate is capped at 10%.

– Repayable in ten years.

Does the loan meet the 'SPPI' or contractual cash flows characteristic test?

Solution

Contractual cash flows of both a fixed rate instrument and a floating rate instrument are payments of principal and interest as long as the interest reflects consideration for the time value of money and credit risk.

Therefore, a loan that contains a combination of a fixed and variable interest rate meets the contractual cash flow characteristics test.

*****

Illustration 17: Trade receivables – Amortised cost

H Ltd. makes sale of goods to customers on credit of 60 days. The customers are entitled to earn a cash discount @ 5% per annum if payment is made before 60 days and an interest @ 12% per annum is charged for any payments made after 60 days. Company does not have a policy of selling its debtors and holds them to collect contractual cash flows.

Evaluate the financial instrument.

Solution

In the above case, since H Ltd. has a contractual right to receive cash flows from its customers and therefore such trade receivable are financial assets for H Ltd.

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Further, H Ltd. business model test to collect will satisfy as the objective is to hold its trade receivable to collect contractual cash flows till the end of maturity period and such trade receivable recorded in books represents contractual cash flows that are solely payments of principal and interest if paid beyond credit period.

Hence such trade receivables are classified at amortised cost.

*****

Illustration 18: Security Deposits – Amortized Costs

A Ltd. (the 'Company') has obtained the premises from B Ltd. on lease to carry on its business. The lease contract period is 5 years. As per the lease agreement, A Ltd. has paid security deposits to B Ltd. amounting to ₹ 10 Lac which is refundable after the expiry of lease agreement.

How would such deposits be treated in books of the A Ltd. ?

Solution

In the above case, since A Ltd. has a contractual right to receive cash flows from its Lessor, B Ltd. and therefore such security deposits receivable are financial assets for A Ltd.

Further, A Ltd. business model test to collect will be satisfied as the objective is to hold its security deposits receivable to collect contractual cash flows till the end of maturity period. And such trade receivable recorded in books represents contractual cash flows that are solely payments of principal and interest.

Hence such security deposits receivables are classified at amortised cost.

*****

2. Financial Assets at Fair Value at Other Comprehensive Income

A. Accounting for debt instruments when it is classified as FVOCI

- **Financial asset (FA) is measured at fair value through OCI (FVOCI) if it meets both of following criteria:**

  1. **'Hold-to-collect and sell' business model test -** Objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset i.e. Intention of the entity is to sell the instrument before the investment matures.

  AND

  2. **'SPPI' contractual cash flow characteristics test -** Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.

- **Examples of FA classified and accounted for at FVOCI:**

  - Investments in government bonds where the investment period is likely to be shorter than its maturity period.
  - Investments in corporate bonds where the investment period is likely to be shorter than its maturity period.

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Illustration 19 : Hold-to-collect' or 'hold-to-collect & sell' business model test

Entity A has surplus funds – INR 50 million

A has not yet found suitable investment opportunity so it buys medium dated (5 year maturity) high quality government bonds in order to generate interest income.

If a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. It is likely that a suitable business opportunity will be found before maturity date.

Whether the investment opportunity will meet the 'hold-to-collect' or 'hold-to-collect & sell business model test?

Solution

Government bonds would not meet the 'hold-to-collect' business model test because it is considered likely that the bonds will be sold well before their contractual maturity.

However, it is likely that such investment would meet the 'hold-to-collect and sell' business model test.

*****

B. Equity instrument when it is classified as FVOCI

- Ind AS 109 requires all equity investments to be measured at fair value. The default approach is that all changes in fair value of instruments to be recognised in profit or loss.
- However, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI, with all subsequent changes in fair value being recognised in other comprehensive income.
- Under FVOCI category, fair value changes are recognised in OCI while dividends are recognised in profit or loss.
- On disposal of the investment the cumulative change in fair value is required to remain in OCI and is not reclassified to profit or loss. However, entities have the ability to transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings).

3. Financial Assets at profit and loss

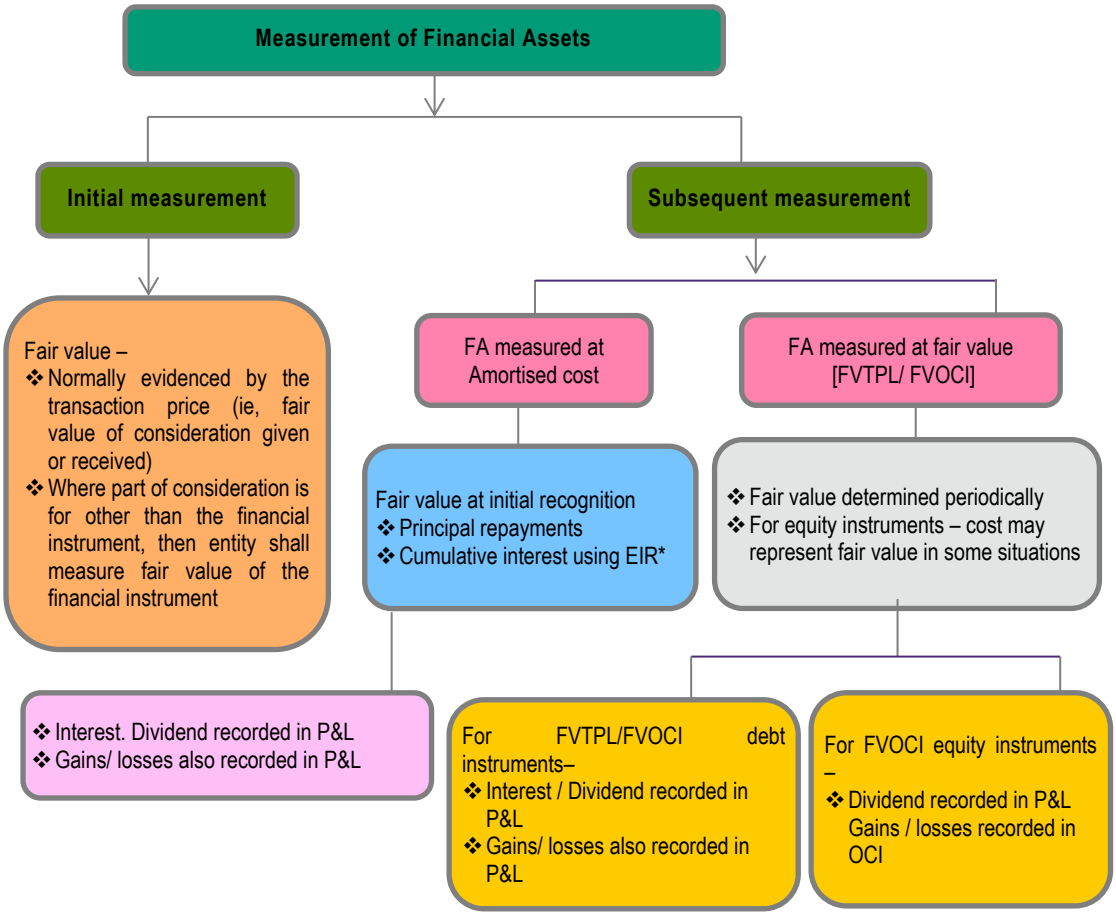
- **Fair value through profit or loss (FVTPL) is the residual category in Ind AS 109.**
- **Financial asset (FA) classified and measured at FVTPL if FA is:**
  - A held-for-trading financial asset
  - A debt instrument that does not qualify to be measured at amortised cost or FVOCI
  - An equity investment which the entity has not elected to classify as at FVOCI

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- **Examples of Financial assets classified and accounted for at fair value through profit or loss (FVTPL):**
  - ♦ Derivatives that have not been designated in a hedging relationship, e.g.:
    - Interest rate swaps
    - Commodity futures/option contracts
    - Foreign exchange futures/option contracts
  - ♦ Investments in shares where the entity has not elected to account for at FVOCI.

2.4 FINANCIAL ASSETS: MEASUREMENT

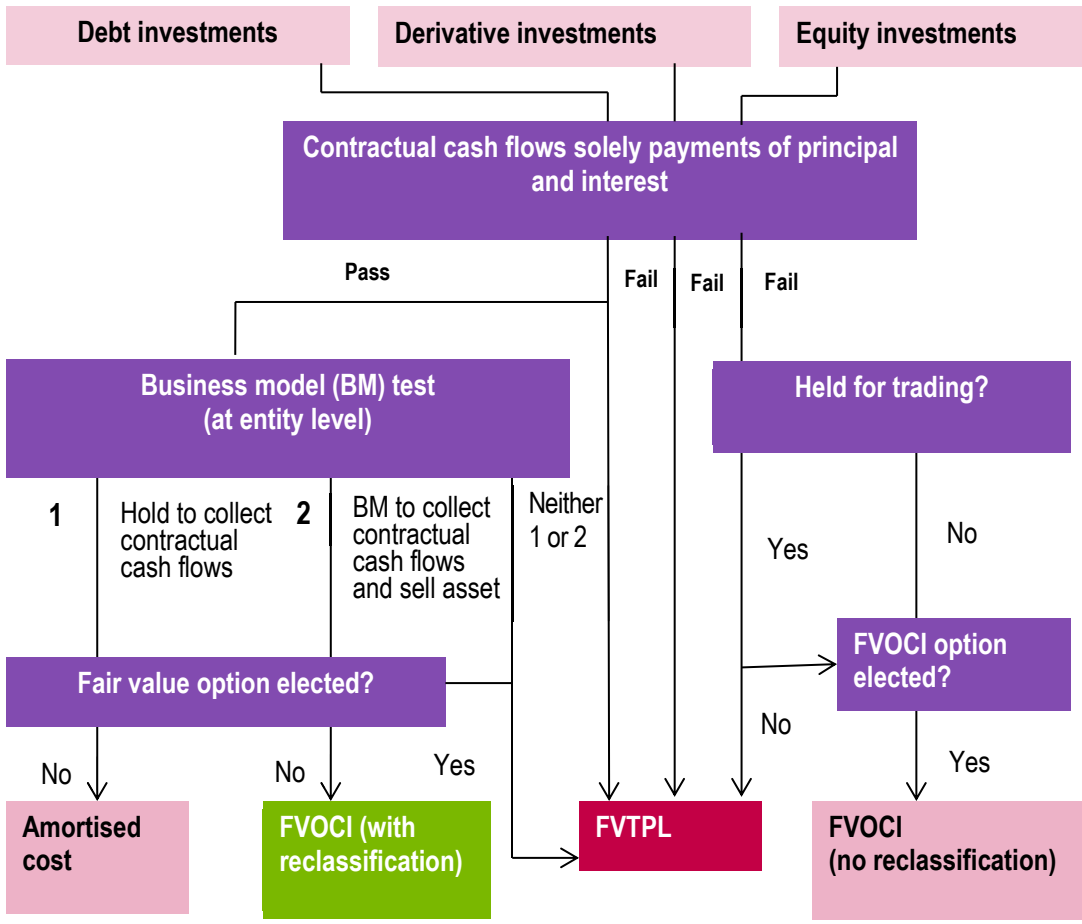
Measurement of financial assets is driven by their classification and can be broadly explained with the help of following diagrammatic presentation:



*EIR – Effective interest rate method

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Based on the above mentioned guidance, the decision tree for classification of financial assets can be understood with the help of following flow chart:



Accounting for transaction costs for the purpose of Effective interest rate method

Fees that are integral part of effective interest rate	Fees that are not an integral part of effective interest rate
(a) **Origination fee** received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.	(a) **Fee** charged for **servicing a loan**;

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Fees that are integral part of effective interest rate	Fees that are not an integral part of effective interest rate
(b) **Commitment fee** received by the entity **to originate a loan where it is probable that the entity will enter into a specific lending arrangement.** These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.	(b) **Commitment fee** to originate a loan when it is **unlikely that a specific lending arrangement will be entered into**;
(c) **Origination fee** paid on issuing financial asset measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.	(c) **Loan syndication fee** received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

Illustration 20

ABC Bank gave loans to a customer – Target Ltd. that carry fixed interest rate @ 10% per annum for a 5 year term and 12% per annum for a 3 year term. Additionally, the bank charges processing fees @1% of the principal amount borrowed. Target Ltd borrowed loans as follows:

- 10 lacs for a term of 5 years

- 8 lacs for a term of 3 years.

Compute the fair value upon initial recognition of the loan in books of Target Ltd. and how will loan processing fee be accounted?

Solution

The loans from ABC Bank carry interest @ 10% and 12% for 5 year term and 3 year term respectively. Additionally, there is a processing fee payable @ 1% on the principal amount on date of transaction. It is assumed that ABC Bank charges all customers in a similar manner and hence this is representative of the market rate of interest.

Amortised cost is computed by discounting all future cash flows at market rate of interest. Further, any transaction fees that are an integral part of the transaction are adjusted in the effective interest rate and recognised over the term of the instrument.

Hence loan processing fees shall be reduced from the principal amount to arrive the value on day 1 upon initial recognition.

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Fair value (5 year term loan) = 10,00,000 – 10,000 (1% x 10,00,000) = 9,90,000

Fair value (3 year term loan) = 8,00,000 – 8,000 (1% x 8,00,000) = 7,92,000.

Now, effective interest rate shall be higher than the interest rate of 10% and 12% on 5 year loan and 3 year loan respectively, so that the processing fees gets recognised as interest over the respective term of loans.

*****

- **Fair value**

  Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

  Per Ind AS 113.B2 – The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all the following:

  (a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account);

  (b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use);

  (c) the principal (or most advantageous) market for the asset or liability.

  (d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

  Now, we go on to understand the key aspects of initial and subsequent measurement along with how classification of assets affects their measurement as explained in detail below:

2.5 FINANCIAL ASSETS: INITIAL MEASUREMENT

Fair value of a financial instrument at initial recognition is **normally the transaction price** (,ie, fair value of consideration given or received).

- **Instrument at off-market terms:** Sometimes certain type of instruments may be exchanged at off market terms (,ie, different from market terms for a similar instrument if exchanged between market participants),

  - For example, a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. In such cases where part of the consideration given or

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received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

- In the aforementioned example, the fair value of the long-term loan or receivable can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. The additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

- **Transaction costs:**

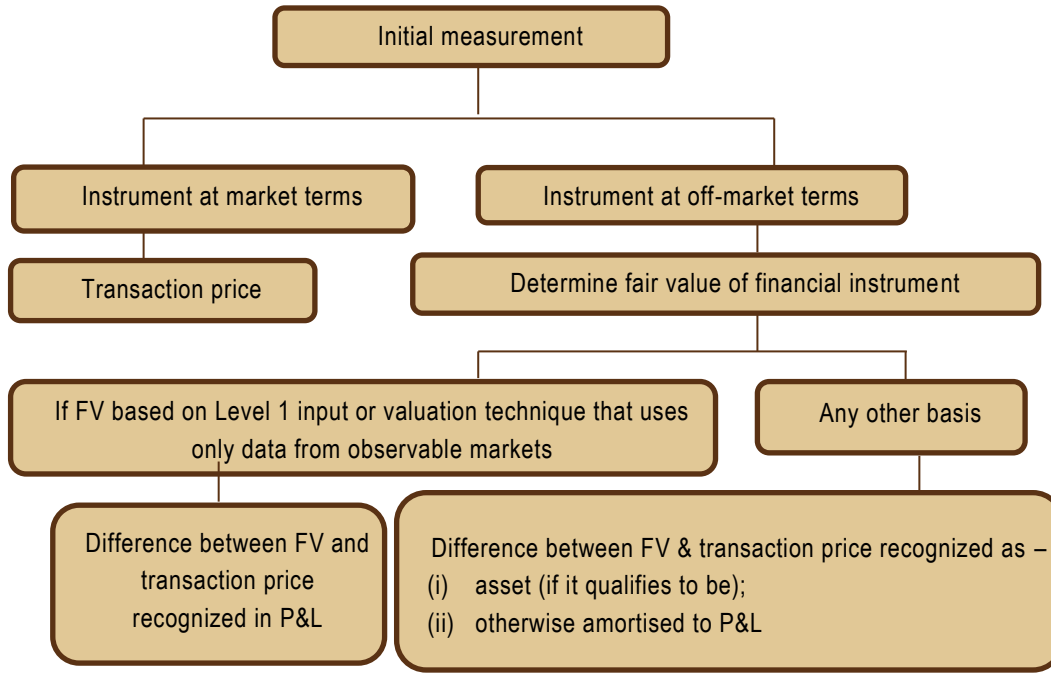
  - Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

  - Any transaction costs incurred for acquisition of the financial asset or issue of financial liability are adjusted upon initial recognition while determining fair value, if the financial asset or financial liability is not classified as subsequently measured at fair value through profit or loss.

  - If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives.

    The decision tree for the aforementioned basis to be applied in establishing fair value at initial recognition can be understood with following diagrammatic presentation:

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- **Specific transactions:**

  - **Determining amortised cost for financial assets carrying floating rate of interest:**

    Per Application Guidance in Appendix B – B.5.4.5 – For floating rate financial instruments, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. To calculate the effective interest in each relevant period, the effective interest rate is applied to the amortised cost of the asset or liability at the previous reporting date. However, if the floating rate financial asset or financial liability is initially recognised at an amount equal to the principal receivable or payable on maturity, then this periodic re-estimation does not have a significant effect on the carrying amount of the asset or liability.

    Therefore, in such cases, for practical reasons the carrying amount of a floating rate instrument would not generally need to be adjusted at each repricing date because the impact would not generally be significant. In such case –

    (a) Interest income or expense is recognised based on the current market rate.

    (b) For a floating rate financial asset or financial liability that is initially recognised at a discount or premium, the interest income or expense is recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium.

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- **Revision of estimated cash flows:**

  Per Application Guidance in Appendix B to Ind AS 109 – B.5.4.6 – If there is a change in the timing or amount of estimated future cash flows (other than due to impairment) –

  - It shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows.
  - The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's **original effective interest rate** (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)

  Then the carrying amount of the instrument (or group of financial instruments) is adjusted in the period of change to reflect the actual and/or revised estimated cash flows, with a corresponding gain or loss being recognised in profit or loss.

  This approach to changes in estimated cash flows should apply to changing prepayment expectations and other estimates of cash flows under the current terms of the financial instrument but not to a renegotiation of the contractual terms of an instrument.

- **Interest income after impairment recognition**

  If a financial asset or a group of similar financial assets has been written down as a result of an impairment loss –

  - Then interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.
  - For assets measured at amortised cost, this interest rate would be the original effective interest rate.

- **Loans between group companies**

  (a) Repayable on demand:

  As per Ind AS 113.47 – The fair value of a financial liability with a demand feature - e.g. a demand deposit - is not less than the amount payable on demand, discounted from the first date that the entity could be required to repay the amount. Accordingly –

  - The fair value of an interest-free loan liability of which the lender can demand repayment of the face value at any time - i.e. a loan repayable on demand - is not less than its face value.

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- This would evenly apply from the perspective of the lender, since a market participant acting in its best interest would be assumed to maximize value by demanding immediate repayment and hence, the fair value shall be equal to the amount payable on demand in books of lender.

(b) No fixed maturity:

If a loan has no fixed maturity date and is available in perpetuity, then in measuring its fair value, discounting should reflect these terms because a market participant acting in its best interest would not assume repayment of the loan. Similarly, the asset holder or lender would also measure fair value that should reflect a market participant's assumptions about the timing of the future cash flows.

In both of above cases–

- Any difference between the amount lent and the fair value of the instrument on initial recognition is recognized as a gain or a loss unless it qualifies for recognition as an asset or a liability.
- If a low-interest loan is given in anticipation of a right to receive goods or services at favourable prices, then the right may be recognised as an asset if it qualifies for recognition as an asset, for example: prepaid expenses, etc.

♦ **Demand deposits**

The fair value of a financial liability with a demand feature - e.g. a demand deposit - is not less than the amount payable on demand, discounted from the first date that the entity could be required to repay the amount.

Hence, fair value of a demand deposit would be the amount payable on demand in books of the party making the deposit (ie, holder of financial asset) as well as in books of entity accepting the deposit (ie, bearer of financial liability).

Illustration 21: Deposits carrying off-market rate of interest:

Containers Ltd provides containers for use by customers for multiple purposes. The containers are returnable at the end of the service contract period (3 years) between Containers Ltd and its customers. In addition to the monthly charge, there is a security deposit that each customer makes with Containers Ltd for ₹ 10,000 per container and such deposit is refundable when the service contract terminates. Deposits do not carry any interest. Analyse the fair value upon initial recognition in books of customers leasing containers. Market rate of interest for 3 year loan is 7% per annum.

Solution

In the above case, lessee (ie, customers leasing the containers) make interest free deposits, which are refundable at the end of 3 years. Now, this money if it was to lent to a third party would fetch interest @ 7% per annum.

Hence, discounting all future cash flows (ie, ₹ 10,000)

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Fair value on initial recognition = 10,000 / $(1+0.07)^3$ = 8,163.

Differential on day 1 = 10,000 – 8,163 = 1,837

The differential on day 1 shall be treated as follows:

- **Scenario 1 –** If fair valuation is determined using level 1 inputs or other observable inputs, difference on day 1 recognised in profit or loss
- **Scenario 2 –** If fair valuation is determined using other inputs, difference on day 1 shall be recognised in profit or loss unless it meets definition of an asset or liability.

However, in case of security deposits level 1 fair value is not available. Therefore, in the above case, the fair valuation is made based on unobservable inputs and hence applying scenario 2, difference can be recognised as an asset if it meets the definition. Now, since the lessee gets to use the containers in return for making an interest free deposit plus monthly charges, the lost interest representing day 1 difference between value of deposit and its fair value is like ''prepaid lease rent' and can be recognised as such. Prepaid rent (ROU Asset) shall be charged off to profit or loss in a straight lined manner as depreciation as per Ind AS 16.

*****

2.6 FINANCIAL ASSETS: SUBSEQUENT MEASUREMENT

- As defined in the flow chart above, the subsequent measurement of financial assets is based on their classification as defined below:

(A) Assets measured at amortised cost

- Assets are classified as measured at amortised cost if below conditions are met (as explained in paragraph – Financial assets: classification):
  - (a) Financial asset is held with BM whose objective is to hold financial assets in order to collect contractual cash flows; and
  - (b) Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding
- Where assets are classified as 'amortised cost' –
  - They are initially measured at fair value plus or minus transaction costs as explained above
  - Subsequently, the carrying value is adjusted for principal repayments and interest accrued using effective interest rate, as explained earlier.

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(B) Assets measured at fair value

- For assets not carried at amortised cost, they shall be carried at fair value. Such assets can be categorised into –

  i. **Measured at fair value through other comprehensive income (FVOCI)**; if–

  (a) Following criteria are satisfied:

  - FA is held with BM whose objective is achieved both by collecting contractual cash flows and selling FA; and
  - Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

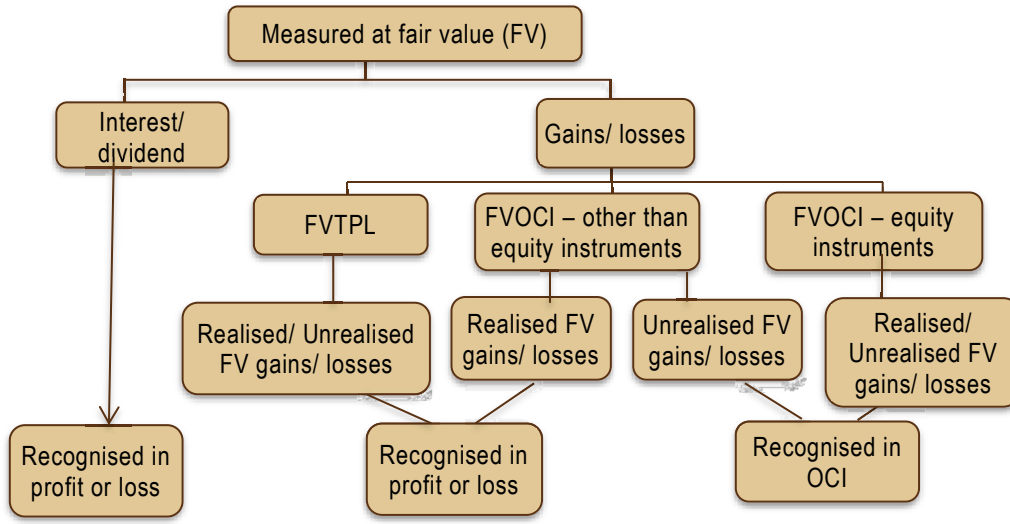
  Or

  (b) An equity instrument, which otherwise shall be carried at fair value through profit or loss may be irrevocably recognised at fair value through other comprehensive income,

  ii. Measured at fair value through profit or loss (FVTPL):

  All assets not classified as 'measured at amortised cost' or 'measured at fair value through OCI' shall be classified in this category.

Incomes and/ or expenses on assets measured at fair value shall be recognised as follows:



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- If a financial instrument that was previously recognised as a financial asset is measured at fair value through profit or loss and its fair value decreases below zero, it is a financial liability measured at fair value.

- **Equity instruments – where FV not determinable**

  - All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range

  - **Indicators that cost might not be representative of fair value include:**

    (a) a significant change in the performance of the investee compared with budgets, plans or milestones.

    (b) changes in expectation that the investee's technical product milestones will be achieved.

    (c) a significant change in the market for the investee's equity or its products or potential products.

    (d) a significant change in the global economy or the economic environment in which the investee operates.

    (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.

    (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.

    (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

  - The list above is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.

  - Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

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Illustration 22: Accounting for transaction costs on initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income:

An entity acquires a financial asset for CU 100 plus a purchase commission of CU 2. Initially, the entity recognises the asset at CU 102. The reporting period ends one day later, when the quoted market price of the asset is CU 100. If the asset were sold, a commission of CU 3 would be paid. How would transaction costs be accounted in books of the entity?

Solution

- On that date, the entity measures the asset at CU 100 (without regard to the possible commission on sale) and recognises a loss of CU 2 in other comprehensive income.
- If the financial asset is measured at fair value through other comprehensive income in accordance with Ind AS 109.4.1.2A, the transaction costs are amortised to profit or loss using the effective interest method.

*****

Illustration 23: Determining fair value upon initial measurement

The shareholders of Company C provide C with financing in the form of loan notes to enable it to acquire investments in subsidiaries. The loan notes will be redeemed solely out of dividends received from these subsidiaries and become redeemable only when C has sufficient funds to do so. In this context, 'sufficient funds' refers only to dividend receipts from subsidiaries. Analyse the initial measurement of loan notes.

Solution

In this case –

Loan notes are repayable only when C earns returns in form of dividends from subsidiaries. Hence, C cannot be forced to obtain additional external financing or to liquidate its investments to redeem the shareholder loans. Consequently, the loan notes are not considered payable on demand.

Accordingly –

- Loan notes shall be initially measured at their fair value, being the present value of the expected future cash flows, discounted using a market-related rate. The amount and timing of the expected future cash flows should be determined on the basis of the expected dividend flow from the subsidiaries. Also, the valuation would need to take

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into account possible early repayments of principal and corresponding reductions in interest expense.

- Since the loan notes are interest-free or bear lower-than-market interest, there will be a difference between the nominal value of the loan notes - i.e. the amount granted - and their fair value on initial recognition. Because the financing is provided by shareholders, acting in the capacity of shareholders, the resulting credit should be reflected in equity as a shareholder contribution in C's balance sheet. Conversely, in books of shareholders, the difference between amount invested and its fair value shall be recorded as 'investment in C Ltd' being representative of the underlying relationship between shareholders and C Ltd.

*****

Illustration 24 : Use of cost v/s fair value determination for equity instruments

Silver Ltd. has made an investment in optionally convertible preference shares (OCPS) of a Company – Bronze Ltd. at ₹ 100 per share (face value ₹ 100 per share). Silver Ltd. has an option to convert these OCPS into equity shares in the ratio of 1:1 and if such option not exercised till end of 9 years, then the shares shall be redeemable at the end of 10 years at a premium of 20%.

Analyse the measurement of this investment in books of Silver Ltd.

Solution

The classification assessment for a financial asset is done based on two characteristics:

i. Whether the contractual cash flows comprise cash flows that are solely payments of principal and interest on the principal outstanding

ii. Entity's business model (BM) for managing financial assets – Whether the Company's BM is to collect cash flows; or a BM that involves realisation of both contractual cash flows & sale of financial assets;

In all other cases, the financial assets are measured at fair value through profit or loss.

In the above case, the Holder can realise return either through conversion or redemption at the end of 10 years, hence it does not indicate contractual cash flows that are solely payments of principal and interest. Therefore, such investment shall be carried at fair value through profit or loss. Accordingly, the investment shall be measured at fair value periodically with gain/ loss recorded in profit or loss.

*****

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Illustration 25 : Accounting for assets at amortised cost

A Ltd has made a security deposit whose details are described below. Make necessary journal entries for accounting of the deposit in the first year and last year. Assume market interest rate for a deposit for similar period to be 12% per annum.

Particulars	*Details*
Date of Security Deposit (Starting Date)	*1-Apr-20X1*
Date of Security Deposit (Finishing Date)	*31-Mar-20X6*
Description	*Lease*
Total Lease Period	*5 years*
Discount rate	*12.00%*
Security deposit (A)	*10,00,000*
Present value factor at the 5th year	*0.567427*

Solution

The above security deposit is an interest free deposit redeemable at the end of lease term for ₹ 10,00,000. Hence, this involves collection of contractual cash flows and shall be accounted at amortised cost.

Upon initial measurement –

Particulars	Details
Security deposit (A)	10,00,000
Total Lease Period (Years)	5
Discount rate	12.00%
Present value factor of 5th year end	0.56743
Present value of deposit at beginning (B)	5,67,427
Prepaid lease payment at beginning (A-B)	4,32,573

Journal Entries

Year – 1 beginning

Particulars		Amount	Amount
Security deposit A/c	Dr.	5,67,427	
Right-of-Use Asset	Dr.	4,32,573	
To Bank A/c			10,00,000

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Subsequently, every annual reporting year, interest income shall be accrued @ 12% per annum and prepaid expenses shall be amortised on straight line basis over the lease term.

Year 1 end

Particulars		Amount	Amount
Security deposit A/c (5,67,427 x 12%)	Dr.	68,091	
To Interest income A/c			68,091

At the end of 5th year, the security deposit shall accrue ₹ 10,00,000 and prepaid lease expenses shall be fully amortised (i.e. depreciated as per Ind AS 116, this prepaid lease rent would be shown as ROU asset). Journal entry for realisation of security deposit –

Particulars		Amount	Amount
Security deposit A/c	Dr.	1,07,143	
To Interest income A/c			1,07,143
Bank A/c	Dr.	10,00,000	
To Security deposit A/c			10,00,000

*****

Illustration 26 : Accounting for assets at FVTPL

A Ltd. invested in equity shares of C Ltd. on 15th March for ₹ 10,000. Transaction costs were ₹ 500 in addition to the basic cost of ₹ 10,000. On 31 March, the fair value of the equity shares was ₹ 11,200 and market rate of interest is 10% per annum for a 10 year loan. Pass necessary journal entries. Analyse the measurement principle and pass necessary journal entries.

Solution

The above investment is in equity shares of C Ltd and hence, does not involve any contractual cash flows that are solely payments of principal and interest. Hence, these equity shares shall be measured at fair value through profit or loss. Also, an irrecoverable option exists to designate such investment as fair value through other comprehensive income.

Journal Entries

Particulars		Amount	Amount
Upon initial recognition –			
Investment in equity shares of C Ltd.	Dr.	10,000	
Transaction cost	Dr.	500	
To Bank A/c			10,500
(Being investment recognized at fair value plus transaction costs upon initial recognition)			

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Profit and Loss A/c	Dr.	500	
To Transaction cost			500
(Being transaction cost incurred on assets measured at FVTPL transferred to P&L A/c)			

Subsequently –			
Investment in equity shares of C Ltd.	Dr.	1,200	
To Fair value gain on financial instruments			1,200
(Being fair value gain recognized at year end in P&L)			
Fair value gain on financial instruments	Dr.	1,200	
To Profit and Loss A/c			1,200
(Being fair value gain transferred to P&L A/c)			

*****

Illustration 27: Accounting for assets at FVOCI

Metallics Ltd. has made an investment in equity instrument of a company – Castor Ltd. for 19% equity stake. Significant influence not exercised. The investment was made for ₹ 5,00,000 for 10,000 equity shares on 01 April 20X1. On 30 June 20X1 the fair value per equity share is ₹ 45. The Company has taken an irrevocable option to measure such investment at fair value through other comprehensive income.

Solution

The Company has made an irrecoverable option to carry its investment at fair value through other comprehensive income. Accordingly, the investment shall be initially recognised at fair value and all subsequent fair value gains/ losses shall be recognised in other comprehensive income (OCI).

Journal Entries

Particulars		**Amount**	**Amount**
Upon initial recognition –			
Investment in equity shares of C Ltd.	Dr.	5,00,000	
To Bank a/c			5,00,000
(Being investment recognized at fair value plus transaction costs upon initial recognition)			

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Subsequently –			
Fair value loss on equity investment	Dr.	50,000	
To Investment in equity shares of C Ltd.			50,000
(Being fair value loss recognized in OCI section of the Statement of Profit and Loss under items that cannot be reclassified to profit or loss)			
Fair Value Reserve for Equity Investments	Dr.	50,000	
To Fair value loss on financial instruments			50,000
(Being fair value loss recognized in other comprehensive income accumulated in equity investments fair value reserve)			

*****

Illustration 28: Accounting for assets at Amortised Cost

XYZ Ltd. is a company incorporated in India. It provides INR 10,00,000 interest free loan to its wholly owned Indian subsidiary (ABC). There are no transaction costs.

How should the loan be accounted for, in the separate financial statements of XYZ, individual financial statements of ABC and consolidated financial statements of the group?

Consider the following scenarios:

a) The loan is repayable on demand.

b) The loan is repayable after 3 years. The current market rate of interest for similar loan is 10% p.a. for both holding and subsidiary.

c) The loan is repayable when ABC has funds to repay the loan.

Solution

Ind AS 109 requires that a financial assets and liabilities are recognized on initial recognition at its fair value, as adjusted for the transaction cost. In accordance with Ind AS 113 Fair Value Measurement, the fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Using the guidance, the loan will be accounted for as below in various scenarios:

Scenario (a)

Since the loan is repayable on demand, it has fair value equal to cash consideration given. The parent and subsidiary recognize financial asset and liability, respectively, at the amount of loan given. Going forward, no interest is accrued on the loan.

Upon repayment, both the parent and the subsidiary reverse the entries made at origination.

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Scenario (b)

Both parent and subsidiary recognize financial asset and liability, respectively, at fair value on initial recognition. The difference between the loan amount and its fair value is treated as an equity contribution to the subsidiary. This represents a further investment by the parent in the subsidiary.

Accounting in the books of XYZ Ltd (Parent)

S. No.	Particulars		Amount	Amount
	On the date of loan			
1	Loan to ABC Ltd (Subsidiary)	Dr.	7,51,315	
	Deemed Investment (Capital Contribution) in ABC Ltd.	Dr.	2,48,685	
	To Bank			10,00,000
	(Being the loan is given to ABC Ltd and recognised at fair value)			
	Accrual of Interest income			
2	Loan to ABC Ltd	Dr.	75,131	
	To Interest income			75,131
	(Being interest income accrued) – Year 1			
3	Loan to ABC Ltd	Dr.	82,645	
	To Interest income			82,645
	(Being interest income accrued) – Year 2			
4	Loan to ABC Ltd	Dr.	90,909	
	To Interest income			90,909
	(Being interest income accrued) – Year 3			
5	**On repayment of loan**			
	Bank	Dr.	10,00,000	
	To Loan to ABC Ltd (Subsidiary)			10,00,000

Accounting in the books of ABC Ltd (Subsidiary)

S. No.	Particulars		Amount	Amount
	On the date of loan			
1	Bank	Dr.	10,00,000	
	To Loan from XYZ Ltd (Payable)			751,315

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	To Equity (Deemed Capital Contribution from XYZ Ltd)			2,48,685
	(Being the loan taken from XYZ Ltd. and recognised at Fair value)			
	Accrual of Interest			
2	Interest expense	Dr.	75,131	
	To Loan from XYZ Ltd (Payable)			75,131
	(Being interest expense recognised) – Year 1			
3	Interest expense	Dr.	82,645	
	To Loan from XYZ Ltd (Payable)			82,645
	(Being interest expense recognised) – Year 2			
4	Interest expense	Dr.	90,909	
	To Loan from XYZ Ltd (Payable)			90,909
	(Being interest expense recognised) – Year 3			
	On repayment of loan			
5	Loan from XYZ Ltd (Payable)	Dr.	10,00,000	
	To Bank			10,00,000

Working Notes:-

1 **Computation of Present value of loan**

Rate	10%
Amount of Loan	10,00,000
Year	3
Present Value	7,51,315

2 **Computation of interest for Year I**

Present Value	7,51,315
Rate	10%
Period of interest - for 1 year	1
Closing value at the end of year 1	8,26,446
Interest for 1st year	75,131

3 **Computation of interest for Year 2**

Value of loan as at the beginning of Year 2	8,26,446
Rate	10%

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Period of interest - for 2nd year	1
Closing value at the end of year 2	9,09,091
Interest for 2nd year	82,645

4 **Computation of interest for Year 3**

Value of loan as at the beginning of Year 3	9,09,091
Rate	10%
Period of interest - for 3rd year	1
Closing value at the end of year 3	10,00,000
Interest for 3rd year	90,909

Scenario (c)

Generally, a loan, which is repayable when funds are available, can't be stated to be repayable on demand. Rather, the entities need to estimate repayment date and determine its measurement accordingly. If the loan is expected to be repaid in three years, its measurement will be the same as in scenario (b).

In the Consolidated Financial Statements (CFS), the loan and interest income/expense will get eliminated as intra-group transaction in all three scenarios. Hence the above accounting will not have any impact in the CFS. However, if the loan is in foreign currency, exchange difference will continue to impact the statement of profit and loss in accordance with the requirements of Ind AS 21.

*****

2.7 FINANCIAL LIABILITIES: CLASSIFICATION

- Upon initial recognition, all financial liabilities are measured at fair value. Subsequently, per Ind AS 109.4.2.1 – the classification of financial liabilities shall be as follows:

  (A) Measured at amortised cost

  (B) Measured at fair value through profit or loss:

  - Liabilities that meet the definition of "held for trading"
  - Contingent consideration recognized by an acquirer in a business combination

  (C) Designated at fair value through profit or loss

  (D) Other specific measurement basis (with changes recognized in profit or loss):

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- financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies: refer paragraph 3.2.15 or 3.2.17 of Ind AS 109
- financial guarantee contracts and commitments to provide a loan at a below-market interest rate are subsequently measured at higher of:
  - the amount of the loss allowance, and
  - the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115."

Irrespective of above classification, any financial liabilities may be designated at fair value through profit or loss if:

i. It eliminates or significantly reduces a measurement or recognition inconsistency (**'accounting mismatch'**) that would otherwise arise from measuring assets or liabilities; or their gains on a different basis; or

ii. A group of financial liabilities and financial assets is managed and its performance is evaluated on fair value basis, in accordance with a documented risk management or investment strategy, and information about that group is provided internally on that basis to the entity's key management personnel.

- **Financial assets and financial liabilities held for trading:**
  - Financial assets and liabilities held for trading are defined as those that:

    (a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;

    (b) on initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

    (c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

    Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin.
  - In addition to derivatives that are not accounted for as hedging instruments, financial liabilities held for trading include:

    (a) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);

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(b) financial liabilities that are incurred with an intention to repurchase them in the near term, such as quoted debt instruments that the issuer may buy back in the near term depending on changes in fair value; and

(c) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

However, the fact that a liability is used merely to fund trading activities does not in itself make that liability one that is held for trading.

Illustration 29 : Trade creditors at market terms

A Company purchases its raw materials from a vendor at a fixed price of ₹ 1,000 per tonne of steel. The payment terms provide for 45 days of credit period, after which an interest of 18% per annum shall be charged. How would the creditors be classified in books of the Company?

Solution

In the above case, creditors for purchase of steel shall be carried at amortised cost, ie, fair value of amount payable upon initial recognition plus interest (if payment is delayed). Here, fair value upon initial recognition shall be the price per tonne. The transaction price is representative of fair value.

*****

Illustration 30

*An entity is about to purchase a portfolio of **fixed rate assets** that will be **financed by fixed rate debentures**. Both financial assets and financial liabilities are subject to the same interest rate risk that gives rise to opposite changes in fair value that tend to offset each other. Provide your comments.*

Solution

The fixed rate assets provide for contractual cash flows and based on business model of the entity, such fixed rate assets may be classified as 'amortised cost' (if entity collects contractual cash flows) or fair value through other comprehensive income (FVOCI) (if entity manages through collecting contractual cash and sale of financial assets).

In the absence of fair value option, the entity can classify the fixed rate assets as FVOCI with gains and losses on changes in fair value recognised in other comprehensive income and fixed rate debentures at amortised cost. However, reporting both assets and liabilities at fair value through profit and loss, ie, FVTPL corrects the measurement inconsistency and produces more relevant information.

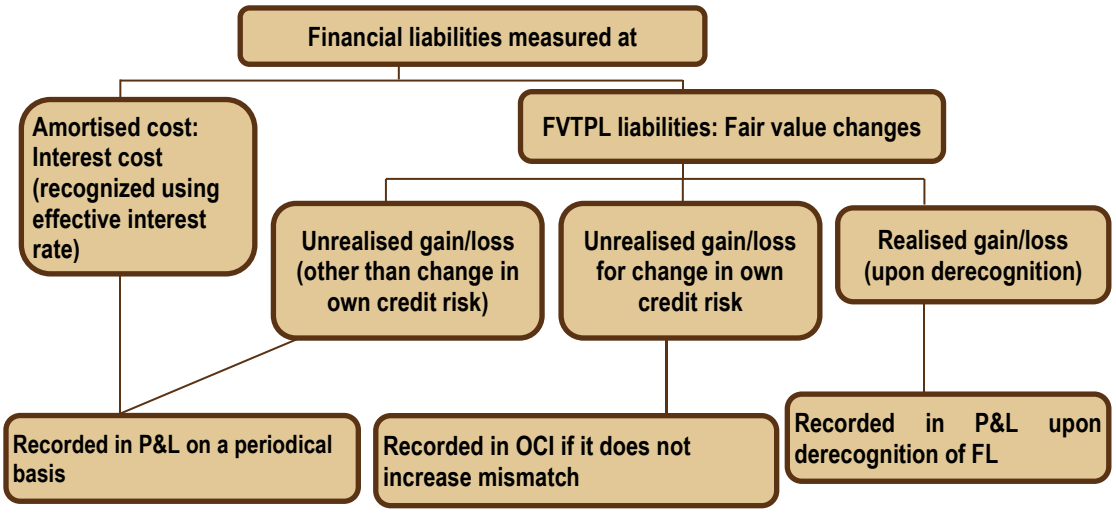
Hence, it may be appropriate to classify the entire group of fixed rate assets and fixed rate debentures at fair value through profit or loss (FVTPL).

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2.8 FINANCIAL LIABILITIES: MEASUREMENT

- Measurement of financial liabilities is driven by their classification upon initial recognition as follows:



- **Specific transactions – restructuring of financial liability**

  If the terms of a financial liability are modified substantially, resulting in an extinguishment of the old financial liability, then the old liability is derecognised and the restructured financial instrument is treated as a new financial liability. If a modification of a financial liability results in derecognition of the financial liability, then the effective interest rate of the new financial liability is calculated based on the revised terms of the financial liability at the date of the modification. In this case, any costs or fees incurred are recognised as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability.

  If the exchange or modification is not accounted for as an extinguishment, then any costs and fees incurred are recognised as an adjustment to the carrying amount of the liability. For changes in future cash flows, the entity shall revised the amortised cost of the financial liability to reflect revised future cash flows by discounting them to their present value at the original effective interest rate. The difference between the carrying value and revised amortised cost is recognized as a gain or loss in profit or loss.

  Modification is considered to be substantial if the discounted present value of the cash flows under the new terms including any fees paid net of any fees received and discounted using the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. Only fees paid or

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received between the borrower and the lender including fees paid or received by either the borrower or lender on the other's behalf are considered in this 10% test.

Illustration 31: Issue of borrowings with fixed rate of interest

A Ltd has borrowed from RBC Bank ₹ 10,000 at a fixed interest of 10% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable after 5 years in bullet repayment of principal. Details are as follows:

Particulars	*Details*
Loan amount	*₹ 10,000*
Date of loan (Starting Date)	*1-Apr-20X1*
Date of repayment of principal amount (Finishing Date)	*31-March-20X6*
Interest rate	*10.00%*
Interest charge	*Interest to be charged and paid yearly*
Upfront fees	*₹ 500*

How would loan be accounted in books of A Ltd?

Solution

The loan taken by A Ltd shall be measured at amortised cost as follows:

- Initial measurement – At transaction price less processing fees

  = 10,000 – 500 = 9,500

- Subsequently – interest to be accrued using effective rate of interest as follows:

Year end	Opening balance	Interest @ 11.42%	Repayment of interest & principal	Closing balance
1	9,500	1,085	1,000	9,585
2	9,585	1,095	1,000	9,679
3	9,679	1,105	1,000	9,785
4	9,785	1,117	1,000	9,902
5	9,902	1,098*	11,000	-

* Difference due to approximation

Computation of IRR

IRR would be the rate using which the present value of cash flow should come out to be ₹ 9,500 i.e. (₹ 10,000 less ₹ 500).

For this, we should first compute present value of cashflows using any two rates as follows:

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Year end	Opening balance	Repayment/Cashflows	Closing balance	PVF @ 10%	Present Value at 10% rate	PVF @ 13%	Present Value at 13% rate
1	9,500	1,000	8,500	0.909	909	0.885	885
2	8,500	1,000	7,500	0.826	826	0.783	783
3	7,500	1,000	6,500	0.751	751	0.693	693
4	6,500	1,000	5,500	0.683	683	0.613	613
5	5,500	11,000	(5,500)	0.621	6,830	0.543	5,970*
					10,000		**8,945**

*Difference is due to approximation

Taking 10% as discount rate, present value (PV) comes out to be ₹ 10,000.

If rate is increased by 3% over a base rate of 10%, PV decreases by ₹ 1,055 (i.e. ₹ 10,000 less ₹ 8945).

To decrease PV by ₹ 1,055, rate should be increased = 3%

To decrease PV by Re.1, rate should be increased = 3%/1,055

To decrease PV by ₹ 500, rate should be increased = 3% x (500/1,055)

= 1.42%

This would mean that the discount rate to get present value of cashflows equivalent to ₹ 9,500 should be 11.42% (i.e. 10% + 1.42%).

Illustration 32: Issue of borrowings with fixed rate of interest

A Ltd has made a borrowing from RBC Bank for ₹ 10,000 at a fixed interest of 12% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable 4 half-yearly instalments of ₹ 2,500 each. Details are as follows:

Particulars	*Details*
Loan amount	*₹ 10,000*
Date of loan (Starting Date)	*1-Apr-20X1*
Date of loan (Finishing Date)	*31-March-20X3*
Description of repayment	*Repayment of loan starts from 30-Sept-20X1 (To be paid half yearly)*
Installment amount	*₹ 2,500*
Interest rate	*12.00%*

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Interest charge	*Interest to be charged quarterly*
Upfront fees	*₹ 500*

How would loan be accounted in books of A Ltd?

Consider IRR is 16.60% p.a.

Solution

The loan taken by A Ltd shall be measured at amortised cost as follows:

- Initial measurement – At transaction price less processing fees

  = 10,000 – 500 = 9,500

- Subsequently – interest to be accrued using effective rate of interest as follows:

Date	Amount of Loan	Re-payment	Upfront fees paid	Amount of Interest	Days	IRR Calcula-tion	Revised Interest computed	Loan Balance
1-Apr-20X1	10,000	-	500	-	-	9,500	-	-
30-Jun-20X1	-	-	-	300	90	(300)	389	9,589
30-Sep-20X1	-	2500	-	300	92	(2,800)	401	7,190
31-Dec-20X1	-	-	-	225	92	(225)	301	7,266
31-Mar 20X2	-	2500	-	225	90	(2,725)	297	4,838
30-Jun-20X2	-	-	-	150	91	(150)	200	4,888
30-Sep-20X2	-	2500	-	150	92	(2,650)	204	2,442
31-Dec-20X2	-	-	-	75	92	(75)	102	2,473
31-Mar-20X3	-	2500	-	75	91	(2,575)	102	-
					IRR	**16.60%**		

*****

Illustration 33: Accounting treatment of processing fees belonging to undisbursed loan amount

X Ltd. had taken 6 year term loan in April 20X0 from bank and paid processing fees at the time of sanction of loan.

The term loan is disbursed in different tranches from April 20X0 to April 20X6. On the date of transition to Ind AS, i.e. 1.4.20X5, it has calculated the net present value of term loan disbursed upto 31.03.20X5 by using effective interest rate and proportionate processing fees has been adjusted in disbursed amount while calculating net present value.

What will be the accounting treatment of processing fees belonging to undisbursed term loan amount?

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Solution

Processing fee is an integral part of the effective interest rate of a financial instrument and shall be included while calculating the effective interest rate.

(a) Accounting treatment in case future drawdown is probable

It may be noted that to the extent there is evidence that it is probable that the undisbursed term loan will be drawn down in the future, the processing fee is accounted for as a transaction cost under Ind AS 109, i.e., the fee is deferred and deducted from the carrying value of the financial liabilities when the draw down occurs and considered in the effective interest rate calculations.

(b) Accounting treatment in case future drawdown is not probable

If it is not probable that the undisbursed term loan will be drawn down in the future, then the fees is recognised as an expense on a straight-line basis over the term of the loan.

*****

Illustration 34: Accounting treatment of prepayment premium and processing fees for obtaining new loan to prepay old loan

PQR Limited had obtained term loan from Bank A in 20X1-20X2 and paid loan processing fees and commitment charges.

In May 20X5, PQR Ltd. has availed fresh loan from Bank B as take-over of facility i.e. the new loan is sanctioned to pay off the old loan taken from Bank A. The company paid prepayment premium to Bank A to clear the old term loan and paid processing fees to Bank B for the new term loan.

Whether the prepayment premium and the processing fees both will be treated as transaction cost (as per Ind AS 109, Financial Instruments) of obtaining the new loan, in the financial statements of PQR Ltd?

Solution

(a) Accounting treatment of prepayment premium

Ind AS 109, provides that if an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment in the statement of profit and loss.

Since the original loan was prepaid, the prepayment would result in extinguishment of the original loan. The difference between the CV of the financial liability extinguished and the consideration paid shall be recognised in profit or loss as per Ind AS 109.

Accordingly, the prepayment premium shall be recognised as part of the gain or loss on extinguishment of the old loan.

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(b) Accounting treatment of unamortised processing fee of old loan

Processing fees are not amortised separately from the loan. Processing fees are part of EIR and therefore are amortised with the loan. Therefore, the accounting treatment of unamortised processing fee will be the same as for the loan that is derecognised from financial liability and recognised in profit or loss. In other words, unamortised processing fee related to the old loan will also be required to be charged to the statement of profit and loss.

(c) Accounting treatment of processing fee for new loan

Transaction costs are "Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument."

It is assumed that the loan processing fees solely relates to the origination of the new loan (i.e. does not represent loan modification/renegotiation fees). Hence, the processing fees paid to avail fresh loan from Bank B will be considered as transaction cost in the nature of origination fees of the new loan and will be included while calculating effective interest rate as per Ind AS 109.

*****

Illustration 35: Accounting treatment of share held as stock in trade

A share broking company is dealing in sale/purchase of shares for its own account and therefore is having inventory of shares purchased by it for trading.

How will these instruments be accounted for in the financial statements?

Solution

Ind AS 2, Inventories, states that this Standard applies to all inventories, except financial instruments (Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments).

Accordingly, the principles of recognising and measuring financial instruments are governed by Ind AS 109, its presentation is governed by Ind AS 32 and disclosures are in accordance with Ind AS 107, Financial Instruments: Disclosures, even if these instruments are held as stock-in trade by a company.

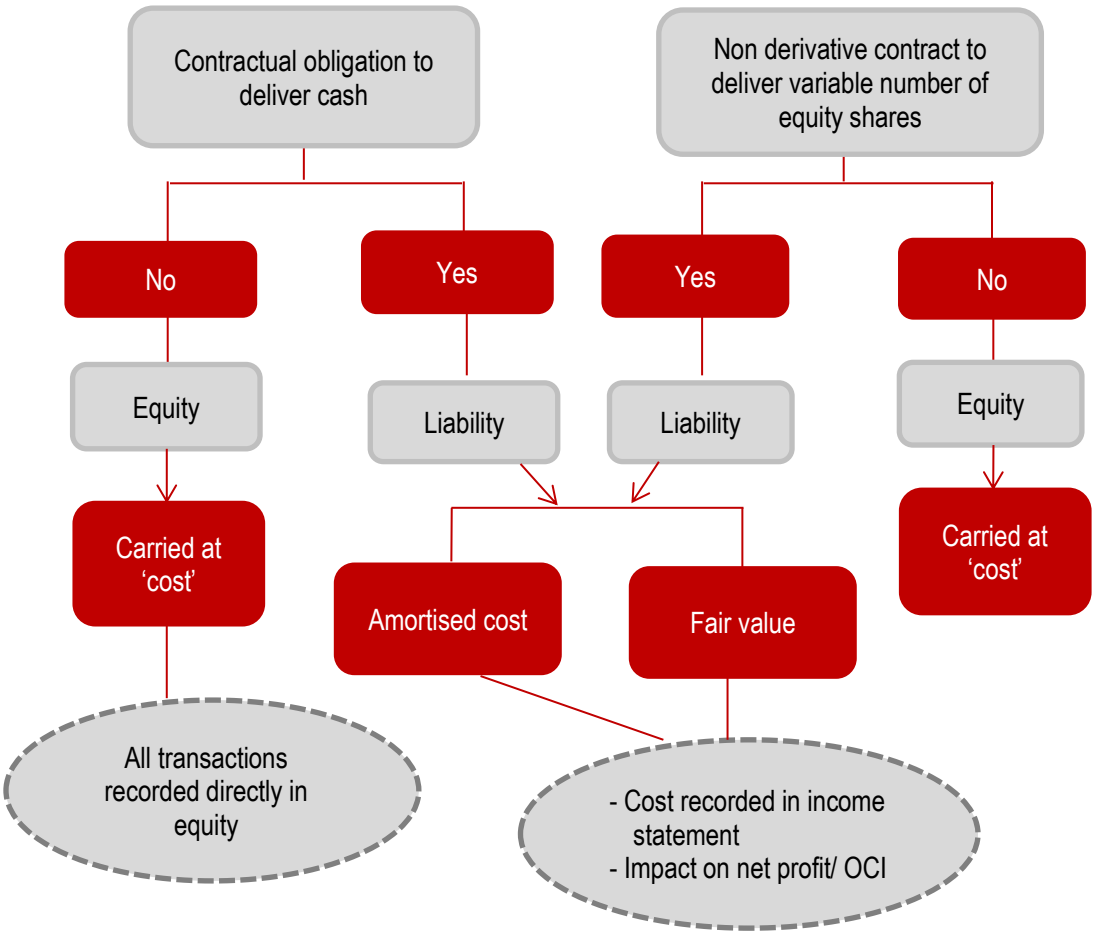
Further Ind AS 101, First-time Adoption of Indian Accounting Standards does not provide any transitional relief from the application of the above standards.

Accordingly, in the given case, the relevant requirements of Ind AS 109, Ind AS 32 and Ind AS 107 shall be applied retrospectively.

*****

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Difference between measurement requirements of financial liability and equity and their comparison can be understood with the help of following diagrammatic presentation –



2.9 RECLASSIFICATION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Per Ind AS 109.4.4.1 – An entity shall reclassify financial assets, *only* if the entity changes its business model for managing those financial assets.

- **Such changes are expected to be very infrequent.** Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line.

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- **Examples** of a change in business model include the following:

  (a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

  (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

- **Accounting for reclassification of financial assets:**

  - A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.
  - If an entity reclassifies any financial asset, it must do so **prospectively from reclassification date.**
  - The entity shall **not restate** any previously recognised gains, losses (including impairment gains or losses) or interest.

- **Following are not changes in business model:**

  (a) a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);

  (b) the temporary disappearance of a particular market for financial assets;

  (c) a transfer of financial assets between parts of the entity with different business models.

- **Following changes in circumstances are not reclassifications:**

  (a) an item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;

  (b) an item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and

  (c) changes in measurement for a financial instrument, if the entity takes credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or part of such financial instrument and consequently, the underlying financial instrument is also designated at fair value through profit or loss.

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- **Financial liabilities are not permitted to be reclassified.**

Illustrative examples:

♦ **Case 1:** Amortised cost to FVTPL

- It is measured at fair value on reclassification date.
- Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Illustration 36

Bonds for ₹ 1,00,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVTPL	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at amortised cost			1,00,000

*****

♦ **Case 2:** Amortised cost to FVOCI

- It is measured at fair value on reclassification date.
- Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income
- Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

Illustration 37

Bonds for ₹ 1,00,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	90,000	
OCI (Loss on reclassification)	Dr.	10,000	
To Bonds at amortised cost			1,00,000

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- **Case 3:** FVTPL to Amortised cost
  - It is measured at fair value on reclassification date and this fair value becomes the new gross carrying amount. Effective interest rate is computed based on this new gross carrying amount.
  - Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Illustration 38

Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at Amortised cost	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at FVTPL			1,00,000

*****

- **Case 4:** FVTPL to FVOCI
  - The financial asset continues to be measured at fair value.
  - The effective interest rate is determined on the basis of fair value of asset at reclassification date.

Illustration 39

Bonds for ₹ 100,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at FVTPL			1,00,000

*****

- **Case 5:** FVOCI to Amortised cost
  - The financial asset is measured at fair value on reclassification date.
  - However, cumulative gain or loss previously recognised in other comprehensive income (OCI) is removed from equity and adjusted against fair value of financial asset at reclassification date.

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- As a result, the financial asset is measured at reclassification date as if it had always been measured at amortised cost. This adjustment affects OCI but does not affect profit or loss and therefore, is not a reclassification adjustment.
- Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

Illustration 40

Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000 and ₹ 10,000 loss was recognised in OCI till date of reclassification. Pass required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	10,000	
To OCI - Loss on reclassification			10,000
[Being loss recognized in OCI now reversed prior to reclassification]			
Bonds (Amortised cost)	Dr.	1,00,000	
To Bonds at FVOCI			1,00,000
[Being bonds reclassified from FVOCI to Amortised cost]			

*****

♦ **Case 6:** FVOCI to FVTPL

- The financial asset continues to be measured at fair value.
- The cumulative gain or loss previously recognised in other comprehensive income (OCI) is reclassified from equity to profit or loss as a reclassification adjustment at the reclassification date.

Illustration 41

Bonds for ₹ 100,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
P&L - Loss on reclassification	Dr.	10,000	
To Bonds at FVTOCI			10,000
Bonds at FVTPL	Dr.	90,000	
To Bonds at FVOCI			90,000

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2.10 IMPAIRMENT

- **Scope of impairment**

  An entity shall recognise a loss allowance for expected credit losses on the following:

  (a) a financial asset that is measured at amortised cost

  (b) a financial asset that is measured at fair value through other comprehensive income

  (c) a lease receivable,

  (d) a contract asset or a loan commitment; and

  (e) a financial guarantee contract

- **The impairment model does not apply to:**

  (a) All financial assets that are equity instruments (because these are measured either at FVTPL or FVTOCI),

  (b) Financial assets that are debt instruments and are measured as at FVTPL,

  (c) Any other financial instrument measured as at FVTPL.

- **What is a credit loss allowance?**

  - For financial assets, a credit loss is the present value of the difference between:

    (a) the contractual cash flows that are due to an entity under the contract; and

    (b) the cash flows that the entity expects to receive (i.e,, cash short falls) discounted at original effective interest rate (or credit adjusted effective interest rate in case of purchased or originated credit-impaired financial assets).

  - An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for eg.: prepayment, extension, call and similar options) through the expected life of the financial instrument.

  - The cash flows that are considered shall include cash flows from sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of the financial instrument can be estimated reliably. In those rare cases when it is no possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

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- **Different approaches for impairment of financial assets.**

  (a) General Approach

  - The general approach requires an entity to recognise, at each reporting date, an impairment loss allowance using either 12 month ECL or lifetime ECL.
  - 12 month ECL typically results in lower impairment since it focuses only on probability of default (PD) within next 12 month period, as against PD over the life of an instrument.
  - The use of ECL depends on whether there has been a significant increase in credit risk on the instrument since its initial recognition.
  - This approach is applicable to all financial instruments covered by impairment requirements of Ind AS 109, except instruments covered in the following two approaches.

  (b) Simplified Approach

  - This approach does not require an entity to track changes in credit risk. Rather, each entity recognises impairment loss allowance based on lifetime ECLs at each reporting date, right from its initial recognition.
  - The application of simplified approach is mandatory for trade receivables or any contractual right to receive cash or another financial asset that result from transactions that are within the scope of Ind AS 115 having no significant financing component.

  (c) Purchased or originated credit-impaired (POCI) financial assets approach

  - This approach is applicable to financial assets which are credit impaired on purchase/origination.

- **What is 12-month expected credit losses and lifetime expected credit losses?**
  - Lifetime expected credit loss is the expected credit losses that result from all possible default events over the expected life of a financial instrument.
  - 12-Month expected credit loss is the portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

- **How the entity determine whether it should apply 12-month ECL or lifetime ECL?**

  The decision tree to be applied in determining whether the entity needs to provide for 12-month expected credit losses or life time expected credit losses is applied as follows:

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Three Stage Model for Impairment			
Particular	Stage 1	Stage 2	Stage 3
	Initial Recognition	Significant increase in credit risk	Credit Impaired
Credit Risk	Low	Moderate to High	Significant
ECL Model	12 Month ECL	Life-time ECL	Life-time ECL
Interest recognition	Interest on gross carrying amount	Interest on gross carrying amount	Interest on amortised cost

- **Appendix A of Ind AS 109 defines gross carrying amount of a financial asset as** the amortised cost of a financial asset, before adjusting for any loss allowance.
- **Appendix A of Ind AS 109 defines amortised cost of a financial asset or financial liability as** the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.
- **Determining whether credit risk has increased significantly:**

  Ind AS 107 defines **credit risk** as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

  - ♦ When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect the credit risk on a financial instrument.
  - ♦ The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

    (a) significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

    (b) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

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(c) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:

i. the credit spread;

ii. the credit default swap prices for the borrower;

iii. the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and

iv. other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

(d) an actual or expected significant change in the financial instrument's external credit rating.

(e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally.

(f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates

(g) an actual or expected significant change in the operating results of the borrower, for eg.: actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure, etc. that results in a significant change in the borrower's ability to meet its debt obligations

(h) significant increases in credit risk on other financial instruments of the same borrower

(i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower

(j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements;

(k) a significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion

(l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of

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credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments

(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument

(n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group

(o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.

(p) Other past due information.

- **30 days past due rebuttable presumption:**

Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

- An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due.
- When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

- **What is credit impaired financial assets:**

♦ A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

(a) Significant financial difficulty of the issuer or the borrower;

(b) Breach of contract, such as a default or past due event;

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(c) Lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;

(d) It is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

(e) the disappearance of an active market for that financial asset because of financial difficulties; or

(f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event-instead, the combined effect of several events may have caused financial assets to become credit-impaired.

- **Measurement of expected credit losses:**
  - An entity shall measure expected credit losses of a financial instrument in a way that reflects:
    (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
    (b) the time value of money; and
    (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.
  - When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.
  - The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.
  - **An entity may use practical expedients when measuring expected credit losses.**
    - An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for

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example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90–180 days past due etc).

- Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

Illustration 42 :12 month expected credit loss – Probability of default approach

Entity A originates a single 10 year amortising loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PoD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PoD are a reasonable approximation of the changes in the lifetime PoD for determining whether there has been a significant increase in credit risk since initial recognition. Loss given default (LGD) is estimated as 25% of the balance outstanding. Calculate loss allowance.

Solution

At reporting date, no change in 12-month POD and entity assesses that there is no significant increase in credit risk since initial recognition – therefore lifetime ECL is not required to be recognised.

Particulars	Details
Loan	₹ 1,000,000 (A)
LGD	25% (B)
PoD – 12 months	0.5% (C)
Loss allowance (for 12-months ECL)	₹ 1,250 (A*B*C)

*****

Illustration 43: 12 month expected credit loss – Loss rate approach

Bank A originates 2,000 bullet loans with a total gross carrying amount of CU 500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU 200, for a total gross carrying amount of CU 200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU 300, for a total gross carrying amount of CU 300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees. Calculate loss rate when

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Group	Historic per annum average defaults	Present value of observed loss assumed
X	4	CU 600
Y	2	CU 450

Solution

- Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans.
- In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss assumed	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU 200	CU 2,00,000	4	CU 800	CU 600	0.3%
Y	1,000	CU 300	CU 3,00,000	2	CU 600	CU 450	0.15%

*****

Illustration 44: Life time expected credit losses (provision matrix for short term receivables)

Company M, a manufacturer, has a portfolio of trade receivables of CU 30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with Ind AS 115. In accordance with paragraph 5.5.15 of Ind AS 109 the loss allowance for such trade receivables is always measured at an amount equal to lifetime expected credit losses.

Please use the following information of debtors outstanding:

	Gross carrying amount
Current	*CU 15,000,000*
1–30 days past due	*CU 7,500,000*
31–60 days past due	*CU 4,000,000*

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61–90 days past due	*CU 2,500,000*
More than 90 days past due	*CU 1,000,000*
	CU 30,000,000

Company M uses following default rates for making provisions:

	Current	***1–30 days past due***	***31–60 days past due***	***61–90 days past due***	***More than 90 days past due***
Default rate	*0.3%*	*1.6%*	*3.6%*	*6.6%*	*10.6%*

Determine the expected credit losses for the portfolio

Solution

To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

	Current	**1–30 days past due**	**31–60 days past due**	**61–90 days past due**	**More than 90 days past due**
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

The trade receivables from the large number of small customers amount to CU 30 million and are measured using the provision matrix.

	Gross carrying amount	**Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)**
Current	CU 15,000,000	CU 45,000
1–30 days past due	CU 7,500,000	CU 120,000
31–60 days past due	CU 4,000,000	CU 144,000
61–90 days past due	CU 2,500,000	CU 165,000
More than 90 days past due	CU 1,000,000	CU 106,000
	CU 30,000,000	**CU 580,000**

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QUICK RECAP

- The classification and measurement of financial instruments are summarized as below :

	Financial Assets			Financial Liabilities		Equity
Classification	**Amortised Cost**	**FVTOCI**	**FVTPL**	**Amortised Cost**	**FVTPL**	**-**
Basis of Classification	▪ BM test to collect ▪ SPPI test	▪ BM test to collect & sell ▪ SPPI test	▪ Held for trading (SPPI or BM test fail)	▪ Default criterial	▪ If held for trading ▪ Entity elects FVTPL (using fair value option)	-
Initial recognition	▪ Fair Value plus or minus transaction costs	▪ Fair Value plus or minus transactio n costs	▪ Fair Value	▪ Fair Value plus or minus transaction costs	▪ Fair Value	▪ Fair Value
Subsequent recognition	▪ Amortised Cost	▪ Fair Value	▪ Fair Value	▪ Amortised cost	▪ Fair Value	▪ No Re-measur ement

- Financial asset (FA) will be classified as amortised cost if the objective is to hold the financial asset in order to collect contractual cash flows and contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.
- Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest on the principal amount outstanding. Contractual cash flows must be consistent with a basic lending arrangement. In respect of Interest element, factors such as time value of money, Credit risk, Liquidity, profit margin, service or administrative costs etc. should be considered. Contractual cash flows linked to features such as changes in equity or commodity prices, would not pass the SPPI test because they introduce exposure to risks or volatility. SPPI Test will be met if there is a prepayment penalty i.e. additional compensation for early termination or extension of contract.

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- An entity may have one of the following models for its debt instruments :
  (a) Hold to collect contractual cash flows
  (b) Hold to collect contractual cash flows and selling financial assets
  (c) Other business model – Actively buying & Selling
- Financial asset (FA) in debt instruments is measured at fair value through OCI (FVTOCI) if it meets both 'Hold-to-collect and sell' business model test and 'SPPI' contractual cash flow characteristics test.
- In respect of Financial asset (FA) in equity instruments, Ind AS 109 requires all equity investments to be measured at fair value. All changes in fair value to be recognised in profit or loss. However, Entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI. Such option is available instrument by instrument i.e. (item by item) and all subsequent changes in fair value being recognised in OCI. Dividends received on equity investments to be recognised in profit or loss.
- Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument

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UNIT 3:
FINANCIAL INSTRUMENTS: EQUITY AND FINANCIAL LIABILITIES

3.1 INTRODUCTION

Ind AS 32 lays down the accounting principles for classifying a financial instrument issued by an entity as either a financial liability or equity or both (a compound instrument). The classification of a financial instrument is governed by the substance of a contract and not its legal form.

As you would see in the following paragraphs, classification of a financial instrument into financial liability or equity or compound involves analysis of each component of a contract. Incorrect classification results in misstatement of financial statements and significantly affects the financial ratios that are derived therefrom.

3.2 DEFINITIONS – FINANCIAL LIABILITY AND EQUITY

It is important to read paragraphs 11 and 16 of Ind AS 32 together to identify the accounting principles that distinguish a financial liability instrument from an equity instrument.

Before we look at the two definitions in a comparative format, it is important to highlight here that the classification of a financial instrument under Ind AS 32 is done from the perspective of the issuer and not from the perspective of the holder.

Financial liability (Ind AS 32.11)	Equity (Ind AS 32.16)
A financial instrument that fulfils **either of (A) or (B)** below: ***Condition (A)***: An instrument that **is a contractual obligation**: i. to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity	A financial instrument that fulfils **both (A) and (B)** below: ***Condition (A)***: An instrument that contains **no contractual obligation**: i. to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity

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Condition (B): An instrument that will or may be settled in the entity's own equity instruments and is: i. a non-derivative **for which the entity is or may be obliged** to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **other than by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.	***Condition (B)***: An instrument that will or may be settled in the entity's own equity instruments and is: i. a non-derivative **that includes no contractual obligation for the issuer** to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **only by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

As can be seen from the table above, the two definitions are mirror images of each other. In the following paragraphs, we will discuss each of these aspects in detail.

Importance of the phrase "contract" and "contractual"

It is important to know that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing [Ind AS 32.13]. Liabilities that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities. Accounting for income taxes is dealt with in Ind AS 12. Similarly, constructive obligations, as defined in Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets, do not arise from contracts and are not financial liabilities.

Items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset. [Ind AS 32.AG11]

It should also be remembered that the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual obligation of the guarantor to pay the lender, if the borrower defaults [Ind AS 32.AG8].

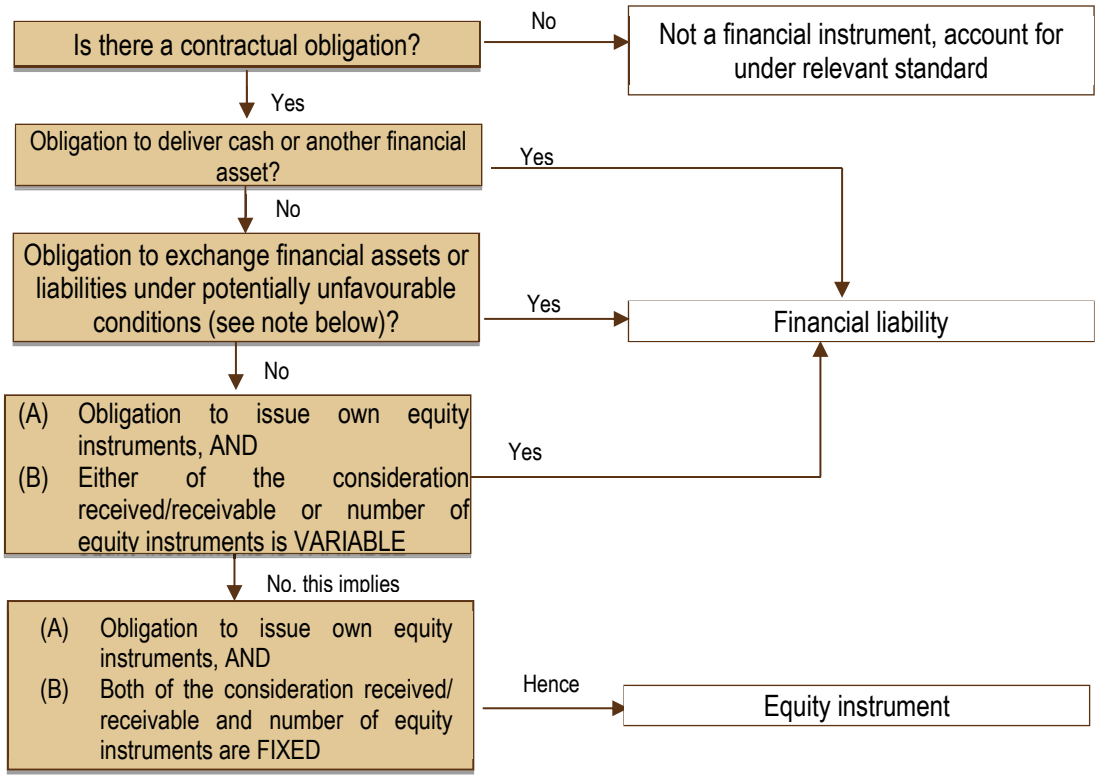
Analysis of the definitions

The following points must be remembered in determination of classification of a financial instrument as a financial liability or equity:

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- ***Evaluation of components***- it is not always that the entire instrument is either a financial liability or equity. The issuer makes this determination for each component part of a contract in accordance with 'substance' thereof and definitions given above [Ind AS 32.15].
- ***Contract is supreme -*** The evaluation of 'substance' does not override or contravene the contractual terms.
- ***Contract cannot override laws -*** The entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

The flowchart below summarises the distinction between the definitions of a financial liability and equity:



Note: Potential unfavourable conditions

Example 1

PQR Ltd. issues a call option (i.e. an option to buy) to ABC Ltd. to subscribe to PQR Ltd.'s equity shares at a price of ₹ 100 per share. The call option is to be settled on a 'net' basis i.e. without physical delivery of shares. If at the balance sheet date, market value of equity share of

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PQR Ltd. is ₹ 110 per share, PQR Ltd. will be obliged to pay ₹ 10 to settle the option. Such a condition is potentially unfavourable to PQR Ltd. and hence ₹ 10 represents a financial liability for PQR Ltd.

3.3 OBLIGATION TO DELIVER CASH

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer (Ind AS 32.17).

There are very limited exceptions to this principle in the form of "puttable instruments" and "obligations arising on liquidation". We will discuss these exceptions in the subsequent paragraphs, "Puttable instruments and obligations arising on liquidation".

The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. [Ind AS 32.18(b)]

Subject to certain exceptions as mentioned above, if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. (Ind AS 32.19)

A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. (Ind AS 32.20)

Illustration 1: Redeemable preference shares with mandatory dividend

A Ltd. (issuer) issues preference shares to B Ltd (holder). Those preference shares are redeemable at the end of 10 years from the date of issue and entitle the holder to a cumulative dividend of 15% p.a. The rate of dividend is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument provides for mandatory fixed dividend payments and redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the preference shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

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Illustration 2 : Redeemable debentures with discretionary dividend

X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

The second component of interest payable is discretion of the issuer and hence will be classified as equity. This is also discussed in detailed in the compound financial instrument section (Also refer Illustration 27 in the subsequent section).

*****

Illustration 3: Perpetual loan with mandatory interest

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

*****

Illustration 4: Restriction on the ability of an entity to satisfy a contractual obligation

Does the lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, will lead to contractual obligation?

Solution

Lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

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Illustration 5: Optionally convertible redeemable preference shares

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

*****

In the section "Compound financial instruments", we will also analyse the other component – the conversion option with the holder and we will explain the nature of the instrument in its entirety.

Illustration 6: Settlement alternative is non-financial obligation

LMN Ltd. issues preference shares to PQR Ltd. These preference shares are redeemable at the end of 5 years from the date of issue.

The instrument also provides a settlement alternative to the issuer whereby it can transfer a particular commercial building to the holder, whose value is estimated to be significantly higher than the cash settlement amount. Examine the nature of the financial instrument.

Solution

Such preference shares are financial liability because the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation.

*****

3.3.1 Puttable instruments and obligations arising on liquidation – Exceptions to classification as 'financial liability' for instruments settled in cash or another financial asset

Let us analyse this in the following two contexts:

A. Mutual funds and unit trusts, wherein the redemption amount is equal to a proportionate share in the net assets of the entity

B. Limited life entities like special purpose vehicles (SPV) for execution of an infrastructure project

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First, let us look at one definition which is relevant for our discussion – "Puttable instrument" is a financial instrument that gives the holder:

- the right to put the instrument back to the issuer for cash or another financial asset, or
- is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

[The phrase "put back to the issuer" refers to redemption of the instrument. If the holder has a right, but not an obligation to require the issuer to redeem the instrument, it is referred to as "put option".]

As discussed above, financial instruments that contain an obligation of the issuer to deliver cash or another financial asset are classified as financial liabilities. As per this principle, the following shall be classified as financial liabilities:

- Puttable instruments (see context A above in Section 3.3.1), and
- Instruments that create an obligation only on liquidation of the entity (see context B above). Liquidation may be certain to occur and outside issuer's control or uncertain to occur and at the option of holder.

However, Ind AS 32 contains an exception whereby such instruments are classified as "equity", despite the fact that they otherwise meet all the conditions for "financial liability". This exception applies if **all** of the following conditions are fulfilled by the instrument (Ind AS 32.16A, 16B, 16C and 16D):

1. It **entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation**. In other words, the instrument should not entitle its holder to a higher or lower share of entity's net assets upon liquidation.

   The logic behind this requirement is that entitlement to a pro rata share of the entity's net assets on liquidation is equivalent to having a residual interest in the assets of an entity.

Illustration 7: Cap on amount payable on liquidation

ABC Ltd. has two classes of puttable shares – Class A shares and Class B shares. On liquidation, Class B shareholders are entitled to a pro rata share of the entity's residual assets up to a maximum of ₹10,000,000.

There is no limit to the rights of the Class A shareholders to share in the residual assets on liquidation. Examine the nature of the financial instrument.

Solution

The cap of ₹ 10,000,000 means that Class B shares do not have entitlement to a pro rata share of the residual assets of the entity on liquidation. They cannot therefore be classified as equity.

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2. It is in the class of instruments that is **subordinate to all other classes of instruments**, that is, in its present form, it has no priority over other claims to the entity's assets **on liquidation** (entity will need to assume liquidation on date of classification).

Illustration 8: Investment manager's share in a mutual fund

Mutual Fund X has an Investment Manager Y. At the inception of the fund, Y had invested a nominal or token amount in units of X. Such units rank last for repayment in the event of liquidation. Accordingly, they constitute the most subordinate class of instruments. Examine the nature of the financial instrument.

Solution

The units held by Y holders are classified as equity as they are most subordinate class of instruments and will be entitled to residual interest.

However, the units held by other unit holders are classified as financial liability as they are not the most subordinate class of instruments – they are entitled to pro rate share of net assets on liquidation, and their claim has a priority over claims of Y.

It may be noted that the most subordinate class of instruments may consist of two or more legally separate types of instruments.

*****

3. (a) In case of puttable instruments, all financial instruments in the most subordinate class have **identical features**: For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

Illustration 9: Differential voting rights

T Motors Ltd. has issued puttable ordinary shares and puttable 'A' ordinary shares whereby holders of ordinary shares are entitled to one vote per share whereas holders of 'A' ordinary shares are not entitled to any voting rights. The holders of two classes of shares are equally entitled to receive share in net assets upon liquidation. Examine whether the financial instrument will be classified as equity.

Solution

Neither of the two classes of puttable shares can be classified as equity, as they do not have identical features due to the difference in voting rights. It is not possible for T Motors Ltd. to achieve equity classification of the ordinary shares by designating them as being more subordinate than the 'A' ordinary shares, as this does not reflect the fact that the two classes of share are equally entitled to share in entity's residual assets on liquidation.

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(b) In contrast to the above, in case of instruments that impose on the entity an obligation to deliver pro rata share of net assets only on liquidation, all financial instruments in the most subordinate class have such identical contractual obligation.

4. In case of puttable instruments, apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, there are **no other contractual obligations**:

- to deliver cash or another financial asset, or
- to settle in variable number of entity's own equity instruments

In other words, there are no other features of the instrument which could satisfy the definition of "financial liability".

Illustration 10: Conversion into a variable number of equity instruments

S Ltd. has issued a class of puttable ordinary shares to T Ltd. Besides the put option (which is consistent with other classes of ordinary shares), T Ltd. is also entitled to convert the class of ordinary shares held by it into equity instruments of S Ltd. whose number will vary as per the market value of S Ltd. Examine whether the financial instrument will be classified as equity.

Solution

The shares cannot qualify for equity classification in their entirety as in addition to the put option there is also a contractual obligation to settle the instrument in variable number of entity's own equity instruments.

*****

5. In case of puttable instruments, the **total expected cash flows attributable to the instrument** over the life of the instrument are based substantially on the:

- profit or loss,
- change in the recognised net assets or
- change in the fair value of the recognised and unrecognised net assets

of the entity over the life of the instrument (excluding any effects of the instrument).

In other words, if the cash flows are attributable to any factors other than the three listed above, for example, an index, the puttable instrument will fail the equity classification.

6. The issuer must have **no other financial instrument or contract** that has:

- total cash flows on same terms as (5) above, with
- the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

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The intent behind this "anti-abuse" clause is to ensure that puttable instruments are not artificially structured to satisfy conditions (1) to (5) above and at the same time the holder of that puttable instrument also holds another financial instrument or has entered into another contract with the issuer whose cash flows indirectly restrict or fix the return on puttable instrument.

However, "another financial instrument" held by or "another contract" entered into, by the holder of puttable instrument, in its capacity as non-owner of puttable instrument, does not affect the classification of the puttable instrument.

Illustration 11: Management fee contract between issuer and puttable instrument holder

P Ltd. has issued puttable ordinary shares to Q Ltd. Q Ltd. has also entered into an asset management contract with P Ltd. whereby Q Ltd. is entitled to 50% of the profit of P Ltd. Normal commercial terms for similar contracts will entitle the service provider to only 4%-6% of the net profits. Examine whether the financial instrument will be classified as equity.

Solution

The puttable ordinary shares cannot qualify for equity classification as (a) in addition to the put option, there is another contract between the issuer (P Ltd.) and holder of puttable instrument (Q Ltd.) whose cash flows are based substantially on profit or loss of issuer, (b) whose contractual terms are not similar to a contract between a non-instrument holder and issuer and (c) it has the effect of substantially restricting return on puttable ordinary shares.

*****

If the terms of asset management contract were assessed to be similar to terms of a contract between a non-instrument holder and the issuer, it would not have precluded equity classification for puttable shares, provided other conditions are met.

To summarise, the following conditions are required to be fulfilled in each of the two contexts set out at the beginning of this paragraphs:

- **Puttable instruments** (see context A above in Section 3.3.1) – conditions (1) to (6)
- **Instruments that create an obligation only on liquidation of the entity** (see context B above) – conditions (1) to (3) and condition (6).

3.3.1.1 Reclassification

- **Date of classification** of a financial instrument as an equity instrument in accordance with exceptions mentioned above – from the date when the instrument has all the features and meets the conditions set out above (Ind AS 32.16E).
- **Date of reclassification** of a financial instrument – from the date when the instrument ceases to have all the features or meet all the conditions set out above (Ind AS 32.16E).

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For example, if an entity redeems all its issued non-puttable instruments and any puttable instrument that remain outstanding have all the features and meet all the conditions mentioned above, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

- **Accounting for reclassification** (Ind AS 32.16F):

Reclassification from	Reclassification to	Measurement	Recognition of difference in carrying amount and measurement of reclassified instrument
Financial liability	Equity	Carrying value at date of reclassification	-N.A.-
Equity	Financial liability	Fair value at date of reclassification	In equity

Illustration 12 : Issue of variable number of shares against issue of CCPS

A Ltd. issued compulsorily convertible preference shares (CCPS) at ₹ 100 each (₹ 10 face value + ₹ 90 premium per share) for ₹ 10,00,000. These are convertible into equity shares at the end of 10 years, where the number of equity shares to be issued shall be determined based on fair value per equity share to be determined at the time of conversion.

Evaluate if this is financial liability or equity? What if the conversion ratio was fixed at the time of issue of such preference shares?

Solution

i. As per Ind AS 32, non-derivative contracts which will be settled against issue of variable number of own equity shares meet the definition of financial liability.

In this case, A Ltd. has issued CCPS which are convertible into variable number of shares. Hence, it is akin to use of own equity shares as currency for settlement of the liability of CCPS issued. Accordingly, it meets the definition of financial liability.

Measurement –

Initial measurement – This shall be measured at fair value on date of transaction. Since A Ltd shall give shares worth ₹ 10 lacs at the end of 10 years which is equal to the amount borrowed on day 1, the liability is recognised at fair value, determined by discounting future settlement of the borrowed amount. For difference arising on day 1 between amount borrowed and that recognised as liability using level 3 inputs, it is deferred and recognised on a systematic basis over the period of liability.

Subsequent measurement – Such liability shall be carried at fair value through profit or loss.

ii. Per Ind AS 109, a non-derivative contract that involves issue of fixed number of equity shares shall be classified as equity.

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In this case, if the conversion of CCPS was into a fixed number of equity shares at the end of 10 years, then it meets the definition of equity and hence, shall be classified as 'equity instrument'.

An equity instrument is carried at cost and no further adjustments made to its carrying value after initial recognition.

*****

3.3.2 Obligation to purchase own equity instruments

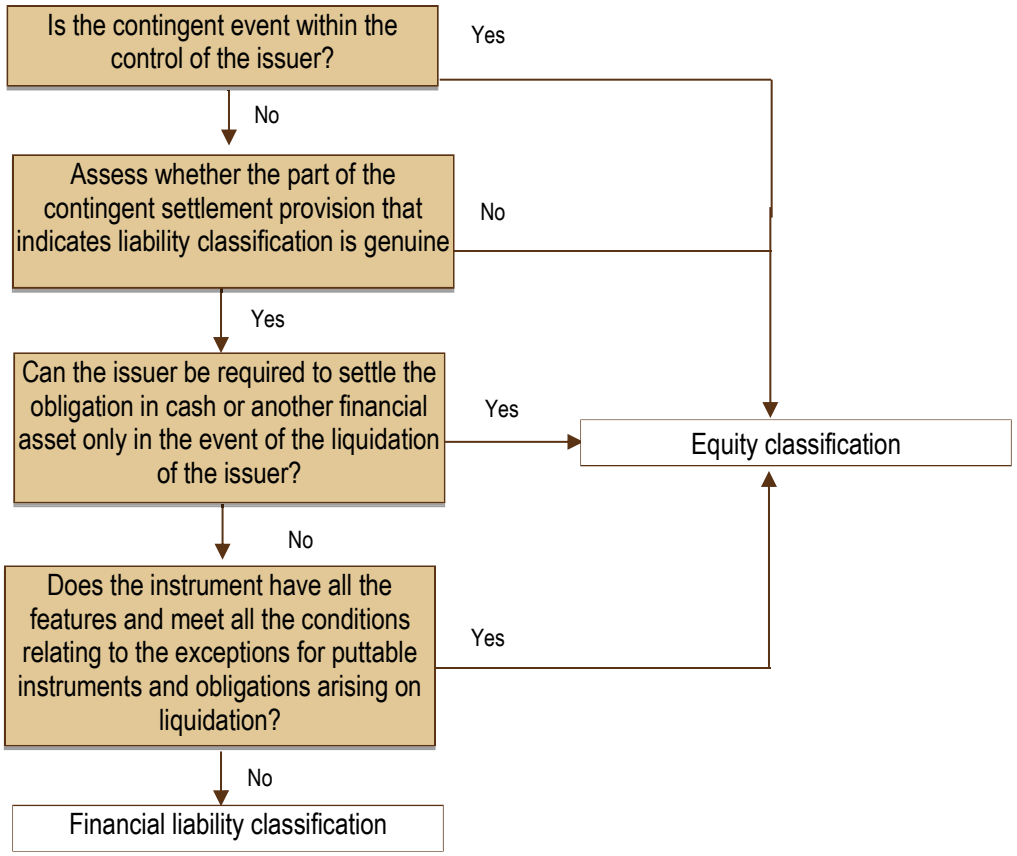
With the exception of the circumstances described above (paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32), a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount. This is the case even for derivatives over equity instruments that meet the fixed for fixed test and would be equity in the absence of this rule. (Ind AS 32.23)

3.3.3 Contingent settlement provisions

A financial instrument may require an entity to deliver cash or another financial asset, or settle it in some other way that would require it to be classified as a financial liability, but only in the event of the occurrence or non-occurrence of some uncertain future event. The 'event' may be within the control of the issuer or of the holder, or beyond the control of both. These types of contractual arrangements are referred to as 'contingent settlement provisions'.

The flowchart below explains the classification process for contingent settlement provisions:

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3.3.4 Written put options over non-controlling interests

In consolidated financial statements, an entity presents non-controlling interests — ie the interests of other parties in the equity and income of its subsidiaries – in accordance with Ind AS 1 and Ind AS 110. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.

When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole.

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To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements. (Ind AS 32.AG29)

3.4 SETTLEMENT IN ENTITY'S OWN EQUITY INSTRUMENTS

A financial instrument is classified as a liability not just when there is an obligation to deliver cash or another financial asset. It is **sometimes** so classified even when the entity's obligation is to settle the instrument through delivery of its own equity instruments.

Let us evaluate two alternate situations for an instrument that is convertible at the option of the issuer:

Illustration 13: Conversion into a number of equity instruments equivalent to a fixed value

CBA Ltd. issues convertible debentures to RQP Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into equity shares of CBA Ltd. using a pre-determined formula. The formula is:

$$\frac{100 \text{ crores } X \ (1+10\%)^{5}}{\text{Fair value on date of conversion}}$$

Examine the nature of the financial instrument.

Solution

Such a contract is a financial liability of the entity even though the entity can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. The underlying thought behind this conclusion is that the entity is using its own equity instruments 'as currency'.

*****

Illustration 14: Conversion into a fixed number of equity instruments

DF Ltd. issues convertible debentures to JL Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of ₹ 10 each.

Examine the nature of the financial instrument.

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Solution

This contract is an equity instrument because changes in the fair value of equity shares arising from market related factors do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered.

*****

From the above two situations, we can conclude as below:

- A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. **If an entity has a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation, such a contract is a financial liability**. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). (Ind AS 32.21). The number of equity instruments to be delivered could vary as a result of entity's own share price. [Ind AS 32.AG27(d)]
- **A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument**. (Ind AS 32.22)

The above requirements are summarised in the table below:

S. No.	Consideration for financial instrument	Number of own equity instruments to be issued in settlement	Classification and rationale
1	Fixed	Variable	Financial liability – own equity instruments are being used as currency to settle an obligation for a fixed amount
2	Fixed	Fixed	Equity – issuer does not have an obligation to pay cash and holder is not exposed to any variability
3	Variable	Fixed	Financial liability – though issuer does not have an obligation to pay cash, but holder is exposed to variability

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4	Variable	Variable	Financial liability – though issuer does not have an obligation to pay cash, but both parties are exposed to variability

The principle at ***serial number 2 in table above*** is also called **"fixed for fixed" test** i.e. fixed amount of cash or other financial asset for fixed number of own equity instruments.

Another point to note is a fine distinction highlighted in the definition of financial liability and equity, as mentioned in the paragraph "Definitions – financial liability and equity". Being mirror images of each other.

Illustration 15: Written option for a fixed or variable number of equity instruments

ST Ltd. purchases an option from AT Ltd. entitling the holder to subscribe to fixed number of equity shares of issuer at a fixed exercise price of ₹ 50 per share at any time during a period of 3 months. Holder paid an initial premium of ₹ 2 per option. Examine whether the financial instrument will be classified as equity.

Solution

For the issuer AT Ltd., this option is an equity instrument as it will be settled by the exchange of a fixed amount of cash for a fixed number of its own equity instruments.

If, on the other hand, if the exercise price of the option was variable, say benchmarked to an index or a variable, the written option will be classified as a "financial liability" in the books of the issuer, AT Ltd.

*****

For discussion on derivative instruments, refer Unit 4: Derivatives and Embedded derivatives.

In the above illustration, if the instrument is classified as "equity instrument", any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. It must also be noted that changes in the fair value of an equity instrument are not recognised in the financial statements. (Ind AS 32.22)

On the contrary, if the derivative instrument (i.e. the written option) is classified as "financial liability", any consideration received is measured initially at fair value and subsequently also at fair value, with fair value changes recognised in profit or loss. ***For detailed discussion on measurement of financial liabilities, refer Unit 2***.

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The chart below summarises the discussion above:

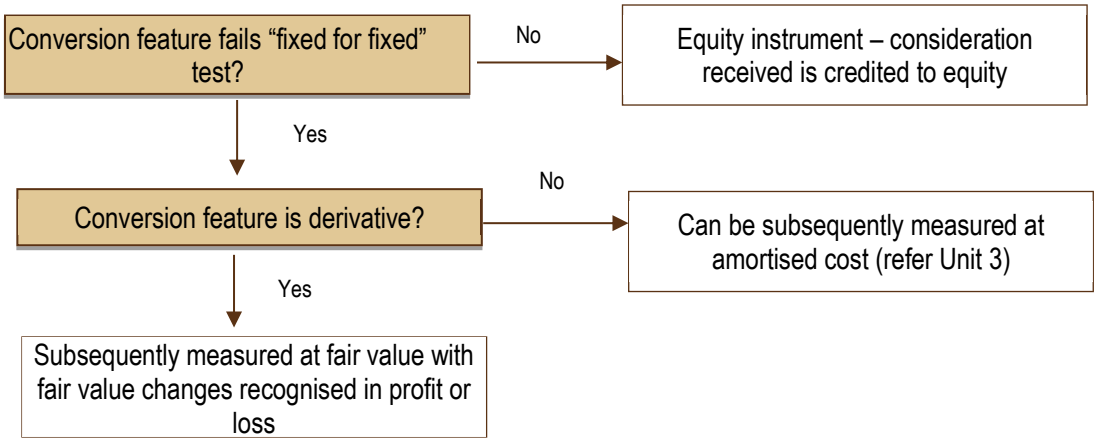


Illustration 16: Written option with multiple exercise prices

WC Ltd. writes an option in favour of GT Ltd. wherein the holder can purchase issuer's equity instruments at prices that fluctuate in response to the share price of issuer.

As per the terms, if the share price of issuer is less than ₹ 50 per share, option can be exercised at ₹ 40 per share. If the share price is equal to or more than ₹ 50 per share, option can be exercised at ₹ 60 per share. Explain the nature of the financial instrument.

Solution

As the contract will be settled by delivery of fixed number of instruments for a variable amount of cash, it is a financial liability.

*****

Illustration 17: Share swap arrangements

Acquirer Ltd. enters into an arrangement with shareholders of Target Ltd. wherein Acquirer Ltd. will purchase shares of Target Ltd. in a share swap arrangement against a variable amount of cash i.e. market value of Target Ltd.'s equity shares. The share swap ratio is agreed as 1:5 i.e. 1 equity share of Acquirer Ltd. for every 5 equity shares held in Target Ltd. Examine whether the financial instrument will be classified as equity.

Solution

Such arrangements will not meet the condition for classification as "equity instrument" since the contract will be settled by delivery of fixed number of Acquirer Ltd.'s own equity instruments against a variable amount of cash i.e. market value of Target Ltd.'s equity shares.

Such a contract will likely result in a derivative liability or asset for both the parties.

*****

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Illustration 18: Conversion ratio changes with time

On 1 January 20X1, NKT Ltd. subscribes to convertible preference shares of VT Ltd. The conversion ratio varies as below:

Conversion upto 31 March 20X1: 1 equity share of VT Ltd. for each preference share held

Conversion upto 30 June 20X1: 1.5 equity share of VT Ltd. for each preference share held

Conversion upto 31 December 20X1: 2 equity share of VT Ltd. for each preference share held.

Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, VT Ltd. The conversion ratio doesn't change corresponding to any underlying variable, it only varies in response to passage of time which is a certain event and hence fixed.

*****

Illustration 19: Conversion ratio changes to protect rights of convertible instrument holders

On 1 January 20X1, HT Ltd. subscribes to convertible preference shares of RT Ltd. The preference shares are convertible in the ratio of 1:1.

The terms of the instrument entitle HT Ltd. to proportionately more equity shares of RT Ltd. in case of a stock split or bonus issue. Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, RT Ltd. The variability in the conversion ratio is only to protect the rights of the holder of convertible instrument vis-à-vis other equity shareholders.

The conversion was always intended to be in a fixed ratio and hence the holder is exposed to the change in equity value. The variability is brought in to maintain holder's exposure in line with other holders.

*****

Illustration 20: Conversion ratio changes if issuer subsequently issues shares to others at a lower price

On 1 January 20X1, PG Ltd. subscribes to convertible preference shares of BG Ltd. at ₹100 per preference share. The preference shares are convertible in the ratio of 10:1 i.e. 10 equity shares for each preference share held. On a fully diluted basis, PG Ltd. is entitled to 30% stake in BG Ltd.

If subsequent to the issuance of these convertible preference shares, BG Ltd. issues any equity instruments at a price lower than ₹ 10 per share, conversion ratio will be changed to

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compensate PG Ltd. for dilution in its stake below the expected dilution at a price of ₹ 10 per share. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, BG Ltd. The variability in the conversion ratio underwrites the return on preference shares and not just protects the rights of convertible instrument holders vis-à-vis equity shareholders.

*****

Illustration 21: Conversion ratio is variable in a narrow range

On 1 January 20X1, NG Ltd. subscribes to convertible preference shares of AG Ltd. at ₹ 100 per preference share. On a fully diluted basis, NG Ltd. is entitled to 30% stake in AG Ltd.

The preference shares are convertible at fair value, subject to, NG Ltd.'s stake not going below 15% and not going above 40%. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, AG Ltd. The variability in the conversion ratio underwrites the return on preference shares to an extent and also restricts that return. The preference shareholder is not entitled to residual net assets of the issuer.

In certain situations, an instrument is convertible only at the option of issuer. While such instruments provide the issuer with an unconditional right to avoid payment of cash, it is important to understand the economic substance of the option. It is also very important to determine whether the option is exercised by the issuer or by shareholders acting in their capacity as instrument holders.

For example, if the convertible instrument is held by the equity shareholders of the issuer and the conversion requires unanimous consent of all the shareholders, it would be inappropriate to consider that the issuer has an unconditional right to avoid payment of cash. In this situation, it would be more relevant to consider the rights of the instrument holders in their capacity as equity shareholders of the issuer.

*****

Illustration 22: Conversion ratio changes under independent scenarios

On 1 January 20X1, STAL Ltd. subscribes to convertible preference shares of ATAL Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests in the issuer within one year

Convertible 1.5:1: if a prospectus filing is successfully completed within 2 years

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Convertible 2:1: if a binding agreement for sale of majority stake by equity shareholders is entered into within 3 years

Convertible 3:1: if none of these events occur in 3 years' time.

Examine whether the financial instrument will be classified as equity.

Solution

In this case the four events can be viewed as discrete because the achievement of each one of these can occur independently of the other (as they relate to different periods). The arrangement can therefore be considered to be economically equivalent to four separate contracts. The price per share and the amount of shares to be issued is fixed in each of these discrete periods, with each event relating to a different year and therefore a separate risk. The "fixed for fixed" test is therefore met.

The instrument is therefore classified as "equity instrument".

*****

Illustration 23: Conversion ratio changes under inter-dependent scenarios

On 1 January 20X1, RHT Ltd. subscribes to convertible preference shares of RDT Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests at an enterprise valuation (EV) of USD 100 million.

Convertible 1.5:1: if another strategic investor invests at EV of USD 150 million

Convertible 2:1: if another strategic investor invests at EV of USD 200 million

Convertible 3:1: if no strategic investment is made within a period of 3 years

Examine the nature of the financial instrument.

Solution

The four events are interdependent because the second event cannot be met without also meeting the first event, and the third event cannot be met unless the first two are met.

Therefore, this contract should be treated as a single instrument when applying the "fixed for fixed" test. The test is then failed because the number of shares to be exchanged for cash are variable.

*****

3.4.1 Settlement Options

When a derivative financial instrument gives one party a choice over how it is settled, it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument. (Ind AS 32.26)

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For instance - a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash is a financial liability.

3.4.2 Settlement by delivery of instruments that meet conditions for exceptions to classification as financial liability

If the entity's own equity instruments to be received, or delivered, by the entity upon settlement of a contract are:

- puttable financial instruments with all the features and meeting the conditions described in paragraphs 16A and 16B of Ind AS 32 (as discussed above), or
- instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation with all the features and meeting the conditions described in paragraphs 16C and 16D of Ind AS 32 (as discussed above),

the contract is a financial asset or a financial liability.

This includes a contract that will be settled by the entity receiving or delivering a fixed number of such instruments in exchange for a fixed amount of cash or another financial asset. (Ind AS 32.22A)

3.4.3 Rights issues, options or warrants to acquire entity's own equity instruments for any currency

Rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. (Ind AS 32.11).

Carve out from IFRS: Equity conversion option embedded in a foreign currency convertible bond

Ind AS 32 considers the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments as an equity instrument if the exercise price is fixed in any currency.

As per IFRS

As per accounting treatment prescribed under IAS 32, equity conversion option in case of foreign currency denominated convertible bonds is considered a derivative liability which is embedded in the bond. Gains or losses arising on account of change in fair value of the derivative need to be recognised in the statement of profit and loss as per IAS 32.

Carve out

In Ind AS 32, an exception has been included to the definition of 'financial liability' in paragraph 11 (b) (ii), whereby conversion option in a convertible bond denominated in foreign currency to

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acquire a fixed number of entity's own equity instruments is classified as an equity instrument if the exercise price is fixed in any currency.

Reasons

This treatment as per IAS 32 is not appropriate in instruments, such as, FCCBs since the number of shares convertible on the exercise of the option remains fixed and the amount at which the option is to be exercised in terms of foreign currency is also fixed; merely the difference in the currency should not affect the nature of derivative, i.e., the option. Further, the fair value of the option is based on the fair value of the share prices of the company. If there is decrease in the share price, the fair value of derivative liability would also decrease which would result in recognition of gain in the statement of profit and loss. This would bring unintended volatility in the statement of profit and loss due to volatility in share prices. This will also not give a true and fair view of the liability as in this situation, when the share prices fall, the option will not be exercised. However, it has been considered that if such option is classified as equity, fair value changes would not be required to be recognised. Accordingly, the exception has been made in definition of financial liability in Ind AS 32.

Let's understand this carve-out using an illustration:

Illustration 24: Foreign currency convertible bond

Entity A issues a bond with face value of USD 100 and carrying a fixed coupon rate of 6% p.a. Each bond is convertible into 1,000 equity shares of the issuer. Examine the nature of the financial instrument.

Solution

While the number of equity shares is fixed, the amount of cash is not. The variability in cash arises on account of fluctuation in exchange rate of INR-USD. Such a foreign currency convertible bond (FCCB) will qualify the definition of "financial liability".

However, Ind AS 32.11 provides, "the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency." Accordingly, FCCB will be treated as an "equity instrument".

But one cannot ignore the fixed coupon rate of 6% which is an obligation to deliver cash and therefore, financial liability. Accordingly, FCCBs under Ind AS 32 shall be classified as compound financial instruments if the interest liability is to be delivered in cash or shares in lieu of cash.

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3.5 COMPOUND FINANCIAL INSTRUMENTS

So far we have discussed two broad aspects of classification:

- Obligations to deliver cash – generally, instruments with such obligations are classified as "financial liability"
- Settlement in own equity instruments – generally, instruments with such provisions are classified as "equity"

There are several exceptions to the general principles stated above, as we have seen in several illustrations discussed so far.

Let us now study those instruments which have features of both a financial liability and equity instrument. Such instruments are called "compound financial instruments". This topic is aimed at discussing the accounting treatment of such instruments and practical complexities that are arise due to issuance of such instruments.

The following illustrations demonstrate the identification of separate components of a financial instrument and determining whether it is a compound financial instrument.

Illustration 25: Redeemable debentures with discretionary dividend (continued from Illustration 2)

X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

The other component, discretionary interest is an equity feature because issuer can avoid payment of cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 26: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

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Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

The other component, perpetual principal, is an equity feature because issuer is not required to pay cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 27: Optionally convertible redeemable preference shares (continued from Illustration 5)

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

The other component, conversion option with the holder, is an equity feature if the "fixed for fixed" test is satisfied. If the conversion option does not fulfil that test, say, because the conversion ratio varies in response to an underlying variable, it is a derivative liability.

Such an instrument is called a "hybrid instrument".

*****

3.5.1 Split accounting for compound financial instruments

Ind AS 109 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components:

- the equity component is assigned the residual amount i.e.
  - ♦ fair value of the instrument as a whole, *less*
  - ♦ the amount separately determined for the liability component.

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- The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.
- No gain or loss arises from initially recognising the components of the instrument separately.

(Ind AS 32.31)

In Illustrations 26 and 27 above, split accounting is performed by first determining the carrying amount of the liability component. This is done by measuring the net present value of the discounted cash flows of interest and/or principal, ignoring the possibility of exercise of the conversion option, if any. The discount rate is the market rate at the time of inception for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by perpetual principal in Illustration 26 and conversion option in Illustration 27 is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

Illustration 28: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder) for ₹ 12 lakhs. The loan is perpetual and entitles the holder to fixed interest of 8% p.a. The rate of interest commensurate with credit risk profile of the issuer is 12% p.a. Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of interest payable in perpetuity (₹ 96,000 discounted at 12%) = ₹ 800,000

Therefore, equity component = fair value of compound instrument, say, ₹ 1,200,000 less financial liability component i.e. ₹ 800,000 = ₹ 400,000.

In subsequent years, the profit and loss account is charged with interest of 12% on the debt instrument.

*****

Illustration 29: Optionally convertible redeemable preference shares (continued from Illustration 27)

On 1 July 20X1, D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a fixed

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coupon of 6% p.a. and is payable every year. The prevailing market rate for similar preference shares, without the conversion feature, is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 9% for 3 years) = ₹ 772,183

Present value of interest payable in arrears for 3 years (₹ 60,000 discounted at 9% for each of 3 years) = ₹ 151,878

Total financial liability = ₹ 924,061

Therefore, equity component = fair value of compound instrument, say, ₹ 1,000,000 less financial liability component i.e. ₹ 924,061 = ₹ 75,939.

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument.

*****

3.5.2 Separation of non-equity embedded derivatives

Sometimes, the issuer also has the option to early redeem the instrument mentioned in Illustration 29. Such an option is issuer's call option. This call option is considered an embedded derivative which is a financial liability. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. (Ind AS 32.31)

Illustration 30: Optionally convertible preference shares with issuer's redemption option

D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a coupon of RBI base rate plus 1% p.a. and is payable at the end of every year.

The prevailing market rate for similar preference shares, without the conversion feature or issuer's redemption option, is RBI base rate plus 4% p.a. On the date of contract, RBI base rate is 9% p.a.

Calculate the value of the liability and equity components.

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Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 13% for 3 years) = ₹ 6,93,050

Present value of interest payable in arrears for 3 years (₹ 100,000 discounted at 13% for each of 3 years) = ₹ 2,36,115

Paragraph AG 31 of Ind AS 32 states that a common form of compound financial instruments is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivatives features.

The liability component = Present value of principal + Present value of Interest

= ₹ 6,93,050 + ₹ 2,36,115 = ₹ 9,29,165

Equity Component = ₹ 10,00,000 – ₹ 9,29,165 = ₹ 70,835

*****

Illustration 31: Instrument convertible only at the option of issuer

XYZ Ltd. issues optionally convertible debentures with the following terms:

The debentures carry interest at the rate of 7% p.a.

Issuer has option to either:

Convert the instrument into a fixed number of its own shares at any time, or redeem the instrument in cash at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted.

The holder has no conversion or redemption options.

Debentures have a tenor of 12 years and, if not converted or redeemed earlier, will be repaid in cash at maturity, including accrued interest, if any.

Examine the nature of the financial instrument.

Solution

The issuer has the ability to convert the debentures into a fixed number of its own shares at any time. The issuer, therefore, has the ability to avoid making a cash payment or settling the debentures in a variable number of its own shares. Therefore, such a financial instrument is likely to be classified as equity.

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However, it must be noted that mere existence of a right to avoid payment of cash is not conclusive. The instrument is to be accounted for as per its substance and hence it needs to be seen whether the conversion option is substantive.

In this particular situation, the issuer will need to determine whether it is favourable to exercise the conversion option or redemption option. In case of latter, the instrument will be classified as a financial liability (a hybrid instrument, whose measurement is dealt with in a subsequent section).

Practical situations do arise wherein the issuer has an option or obligation to issue own equity instruments only in particular circumstances i.e. the instrument is contingently convertible.

*****

3.5.3 Conversion or early settlement of compound financial instruments

3.5.3.1 Conversion

Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction. (Ind AS 32.30)

On conversion of a convertible instrument at maturity, the entity:

- derecognises the liability component and
- recognises it as equity.
- original equity component remains as equity (although it may be transferred from one line item within equity to another).
- there is no gain or loss on conversion at maturity.

3.5.3.2 Early settlement

When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is

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consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued. (Ind AS 32.AG33)

In other words, the issuer:

- starts by **allocating the settlement price to the remaining liability** i.e. it determines the fair value of the remaining liability using a discount rate that is based on circumstances at the settlement date (this rate may differ from the rate used for the original allocation), and
- allocates the residual settlement amount to the equity component.

As per Ind AS 32.AG34, once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

a) the amount of gain or loss relating to the liability component is recognised in profit or loss; and

b) the amount of consideration relating to the equity component is recognised in equity.

Illustration 32: Optionally convertible redeemable preference shares (continued from Illustration 29)

The amortisation schedule of the instrument is set out below:

Dates	Cash flows	Finance cost at effective interest rate	Liability	Equity
1July 20X1	1,000,000	-	9,24,061	75,939
30 June 20X2	(60,000)	83,165	9,47,226	75,939
30 June 20X3	(60,000)	85,250	9,72,476	75,939
30 June 20X4	(10,60,000)	87,524	-	75,939

Assume that D Ltd. has an early redemption option to prepay the instrument at ₹ 11 lakhs and on 30 June 20X3, it exercises that option. At 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%. Calculate the value of the liability and equity components.

Solution

Ind AS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

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The split will be made as below:

Particulars	Amount (₹)
Present value of principal payable at 30 June 20X4 in one year's time (₹ 10 lakhs discounted at 5% for one year)	9,52,381
Present value of interest payable (₹ 60,000 discounted at 5% for one year)	57,142
Total liability component	10,09,523
Consideration paid	11,00,000
Residual – equity component	90,477

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is recognised in equity.

*****

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date.

The difference, at the date the terms are amended, between:

- the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and
- the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

3.6 TREASURY SHARES

If an entity reacquires its own equity instruments:

- Consideration paid for those instruments ('treasury shares') shall be deducted from equity. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired.
- Consideration received shall be recognised directly in equity.

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- No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments

In the consolidated financial statements, consideration for treasury shares acquired and held by other members of the consolidated group, is deducted from equity.

It may be noted that when an entity holds its own equity on behalf of others, eg a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.

3.7 INTEREST, DIVIDENDS, LOSSES AND GAINS

The accounting principles related to transactions arising consequent to recognition of financial instruments are summarised below (Ind AS 32.35-41):

- The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss.
  - ♦ Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.
  - ♦ Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.
- **Transaction costs:**
  - ♦ Equity transaction – accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.
  - ♦ Compound financial instrument – allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.
- Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12 Income Taxes
- Changes in the fair value of an equity instrument are not recognised in the financial statements.
- **Presentation:**
  - ♦ The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately in accordance with Ind AS 1.
  - ♦ Dividends classified as an expense may be presented in the Statement of Profit and Loss either with interest on other liabilities or as a separate item.

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- Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset.

3.8 OFFSETTING A FINANCIAL ASSET AND A FINANCIAL LIABILITY

In many situations, an entity has the right to receive or pay a single net amount in relation to two or more separate financial instruments and intends to do so as well.

As per Ind AS 32.42 and Ind AS 32.AG38A, a financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

a) currently has a **legally enforceable right to set off** the recognised amounts – this means that the right of set off:

   i. must not be contingent on a future event; and

   ii. must be legally enforceable in the normal course of business, in the event of default and in the event of insolvency or bankruptcy of the entity and all of the counterparties.

b) **intends** either to settle on a net basis, or to realise the asset and settle the liability simultaneously - If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion. This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle.

Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the balance sheet but also may result in recognition of a gain or loss. (Ind AS 32.44).

A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. (Ind AS 32.45).

The conditions set out above are generally not satisfied and offsetting is usually inappropriate when (Ind AS 32.49):

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a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument') - For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt:

   i. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions

   ii. Each may be transferred or settled separately.

   iii. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed.

   Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented in an entity's balance sheet on a net basis unless they meet the criteria for offsetting.

b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counter parties;

c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

QUICK RECAP

- Classification as a financial liability or as equity depends on the substance of a financial instrument rather than its legal form. The substance depends on the instrument's contractual rights and obligations.
- Liability classification - a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset or own equity shares in lieu of cash to the instrument holder
- There are certain rule-based exceptions to the basic principle for classification of an instrument as financial liability – puttable instruments and obligations arising only on liquidation
- Financial instrument containing a contingent settlement provision, under which the instrument would be classified as a financial liability on the occurrence or non-occurrence of

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some uncertain future event beyond the control of both the issuer and the holder – usually classified as a financial liability unless the part of the contingent settlement provision that indicates liability classification is not genuine; or the issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer

- Instruments which may or will be settled in an entity's own equity instruments – apply "fixed for fixed" test
- Instruments with both equity and liability features are compound instruments – equity and liability components are accounted for separately ('split accounting')
- Split accounting involves first calculating the fair value of the liability component. The equity component is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole
- Subsequent changes in the value of the equity instruments are not recognised in the financial statements.
- The accounting implication of classification of a financial instrument as a financial liability or equity is given in table below:

Accounting aspect	Financial liability	Equity instrument
Re-measurement standard	Ind AS 109	Generally, not re-measured after initial measurement
Recognition of interest, dividends, losses and gains	Profit or loss	Retained earnings
Recognition of transaction costs	Included in calculation of effective interest rate and amortised over expected life of the instrument	Deduction from equity

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UNIT 4:
DERIVATIVES AND EMBEDDED DERIVATIVES

4.1 INTRODUCTION

Derivatives may exist as standalone financial instruments or may be embedded in other financial or non-financial instruments.

In Unit 3 of this chapter, we analysed the definitions of financial liability and equity. Both these definitions envisage situations in which an instrument is settled by exchange of own equity instruments which are derivatives. To be specific, let's reproduce the relevant portion of these definitions and set the context of discussion for this paragraph in terms of this situation.

Financial liability

A financial instrument that fulfils **either** of (A) or (B) below:

(A) .....

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) .....

(ii) **a derivative** that will or may be settled **other than by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Equity

A financial instrument that fulfils both (A) and (B) below:

(A) .....

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) .....

(ii) **a derivative** that will or may be settled **only by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

4.2 DEFINITION

4.2.1 Derivatives

Ind AS 109.Appendix A defines a derivative as a financial instrument or other contract with all of the following three characteristics:

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i. **Value changes due to an underlying**: its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided **in the case of a non-financial variable that the variable is not specific to a party to the contract** (sometimes called the 'underlying');

Examples of common derivative contracts and the identified underlying variable:

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity of another entity)
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity of another entity)

The definition of derivative excludes contracts which fulfil following two conditions:

- Value of the contract changes with reference to one or more non-financial variables; and

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- That non-financial variable is specific to one of the parties to the contract.

As per paragraph BA.5 of Ind AS 109, a change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable).

Examples of non-financial variables that are not specific to a party to the contract are an index of earthquake losses in a particular region and an index of temperatures in a particular city.

Non-financial variables specific to a party to the contract include:

- the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract
- residual value of an asset which changes in response to changes in the asset's physical condition

Derivatives give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. Because the terms of the exchange are determined at inception, as prices in the financial markets change, those terms may become favourable or unfavourable.

A derivative usually has a notional amount, which can be an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. The changes in value of a derivative are measured corresponding to the notional amount. Refer illustration 1 and 2 below.

ii. **No or little initial net investment**: it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

Illustration 1: Prepaid interest rate swap (fixed rate payment obligation prepaid at inception)

Entity S enters into a ₹ 100 crores notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C.

- *The interest rate of the variable part of the swap is reset on a quarterly basis to three-month Mumbai Interbank Offer Rate (MIBOR).*
- *The interest rate of the fixed part of the swap is 10% p.a.*
- *Entity S prepays its fixed obligation under the swap of ₹ 50 crores (₹ 100 crores × 10% × 5 years) at inception, discounted using market interest rates*

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- *Entity S retains the right to receive interest payments on the ₹ 100 crores reset quarterly based on three-month MIBOR over the life of the swap.*

Analyse.

Solution

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond.

Therefore, the contract fulfils the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'.

Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

*****

Illustration 2: Prepaid pay-variable, receive-fixed interest rate swap

- *Entity S enters into a ₹ 100 crores notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C.*
- *The variable leg of the swap is reset on a quarterly basis to three-month MIBOR.*
- *The fixed interest payments under the swap are calculated as 10% of the swap's notional amount, i.e. ₹ 10 crores p.a.*
- *Entity S prepays its obligation under the variable leg of the swap at inception at current market rates. Say, that amount is ₹ 36 crores.*
- *It retains the right to receive fixed interest payments of 10% on ₹ 100 crores every year.*

Analyse.

Solution

In effect, this contract results in an initial net investment of ₹ 36 crores which yields a cash inflow of ₹ 10 crores every year, for five years. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions.

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For this reason, the instrument fails the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'. Therefore, the contract is not accounted for as a derivative contract.

*****

Illustration 3: Prepaid forward

Entity XYZ enters into a forward contract to purchase 1 million ordinary shares of Entity T in one year

- *The current market price of T is ₹ 50 per share*
- *The one-year forward price of T is ₹ 55 per share*
- *XYZ is required to prepay the forward contract at inception with a ₹ 50 million payment.*

Analyse.

Solution

Purchase of 1 million shares for current market price is likely to have the same response to changes in market factors as the contract mentioned above. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

*****

iii. **Future settlement**: it is settled at a future date.

However, it is not relevant whether the derivative is settled gross or not. For example, an interest rate swap is a derivative instrument, whether the counterparties pay interest to each other or settle it on a net basis.

Further, an option, say a call option i.e. a right to purchase shares at a fixed price at a certain date in future, may expire unexercised at maturity because it is 'out of money'. Such a contract is still a derivative contract because expiry at maturity is also a form of settlement even though there is no exchange of consideration eventually.

Illustration 4

Entity ABC Ltd., whose functional currency is Indian Rupees, sells products in France denominated in Euro. ABC enters into a contract with an investment bank to convert Euro to Indian Rupees at a fixed exchange rate. The contract requires ABC to remit Euro based on its sales volume in France in exchange for Indian Rupees at a fixed exchange rate of 80.00. Is that contract a derivative?

Solution

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales); no initial net investment or an initial net investment that is smaller than would be

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required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision.

*****

Illustration 5

The definition of a derivative requires that the instrument "is settled at a future date". Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Solution

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

*****

Accounting for derivatives

All derivatives are measured at fair value with changes in fair value being recognized in profit and loss for the period, except derivatives that qualify as hedging instruments. Accounting for derivatives that qualify as hedging instruments is dealt with in the Hedge Accounting chapter.

Illustration 6

Silver Ltd. has purchased 100 ounces of gold on 10 March 20X1. The transaction provides for a price payable which is equal to market value of 100 ounces of gold on 10 April 20X1 and shall be settled by issue of such number of equity shares as is required to settle the aforementioned transaction price at ₹ 10 per share on 10 April 20X1. Whether this is classified as liability or equity? Own use exemption does not apply.

Solution

In the above scenario, there is a contract for purchase of 100 ounces of gold whose consideration varies in response to changing value of gold. Analysing this contract as a derivative –

(a) Value of contract changes in response to change in market value of gold;

(b) There is no initial net investment

(c) It will be settled at a future date, i.e. 10 April 20X1.

Since the above criteria are met, this is a derivative contract.

Now, a derivative contract that is settled in own equity other than exchange of fixed amount of cash for fixed number of shares is classified as 'liability'. In this case, since the contract results in issue of variable number of shares based on transaction price to be determined in future, hence, this shall be classified as 'derivative financial liability'.

Per Ind AS 109.4.2.1 – A derivative financial liability shall be carried at fair value through profit or loss.

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Illustration 7 : Derivative contract:

Entity – B Ltd writes an option contract for sale of shares of Target Ltd. at a fixed price of ₹ 100 per share to C Ltd. This option is exercisable anytime for a period of 90 days ('American option'). Evaluate this under the definition of financial instrument.

Solution

In the above case – B Ltd has written an option, which if exercised by C Ltd. will result in B Ltd. selling equity shares of Target Ltd. for fixed price of ₹ 100 per share. Such option will be exercised by C Ltd. only if the market price of shares of Target Ltd. increases beyond ₹ 100, thereby resulting in contractual obligation over B Ltd. to settle the contract under potential unfavorable terms.

If the market price goes to ₹ 120 then the option will be exercised by C Ltd. So, B Ltd has to buy shares from the market at ₹ 120 per share and sell at ₹ 100, thereby resulting in a loss or exchange at unfavorable terms to B Ltd. Hence, the option will meet the definition of financial liability in the books of B Ltd.

The additional question that arises here is the nature of this financial liability and whether it meets the definition of derivative. A derivative is a financial instrument that meets following conditions:

(a) Its value changes in response to change in specified variable like interest rate, equity index, commodity price, etc. If the variable is non-financial, it is not specific to party to the contract

(b) It requires no or little initial net investment

(c) It is settled at a future date.

Evaluating the above instrument, B Ltd. has written an option whose value changes based on change in market price of equity share, it requires no initial net investment and is settled at a future date (anytime in 90 days). Hence, it meets definition of derivative financial liability in books of B Ltd.

*****

Illustration 8: Derivative contract to be settled in own equity instruments

A Ltd. issues warrants to all existing shareholders entitling them to purchase additional equity shares of A Ltd. (with face value of ₹ 100 per share) at an issue price of ₹ 150 per share. Evaluate whether this constitutes an equity instrument or a financial liability?

Solution

In this case, Company A Ltd. has issued warrants entitling the shareholders to purchase equity shares of the Company at a fixed price. Hence, it constitutes a contractual arrangement for issuance of fixed number of shares against fixed amount of cash.

Now, evaluating this contract under definition of derivative –

(i) The value of warrant changes in response to change in value of underlying equity shares;

(ii) This involves no initial net investment

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(iii) It shall be settled at a future date.

Hence, this warrant meets the definition of derivative.

Applying definition of equity under Ind AS 32, a derivative contract that will be settled by exchange of fixed number of equity shares for fixed amount of cash meets definition of equity instrument. The above contract is derivative contract that will be settled by issue of fixed number of own equity instruments by A Ltd. for fixed amount of cash and hence meets definition of equity instrument.

*****

4.2.2 Embedded derivatives

Paragraph 4.3.1 of Ind AS 109 defines an embedded derivative as:

"An embedded derivative is:

- a **component** of a hybrid contract
- that also includes a **non-derivative host**
- with the effect that **some** of the **cash flows** of the combined instrument **vary** in a way **similar to a stand-alone derivative**.

An embedded derivative **causes**:

- some or all of the **cash flows** that otherwise would be **required by the contract**
- to be **modified** according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable,
- provided **in the case of a non-financial variable** that the **variable is not specific to a party** to the contract.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument."

Examples 1 - 3 of embedded derivatives:

1. Company MNL Ltd. holds a bond which is convertible into the ordinary shares of Company Z Ltd. The hybrid contract is the convertible bond; the host contract is the bond asset; the embedded derivative is the conversion option.
2. 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.
3. 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 ₹/USD forward.

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Illustration 9

A lease contract contains a provision that rentals increase each year by ₹ 3 million. Is there an embedded derivative in this contract?

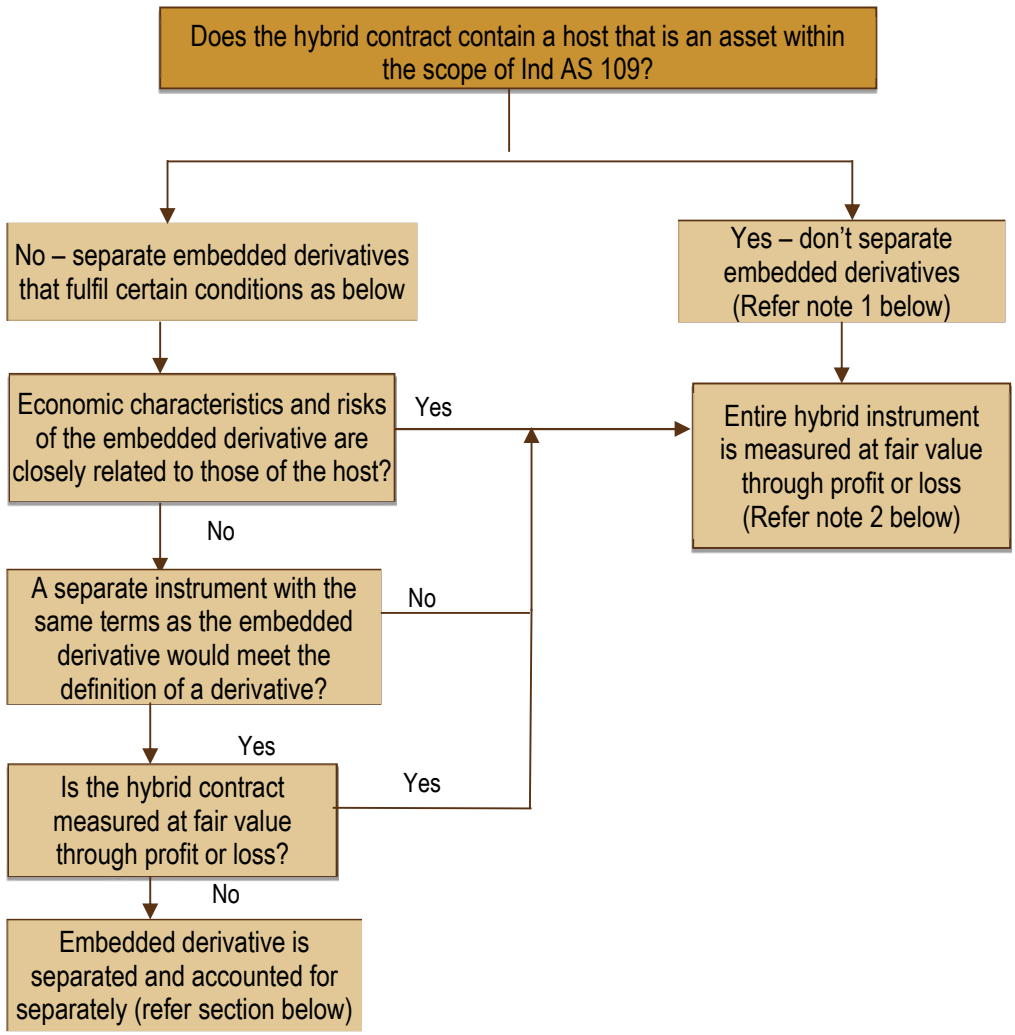
Solution

The price adjustment feature does not meet the definition of a derivative on a stand-alone basis since its value does not change in response to changes of some underlying. There is no underlying in this case; hence there is no embedded derivative in the lease contract.

*****

4.2.2.1 Separation of embedded derivatives from host contract

In certain circumstances, an embedded derivative is required to be separated from the host contract and accounted for separately as a financial instrument. The flowchart below analyses those circumstances:



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Note 1: This implies that embedded derivatives are permitted to be separated from only such hybrid contracts that contain a host which is either a (a) financial instrument classified as financial liability or equity or compound; or (b) contract for purchase or sale of a non-financial item.

Note 2: If both the host and embedded derivative have economic characteristics of an equity instrument, the hybrid instrument is not carried at fair value through profit or loss. In other words, this measurement category is applicable only for host contracts which are financial liabilities.

4.2.2.2 Economic characteristics and risks of the embedded derivative – whether closely related to those of the host?

Paragraphs B4.3.5 and B4.3.8 of Ind AS 109 provide examples of situations in which economic characteristics of the embedded derivative are considered to be closely related or not closely related to those of the host.

Some of these examples are explained below, though students are advised to understand all the examples given in the application guidance of the standards.

1. Underlying indices

Illustration 10: Debt instrument with indexed repayments

Entity X issues a redeemable fixed interest rate debenture to Entity Y. Amount of interest and principal is indexed to the value of equity instruments of Entity X.

Analyse

Solution

In the given case, the host is a fixed interest rate debt instrument. The economic characteristics and risks of a debt instrument are not closely related to those of an equity instrument.

Hence, the exposure of this hybrid instrument to changes in value of equity instruments is an embedded derivative which is required to be separated.

The response above will not change even if the interest payment and principal repayments are indexed to a commodity index or similar underlying.

*****

Illustration 11: Lease contracts dependent on inflation index

A lease contract, between two Indian companies of an asset in India, includes contingent lease rentals that are dependent upon an US inflation index. Can the entity treat inflation linked features as closely related?

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Solution

For inflation linked features, an embedded derivative in a lease contract is considered as closely related to the host if it is an inflation—related index related to inflation in the entity's own economic environment.

In this case, whilst the asset and the lessor and lessee are located in India, lease payment are linked to US index. Hence, embedded derivative is not closely related and needs to be separated.

*****

Illustration 12: Lease contracts dependent on inflation index

As per the contract entered between lease and lessor, lease rentals will increase by ₹ 3 million, if profit after tax is over ₹ 200 million. Can the entity treat inflation linked features as closely related?

Solution

No. Whilst contingent rentals based on sales are closely related to a host lease contract, the same is not true of contingent rentals based on profit after tax.

*****

2. Prepayment options in debt instruments

It is very common to have debt prepayment options in ordinary borrowing arrangements. Paragraph B4.3.5(e) of Ind AS 109 provides the guidance in this respect:

"A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

i. the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract;

or

ii. the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with Ind AS 32."

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Ind AS 109 does not interpret the term "approximately equal". Management of entities will need to adopt a consistent accounting policy to apply this principle in general.

Illustration 13: Debt instrument with prepayment option

Entity PQR borrows ₹ 100 crores from CFDH Bank on 1 April 20X1. Interest is payable at 12% p.a. and there is a bullet repayment of principal at the end of the term.

Term of the loan is 6 years.

The loan includes an option to prepay the loan at 1st April each year with a prepayment penalty of 3%. There are no transaction costs. Without the prepayment option, the interest rate quoted by bank is 11% p.a.

Analyse

Solution

Step 1: Identify the host contract and embedded derivative, if any

In the given case,

- Host is a debt instrument comprising annual interest payment at 12% p.a. and bullet principal repayment at the end of 6 years.
- Option to prepay the debt at ₹ 103 crores is an embedded derivative

Step 2: Determine the amortised cost of the host debt instrument

Whether the prepayment option is likely to be exercised or not, the amortised cost of the host debt instrument should be calculated as present value (PV) of expected cash flows using a fair market interest rate for a debt without the prepayment option (11% p.a. in this case). This is calculated below as ₹ 104.23 crores:

Year	Cash outflow	PV @ 11% p.a.	Finance cost	Amortised cost
	₹ crores			
1	12.00	10.81	11.46	103.68
2	12.00	9.74	11.41	103.09
3	12.00	8.77	11.34	102.43
4	12.00	7.90	11.27	101.70
5	12.00	7.12	11.20	100.90
6	112.00	59.88	11.10	-
		104.22	**67.78**	

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Step 3: Compare the exercise price of the prepayment option with the amortised cost of the host debt instrument

Year	Amortised cost	Exercise price of prepayment option	Difference
	₹ Crores		
1	103.68	103.00	0.7%
2	103.09	103.00	0.1%
3	102.43	103.00	-0.6%
4	101.70	103.00	-1.3%
5	100.90	103.00	-2.1%
6	-	N/A	

The management of Entity PQR may formulate an appropriate accounting policy to determine what constitutes "approximately equal". In this case, if the management determines that a difference of more than 2% will indicate that the option's exercise price is not approximately equal to the amortised cost of the host debt instrument, it will need to separate the embedded derivative and account for it as per principles given in the subsequent sub-section.

It may be questioned as to why an option to repay a fixed rate loan early meets the definition of embedded derivative. Let us revisit an important phrase from the definition of embedded derivative:

"...some or all of the cash flows that otherwise would be required by the contract to be modified..."

In the context of a fixed rate debt, it may be interpreted that:

- the option affects cash flows only if exercised; and
- the cash flows of a fixed rate debt do not vary with interest rates.

However, in this context, a variation in cash flows should be interpreted as a possible change in the fair value of expected cash flows. Accordingly, the option's expected cash flows vary according to interest rates in a similar way as a separate option to purchase a fixed rate debt asset at a fixed price. A fixed price option to prepay a fixed rate loan will increase in value as interest rates decline (and vice versa).

*****

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3. Foreign currency derivative embedded in contract for purchase or sale of non-financial items

Another common situation in trade and commerce in today's world is a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency. Paragraph B4.3.8(d) provides following guidance in this respect.

"An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

i. the functional currency of any substantial party to that contract;

ii. the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

iii. a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade)."

The functional currencies of the parties should be determined in accordance with the definition and guidance in Ind AS 21.9 to 13.

Unless the above exceptions apply, the embedded foreign currency derivative should be separated from the host contract. Certain guidance on how to carry out the separation are enumerated below in detail:

1. the host contract is a sale or purchase contract denominated in the functional currency of the reporting entity

2. the amount of functional currency is determined using the relevant forward exchange rate (to the date of delivery) at the date the contract is entered into

3. the embedded derivative is a forward currency contract to buy or sell the applicable amount of the contract currency for the functional currency, at the same forward exchange rate. The effect is that the fair value of the embedded derivative is initially zero

4. subsequent changes in the fair value of the embedded derivative are recorded in profit or loss

5. on delivery of the non-financial item, the host contract is fulfilled and the embedded derivative is effectively settled. A foreign currency debtor or creditor is recognised for the contract amount, translated at the spot rate in accordance with Ind AS 21.23(a). The

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closing carrying amount of the embedded derivative is added to the functional currency amount of the host contract to give the initial carrying amount of the debtor or creditor.

4. Option and non-option based derivatives

A. Non-option based derivatives

The terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid contract. Non-option based derivatives represent obligations of the counterparties to a contract.

Fair value of a financial instrument is a combination of its intrinsic value and time value. In a fair and perfect market, it would be inappropriate to conclude that immediately at the inception of a contract, it results in creation of rights and obligations for two independent parties i.e. the contract has no intrinsic value at inception. Also, the time value starts accumulating only after the first day of the contract.

The standard specifies that if it were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid contract.

Further, in the case of non-option based derivatives, terms of the host debt instrument reflect the (a) stated or (b) implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement of the terms.

B. Option based derivatives

The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or exercise price) specified for the option feature in the hybrid contract. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, options or swap feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract (unlike a non-option based derivative which is separated on the basis of implied terms also). As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a

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zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price of the underlying variable at the initial recognition of the hybrid contract.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid contract. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid contract, that amount would essentially represent a borrowing or lending. Accordingly, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid contract.

4.2.2.3 Accounting for embedded derivatives

If the flowchart given in paragraph "Separation of embedded derivatives" results in the conclusion that the embedded derivatives are required to be separated, an entity shall measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss. *[Paragraph 4.3.4 of Ind AS 109]*

The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative. *[Paragraph B4.3.3 of Ind AS 109]*

As per paragraph 4.3.5 of Ind AS 109, if a contract contains one or more embedded derivatives and the host is not a financial asset, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

i. the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or

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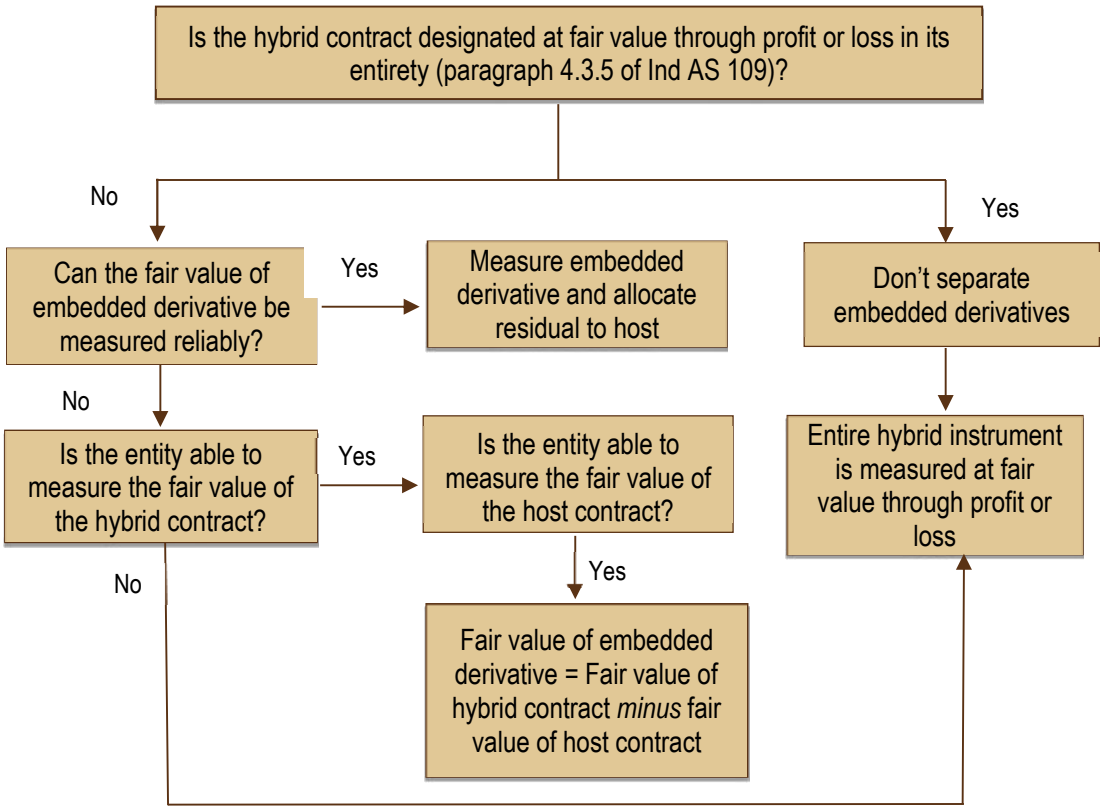
ii. it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

These are two exceptions to the general principle that hybrid contracts can be measured at fair value in their entirety, without separation of embedded derivatives. ***Refer explanation below for interpretation of the phrase "significantly modify cash flows" mentioned above***.

Further, as per paragraph 4.3.6 of Ind AS 109, if an entity is required to separate an embedded derivative from its host (as per flowchart presented earlier in this paragraph), but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.

If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, the hybrid contract is designated as at fair value through profit or loss.

To conclude, picking up from the flowchart presented earlier in this paragraph, the accounting implications are demonstrated in the flow chart below:



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Reassessment of Embedded Derivatives

An entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract.

Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

Illustration 14: Contracts for purchase or sale of non-financial item

Key terms of contracts to buy/sell non-financial items

Company Z is engaged in the business of importing oil seeds for further processing as well as trading purposes. It enters into the following types of contracts as on 1 October 20X1:

Particulars	Contract 1	Contract 2	Contract 3
Nature of Contract	Import of oil seeds from a foreign supplier	Purchase of oil seeds from a domestic producer / supplier	Contract to sell oil seeds on the commodity exchange
Quantity and rate	100 MT at USD 400 per MT to be delivered as on 31 March 20X2	50 MT at ₹ 30,000 per MT to be delivered as on 31 January 20X2	50 MT at USD 450 per MT, maturing as on 15 January 20X2
Net settlement clause included in the contract	Yes	Yes	Yes
Net settlement in practice for similar contracts	There have also been several instances of the oil seeds being sold prior to or shortly after taking delivery. These instances of net settlement constitute approximately 30 per cent of the value of total import contracts.	Yes – company Z has net settled some of the domestic purchase contracts. However, these instances constitute only 1 per cent of the total domestic purchase contracts in value. The remaining contracts are settled by taking delivery of oil seeds which are used for further processing.	Yes – these contracts are required to be net settled with the exchange on the maturity date. Company Z enters into these types of derivative contracts to hedge the risks on its domestic oil seeds purchase contracts

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Company Z is required to determine if the contracts entered into for purchase and sale of oil seeds are derivatives within the scope of Ind AS 109 or are executory contracts outside the scope of Ind AS 109.

Solution

Contract 1:

The following factors indicate that this contract does not meet the 'own use' exemption:

- The contract permits net settlement, and
- There is a past practice of a significant proportion (30 per cent in this illustration) of similar contracts being settled on a net basis either in cash or by sale of the oil seeds prior to delivery/shortly after taking delivery.

Therefore, this contract would fall within the scope of Ind AS 109 and should be recognised as a derivative instrument as on 1 October 20X1. The contract would be in the nature of a forward contract to buy 100 MT of oil seeds as on 31 March 20X2 at USD 400 per MT. Company Z would have to recognise the fair value changes (based on change in forward purchase rate) on this contract in the statement of profit and loss at each reporting date.

Contract 2

Contract 2 also permits net settlement in cash. Further, there have been some instances of similar domestic purchase contracts being settled net in cash in the past. However, these have been infrequent in nature and insignificant in proportion to the total value of similar contracts (i.e.1 percent in this illustration).

Company Z is in the practice of taking delivery of the oil seeds purchased under similar contracts and using them for further processing in its plants.

This indicates that the domestic purchase contract meets the criteria for the 'own-use' exemption and should be considered as an executory contract.

Therefore, this contract would not fall within the scope of Ind AS 109.

Contract 3

This contract is in the nature of a derivative contract transacted on a commodity exchange and is required to be net settled in cash on maturity. Therefore, this derivative contract would be covered by Ind AS 109 and required to be classified and measured at FVTPL.

*****

Illustration 15: Foreign currency embedded derivatives

Company A, an Indian company whose functional currency is ₹, enters into a contract to purchase machinery from an unrelated local supplier, company B. The functional currency of company B is also ₹. However, the contract is denominated in USD, since the machinery is sourced by company B from a US based supplier. Payment is due to company B on delivery of the machinery.

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Key terms of the contract:

Contractual features	Details
Contract/order date	9 September 20X1
Delivery/payment date	31 December 20X1
Purchase price	USD 1,000,000
USD/₹ Forward rate on 9 September 20X1 for 31 December 20X1 maturity	67.8
USD/₹ Spot rate on 9 September 20X1	66.4
USD/₹ Forward rates for 31 December, on:	
30 September	67.5
31 December (spot rate)	67.0

Company A is required to analyse if the contract for purchase of machinery (a capital asset) from company B contains an embedded derivative and whether this should be separately accounted for on the basis of the guidance in Ind AS 109. Also give necessary journal entries for accounting the same.

Solution

Based on the guidance above, the USD contract for purchase of machinery entered into by company A includes an embedded foreign currency derivative due to the following reasons:

- The host contract is a purchase contract (non-financial in nature) that is not classified as, or measured at FVTPL.
- The embedded foreign currency feature (requirement to settle the contract by payment of USD at a future date) meets the definition of a stand-alone derivative – it is akin to a USD-₹ forward contract maturing on 31 December 20X1.
- USD is not the functional currency of either of the substantial parties to the contract (i.e., neither company A nor company B).
- Machinery is not routinely denominated in USD in commercial transactions around the world. In this context, an item or a commodity may be considered 'routinely denominated' in a particular currency only if such currency was used in a large majority of similar commercial transactions around the world. For example, transactions in crude oil are generally considered routinely denominated in USD. A transaction for acquiring machinery in this illustration would generally not qualify for this exemption.
- USD is not a commonly used currency for domestic commercial transactions in the economic environment in which either company A or B operate. This exemption generally applies when the business practice in a particular economic environment is to use a more stable or liquid foreign currency (such as the USD), rather than the local currency, for a majority of internal or cross-border transactions, or both. In the illustration above, companies A and B are companies operating in India and the purchase contract is an internal/domestic transaction. USD is not a commonly used currency for internal trade

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within this economic environment and therefore the contract would not qualify for this exemption.

Accordingly, company A is required to separate the embedded foreign currency derivative from the host purchase contract and recognise it separately as a derivative.

The separated embedded derivative is a forward contract entered into on 9 September 20X1, to exchange USD 10,00,000 for ₹ at the USD/₹ forward rate of 67.8 on 31 December 20X1. Since the forward exchange rate has been deemed to be the market rate on the date of the contract, the embedded forward contract has a fair value of zero on initial recognition.

Subsequently, company A is required to measure this forward contract at its fair value, with changes in fair value recognised in the statement of profit and loss. The following is the accounting treatment at quarter-end and on settlement:

Accounting treatment:

Date	Particulars	Amount (₹)	Amount (₹)
09-Sep-X1	***On initial recognition of the forward contract***		
	(No accounting entry recognised since initial fair value of the forward contract is considered to be nil)	Nil	Nil
30-Sep-X1	***Fair value change in forward contract***		
	Derivative asset (company B) Dr. [(67.8-67.5) x10,00,000]	3,00,000	
	To Profit or loss		3,00,000
31-Dec-X1	***Fair value change in forward contract***		
	Forward contract asset (company B) Dr. [{(67.8-67) x 10,00,000} - 3,00,000]	5,00,000	
	To Profit or loss		5,00,000
31-Dec-X1	***Recognition of machinery acquired and on settlement***		
	Property, plant and equipment Dr. (at forward rate)	6,78,00,000	
	To Forward contract asset (company B)		8,00,000
	To Creditor (company B) / Bank		6,70,00,000

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UNIT 5: RECOGNITION AND DERECOGNITION OF FINANCIAL INSTRUMENTS

The concepts of recognition and derecognition of any asset or liability refer to the timing i.e. when is the financial instrument included in an entity's balance sheet (recognition) and when is it removed from the entity's balance sheet (derecognition).

5.1 INITIAL RECOGNITION

As per paragraph 3.1.1 of Ind AS 109, an entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument.

Paragraph B3.1.2 of Ind AS 109 provides certain examples of applying the aforementioned accounting principle:

Nature of contract	Recognition principle – when are assets or liabilities recognised?
Unconditional receivables and payables	When the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash
Firm commitment to purchase or sell goods or services	When at least one of the parties has performed under the agreement i.e. until the ordered goods or services have been shipped, delivered or rendered.
Firm commitment to purchase or sell goods or services designated as measured at fair value through profit or loss (refer note 2 below)	Net fair value is recognised as an asset or a liability on the commitment date
Forward contract	On the commitment date. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero (refer note 1 below). If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.
Option contracts	When the holder or writer becomes a party to the contract (refer note 1 below).
Planned future transactions	Never

Note 1: Generally, no upfront premium is paid by one party in a forward contract to the other at the inception of the contract. This is indicative of the fact that the fair value of a forward contract on inception is approximately zero. On the other hand, the option holder generally pays an upfront

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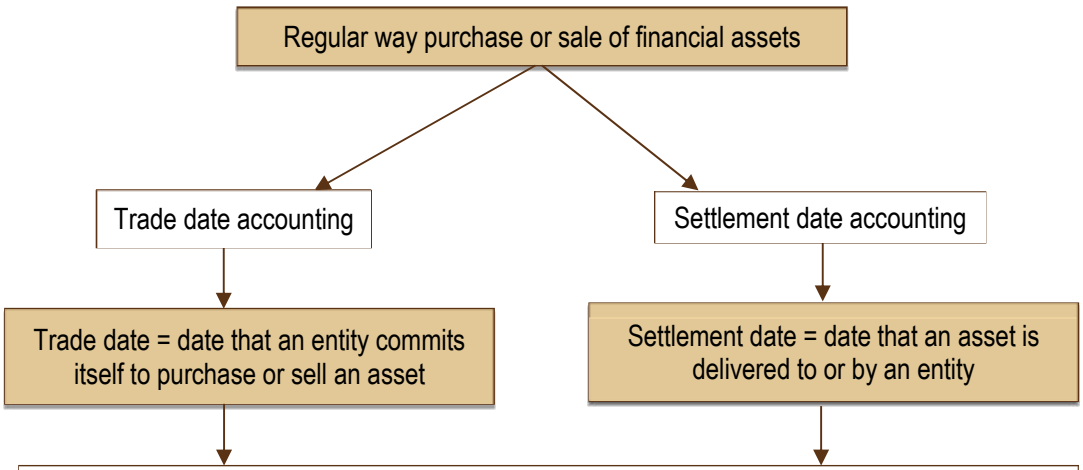
premium to the option writer at the inception of the option contract. This provides evidence that there is some fair value of the rights and obligations of the parties at the inception of an options contract.

Note 2: Contracts to buy or sell non-financial assets that can be settled net or by exchanging financial instruments are treated as if they are financial instruments, that is, derivatives unless they were entered into and continued to be held to meet the entity's normal purchase, sale or usage requirements

5.2 REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS

Ind AS 109 defines a regular way purchase or sale as,

- a **purchase or sale** of a financial asset
- under a **contract**
- whose terms require **delivery** of the asset
- within the **time frame**
- established generally by **regulation or convention in the marketplace** concerned



- Recognition of an asset to be received and the liability to pay for it
- Derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment

For instance, on the Bombay Stock Exchange in India, all transactions in all groups of securities in the Equity segment, Fixed Income securities and Government securities are settled on "T+2" basis. In this case, "T" is the trade date and "T+2" is the settlement date i.e. exchange of monies and securities between the buyers and sellers respectively takes place on second business day (excluding Saturdays, Sundays, bank and Exchange trading holidays) after the trade date.

It follows that if a contract is entered into with a broker for purchase or sale of securities which is normally traded on the Bombay Stock Exchange, with a settlement period that differs from the norms mentioned above, it would not be regarded as a regular way purchase or sale.

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When trade date accounting is applied, the buyer of a financial asset recognises the financial asset and its liability to pay on the trade date itself. Correspondingly, the seller derecognises the financial asset and recognises any gain or loss on sale on the trade date. The buyer subsequently measures the financial asset in accordance with its classification category.

When settlement date accounting is applied, a **buyer of financial asset accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date** in the same way as it accounts for the acquired asset. In other words,

- assets measured at amortised cost - change in value is not recognised;
- assets classified as financial assets measured at fair value through profit or loss (whether mandatorily or designated) – change in value is recognised in profit or loss;
- financial assets measured at fair value through other comprehensive income (including investments in equity instruments for which irrevocable option is selected) – change in fair value is recognised in other comprehensive income.

Correspondingly, the seller of a financial asset derecognises the same at the settlement date and does not recognise any fair value changes between the trade date and settlement date.

An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with Ind AS 109.

Illustration 1: Regular way contracts: forward contracts

ST Ltd. enters into a forward contract to purchase 10 lakh shares of ABC Ltd. in a month's time for ₹ 50 per share. This contract is entered into with a broker, Mr. AG and not through regular trading mode in a stock exchange. The contract requires Mr. AG to deliver the shares to ST Ltd. upon payment of agreed consideration. Shares of ABC Ltd. are traded on a stock exchange. Regular way delivery is two days. Assess the forward contract.

Solution

In this case, the forward contract is not a regular way transaction and hence must be accounted for as a derivative i.e. between the date of entering into the contract to the date of delivery, all fair value changes are recognised in profit or loss.

*****

Illustration 2: Regular way contracts: option contracts

NKT Ltd. purchases a call option in a public market permitting it to purchase 100 shares of VT Ltd. at any time over the next one month at a price of ₹ 1,000 per share. If NKT Ltd. exercises its option, it has 7 days to settle the transaction according to regulation or convention in the options market. VT Ltd.'s shares are traded in an active public market that requires two-day settlement.

Solution

In this case, the options contract is a regular way transaction as the settlement of the option is governed by regulation or convention in the marketplace for options. Fair value changes between the trade date and settlement date are recognised in profit or loss.

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The illustrations below explain the flow of journal entries in case of trade date accounting and settlement date accounting for regular way purchase and sale of financial assets.

Illustration 3: Regular way purchase of financial asset

On 1 January 20X1, X Ltd. enters into a contract to purchase a financial asset for ₹ 10 lakhs, which is its fair value on trade date. On 4 January 20X1 (settlement date), the fair value of the asset is ₹ 10.5 lakhs. The amounts to be recorded for the financial asset will depend on how it is classified and whether trade date or settlement date accounting is used. Pass necessary journal entries.

Solution

Journal Entries in the Buyer's Books

Trade date accounting

Dr. / Cr.	Particulars	Amortised cost	Fair value through P&L	Fair value through OCI
1 January 20X1				
Dr.	Financial asset	10,00,000	10,00,000	10,00,000
Cr.	Financial liability (to pay)	(10,00,000)	(10,00,000)	(10,00,000)
4 January 20X1				
Dr.	Financial asset	-	50,000	50,000
Dr.	Financial liability (to pay)	10,00,000	10,00,000	10,00,000
Cr.	Profit or loss	-	(50,000)	-
Cr.	Other comprehensive income	-	-	(50,000)
Cr.	Cash	(10,00,000)	(10,00,000)	(10,00,000)

Settlement date accounting

Dr. / Cr.	Particulars	Amortised cost	Fair value through P&L	Fair value through OCI
4 January 20X1				
Dr.	Financial asset	10,00,000	10,50,000	10,50,000
Cr.	Profit or loss	-	(50,000)	-
Cr.	Other comprehensive income	-	-	(50,000)
Cr.	Cash	(10,00,000)	(10,00,000)	(10,00,000)

The above mentioned accounting principles apply only to financial assets and Ind AS 109 does not contain any such principles for financial liabilities.

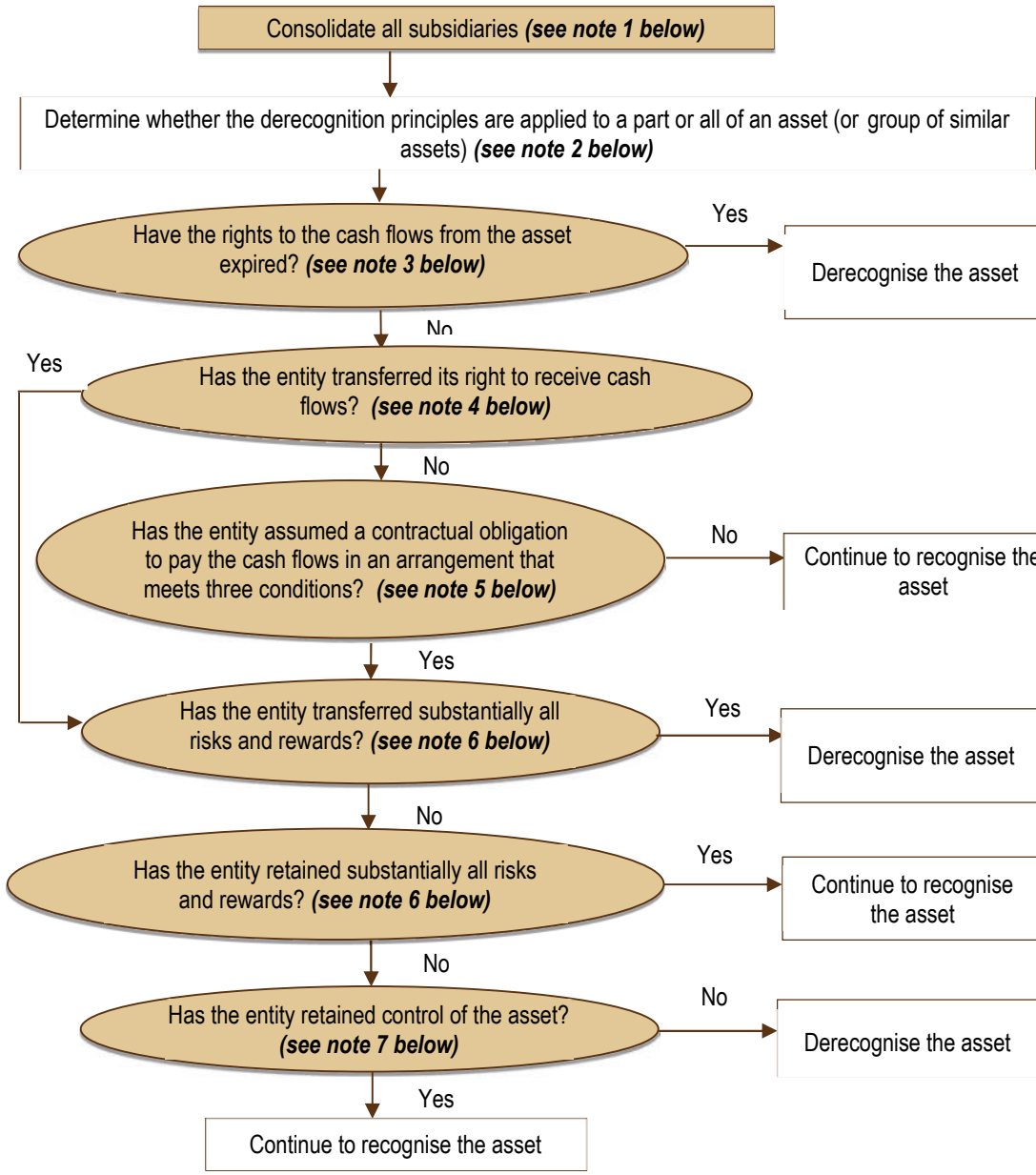
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5.3 DERECOGNITION OF FINANCIAL ASSETS

In simple words, derecognition refers to the timing of removing a financial asset from the balance sheet. To take an example, if a company gets its trade receivables discounted from a bank, it would need to determine whether it can remove those trade receivables from its balance sheet.

Paragraph B3.2.1 of Ind AS 109 provides a step-by-step flowchart for making this determination.



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Notes:

1. In consolidated financial statements, accounting principles for derecognition are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with Ind AS 110 and then applies those requirements to the resulting group. (Ind AS 109.3.2.1)

   The importance of this criteria is that sometimes sales of financial assets are made to entities which are specifically designed for this purpose. In those circumstances, it would be inappropriate to derecognise the financial asset if the purchaser entity is indirectly controlled by the seller entity.

2. Let's understand this step using a few fact patterns:

Illustration 4: Part of a financial asset

State whether the derecognition principles will be applied or not.

i. Interest strip of an interest-bearing financial asset i.e. the part entitles its holder to interest cash flows of a financial asset

ii. Dividend strip of an equity share i.e. the part entitles its holder to only dividends arising from an equity share

iii. Cash flows (principal and asset) upto a certain tenure or first right on a proportion of cash flows of an amortising financial asset. Say, the part entitles its holder to first 80% of the cash flows or cash flows for first 4 of the 6 years' tenure.

Solution

Derecognition requirements are applied to a part of a financial asset if that part meets **any of the following three** conditions:

a) The part comprises only **specifically identified cash flows** from a financial asset (or a group of similar financial assets).

   For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, derecognition principles are applied to the interest cash flows

b) The part comprises only a **fully proportionate (pro rata) share of the cash flows** from a financial asset (or a group of similar financial assets).

   For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, derecognition principles are applied to 90 per cent of those cash flows.

c) The part comprises only a **fully proportionate (pro rata) share of specifically identified cash flows** from a financial asset (or a group of similar financial assets).

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For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, derecognition principles are applied to 90 per cent of those interest cash flows.

The example of a part of a financial asset at (iii) in Illustration 4 above will not qualify conditions at (b) and (c) above since it does not represent pro rata share of all or specifically identified cash flows.

In (b) and (c) above, if there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

In all other cases, derecognition principles are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety).

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Illustration 5: Part of a financial asset

State whether the derecognition principles will be applied or not.

i. Entity Y transfers the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets)

ii. Entity Z transfers the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables.

Solution

In the above circumstances, Entity Y and Entity Z need to apply the derecognition requirements to the financial asset (or a group of similar financial assets) in its entirety.

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3. Cash flows from a financial asset expire upon payment of entire due amount or the legal release of the debtor by the creditor from the obligation to pay. In case of derivatives, this condition is considered met when, for example, contractual exercise period of an option expires and option is not exercised.

Ind AS 109 contains elaborate guidance on when renegotiation of the terms of a financial liability results in derecognition thereof. Refer paragraph "Exchange of financial liability instruments" for more details on the same. However, in respect of financial assets, such elaborate guidance has not been provided.

One may use the principles of quantitative and qualitative tests prescribed for financial liabilities to evaluate whether renegotiation of the terms of a financial asset results in derecognition or not.

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We discuss below a few circumstances wherein renegotiation does result in "expiry of right to receive cash flows":

- Agreeing to a moratorium period for repayment of principal or extension of the overall tenor of the loan.
- Substantial reduction in the interest rates
- Agreeing to a right to convert loan or a part thereof into equity shares after a certain period of time

4. Examples of transfer of rights to receive cash flows include sale of a financial asset, such as an investment in a debenture or assignment of a receivable (like factoring arrangements with banks or financial institutions). Refer comprehensive examples below on debt factoring and invoice discounting.

5. In some situations, though an entity retains the contractual rights to receive cash flows of a financial asset ('original asset'), it does assume a contractual obligation to pay those cash flows to one or more entities ('eventual recipients').

   For example, securitisation arrangements are a common form of transfer of financial assets in India. In these arrangements, the originator of a financial asset, say a bank or a NBFC, settle a Trust and transfer a portfolio of financial assets to that Trust. Thereafter, securities of that Trust are issued to unrelated parties or investors. Such arrangements are often "pass through" arrangements, in the sense that the originator or the Trust retains the rights to receive cash flows from the financial asset, but they have a simultaneous obligation to pay those cash flows to a recipient.

   As per paragraph 3.2.5 of Ind AS 109, **all of the** following conditions need to be met in such situations for the transaction to qualify as a "transfer":

   - The entity has **no obligation to pay amounts** to the eventual recipients **unless it collects equivalent amounts** from the original asset.

     Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition. However, existence of guarantees or options that allow the transferee to transfer receivables back to the entity and other recourse arrangements are likely to conflict with this condition.

   - The entity is **prohibited** by the terms of the transfer contract **from selling or pledging the original asset** other than as security to the eventual recipients for the obligation to pay them cash flows.

   - The entity has an **obligation to remit any cash flows** it collects on behalf of the eventual recipients **without material delay.**

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- entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period, and interest earned on such investments is passed to the eventual recipients.

  The standard does not define the word "material" in this condition. Therefore, the same should be understood in common trade parlance.

Illustration 6: Proportionate "pass through" arrangement

Entity A makes a five-year interest-bearing loan (the 'original asset') of ₹ 100 crores to Entity B. Entity A settles a Trust and transfers the loan to that Trust. The Trust issues participatory notes to an investor, Entity C, that entitle the investor to the cash flows from the asset.

As per Trust's agreement with Entity C, in exchange for a cash payment of ₹ 90 crores, Trust will pass to Entity C 90% of all principal and interest payments collected from Entity B (as, when and if collected). Trust accepts no obligation to make any payments to Entity C other than 90% of exactly what has been received from Entity B. Trust provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90% of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B.

Compute the amount to be derecognised.

Solution

If the three conditions are met, the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, Entity A would report a loan asset of ₹ 10 crores and derecognise ₹ 90 crores.

*****

6. Let's illustrate the "risks and rewards" test with certain examples given in application guidance of Ind AS 109:

   Examples of when an entity **has transferred** substantially all the risks and rewards of ownership are:

   (a) an unconditional sale of a financial asset;

   (b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

   (c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).

   Examples of when an entity has retained substantially all the risks and rewards of ownership are:

   (a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

   (b) a securities lending agreement;

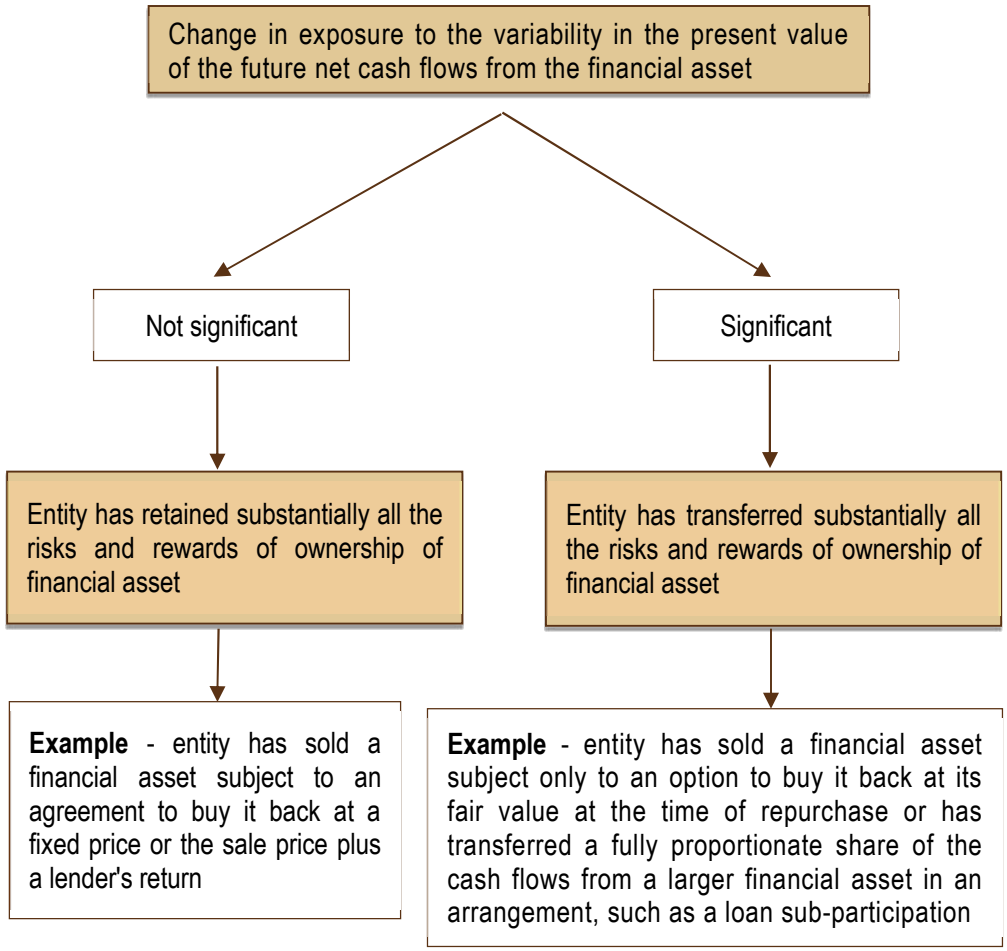
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(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

Paragraph 3.2.7 of Ind AS 109 provides the guidance on **"risks and rewards" test**



In evaluating the extent to which risks and rewards are transferred or retained, risks and rewards that are reasonably expected to be significant in practice should be considered.

So, what is the most significant risk in a portfolio of short term receivables? It is usually credit risk i.e. the risk that the customer will default. Therefore, an **arrangement that involves the transferee having full recourse to the transferor for credit losses will "fail" the risks and rewards tests. An arrangement in which the transferee has no**

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recourse to the transferor for credit losses will generally "pass" the risks and rewards tests.

What are the most significant risks in longer term receivables? Well, interest rate risk and slow payment risk are fairly significant in those cases. An arrangement in which the entity continues to pay interest to the transferee until the underlying debtor settles involves the transferee retaining the risk of slow payment.

7. Whether the entity has retained control of the transferred asset depends on the **transferee's ability to sell the asset**. If the transferee,

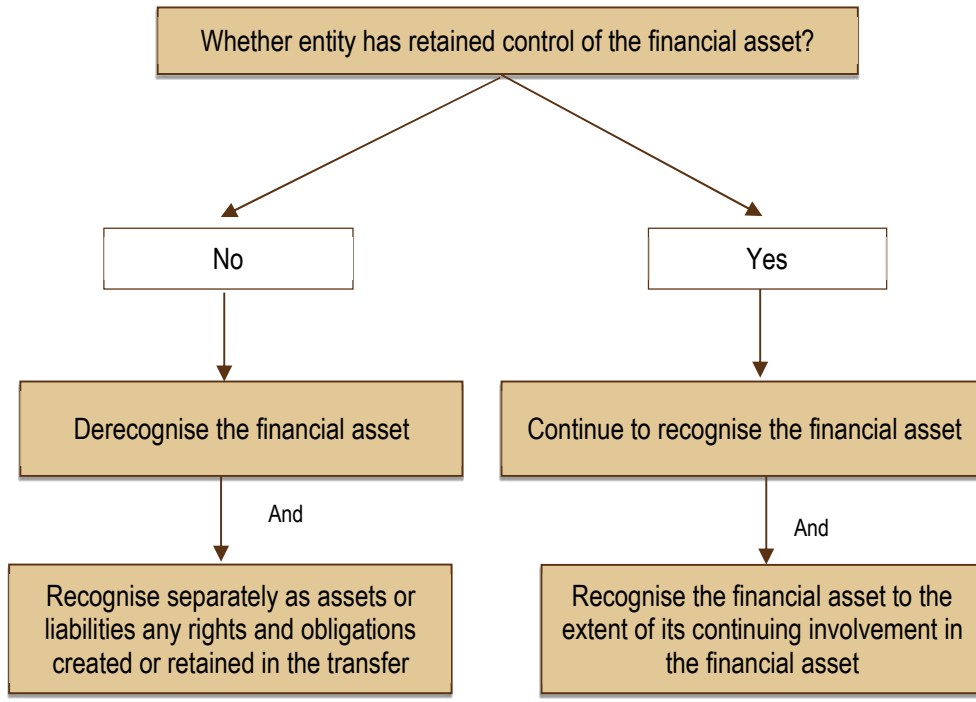
   i. has the practical ability to sell the asset in its entirety to an unrelated third party, and

   ii. is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer

   the entity has not retained control.

   In all other cases, the entity has retained control.

   The accounting treatment as a consequence of this decision is as below:



The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist.

Paragraphs B3.2.7 and 3.2.8 give examples of certain situations in which transferee is evaluated to have such practical ability and situations in which it doesn't have.

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Example 1: Situation when transferee has practical ability to sell the financial asset

Transferred asset is subject to an option that allows the entity to repurchase it and it is traded in an active market: transferee has the practical ability to sell the financial asset as it can readily obtain the transferred asset in the market if the option is exercised.

Example 2: Situations when transferee doesn't have practical ability to sell the financial asset

- Transferred asset is subject to an option that allows the entity to repurchase it and it is not traded in an active market: transferee doesn't have the practical ability to sell the financial asset as it cannot readily obtain the transferred asset in the market if the option is exercised.
- A put option or guarantee with respect to the transferred asset which is sufficiently valuable in the sense that it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. In this situation, the transferor has retained control of the transferred asset.

Illustrations on application of derecognition principles

Paragraph B3.2.16 of Ind AS 109 provides certain illustrations which are summarised below:

Illustration 7: Repurchase agreements

A financial asset is sold under repurchase agreement. The repurchase price as per that agreement is (a) fixed price or (b) sale price plus a lender's return. Let's look at three alternate scenarios:

i. Repurchase agreement is for the same financial asset.

ii. Repurchase agreement is for substantially the same asset

iii. Repurchase agreement provides the transferee a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date.

State whether the derecognition principles will be applied or not.

Solution

In each of these scenarios, the transferred financial asset is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

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Let's look at another scenario:

Repurchase agreement provides the transferor only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it

In this scenario, the transferred financial asset is derecognised because the transferor has transferred substantially all the risks and rewards of ownership.

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Illustration 8: Put options on transferred financial assets

A financial asset is sold and the transferee has a put option. Let's look at some alternate scenarios:

i. Put option is deeply in the money

ii. Put option is deeply out of the money.

State whether the derecognition principles will be applied or not.

Solution

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

*****

Illustration 9: Call options on transferred financial assets

A financial asset is sold and the transferor has a call option. Let's look at some alternate scenarios:

i. Call option is deeply in the money

ii Call option is deeply out of the money.

What if the transferor holds a call option on an asset that is readily obtainable in the market?

iii Call option is neither deeply in the money nor deeply out of the money

State whether the derecognition principles will be applied or not.

Solution

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

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In the third scenario, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control.

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Illustration 10: Amortising interest rate swaps

An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount.

Scenarios:

i. Notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time.

ii. Amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset.

State whether the derecognition principles will be applied or not.

Solution

In the first scenario, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement.

Such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

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5.3.1 Accounting treatment of transfers

5.3.1.1Transfers that qualify for derecognition

If the arrangement results in de-recognition of the financial asset in its entirety:

- in the case of assets included in the "fair value through other comprehensive income" category, any gain or loss previously recorded in equity is recycled to the statement of profit and loss as per the requirements of the standards;
- any new financial assets obtained, financial liabilities assumed and any servicing obligations are recognised at fair value. new asset is part of the proceeds of sale. Any

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liability assumed, even if it is related to the transferred asset, is a reduction of the sales proceeds.

- the difference between the carrying amount and the consideration received is recognised in the statement of comprehensive income.

Illustration 11: Assignment of receivables

ST Ltd. assigns its trade receivables to AT Ltd. The carrying amount of the receivables is ₹ 10,00,000. The consideration received in exchange of this assignment is ₹ 9,00,000. Customers have been instructed to deposit the amounts directly in a bank account for the benefit of AT Ltd. AT Ltd. has no recourse to ST Ltd. in case of any shortfalls in collections.

State whether the derecognition principles will be applied or not.

Solution

In this situation, ST Ltd. has transferred the rights to contractual cash flows and has also transferred substantially all the risks and rewards of ownership (credit risk being the most significant risk in this situation).

Accordingly, ST Ltd. derecognises the financial asset and recognises ₹ 1,00,000, the difference between consideration received and carrying amount, as an expense in the statement of profit or loss.

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5.3.1.2 Transfers that do not qualify for derecognition

If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset (for example, in a situation when the transferor guarantees transferee against any default losses), the entity shall,

- continue to recognise the transferred asset in its entirety,
- recognise a financial liability for the consideration received, recognised at fair value less any transaction costs incurred. The liability is subsequently measured at amortised cost using the effective interest method, and
- in subsequent periods, recognise any income on the transferred asset and any expense incurred on the financial liability.

5.3.1.3 Continuing involvement in transferred assets (partial de-recognition)

If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset,

- the entity **continues to recognise the transferred asset to the extent of its continuing involvement**. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset.
    - ♦ *Guarantees for transferred asset*

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The extent of the entity's continuing involvement is the lower of

(i) the amount of the asset, and

(ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').

Illustration 12A: Debt factoring with recourse – continuing involvement asset

Entity C agrees with factoring company D to enter into a debt factoring arrangement. Under the terms of the arrangement, the factoring company D agrees to pay ₹ 91.5 crores, less a servicing charge of ₹ 1.5 crores (net proceeds of ₹ 90 crores), in exchange for 100% of the cash flows from short-term receivables.

The receivables have a face value of ₹ 100 crores and carrying amount of ₹ 95 crores.

The customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses upto ₹ 5 crores, over and above the expected credit losses of ₹ 5 crores. The guarantee is estimated to have a fair value of ₹ 0.5 crores. Calculate the amount of continuing involvement asset.

Solution

In this situation, the "continuing involvement asset" will be recognised at ₹ 5.5 crores i.e. lower of:

i. the amount of the asset – ₹ 95 crores

ii. the guarantee amount – ₹ 5.5 crores

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- the entity also **recognises an associated liability** that is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:
  - ♦ the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost, or
  - ♦ equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.
- Recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other and shall not be offset.
- If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.
- In case of guarantees, as per the application guidance in Ind AS 109, the associated liability is initially measured at
  - ♦ the guarantee amount plus

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- the fair value of the guarantee (which is normally the consideration received for the guarantee).

Illustration 12B: Debt factoring with recourse – associated liability

Continuing illustration 12A, calculate the amount of associated liability.

Solution

The amount of associated liability is recognised at ₹ 5.5 crores, as below:

i. the guarantee amount (i.e. ₹ 5 crores) plus

ii. the fair value of the guarantee (i.e. ₹ 0.5 crores).

*****

- If an entity's continuing involvement is in only a part of a financial asset, the entity **allocates the previous carrying amount** of the financial asset **between the part it continues to recognise under continuing involvement, and the part it no longer recognises** on the basis of the relative fair values of those parts on the date of the transfer. The difference between:
  - the carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised and
  - the consideration received for the part no longer recognised

  shall be recognised in profit or loss.
- the entity shall **continue to recognise any income arising on the transferred asset to the extent of its continuing involvement** and shall recognise any expense incurred on the associated liability

Illustration 12C: Debt factoring with recourse – gain or loss on derecognition

Continuing illustration 12A and 12B, pass the necessary Journal Entry.

Solution

The journal entries passed by Entity C on the date of derecognition is as below:

Cash	Dr.	₹ 90 crores	
Loss on derecognition	Dr.	₹ 5 crores	
Continuing involvement asset	Dr.	₹ 5.5 crores	
To Receivables			₹ 95 crores
To Associated liability			₹ 5.5 crores

The guarantee liability of ₹ 0.5 crores shall be amortised in profit or loss over the underlying period.

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5.4 DERECOGNITION OF FINANCIAL LIABILITIES

5.4.1 General principles

5.4.1.1 Timing of derecognition

An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires. (Paragraph 3.3.1 of Ind AS 109)

A financial liability (or part of it) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

(Paragraph B3.3.1 of Ind AS 109)

If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party. (Paragraph B3.3.4 of Ind AS 109)

5.4.1.2 Accounting treatment for extinguishment

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss. (Paragraph 3.3.3 of Ind AS 109)

Further, in some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and

(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

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5.4.2 Exchange of financial liability instruments

Many times entities re-negotiate terms of their existing debt with the lenders. In India, this is popularly known as "Strategic Debt Restructuring" or SDR. Sometimes, entities approach their lenders to renegotiate terms of their debt, when they want to take advantage of the falling interest rate regime.

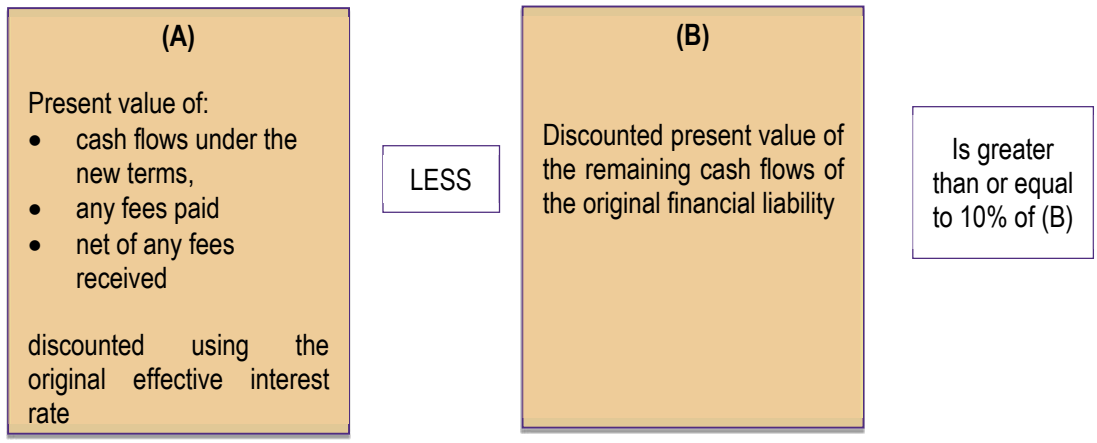
In accounting terms, such situations need to be evaluated to determine whether the original debt is extinguished.

As per paragraph 3.3.2 of Ind AS 109, an exchange between an existing borrower and lender of debt instruments with **substantially different terms** shall be accounted for as:

- an extinguishment of the original financial liability, and
- the recognition of a new financial liability.

Similarly, a **substantial modification** of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted as mentioned above.

As per application guidance in paragraph B3.3.6 of Ind AS 109, the **terms are substantially different if:**



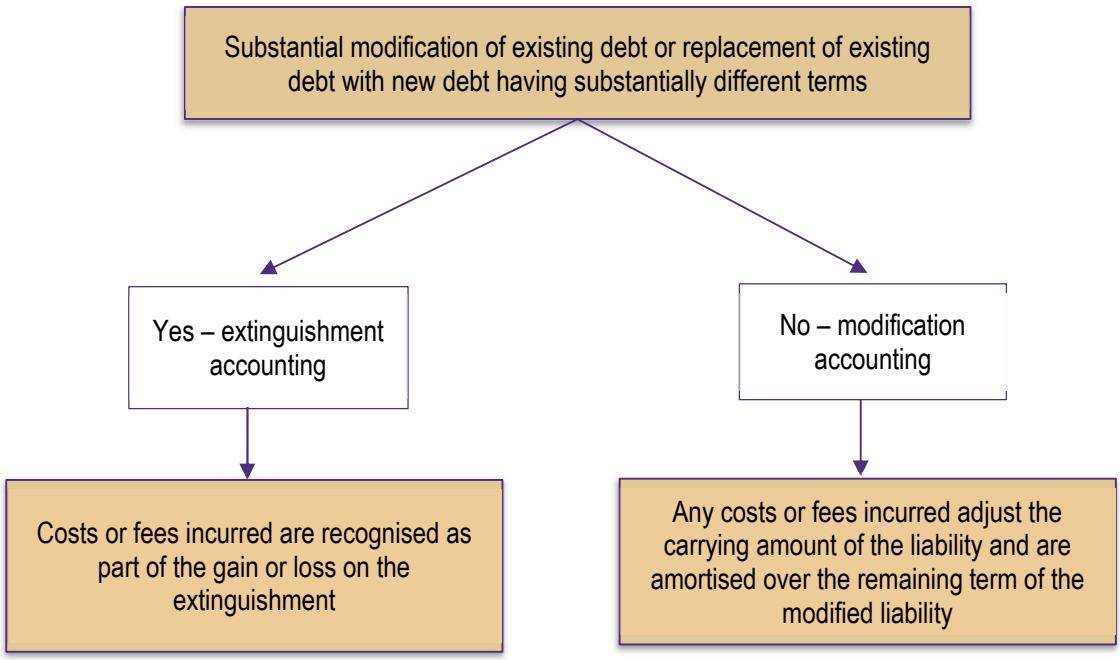
5.4.2.1 Accounting treatment

If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. In determining those fees paid net of any fees received, a borrower includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf.

If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of

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the modified liability. It may be noted here that the costs or fees considered for this purpose differs from the costs or fees considered for the purpose of 10% test. In the case where modification does not result in derecognition, any costs or fees incurred is considered to adjust the effective interest rate whereas for the 10% test only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf are considered.



1. Extinguishment accounting

If the 10% test is passed, principle of "extinguishment accounting" are applied, that is:

- de-recognition of the existing liability
- recognition of the new or modified liability at its fair value (net of any fees incurred directly related to the new liability)
- recognition of a gain or loss equal to the difference between the carrying value of the old liability and the fair value of the new one
- recognising any incremental costs or fees incurred for modification (and not for the new liability), and any consideration paid or received, in profit or loss
- calculating a new effective interest rate for the modified liability, which is then used in future periods.

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Fair value of the new or modified liability is estimated based on the expected future cash flows of the modified liability, discounted using the interest rate at which the entity could raise debt with similar terms and conditions in the market.

Example 3: Extinguishment accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 10,00,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 10,00,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- the term is extended to 31 December 20Y1;
- interest payments are reduced to 5% p.a.;
- the bonds are redeemable on 31 December 20Y1 for ₹ 15,00,000; and
- legal and other fees of ₹ 1,00,000 are incurred.

XYZ Ltd. determines that the market interest rate on 1 January 20X5 for borrowings on similar terms is 11%.

The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(100,000)	10,00,000
31 December 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

- cash flows under the new terms – i.e. ₹ 15,00,000 payable on 31 December 20Y1 and ₹ 50,000 payable for each of the 7 years ending 31 December 20Y1.
- fees paid by the borrower to the lender – i.e. ₹ 1,00,000

using the original effective interest rate of 10%.

The total of these amounts to ₹ 11,13,158 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 11.32% i.e. by more than 10%. Hence, extinguishment accounting applies.

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The next step is to estimate the fair value of the modified liability. This is determined as the present value of the future cash flows (interest and principal), using an interest rate of 11% (the market rate at which XYZ Ltd. could issue new bonds with similar terms). The estimated fair value on this basis is ₹ 958,097 (Refer Working Note). A gain or loss on modification is then determined as:

Gain (loss) = carrying value of existing liability - fair value of modified liability - fees and costs incurred i.e. ₹ 10,00,000 – ₹ 9,58,097 – ₹ 1,00,000 = Loss of ₹ 58,097

Working Note:

Year	Discount factor @ 10%	Discount factor @ 11%
1	0.909091	0.900901
2	0.826446	0.811622
3	0.751315	0.731191
4	0.683013	0.658731
5	0.620921	0.593451
6	0.564474	0.534641
7	0.513158	0.481658
Annuity	4.868419	4.712196

Amount	Discounting factor @ 10%	Present value	Discounting factor @ 11%	Present value
15,00,000	0.513158	7,69,737	0.481658	7,22,487
1,00,000		1,00,000		
50,000 for 7 years	4.868419	2,43,421	4.712196	2,35,610
		11,13,158		9,58,097
PV of original cash flows @ original EIR		(10,00,000)		
Difference		1,13,158		
Difference %		11.32%		

Modification accounting

Ind AS 109 is not clear as to the accounting treatment if the 10% test is failed. Two alternate approaches are therefore possible:

Amortisation of any cost or fees incurred on modification

Under this approach,

- the fees or costs incurred are netted against the existing liability;

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- the effective interest rate is recalculated. This is the rate which discounts the future cash flows as per modified contractual terms to the adjusted carrying amount mentioned above
- the adjusted effective interest rate is used to determine the amortised cost and interest expense in future periods

Example 4: Modification accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 1,000,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 1,000,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- no further interest payments are made
- the bonds are redeemed on the original due date (31 December 20X9) for ₹ 1,600,000;
- fees paid by the borrower to lender ₹ 50,000
- .

The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X5	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

i. cash flows under the new terms – i.e. ₹ 16,00,000 payable on 31 December 20X9

ii. any fees paid (net of any fees received) – i.e. ₹ 50,000

using the original effective interest rate of 10%.

The total of these amounts to ₹ 10,43,474 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 4.35% i.e. by less than 10%. Hence, modification accounting applies.

On this basis:

i. the fees paid of ₹ 50,000 are netted against the existing liability of ₹ 10,00,000, resulting in an adjusted carrying amount of ₹ 9,50,000;

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ii. the effective interest rate (EIR) is recalculated. This is the rate which discounts the future cash flows (₹ 16,00,000 in five years' time) to the adjusted carrying amount of ₹ 9,50,000. The adjusted EIR is 10.99%

iii. the adjusted EIR is used to determine the amortised cost and interest expense in future periods.

Working Note:

For testing extinguishment -

Cash flows under new terms	16,00,000
PV as at 01 January 20X5	
Revised cash flows@ original EIR	9,93,474
Fees incurred	50,000
PV of revised cash flows @ original EIR	10,43,474
PV of original cash flows @ original EIR	(10,00,000)
Difference	43,474
Difference %	4%
Less than 10% - Indicates modification	

Accounting for revised cash flows @ original EIR

Year	Opening balance	Interest	Payment	Closing balance
0	10,00,000	-	-50,000	9,50,000
1	9,50,000	1,04,405	0	10,54,405
2	10,54,405	1,15,879	0	11,70,284
3	11,70,284	1,28,614	0	12,98,898
4	12,98,898	1,42,749	0	14,41,647
5	14,41,647	1,58,353*	-16,00,000	-
* Difference is due to approximation				

Illustration 13: Renegotiation of terms of (defaulted) borrowings subsequent to the year-end

Ind AS 109, Financial Instruments requires recognition of renegotiation gain/loss subject to fulfillment of certain conditions as mentioned in the standard. If there has been a renegotiation of terms of (defaulted) borrowings subsequent to the year end, but before the date of approval of financial statements, then should such modification gain/loss be recognised in the current year

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financial statements itself or in the next year when the terms of (defaulted) borrowings have been renegotiated in accordance with Ind AS 109?

Solution

As per paragraph 5.4.3 of Ind AS 109, Financial Instruments, whenever contractual cash flows of a financial instrument are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss.

In accordance with the above, modification gain or loss should be recognised in profit or loss in the period in which the renegotiation has contractually taken place. Accordingly, in the given case, if the terms of the (defaulted) borrowings have been renegotiated in the next year, then the related gain/loss should also be recognised in the next year.

*****

5.4.3 Debt for equity swaps

A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'.

Appendix D to Ind AS 109, "Extinguishing Financial Liabilities with Equity Instruments" deals with accounting for such situations.

It must be noted that these accounting principles do not apply in following situations:

- the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder
- the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity
- extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability

The accounting principles are summarised below:

- An entity shall **remove a financial liability** (or part of a financial liability) from its balance sheet when, and only **when, it is extinguished** in accordance with derecognition principles mentioned above

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- When **equity instruments issued to a creditor** to extinguish all or part of a financial liability are recognised initially, an entity shall **measure them at the fair value** of the equity instruments issued, unless that fair value cannot be reliably measured.
- **If the fair value of the equity instruments issued cannot be reliably measured** then the equity instruments shall be measured to reflect the **fair value of the financial liability** extinguished.
- **If only part of the financial liability is extinguished**, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid **does relate to a modification of the terms** of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding.
- The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. **If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability**.
- The **difference** between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be **recognised in profit or loss.**

Example 5: Extinguishment of part of a financial liability through issue of equity instruments

JK Ltd. has an outstanding unsecured loan of ₹ 90 crores to a bank. The effective interest rate (EIR) of this loan is 10%. Owing to financial difficulties, JK Ltd. is unable to service the debt and approaches the bank for a settlement.

The bank offers the following terms which are accepted by JK Ltd.:

- 2/3rd of the debt is unsustainable and hence will be converted into 70% equity interest in JK Ltd. The fair value of net assets of JK Ltd. is ₹ 80 crores.
- 1/3rd of the debt is sustainable and the bank agrees to certain moratorium period and decrease in interest rate in initial periods. The present value of cash flows as per these revised terms calculated using original EIR is ₹ 25 crores. The fair value of the cash flows as per these revised terms is ₹ 28 crores.

Fair value of the consideration paid is ₹ 56 crores (70% of ₹ 80 crores) plus ₹ 28 crores i.e. ₹ 84 crores.

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Accordingly, 2/3rd of the original financial liability is extinguished through issue of equity shares and terms of 1/3rd of the original financial liability have been modified. JK Ltd. will need to evaluate if this modification tantamount to "substantial modification" or not.

Applying the guidance contained in Appendix D to Ind AS 109:

- Difference between the fair value of equity instruments (₹ 56 crores) and 2/3rd of the original financial liability (2/3rd of ₹ 90 crores = ₹ 60 crores) i.e. ₹ 4 crores will be recognised as a gain in the statement of profit and loss
- Carrying amount of original financial liability which is not extinguished (1/3rd of ₹ 90 crores = ₹ 30 crores) is compared with the present value of cash flows as per these revised terms (₹ 25 crores)
- As the difference is more than 10%, this results in substantial modification of the original financial liability. Resultantly, the existing financial liability (₹ 30 crores) will be extinguished and the new financial liability will be recognised at its fair value i.e. ₹ 28 crores.
- The difference i.e. ₹ 2 crores will be recognised as a gain in the statement of profit and loss.

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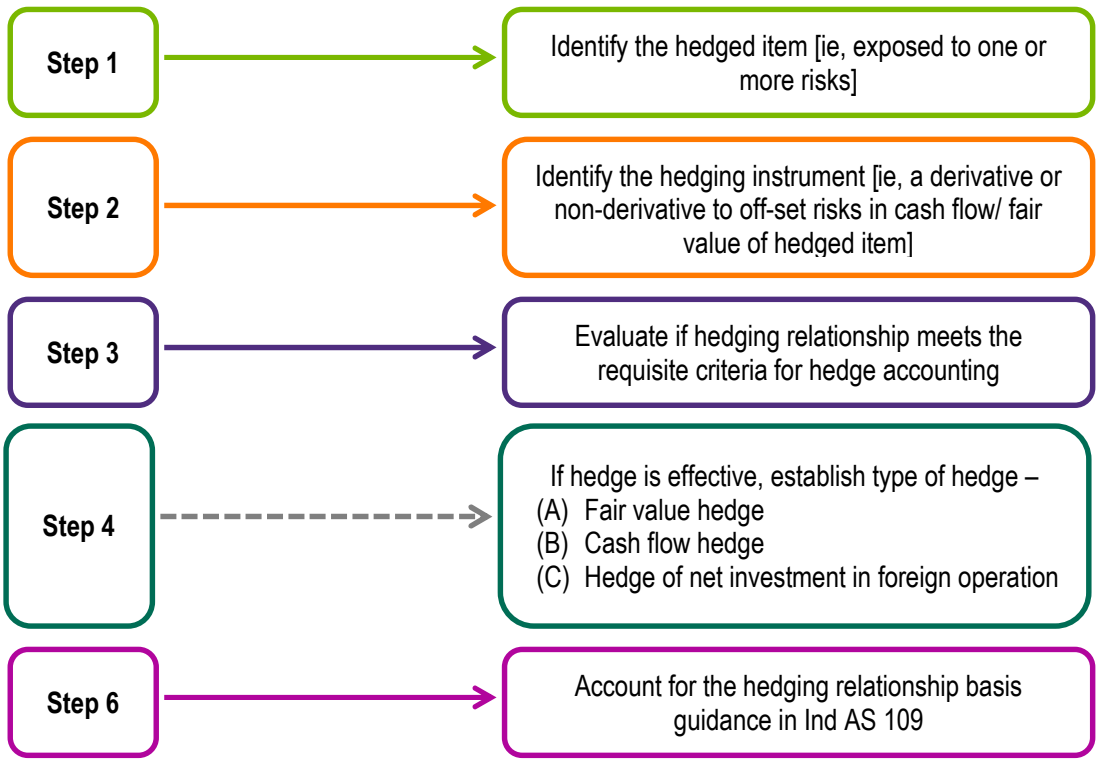
UNIT 6: HEDGE ACCOUNTING

6.1 INTRODUCTION

The objective of hedge accounting is to **represent**, in the financial statements, **the effect of an entity's risk management activities that use financial instruments to manage exposures** arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item, i.e, hedge accounting is an option provided qualifying criteria are met. In such a case, accounting for gain / loss arising on the hedging relationship, ie, including hedging instrument and hedged item shall be accounted in a specific manner as detailed further in the unit in order to avoid measurement and recognition inconsistencies which may arise otherwise if the hedging instrument and hedged item were accounted separately.

A step wise analysis has been presented using the following diagrammatic presentation –



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A hedge relationship can be evaluated for a single hedged item or group of items and the hedging instrument can also be a single instrument or multiple instruments hedging specific risk associated with the hedged item.

6.2 IDENTIFYING THE HEDGED ITEM AND DESIGNATION OF HEDGED ITEMS

- A hedged item can be a recognised **asset** or **liability**, an unrecognised **firm commitment**, a **forecast transaction** or a **net investment in a foreign operation**. The hedged item can be:

  (a) a single item; or

  (b) a group of items.

  A hedged item can also be a component of such an item or group of items.

- The hedged item must be reliably measurable.
- If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.
- An entity may designate an item in its **entirety or a component of an item** as the hedged item in a hedging relationship.
  - ♦ An entire item comprises all changes in cash flows or fair value of an item.
  - ♦ A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

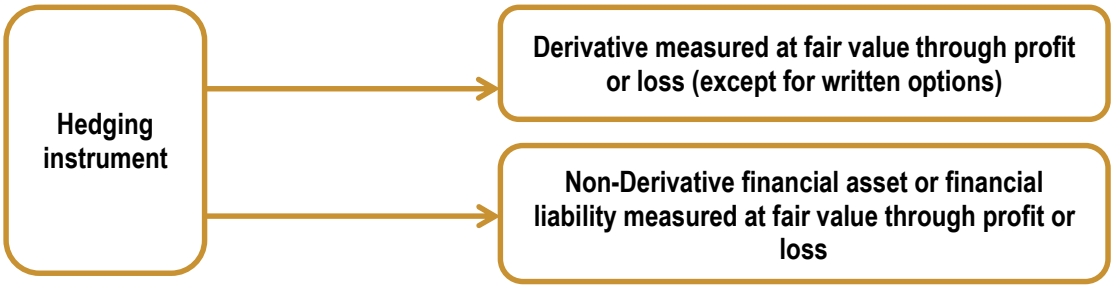
    (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable. Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).

    (b) one or more selected contractual cash flows.

    (c) components of a nominal amount, ie a specified part of the amount of an item

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6.3 QUALIFYING INSTRUMENTS FOR HEDGE ACCOUNTING AND DESIGNATION OF HEDGING INSTRUMENTS



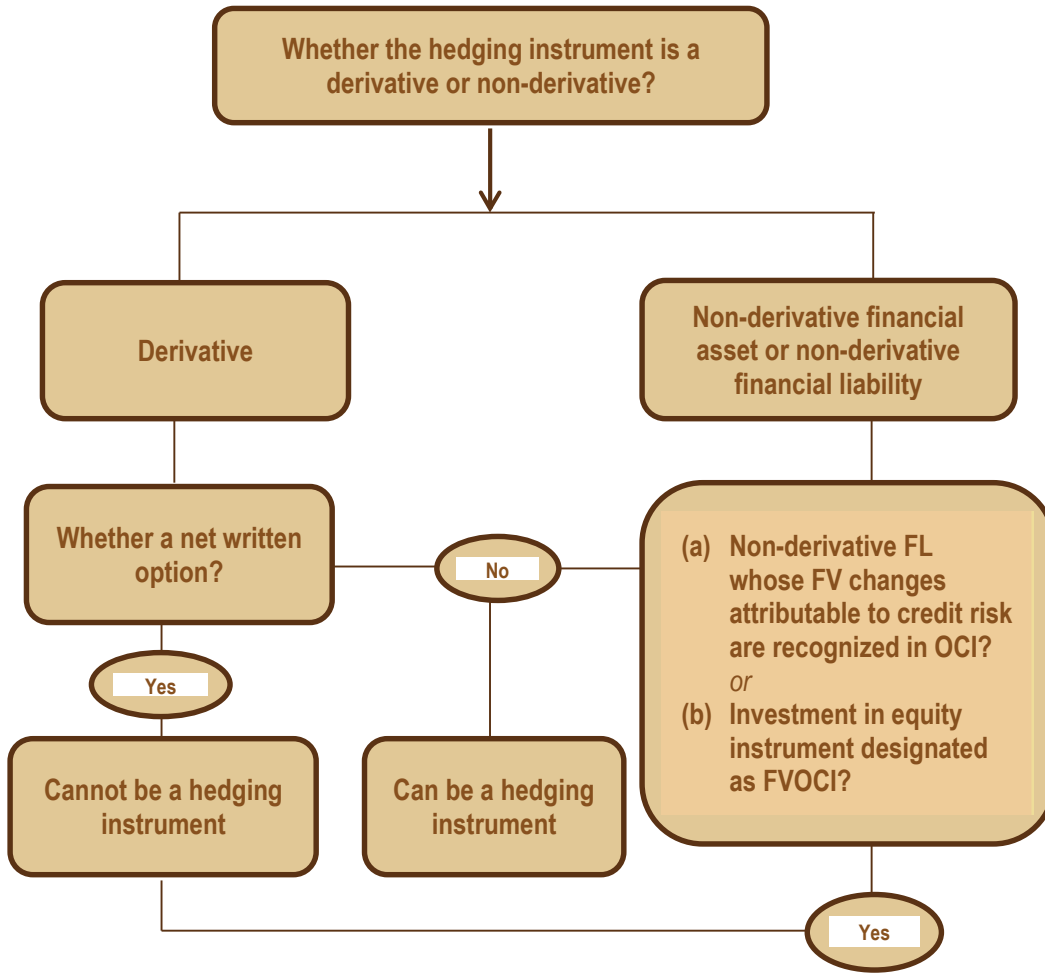
- **Exceptions to designating non-derivative financial asset or non-derivative financial liability as hedging instrument:**
  - ♦ A financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.
  - ♦ For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.
- For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments.
- **A qualifying instrument must be designated in its entirety as a hedging instrument.** The only **exceptions permitted** are:
  - (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value;
  - (b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; and
  - (c) a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair

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value that results from only a portion of the time period during which the hedging instrument remains outstanding.

- **Written options are not hedging instruments:** A derivative instrument that combines a written option and a purchased option (for example, an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option at the date of designation.

The decision tree to determining if an instrument can be designated as a hedging instrument is as follows:



6.4 QUALIFYING CRITERIA FOR HEDGE ACCOUNTING

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

(a) Hedging relationship consists only of **eligible hedging instruments and eligible hedged items**.

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(b) At the inception of the hedging relationship, there is **formal designation and documentation of the hedging relationship** and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio)

(c) Hedging relationship **meets all** of the following **hedge effectiveness requirements**:

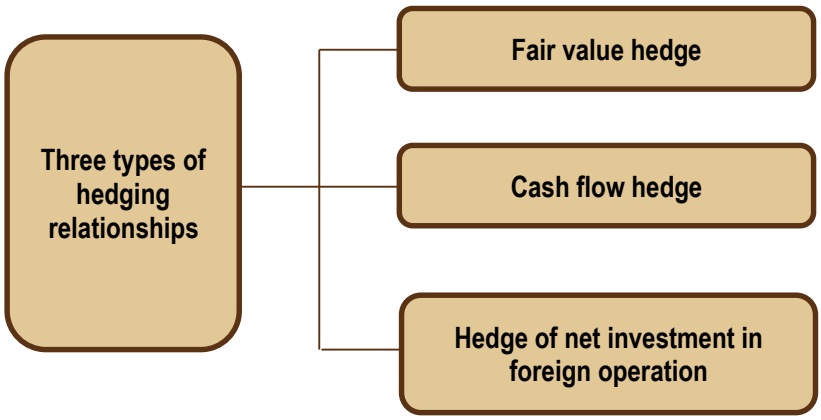
i. there is an **economic relationship** between the hedged item and the hedging instrument;

ii. the effect of **credit risk does not dominate** the value changes that result from that economic relationship; and

iii. the **hedge ratio** of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

6.5 ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

- An entity applies hedge accounting to hedging relationships that meet the qualifying criteria.
- **Types of hedging relationships:**

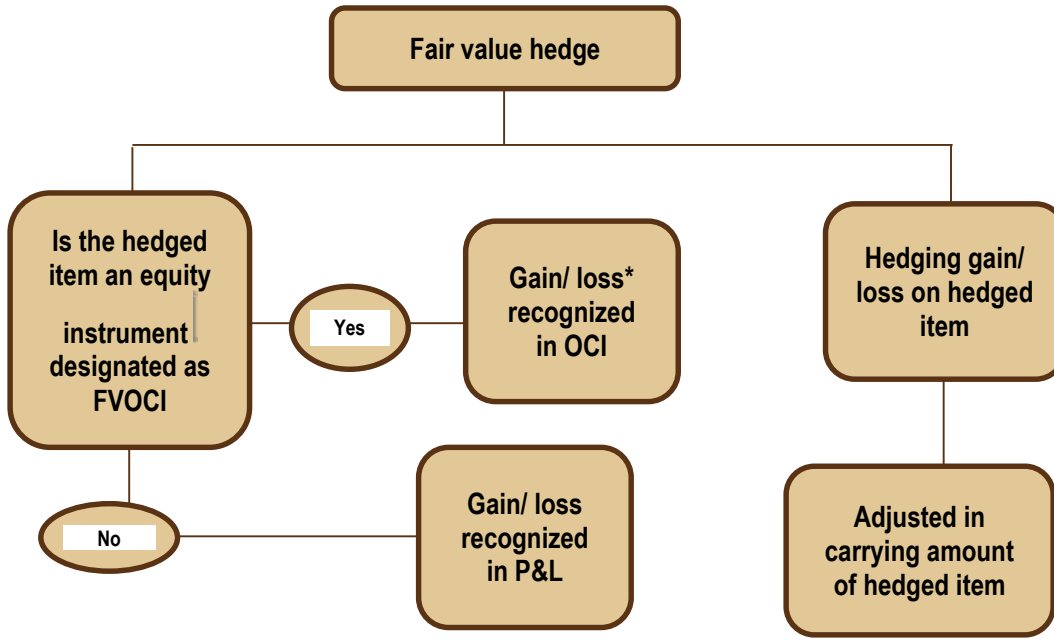


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- **Fair value hedge**

  A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

  Where a fair value hedge meets the qualifying criteria, fair value hedge shall be accounted as follows:



***Gain/ loss comprises both hedging instrument and hedged item**

- If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive income (FVOCI) other than equity instrument designated as FVOCI in accordance with Ind AS 109, the hedging gain or loss on the hedged item shall be recognised in profit or loss.
- When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

- **Cash flow hedge**

  A cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable debt), or a highly probable forecast transaction, and could affect profit or loss.

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Where a cash flow hedge meets the qualifying criteria, it shall be accounted as follows:

(a) the separate component of equity associated with the hedged item (**cash flow hedge reserve**) is adjusted to the lower of the following (in absolute amounts):

  i. the cumulative gain or loss on the hedging instrument from inception of the hedge; and

  ii. the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

(b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss

(d) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

  i. If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment as defined in IAS 1 and hence it does not affect other comprehensive income.

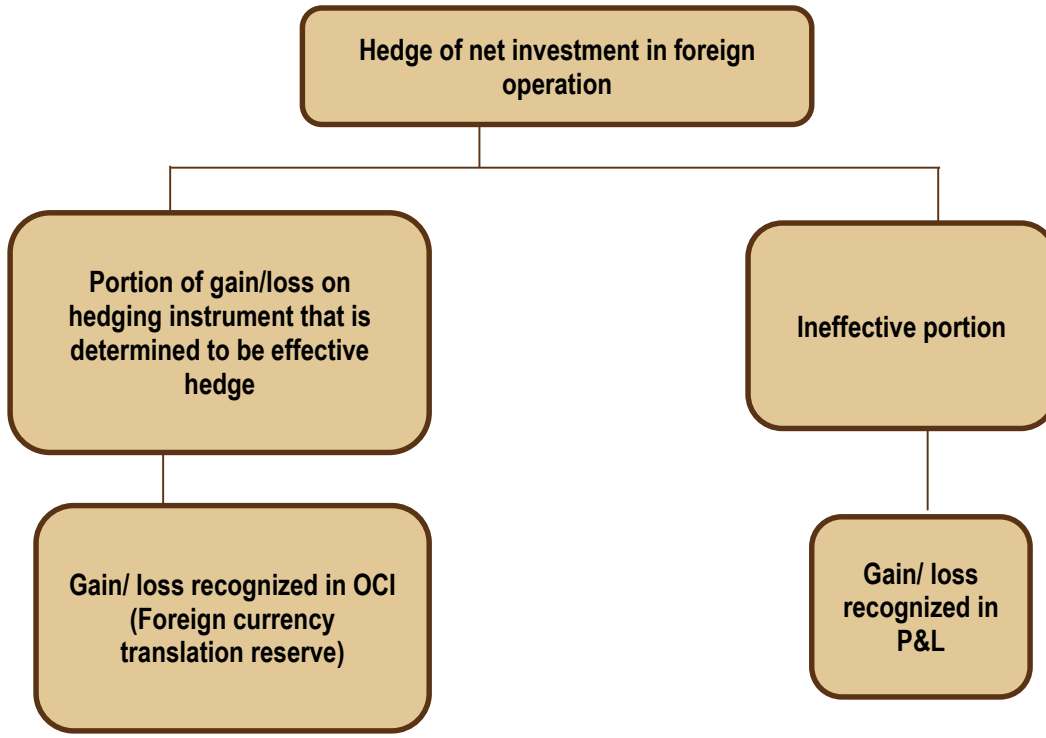
  ii. For cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

  iii. However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.

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- **Hedge of net investment in foreign operation**

  Hedge of a net investment in foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to cash flow hedges:



The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment on the disposal or partial disposal of the foreign operation.

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UNIT 7: DISCLOSURES

7.1 INTRODUCTION

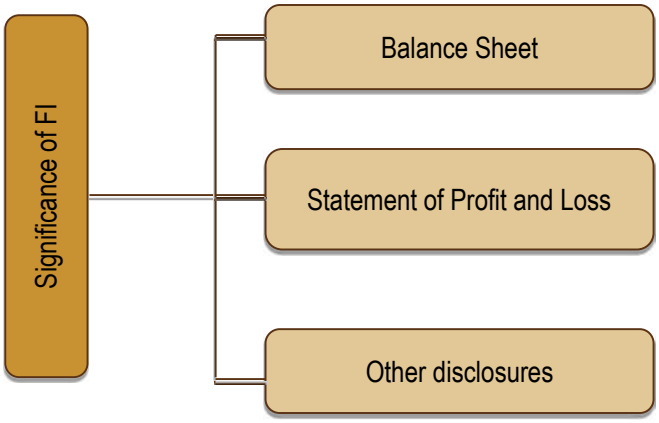
Ind AS 107 provides disclosures for financial instruments to be made in the financial statements that enable users to evaluate:

(a) The significance of financial instruments for the entity's financial position and performance; and

(b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period; and how the entity manages those risks.

7.2 SIGNIFICANCE OF FINANCIAL INSTRUMENTS

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.



7.3 BALANCE SHEET

- **Categories of financial assets and financial liabilities**

  The carrying amounts of each of the following categories, as defined in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:

  (a) Financial assets measured at fair value through profit or loss, showing separately

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i. those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 (ie, financial asset whose credit risk exposure is managed through credit derivative that is measured at fair value through profit or loss and hence, such financial asset is also managed at fair value through profit or loss); and

ii. those mandatorily measured at fair value through profit or loss in accordance with Ind AS 109.

(b) financial liabilities at fair value through profit or loss, showing separately –

i. those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 (ie, financial liability whose credit risk exposure is managed through credit derivative that is measured at fair value through profit or loss and hence, such financial liability is also managed at fair value through profit or loss; and

ii. those that meet the definition of held for trading in Ind AS 109.

(c) financial assets measured at amortised cost.

(d) financial liabilities measured at amortised cost.

(e) financial assets measured at fair value through other comprehensive income, showing separately –

i. financial assets that are measured at fair value through other comprehensive income in accordance with Ind AS 109;

ii. investments in equity instruments designated as such upon initial recognition in accordance with Ind AS 109.

- **Financial assets or financial liabilities at fair value through profit or loss**

  - If the entity has designated as measured at fair value through profit or loss a financial asset (or group of financial assets) that would otherwise be measured at fair value through other comprehensive income or amortised cost, it shall disclose:

    (a) the maximum exposure to credit risk of the financial asset (or group of financial assets) at the end of the reporting period.

    (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

    (c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:

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i. as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

ii. using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.

- If the entity has designated a financial liability as at fair value through profit or loss in accordance with Ind AS 109 and is required to present the effects of changes in that liability's credit risk in other comprehensive income, it shall disclose:

(a) the amount of change, cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

(c) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

(d) if a liability is derecognised during the period, the amount (if any) presented in other comprehensive income that was realised at derecognition.

- If an entity has designated a financial liability as at fair value through profit or loss in accordance with Ind AS 109 and is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss, it shall disclose:

(a) Amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability;

and

(b) Difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

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- **Investments in equity instruments designated at fair value through other comprehensive income**
  - ♦ If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income in accordance with Ind AS 109, it shall disclose:
    (a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.
    (b) the reasons for using this presentation alternative.
    (c) the fair value of each such investment at the end of the reporting period.
    (d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.
    (e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.
  - ♦ If an entity derecognised investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:
    (a) the reasons for disposing of the investments
    (b) the fair value of the investments at the date of derecognition
    (c) the cumulative gain or loss on disposal.
- **Reclassifications**
  - ♦ An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with Ind AS 109. For each such event, an entity shall disclose –
    (a) the date of reclassification.
    (b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.
    (c) the amount reclassified into and out of each category.
  - ♦ For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income in accordance with Ind AS 109:
    (a) the effective interest rate determined on the date of reclassification; and
    (b) the interest revenue recognised.

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- If, since its last annual reporting date, an entity has reclassified financial assets out of the fair value through other comprehensive income category so that they are measured at amortised cost; or out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income it shall disclose:

  (a) the fair value of the financial assets at the end of the reporting period; and

  (b) the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income during the reporting period if the financial assets had not been reclassified.

- **Off-setting financial assets and financial liabilities**

  - An entity shall disclose, at the end of the reporting period, the following quantitative information separately for recognised financial assets and recognised financial liabilities that have been off-set in accordance with Ind AS 32:

    (a) the gross amounts of those recognised financial assets and recognised financial liabilities;

    (b) the amounts that are set off in accordance with the criteria in Ind AS 32 when determining the net amounts presented in the balance sheet;

    (c) the net amounts presented in the balance sheet;

    (d) the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in the information disclosed for amounts set off in paragraph (b) above, including:

      i. amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of Ind AS 32; and

      ii. amounts related to financial collateral (including cash collateral); and

    (e) the net amount after deducting the amounts in (d) from the amounts in (c) above.

- Collateral

  - An entity shall disclose:

    (a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with Ind AS 109; and

    (b) the terms and conditions relating to its pledge.

  - When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:

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(a) the fair value of the collateral held;

(b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

(c) the terms and conditions associated with its use of the collateral.

- **Allowance for credit losses**

  The carrying amount of financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109 is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the balance sheet as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

- **Compound financial instruments with multiple embedded derivatives**

  If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

- **Defaults and breaches**

  - For loans payable recognised at the end of the reporting period, an entity shall disclose:

    (a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

    (b) the carrying amount of the loans payable in default at the end of the reporting period; and

    (c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

  - If, during the period, there were breaches of loan agreement terms other than those that are existing at the year end and covered by year-end disclosure above, an entity shall disclose the same information as required by paragraph above, if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the end of the reporting period).

7.4 STATEMENT OF PROFIT AND LOSS

An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

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(a) net gains or net losses on:

i. financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (eg financial liabilities that meet the definition of held for trading in Ind AS 109).

For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

ii. financial liabilities measured at amortised cost

iii. financial assets measured at amortised cost

iv. investments in equity instruments designated at fair value through other comprehensive income in accordance with Ind AS 109

v. financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period.

(b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

i. financial assets and financial liabilities that are not at fair value through profit or loss; and

ii. trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

7.5 OTHER DISCLOSURES

- **Accounting policies**

An entity discloses its significant accounting policies comprising the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

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- **Hedge accounting**

  An entity shall apply these disclosure requirements for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:

  (a) an entity's risk management strategy and how it is applied to manage risk;

  (b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

  (c) the effect that hedge accounting has had on the entity's balance sheet, statement of comprehensive income and statement of changes in equity.

- **Fair value**

  - For each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount. In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the balance sheet.

  - In some cases, an entity does not recognise a gain or loss on initial recognition of a financial asset or financial liability because the fair value is neither evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) nor based on a valuation technique that uses only data from observable markets. In such cases, the entity shall disclose by class of financial asset or financial liability:

    (a) its accounting policy for recognising in profit or loss the difference between the fair value at initial recognition and the transaction price to reflect a change in factors (including time) that market participants would take into account when pricing the asset or liability

    (b) aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

    (c) why the entity concluded that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value.

  - Disclosures of fair value are not required:

    (a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

    (b) for a contract containing a discretionary participation feature (as described in Ind AS 104) if the fair value of that feature cannot be measured reliably; or

    (c) for lease liabilities.

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- In case of contracts with discretionary participation feature, where fair value cannot be determined reliably, an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts and their fair value, including:

  (a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;

  (b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;

  (c) information about the market for the instruments;

  (d) information about whether and how the entity intends to dispose of the financial instruments; and

  (e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

- **Nature and extent of risks arising from financial instruments**

  - An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

  - The disclosures described below focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, **credit risk, liquidity risk and market risk**.

  - **Qualitative disclosures**

    For each type of risk arising from financial instruments, an entity shall disclose:

    (a) the exposures to risk and how they arise;

    (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

    (c) any changes in (a) or (b) from the previous period.

  - **Quantitative disclosures –**

    For each type of risk arising from financial instruments, including – credit risk, liquidity risk and market risk, an entity shall disclose:

    (a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided

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internally to key management personnel of the entity, for example the entity's board of directors or chief executive officer

(b) certain detailed disclosures required for each type of risk mentioned above, to the extent not provided in accordance with (a).

(c) concentration of risk if not apparent from the disclosures made in accordance with (a) and (b).

If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

- **Credit risk:**

An entity shall apply the disclosure requirements in paragraphs 35F–35N of Ind AS 107 (as described below) to financial instruments to which the impairment requirements in Ind AS 109 are applied. However:

(a) For trade receivables, contract assets and lease receivables, ***paragraph 35J(a)*** applies to those trade receivables, contract assets or lease receivables on which lifetime expected credit losses are recognised in accordance with Ind AS 109, if those financial assets are modified while more than 30 days past due; and

(b) paragraph 35K(b) does not apply to lease receivables.

- The credit risk disclosures described below shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, credit risk disclosures shall provide:

(a) information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses

(b) quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes; and

(c) information about an entity's credit risk exposure (ie the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

- **The credit risk management practices**

An entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective an

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entity shall disclose information that enables users of financial statements to understand and evaluate:

(a) how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:

ii. financial instruments are considered to have low credit risk in accordance with Ind AS 109, including the classes of financial instruments to which it applies; and

iii. the presumption of Ind AS 109, that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted;

(b) an entity's definitions of default, including the reasons for selecting those definitions;

(c) how the instruments were grouped if expected credit losses were measured on a collective basis;

(d) how an entity determined that financial assets are credit-impaired financial assets;

(e) an entity's write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity; and

(f) how the requirements in Ind AS 109 for the modification of contractual cash flows of financial assets have been applied, including how an entity:

i. determines whether the credit risk on a financial asset that has been modified while the loss allowance was measured at an amount equal to lifetime expected credit losses, has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month expected credit losses in accordance with Ind AS 109; and

ii. monitors the extent to which the loss allowance on financial assets meeting the criteria in (i) is subsequently remeasured at an amount equal to lifetime expected credit losses in accordance with Ind AS 109.

- An entity shall explain the inputs, assumptions and estimation techniques used to apply the impairment requirements in Ind AS 109. For this purpose, an entity shall disclose:

(a) the basis of inputs and assumptions and the estimation techniques used to:

i. measure the 12-month and lifetime expected credit losses;

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ii. determine whether the credit risk of financial instruments has increased significantly since initial recognition; and

iii. determine whether a financial asset is a credit-impaired financial asset.

(b) how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and

(c) changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

- Quantitative and qualitative information about amounts arising from expected credit losses

To explain the changes in the loss allowance and the reasons for those changes, an entity shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for:

(a) the loss allowance measured at an amount equal to 12-month expected credit losses;

(b) the loss allowance measured at an amount equal to lifetime expected credit losses for:

i. financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;

ii. financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

iii. trade receivables, contract assets or lease receivables for which the loss allowances are measured in accordance with Ind AS 109

(c) financial assets that are purchased or originated credit-impaired. In addition to the reconciliation, an entity shall disclose the total amount of undiscounted expected credit losses at initial recognition on financial assets initially recognised during the reporting period.

- **Credit risk exposure**

To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity shall disclose, by credit risk rating grades, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information shall be provided separately for financial instruments:

(a) for which the loss allowance is measured at an amount equal to 12-month expected credit losses;

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(b) for which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:

i. financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;

ii. financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

iii. trade receivables, contract assets or lease receivables for which the loss allowances are measured at life-time expected credit losses as an option provided in Ind AS 109.

♦ For all financial instruments to which the impairment requirements in Ind AS 109 are not applied, an entity shall disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not quality for offset in accordance with Ind AS 32); this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk.

(b) a description of collateral held as security and other credit enhancements, and their financial effect (eg quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk (whether disclosed in accordance with (a) or represented by the carrying amount of a financial instrument).

- **Liquidity risk**

An entity shall disclose:

(a) a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.

(b) a maturity analysis for derivative financial liabilities.

The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows.

(c) a description of how it manages the liquidity risk inherent in (a) and (b).

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- **Market risk**
  - An entity shall disclose:
    (a) a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
    (b) the methods and assumptions used in preparing the sensitivity analysis; and
    (c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.
  - If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity shall also disclose:
    (a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
    (b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Note: Students are advised to read the application guidance to Ind AS 107 for better understanding of the disclosure requirements related to financial instruments.

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COMPREHENSIVE ILLUSTRATIONS

Illustration 1

A Ltd. issued redeemable preference shares to a Holding Company – Z Ltd. The terms of the instrument have been summarized below. Account for this in the books of Z Ltd.

Nature	Non-cumulative redeemable preference shares
Repayment:	*Redeemable after 5 years*
Date of Allotment:	*1-Apr-20X1*
Date of repayment:	*31-Mar-20X6*
Total period:	*5.00 years*
Value of preference shares issued:	*100,000,000*
Dividend rate	*0.0001%*
Market rate of interest	*12% per annum*
Present value factor	*0.56743*

Solution

Applying the guidance in Ind AS 109, a 'financial asset' shall be recorded at its fair value upon initial recognition. Fair value is normally the transaction price. However, sometimes certain type of instruments may be exchanged at off market terms (ie, different from market terms for a similar instrument if exchanged between market participants).

For example, a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. In such cases where part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

In the above case, since A Ltd has issued preference shares to its Holding Company – Z Ltd, the relationship between the parties indicates that the difference in transaction price and fair value is akin to investment made by Z Ltd. in its subsidiary.

Following is the table summarising the computations on initial recognition:

Market rate of interest	12%
Present value factor	0.56743
Present value	56,742,686
Loan component	56,742,686
Investment in subsidiary	43,257,314

Subsequently, such preference shares shall be carried at amortised cost at each reporting date. The computation of amortised cost at each reporting date has been done as follows:

Year	Date	Opening Asset	Days	Interest @ 12%	Closing balance
	1-Apr-20X1				56,742,686
1	31-Mar-20X2	56,742,686	365	6,809,122	63,551,808
2	31-Mar-20X3	63,551,808	365	76,26,217	71,178,025
3	31-Mar-20X4	71,178,025	365	85,41,363	79,719,388
4	31-Mar-20X5	79,719,388	365	95,66,327	89,285,715
5	31-Mar-20X6	89,285,715	365	10,714,285	100,000,000

Journal Entries to be done at every reporting date

Particulars		Amount	Amount
Date of transaction			
Investment - Equity portion	Dr.	43,257,314	
Loan receivable	Dr.	56,742,686	
To Bank			100,000,000
Interest income - March 31, 20X2			
Loan receivable	Dr.	6,809,122	
To Interest income			6,809,122
Interest income - March 31, 20X3			
Loan receivable	Dr.	76,26,217	
To Interest income			76,26,217
Interest income - March 31, 20X4			
Loan receivable	Dr.	85,41,363	
To Interest income			85,41,363
Interest income - March 31, 20X5			
Loan receivable	Dr.	95,66,327	
To Interest income			95,66,327
Interest income - March 31, 20X6			
Loan receivable	Dr.	10,714,285	
To Interest income			10,714,285

Settlement of transaction			
Bank	Dr.	100,000,000	
To Loan receivable			100,000,000

*****

Illustration 2

A Limited issues ₹ 1 crore optionally convertible bonds on 1 April 20X1. The bonds have a life of eight years and a face value of ₹ 10 each, and they offer interest, payable at the end of each financial year, at a rate of 6 per cent annum. The bonds are issued at their face value and each bond can be converted into one ordinary share in A Limited at any time in the next eight years. Companies of a similar risk profile have recently issued debt with similar terms, without the option for conversion, at a rate of 8 per cent per annum.

Required:

(a) Provide the appropriate accounting entries for initial recognition.

(b) Calculate the stream of interest expenses across the eight years of the life of the bonds.

(c) Provide the accounting entries if the holders of the bonds elect to convert the bonds to ordinary shares at the end of the third year (after receiving interest for the third year).

Solution

(a) Applying the guidance for compound instruments, the present value of the bond is computed to identify the liability component and then difference between the present value of these bonds & the issue price of ₹ 1 crore shall be allocated to the equity component. In determining the present value, the rate of 8 per cent will be used, which is the interest rate paid on debt of a similar nature and risk that does not provide an option to convert the liability to ordinary shares.

Present value of bonds at the market rate of debt

Present value of principal to be received in eight years discounted at 8%

(10,000,000 X 0.5403) = 5,403,000

Present value of interest stream discounted at 8% for 8 years

(6,00,000 X 5.7466) = 3,447,960

Total present value = 8,850,960

Equity component = 1,149,040

Total face value of convertible bonds = 10,000,000

The accounting entries will be as follows:

	Dr. Amount (₹)	Cr. Amount (₹)
1 April, 20X1		
Bank Dr.	10,000,000	
To Convertible bonds (liability)		8,850,960
To Convertible bonds (equity component)		1,149,040
(Being entry to record the convertible bonds and the recognition of the liability and equity components)		
31st March, 20X2		
Interest expense Dr.	708,077	
To Bank		600,000
To Convertible bonds (liability)		108,077
(Being entry to record the interest expense, where the expense equals the present value of the opening liability multiplied by the market rate of interest).		

(b) The stream of interest expense is summarised below, where interest for a given year is calculated by multiplying the present value of the liability at the beginning of the period by the market rate of interest, this is being 8 per cent.

Date	Payment	Interest expense at 8%	Increase in bond liability	Total bond liability
1 April, 20X1				8,850,960
31 March 20X2	600,000	708,077	108,077	8,959,037
31 March 20X3	600,000	716,723	116,723	9,075,760
31 March 20X4	600,000	726,061	126,061	9,201,821
31 March 20X5	600,000	736,146	136,146	9,337,967
31 March 20X6	600,000	747,037	147,037	9,485,004
31 March 20X7	600,000	758,800	158,800	9,643,804
31 March 20X8	600,000	771,504	171,504	9,815,308
31 March 20X9	600,000	784,692*	184,692	10,000,000

*difference is due to rounding off

(c) If the holders of the bonds elect to convert the bonds to ordinary shares at the end of the third year (after receiving their interest payments), the entries in the third year would be:

		Dr. Amount (₹)	Cr. Amount (₹)
31 March 20X4			
Interest expense	Dr.	726,061	
To Bank			600,000
To Convertible bonds (liability)			126,061
(Being entry to record interest expense for the period)			
31 March 20X4			
Convertible bonds (liability)	Dr.	9,201,821	
Convertible bonds (equity component)	Dr.	1,149,040	
To Ordinary share capital A/c			10,000,000
To Securities Premium A/c			350,861
(Being entry to record the conversion of bonds into shares of A Limited recognised in equity share capital account at face value of the shares and there being no premium on equity shares, the balance has been transferred to retained earnings.)			

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Illustration 3

On 1st January 20X1, SamCo. Ltd. agreed to purchase USD ($) 20,000 from JT Bank in future on 31st December 20X1 for a rate equal to ₹ 68 per USD. SamCo. Ltd. did not pay any amount upon entering into the contract. SamCo Ltd. is a listed company in India and prepares its financial statements on a quarterly basis.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for each quarter ended till the date of actual purchase of USD.

For the purposes of accounting, please use the following information representing marked to market fair value of forward contracts at each reporting date:

As at 31st March 20X1 – ₹ (25,000)

As at 30th June 20X1 - ₹ (15,000)

As at 30th September 20X1 - ₹ 12,000

Spot rate of USD on 31st December 20X1 - ₹ 66 per USD

Solution

(i) Assessment of the arrangement using the definition of derivative included under Ind AS 109

Derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c) it is settled at a future date.

Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:

a) the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.

b) the initial amount paid to enter into the contract is zero. A contract which would give the holder a similar response to foreign exchange rate changes would have required an investment of USD 20,000 on inception.

c) the contract is settled in future

The derivative is a forward exchange contract.

As per Ind AS 109, derivatives are measured at fair value upon initial recognition and are subsequently measured at fair value through profit and loss.

(ii) Accounting on 1st January 20X1:

As there was no consideration paid and without evidence to the contrary the fair value of the contract on the date of inception is considered to be zero. Accordingly, no accounting entries shall be recorded on the date of entering into the contract.

(iii) Accounting on 31st March 20X1:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Profit and loss A/c	Dr.	25,000	
To derivative financial liability			25,000
(Being mark to market loss on forward contract recorded)			

(iv) Accounting on 30th June 20X1:

The change in value of the derivative forward contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c	Dr.	10,000	
To Profit and loss A/c			10,000
(being partial reversal of mark to market loss on forward contract recorded)			

(v) Accounting on 30th September 20X1:

The value of the derivative forward contract shall be recorded as a derivative financial asset in the books of SamCo Ltd. by recording the following journal entry:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c	Dr	15,000	
Derivative financial asset A/c	Dr	12,000	
To Profit and loss A/c			27,000
(being gain on mark to market of forward contract booked as derivative financial asset and reversal of derivative financial liability)			

(vi) Accounting on 31st December 20X1:

The settlement of the derivative forward contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. by recording the following journal entry:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank (USD Account) @ 20,000 x 66	Dr.	13,20,000	
Profit and loss A/c	Dr.	52,000	
To Bank @ 20,000 x 68			13,60,000
To Derivative financial asset A/c			12,000
(being loss on settlement of forward contract booked on actual purchase of USD)			

*****

Illustration 4

Entity A (an ₹ functional currency entity) enters into a USD 1,000,000 sale contract on 1 January 20X1 with Entity B (an ₹ functional currency entity) to sell equipment on 30 June 20X1.

Spot rate on 1 January 20X1: ₹/ USD	*45*
Spot rate on 31 March 20X1: ₹/ USD	*57*
Three-month forward rate on 31 March 20X1: ₹/ USD	*45*
Six-month forward rate on 1 January 20X1: ₹/ USD	*55*
Spot rate on 30 June 20X1: ₹/ USD	*60*

Assume that this contract has an embedded derivative that is not closely related and requires separation. Please provide detailed journal entries in the books of Entity A for accounting of such embedded derivative until sale is actually made.

Solution

The contract should be separated using the 6 month USD / ₹ forward exchange rate, as at the date of the contract (₹/USD = 55). The two components of the contract are therefore:

- A sale contract for ₹ 55 Million
- A six-month currency forward to purchase USD 1 Million at 55
- This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery

1. Entity A records the sales at the amount of the host contract = ₹ 55 Million
2. The embedded derivative is considered to expire.
3. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial asset on delivery.
4. In this case the carrying value of the currency forward at 30 June 20X1 on maturity is = ₹ (1,000,000 x 60 – 55 x 1,000,000) = ₹ 5,000,000 (profit/asset)

The table summarising the computation of gain/ loss to be recorded at every period end -

Date	Transaction	Sales	Debtors	Derivative Asset (Liability)	(Profit) Loss
		₹	₹	₹	₹
1-Jan-20X1	Embedded Derivative	Nil Value			
31-Mar-20X1	Change in Fair Value of Embedded Derivatives MTM (55-45) x 1 Million			(10,000,000)	10,000,000

30-Jun-20X1	Change in Fair Value of Embedded Derivatives (60-45) x 1 Million			15,000,000	(15,000,000)
30-Jun-20X1	Recording sales at forward rate	(55,000,000)	55,000,000		
30-Jun-20X1	Embedded derivative-settled against debtors		5,000,000	(5,000,000)	

Journal Entries to be recorded at every period end

a. 01 January 20X1 – No entry to be made

b. 31 March 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Profit and loss A/c	Dr.	10,000,000	
To Derivative financial liability A/c			10,000,000
(being loss on mark to market of embedded derivative booked)			

c. 30 June 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial asset A/c	Dr.	5,000,000	
Derivative financial liability A/c	Dr.	10,000,000	
To Profit and loss A/c			15,000,000
(being gain on embedded derivative based on spot rate at the date of settlement booked)			

d. 30 June 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Trade receivable A/c	Dr.	55,000,000	
To Sales A/c			55,000,000
(being sale booked at forward rate on the date of transaction)			

e. 30 June 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Trade receivable A/c	Dr	5,000,000	
To Derivative financial asset A/c			5,000,000
(being derivative asset re-classified as a part of trade receivables, bringing it to spot rate on the date of sale)			

*****

Illustration 5

On 1st January 20X1, SamCo. Ltd. entered into a written put option for USD ($) 20,000 with JT Corp to be settled in future on 31st December 20X1 for a rate equal to ₹ 68 per USD at the option of JT Corp. SamCo. Ltd. did not receive any amount upon entering into the contract. SamCo Ltd. is a listed company in India and prepares its financial statements on a quarterly basis.

Following the classification principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for each quarter ended till the date of actual purchase of USD.

For the purposes of accounting, please use the following information representing marked to market fair value of put option contracts at each reporting date:

As at 31st March 20X1 – ₹ (25,000)

As at 30th June 20X1 - ₹ (15,000)

As at 30th September 20X1 - ₹ NIL

Spot rate of USD on 31st December 20X1 - ₹ 66 per USD

Solution

i. Assessment of the arrangement using the definition of derivative included under Ind AS 109

Derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

a. its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

b. it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. it is settled at a future date.

Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:

a) the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.

d) the initial amount received to enter into the contract is zero. A contract which would give the holder a similar response to foreign exchange rate changes would have required an investment of USD 20,000 on inception.

e) the contract is settled in future

The derivative liability is a written put option contract.

As per Ind AS 109, derivatives are measured at fair value upon initial recognition and are subsequently measured at fair value through profit and loss.

ii. Accounting on 1st January 20X1

As there was no consideration paid and without evidence to the contrary the fair value of the contract on the date of inception is considered to be zero. Accordingly, no accounting entries shall be recorded on the date of entering into the contract.

iii. Accounting on 31st March 20X1

The value of the derivative put option contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Profit and loss A/c	Dr.	25,000	
To derivative financial liability			25,000
(Being mark to market loss on the put option contract recorded)			

iv. Accounting on 30th June 20X1

The change in value of the derivative put option contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c	Dr.	10,000	
To Profit and loss A/c			10,000
(Being partial reversal of mark to market loss on the put option contract recorded)			

v. Accounting on 30th September 20X1

The change in value of the derivative option contract shall be recorded as a zero in the books of SamCo Ltd. by recording the following journal entry:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c	Dr.	15,000	
To Profit and loss A/c			15,000
(Being gain on mark to market of put option contract booked to make the value the derivative liability as zero)			

vi. Accounting on 31st December 20X1

The settlement of the derivative put option contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. upon exercise by JT Corp. by recording the following journal entry:

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank (USD Account) @ 20,000 x 66	Dr.	13,20,000	
Profit and loss A/c	Dr.	40,000	
To Bank @ 20,000 x 68			13,60,000
(being loss on settlement of put option contract booked on actual purchase of USD)			

*****

Illustration 6

ABC Company issued 10,000 compulsory cumulative convertible preference shares (CCCPS) as on 1 April 20X1 @ ₹ 150 each. The rate of dividend is 10% payable every year. The preference shares are convertible into 5,000 equity shares of the company at the end of 5th year from the date of allotment. When the CCCPS are issued, the prevailing market interest rate for similar debt without conversion options is 15% per annum. Transaction cost on the date of issuance is 2% of the value of the proceeds.

Key terms:

Date of Allotment	*01-Apr-20X1*
Date of Conversion	*01-Apr-20X6*
Number of Preference Shares	*10,000*
Face Value of Preference Shares	*150*
Total Proceeds	*15,00,000*

Rate of dividend	*10%*
Market Rate for Similar Instrument	*15%*
Transaction Cost	*30,000*
Face value of equity share after conversion	*10*
Number of equity shares to be issued	*5,000*
Effective interest rate	*15.86%*

You are required to compute the liability and equity component and pass journal entries for entire term of arrangement i.e. from the issue of preference shares till their conversion into equity shares keeping in view the provisions of relevant Ind AS.

Solution

This is a compound financial instrument with two components – liability representing present value of future cash outflows and balance represents equity component.

a. Computation of Liability & Equity Component

Date	Particulars	Cash Flow	Discount Factor	Net present Value
01-Apr-20X1		0	1	0.00
31-Mar-20X2	Dividend	150,000	0.869565	130,434.75
31-Mar-20X3	Dividend	150,000	0.756144	113,421.6
31-Mar-20X4	Dividend	150,000	0.657516	98,627.4
31-Mar-20X5	Dividend	150,000	0.571753	85,762.95
31-Mar-20X6	Dividend	150,000	0.497177	74,576.55
Total Liability Component				502,823.25
Total Proceeds				1,500,000.00
Total Equity Component (Bal fig)				997,176.75

b. Allocation of transaction costs

Particulars	Amount	Allocation	Net Amount
Liability Component	502,823	10,056	492,767
Equity Component	997,177	19,944	977,233
Total Proceeds	1,500,000	30,000	1,470,000

c. Accounting for liability at amortised cost:

- Initial accounting = Present value of cash outflows less transaction costs

- Subsequent accounting = At amortised cost, ie, initial fair value adjusted for interest and repayments of the liability.

	Opening Financial Liability A	Interest B	Cash Flow C	Closing Financial Liability A+B-C
01-Apr-20X1	492,767	-	-	4,92,767
31-Mar-20X2	492,767	78,153	150,000	4,20,920
31-Mar-20X3	420,920	66,758	150,000	3,37,678
31-Mar-20X4	337,678	53,556	150,000	2,41,234
31-Mar-20X5	241,234	38,260	150,000	1,29,494
31-Mar-20X6	129,494	20,506	150,000	-

d. Journal Entries to be recorded for entire term of arrangement are as follows:

Date	Particulars		Debit	Credit
01-Apr-20X1	Bank A/c	Dr.	1,470,000	
	To Preference Shares Liability A/c			492,767
	To Equity Component of Preference shares A/c			977,233
	(Being compulsorily convertible preference shares issued. The same are divided into equity component and liability component as per the calculation)			
31-Mar-20X2	Preference shares Liability A/c	Dr.	150,000	
	To Bank A/c			150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)			
31-Mar-20X2	Finance cost A/c	Dr.	78,153	
	To Preference Shares Liability A/c			78,153
	(Being interest as per EIR method recorded)			
31-Mar-20X3	Preference shares Liability A/c	Dr.	150,000	
	To Bank A/c			150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)			

31-Mar-20X3	Finance cost A/c Dr.	66,758	
	To Preference Shares Liability A/c		66,758
	(Being interest as per EIR method recorded)		
31-Mar-20X4	Preference shares Liability A/c Dr.	150,000	
	To Bank A/c		150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X4	Finance cost A/c Dr.	53,556	
	To Preference Shares Liability A/c		53,556
	(Being interest as per EIR method recorded)		
31-Mar-20X5	Preference shares Liability A/c Dr.	150,000	
	To Bank A/c		150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X5	Finance cost A/c Dr.	38,260	
	To Preference Shares Liability A/c		38,260
	(Being interest as per EIR method recorded)		
31-Mar-20X6	Preference shares Liability A/c Dr.	150,000	
	To Bank A/c		150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X6	Finance cost A/c Dr.	20,506	
	To Preference Shares Liability A/c		20,506
	(Being interest as per EIR method recorded)		
31-Mar-20X6	Equity Component of Preference shares A/c Dr.	977,233	
	To Equity Share Capital A/c		50,000
	To Securities Premium A/c		927,233
	(Being Preference shares converted in equity shares and remaining equity component is recognised as securities premium)		

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EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

A. Disclosure of Preference Shares under Liabilities (and not Shareholders' Funds) in the Annual Report of Tata Capital Ltd. For the year 2022-2023:

TATA CAPITAL
Count on us

Annual Report 2022-23

NOTES FORMING PART OF STANDALONE FINANCIAL STATEMENTS

NOTE "14" (₹ in lakh)

SUBORDINATED LIABILITIES	As at March 31, 2023	As at March 31, 2022
At Amortised cost		
UNSECURED		
(a) Preference Shares other than those that qualify as equity		
(i) Cumulative Redeemable Preference Shares [Face Value ₹ 1,06,972 lakh (As at March 31, 2022 ₹ 1,10,992 lakh)]	**1,07,013**	1,10,983
Total (A)	**1,07,013**	**1,10,983**
Subordinated Liabilities in India	**1,07,013**	1,10,983
Subordinated Liabilities outside India	-	-
Total (B)	**1,07,013**	**1,10,983**

No default has been made in repayment of any Debt securities, Subordinated liabilities and interest thereon for the year ended March 31, 2023 and March 31, 2022.

(Source: Annual reports for 2022-2023 of Tata capital Ltd.)

B. Accounting Policy and OCI Extracts from the annual reports of Reliance Industries Ltd. For the year 2021-2022-Presentation of movements in Fair Values of Financial Instruments through OCI

Notes

to the Standalone Financial Statements for the year ended 31st March, 2022

(₹ in crore)

	2021-22	2020-21
27.1 Other Comprehensive Income - Items that will not be Reclassified to Profit and Loss		
Remeasurement gain / (loss) of Defined Benefit Plan	(42)	21
Equity instruments through OCI	283	329
Total	**241**	**350**

(₹ in crore)

	2021-22	2020-21
27.2 Other Comprehensive Income - Items that will be reclassified to Profit and Loss		
Government Securities	(121)	(152)
Debenture or Bonds	(146)	83
Debt Income Fund	(686)	(491)
Fixed Maturity Plan	(344)	84
Commodity Hedge	91	504
Cash flow Hedge	(1,499)	2,727
Total	**(2,705)**	**2,755**

38. Financial Instruments

A. Fair Value Measurement Hierarchy

(₹ in crore)

Particulars	As at 31st March, 2022				As at 31st March, 2021			
	Carrying Amount	Level of input used in			Carrying Amount	Level of input used in		
		Level 1	Level 2	Level 3		Level 1	Level 2	Level 3
Financial Assets								
At Amortised Cost								
Investments *	30,874	-	-	-	38,222	-	-	-
Trade Receivables	14,394	-	-	-	4,159	-	-	-
Cash and Cash Equivalents	21,714	-	-	-	5,573	-	-	-
Loans	42,112	-	-	-	65,066	-	-	-
Other Financial Assets	55,428	-	-	-	58,933	-	-	-
At FVTPL								
Investments	28,098	24,825	3,023	250	31,810	27,235	4,325	250
Other Financial Assets	1,720	-	1,720	-	2,245	-	2,245	-
At FVTOCI								
Investments	1,80,655	68,724	33,191	78,740	1,45,484	64,944	2,268	78,272
Other Financial Assets	-	-	-	-	7	-	7	-
Financial Liabilities								
At Amortised Cost								
Borrowings	1,94,563	-	-	-	2,21,698	-	-	-
Trade Payables	1,34,005	-	-	-	86,999	-	-	-
Lease Liabilities	2,876				2,985			
Other Financial Liabilities	31,034	-	-	-	30,790	-	-	-
At FVTPL								
Other Financial Liabilities	4,951	-	4,951	-	3,463	-	3,463	-
At FVTOCI								
Other Financial Liabilities	450	-	450	-	-	-	-	-

* Exclude Group Company investments ₹ 1,69,170 crore (Previous Year ₹1,31,769 crore) measured at cost (Refer Note 2.1).

A.1 Reconciliation of fair value measurement of the investment categorised at level 3:

(₹ in crore)

Particulars	As at 31st March, 2022		As at 31st March, 2021	
	At FVTPL	At FVTOCI	At FVTPL	At FVTOCI
Opening Balance	250	78,272	965	77,910
Addition during the year	-	232	-	84
Sale/Reduction during the year	-	94	715	-
Total Gain/(Loss)	-	330	-	278
Closing Balance	250	78,740	250	78,272
Line item in which gain/(loss) recognised		Other Comprehensive Income- Items that will not be reclassified to Profit or Loss		Other Comprehensive Income-Items that will not be reclassified to Profit or Loss

A.2 Sensitivity of level 3 financial instrument's fair value to changes in significant unobservable inputs used in their fair valuation:

(₹ in crore)

Particulars	Valuation Technique	Significant Unobservable Input	Change in %	Sensitivity of the fair value to change in input	
				31st March, 2022	31st March, 2021
Investment in OCPS (FVTOCI)	Discounting Cash Flow	Discounting rate - 14.51% (Previous Year -13.12%)	+0.10%	(1,547)	(1,436)
			-0.10%	1,573	1,463

A.3 The below table summarises the fair value of borrowings which are carried at amortised cost:

(₹ in crore)

Particulars	Level	31st March, 2022	31st March, 2021
Non-current borrowings (including current maturities)	Level 1	1,03,546	1,11,025
	Level 2	79,857	82,180
	Level 3	3,137	3,796

For current borrowings, the carrying amounts approximates fair value due to the short maturity of these instruments.

The financial instruments are categorised into three levels based on the inputs used to arrive at fair value measurements as described below

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2: Inputs other than the quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and

Level 3: Inputs based on unobservable market data.

Valuation Methodology

All financial instruments are initially recognised and subsequently re-measured at fair value as described below:

a) The fair value of investment in quoted Equity Shares, Bonds, Government Securities, Treasury Bills, Certificate of Deposit and Mutual Funds is measured at quoted price or NAV.

b) The fair value of Interest Rate Swaps is calculated as the present value of the estimated future cash flows based on observable yield curves.

c) The fair value of Forward Foreign Exchange contracts and Currency Swaps is determined using observable forward exchange rates and yield curves at the balance sheet date.

d) The fair value of over-the-counter Foreign Currency Option contracts is determined using the Black Scholes valuation model.

e) Commodity derivative contracts are valued using available information in markets and quotations from exchange, brokers and price index developers.

f) The fair value for level 3 instruments is valued using inputs based on information about market participants assumptions and other data that are available.

g) The fair value of the remaining financial instruments is determined using discounted cash flow analysis.

h) All foreign currency denominated assets and liabilities are translated using exchange rate at reporting date.

B. Financial Risk Management

The company's activities expose it to variety of financial risks: market risk, credit risk, interest rate risk and liquidity risk. Within the boundaries of approved Risk Management Policy framework The Company uses derivative instruments to manage the volatility of financial markets and minimize the adverse impact on its financial performance.

i) Market Risk

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: interest rate risk, currency risk and other price risk, such as equity price risk and commodity risk.

a) Foreign Currency Risk

Foreign currency risk is the risk that the Fair Value or Future Cash Flows of an exposure will fluctuate because of changes in foreign currency rates. Exposures can arise on account of the various assets and liabilities which are denominated in currencies other than Indian Rupee.

The following table shows foreign currency exposures in US Dollar, Euro and Japanese Yen on financial instruments at the end of the reporting period. The exposure to all other foreign currencies are not material.

(₹ in crore)

Particulars	Foreign Currency Exposure					
	As at 31st March, 2022			As at 31st March, 2021		
	USD	EUR	JPY	USD	EUR	JPY
Borrowings	1,15,850	11,993	10,731	96,823	12,634	11,555
Trade and Other Payables	1,30,415	1,154	-	81,227	2,528	-
Trade and Other Receivables	(13,639)	(244)	(13)	(3,692)	(110)	(13)
Derivatives						
- Forwards & Futures	(54,958)	(12,500)	(10,927)	(55,461)	(13,970)	(11,528)
- Currency Swap	-	-	-	2,655	-	-
- Options	(2,877)	126	(319)	(19,347)	(472)	727
Exposure	1,74,791	529	(528)	1,02,205	610	741

Sensitivity analysis of 1% change in exchange rate at the end of reporting period net of hedges *

(₹ in crore)

Particulars	Foreign Currency Sensitivity					
	As at 31st March, 2022			As at 31st March, 2021		
	USD	EUR	JPY	USD	EUR	JPY
1% Depreciation in INR						
Impact on Equity	(165)	-	-	(260)	(11)	(28)
Impact on P&L	(114)	(5)	5	(240)	11	28
Total	**(279)**	**(5)**	**5**	**(500)**	**-**	**-**
1% Appreciation in INR						
Impact on Equity	165	-	-	260	11	28
Impact on P&L	114	5	(5)	240	(11)	(28)
Total	**279**	**5**	**(5)**	**500**	**-**	**-**

* Includes natural hedges arising from foreign currency denominated earnings, for which hedge accounting may be implemented.

b) Interest Rate Risk

The Company is also exposed to interest rate risk, changes in interest rates will affect future cash flows or the fair values of its financial instruments, principally debt. The Company issues debt in a variety of currencies based on market opportunities and it uses derivatives to hedge interest rate exposures.

The exposure of the company's borrowings and derivatives to interest rate changes at the end of the reporting period are as follows:

(₹ in crore)

Interest Rate Exposure		
Particulars	**As at 31st March, 2022**	**As at 31st March, 2021**
Borrowings		
Non-Current - Floating (includes Current Maturities)*	**86,216**	88,618
Non-Current - Fixed (includes Current Maturities)*	**99,978**	1,00,721
Current #	**9,418**	33,301
Total	**1,95,612**	**2,22,640**
Derivatives		
Foreign Currency Interest Rate Swaps		
- Receive Fix	**5,647**	2,924
- Pay Fix	**1,516**	29,606
Rupees Interest Rate Swaps		
- Receive Fix	**32,495**	7,975
- Pay Fix	**14,525**	11,475
Currency Swaps		
- INR to USD Swap ^	**-**	2,655

* Include ₹ 1,029 crore (Previous Year ₹ 793 crore) as Prepaid Finance Charges.
# Include ₹ 20 crore (Previous Year ₹ 149 crore) as Commercial Paper Discount.
^ Receive fix in INR and pay floating in USD

Sensitivity analysis of 1% change in Interest rate

(₹ in crore)

Particulars	Interest rate Sensitivity			
	As at 31st March, 2022		**As at 31st March, 2021**	
	Up Move	**Down Move**	**Up Move**	**Down Move**
Impact on Equity	**(187)**	**182**	(123)	123
Impact on P&L	**(976)**	**920**	(665)	665
Total Impact	**(1,163)**	**1,102**	**(788)**	**788**

ii) Commodity Price Risk

Commodity price risk arises due to fluctuation in prices of crude oil, other feed stock and products. The company has a risk management framework aimed at prudently managing the risk arising from the volatility in commodity prices and freight costs.

The Company's commodity risk is managed centrally through well-established trading operations and control processes. In accordance with the risk management policy, the Company enters into various transactions using derivatives and uses over-the-counter as well as Exchange Traded Futures, Options and Swap contracts to hedge its commodity and freight exposure.

iii) Credit Risk

Credit risk is the risk that a customer or counterparty to a financial instrument fails to perform or pay the amounts due causing financial loss to the company. Credit risk arises from company's activities in investments, dealing in derivatives and receivables from customers. The Company ensure that sales of products are made to customers with appropriate creditworthiness. Investment and other market exposures are managed against counterparty exposure limits. Credit information is regularly shared between businesses and finance function, with a framework in place to quickly identify and respond to cases of credit deterioration.

The company has a prudent and conservative process for managing its credit risk arising in the course of its business activities. Credit risk is actively managed through Letters of Credit, Bank Guarantees, Parent Company Guarantees, advance payments and factoring & forfaiting without recourse to the company to avoid concentration of risk. The company restricts its fixed income investments to liquid securities carrying high credit rating.

iv) Liquidity Risk

Liquidity risk arises from the Company's inability to meet its cash flow commitments on the due date. The company maintains sufficient stock of cash, marketable securities and committed credit facilities. The company accesses global and local financial markets to meet its liquidity requirements. It uses a range of products and a mix of currencies to ensure efficient funding from across well-diversified markets and investor pools. Treasury monitors rolling forecasts of the company's cash flow position and ensures that the company is able to meet its financial obligation at all times including contingencies.

The company's liquidity is managed centrally with operating units forecasting their cash and liquidity requirements. Treasury pools the cash surpluses from across the different operating units and then arranges to either fund the net deficit or invest the net surplus in a range of short-dated, secure and liquid instruments including short-term bank deposits, money market funds, reverse repos and similar instruments. The portfolio of these investments is diversified to avoid concentration risk in any one instrument or counterparty.

(₹ in crore)

Particulars ^	Maturity Profile as at 31st March, 2022						
	Below 3 Months	3-6 Months	6-12 Months	1-3 Years	3-5 Years	Above 5 Years	Total
Borrowings							
Non-Current *@	2,169	6,416	9,517	74,969	32,724	60,399	1,86,194
Current #$	9,328	90	-	-	-	-	9,418
Total	**11,497**	**6,506**	**9,517**	**74,969**	**32,724**	**60,399**	**1,95,612**
Lease Liabilities (Gross)	**85**	**79**	**148**	**552**	**552**	**4,577**	**5,993**
Derivative Liabilities							
Forwards	3,033	601	677	390	-	-	4,701
Options	151	2	20	-	-	-	173
Interest Rate Swaps	-	-	4	43	30	-	77
Total	**3,184**	**603**	**701**	**433**	**30**	**-**	**4,951**

^ Does not include Trade Payables (Current) ₹ 1,34,005 crore.
* Include ₹ 1,029 crore as Prepaid Financial Charges.
@ Does not include interest thereon (For Interest rate refer Note 16.2).
# Include ₹ 20 crore of Commercial Paper Discount.
$ Interest rate on current borrowings ranges from 2.5% to 8.6%.

(₹ in crore)

Particulars ^	Maturity Profile as at 31st March, 2021						
	Below 3 Months	3-6 Months	6-12 Months	1-3 Years	3-5 Years	Above 5 Years	Total
Borrowings							
Non-Current *@	3,048	4,606	20,447	65,641	61,593	34,004	1,89,339
Current #$	30,638	2,663	-	-	-	-	33,301
Total	**33,686**	**7,269**	**20,447**	**65,641**	**61,593**	**34,004**	**2,22,640**
Lease Liabilities (Gross)	**88**	**88**	**175**	**587**	**552**	**4,853**	**6,343**
Derivative Liabilities							
Forwards	1,476	349	176	1,097	-	-	3,098
Options	178	-	33	-	-	-	211
Interest Rate Swaps	10	1	22	45	76	-	154
Total	**1,664**	**350**	**231**	**1,142**	**76**	**-**	**3,463**

^ Does not include Trade Payables (Current) ₹ 86,999 crore.
* Include ₹ 793 crore as Prepaid Financial Charges.
@ Does not include interest thereon.
# Include ₹ 149 crore as Commercial Paper Discount.
$ Interest rate on current borrowings ranges from 3.4% to 8.6%.

C. Hedge Accounting

The Company's business objective includes safe-guarding its earnings against adverse price movements of crude oil and other feedstock, refined products, freight costs as well as foreign exchange and interest rates. The Company has adopted a structured risk management policy to hedge all these risks within an acceptable risk limit and an approved hedge accounting framework which allows for Fair Value and Cash Flow hedges. Hedging instruments include exchange traded futures and options, over-the-counter swaps, forwards and options as well as non-derivative instruments to achieve this objective.

There is an economic relationship between the hedged items and the hedging instruments. The Company has established a hedge ratio of 1:1 for the hedging relationships. To test the hedge effectiveness, the Company uses the hypothetical derivative method and Dollar offset method.

The hedge ineffectiveness can arise from:

- Differences in the timing of the cash flows.
- Different indexes (and accordingly different curves).
- The counterparties' credit risk differently impacting the fair value movements.

The table below shows the position of hedging instruments and hedged items as on the balance sheet date:

Disclosure of effects of hedge accounting

A. Fair Value Hedge

Hedging Instrument

(₹ in crore)

Particulars	Nominal Value	Quantity (Kbbl)	Carrying Amount		Changes in Fair Value	Hedge Maturity	Line Item in Balance Sheet
			Assets	Liabilities			
As on 31st March, 2022							
Foreign Currency Risk							
Derivative Contracts	-	-	-	-	-	-	-
Commodity Price Risk							
Derivative Contracts	**33,663**	**1,58,884**	**1,274**	**2,114**	**(1,094)**	**April 2022 to December 2023**	**Other Financial Assets / Liabilities**
As on 31st March, 2021							
Foreign Currency Risk							
Derivative Contracts	2,557	-	-	86	(72)	April 2021 to May 2021	Other Financial Liabilities
Commodity Price Risk							
Derivative Contracts	30,478	3,85,566	1,524	597	20	April 2021 to December 2023	Other Financial Assets / Liabilities

Hedged Items

(₹ in crore)

Particulars	Carrying Amount		Changes in Fair Value	Line Item in Balance Sheet
	Assets	Liabilities		
As on 31st March, 2022				
Foreign Currency Risk				
Import Firm Commitments	-	-	-	
Commodity Price Risk				
Firm Commitments for purchase of feedstock and freight	-	**1,010**	**(943)**	**Other Current Assets / Liabilities**
Firm Commitments for sale of products	**2,114**	-	**2,301**	**Other Current Assets**
Inventories	**3807**	-	**(264)**	**Inventories**
As on 31st March, 2021				
Foreign Currency Risk				
Import Firm Commitments	86	-	72	Other Financial Assets
Commodity Price Risk				
Firm Commitments for purchase of feedstock and freight	-	306	(656)	Other Current Assets / Liabilities
Firm Commitments for sale of products	-	1,218	(446)	Other Current Assets

B. Cash Flow Hedge

Hedging Instruments

(₹ in crore)

Particulars	Nominal Value	Carrying amount		Changes in Fair Value	Hedge Maturity	Line Item in Balance Sheet
		Assets	Liabilities			
As on 31st March, 2022						
Foreign Currency Risk						
Foreign Currency Risk Component - Trade Payables	22,301	-	22,738	(437)	1st April, 2022 to 31st March, 2025	Trade Payables
Foreign Currency Risk Component-Borrowings	1,20,017	-	1,23,697	(3,685)	30th September, 2022 to 30th September, 2033	Non-Current Liabilities-Financial Liabilities-Borrowings
Interest Rate Risk						
Interest Rate Swaps	-	-	-	-	-	-
As on 31st March, 2021						
Foreign Currency Risk						
Foreign Currency Risk Component - Trade Payables	-	-	-	-	-	-
Foreign Currency Risk Component-Borrowings	7,218	-	7,311	256	June 2022	Non-Current Liabilities-Financial Liabilities-Borrowings
Interest Rate Risk						
Interest Rate Swaps	33,590	82	-	141	April 2021 to March 2025	Other Financial Assets

Hedged Items

(₹ in crore)

Particulars	Nominal Value	Changes in Fair Value	Hedge Reserve	Line Item in Balance Sheet
As on 31st March, 2022				
Foreign Currency Risk				
Highly Probable Forecasted Exports	1,42,318	4,122	(4,810)	Other Equity
Interest Rate Risk				
Borrowings	-	-	-	-
As on 31st March, 2021				
Foreign Currency Risk				
Highly Probable Forecasted Exports	7,218	(256)	(3,059)	Other Equity
Interest Rate Risk				
Borrowings	33,590	(141)	(97)	Other Equity

C. Movement in Cash Flow Hedge

(₹ in crore)

Sr. No.	Particulars	2021-22	2020-21	Line Item in Balance Sheet / Statement of Profit and Loss
1	At the beginning of the year	(3,156)	(5,883)	
2	Gain/ (loss) recognised in other comprehensive income during the year.	(4,334)	914	Items that will be reclassified to Profit & Loss
3	Amount reclassified to Profit and Loss during the year	2,835	1,813	Value of Sale
4	At the end of the year	(4,655)	(3,156)	Other Comprehensive Income

Extract of Accounting Policy in respect of Financial Instruments: Page 319-320

(q) Financial Instruments

i. Financial Assets

A. Initial Recognition and Measurement

All Financial Assets are initially recognised at fair value. Transaction costs that are directly attributable to the acquisition or issue of Financial Assets, which are not at Fair Value Through Profit or Loss, are adjusted to the fair

value on initial recognition. Purchase and sale of Financial Assets are recognised using trade date accounting.

B. Subsequent Measurement

a) **Financial Assets measured at Amortised Cost (AC)**

A Financial Asset is measured at Amortised Cost if it is held within a business model whose objective is to hold the asset in order to collect contractual cash flows and the contractual terms of the Financial Asset give rise to cash flows on specified dates that represent solely payments of principal and interest on the principal amount outstanding.

b) **Financial Assets measured at Fair Value Through Other Comprehensive Income (FVTOCI)**

A Financial Asset is measured at FVTOCI if it is held within a business model whose objective is achieved by both collecting contractual cash flows and selling Financial Assets and the contractual terms of the Financial Asset give rise on specified dates to cash flows that represents solely payments of principal and interest on the principal amount outstanding.

c) **Financial Assets measured at Fair Value Through Profit or Loss (FVTPL)**

A Financial Asset which is not classified in any of the above categories are measured at FVTPL. Financial assets are reclassified subsequent to their recognition, if the Company changes its business model for managing those financial assets. Changes in business model are made and applied prospectively from the reclassification date which is the first day of immediately next reporting period following the changes in business model in accordance with principles laid down under Ind AS 109 – Financial Instruments.

C. Investment in Subsidiaries, Associates and Joint Ventures

The Company has accounted for its investments in Subsidiaries, associates and joint venture at cost less impairment loss (if any). The investments in preference shares with the right of surplus assets which are in nature of equity in accordance with Ind AS 32 are treated as separate category of investment and measured at FVTOCI.

D. Other Equity Investments

All other equity investments are measured at fair value, with value changes recognised in Statement of Profit and Loss, except for those equity investments for which the Company has elected to present the value changes in 'Other Comprehensive Income'. However, dividend on such equity investments are recognised in Statement of Profit and loss when the Company's right to receive payment is established.

E. Impairment of Financial Assets

In accordance with Ind AS 109, the Company uses 'Expected Credit Loss' (ECL) model, for evaluating impairment of Financial Assets other than those measured at Fair Value Through Profit and Loss (FVTPL).

Expected Credit Losses are measured through a loss allowance at an amount equal to:

- The 12-months expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or
- Full lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

For Trade Receivables the Company applies 'simplified approach' which requires expected lifetime losses to be recognised from initial recognition of the receivables.

The Company uses historical default rates to determine impairment loss on the portfolio of trade receivables. At every reporting date these historical default rates are reviewed and changes in the forward-looking estimates are analysed.

For other assets, the Company uses 12 month ECL to provide for impairment loss where there is no significant increase in credit risk. If there is significant increase in credit risk full lifetime ECL is used.

ii. Financial Liabilities

A. Initial Recognition and Measurement

All Financial Liabilities are recognised at fair value and in case of borrowings, net of directly attributable cost. Fees of recurring nature are directly recognised in the Statement of Profit and Loss as finance cost.

B. Subsequent Measurement

Financial Liabilities are carried at amortised cost using the effective interest method. For trade and other payables maturing within one year from the balance sheet date, the carrying amounts approximate fair value due to the short maturity of these instruments.

iii. Derivative Financial Instruments and Hedge Accounting

The Company uses various derivative financial instruments such as interest rate swaps, currency swaps, forwards & options and commodity contracts to mitigate the risk of changes in interest rates, exchange rates and commodity prices. At the inception of a hedge relationship, the Company formally designates and documents the hedge relationship to which the Company wishes to apply hedge accounting and the risk management objective and strategy for undertaking the hedge. Such derivative financial instruments are initially recognised at fair value on the date on which a derivative contract is entered into and are also subsequently measured at fair value.

Derivatives are carried as Financial Assets when the fair value is positive and as Financial Liabilities when the fair value is negative. Any gains or losses arising from changes in the fair value of derivatives are taken directly to Statement of Profit and Loss, except for the effective portion of cash flow hedge which is recognised in Other Comprehensive Income and later to Statement of Profit and Loss when the hedged item affects profit or loss or is treated as basis adjustment if a hedged forecast transaction subsequently results in the recognition of a Non-Financial Assets or Non-Financial liability.

Hedges that meet the criteria for hedge accounting are accounted for as follows:

A. Cash Flow Hedge

The Company designates derivative contracts or non-derivative Financial Assets/ Liabilities as hedging instruments to mitigate the risk of movement in interest rates and foreign exchange rates for foreign exchange exposure on highly probable future cash flows attributable to a recognised asset or liability or forecast cash transactions.

When a derivative is designated as a cash flow hedging instrument, the effective portion of changes in the fair value of the derivative is recognised in the cash flow hedging reserve being part of Other Comprehensive Income. Any ineffective portion of changes in the fair value of the derivative is recognised immediately in the Statement of Profit and Loss. If the hedging relationship no longer meets the criteria for hedge accounting, then hedge accounting is discontinued prospectively. If the hedging instrument expires or is sold or terminated or exercised, the cumulative gain or loss on the hedging instrument recognised in cash flow hedging reserve till the period the hedge was effective remains in cash flow hedging reserve until the underlying transaction occurs. The cumulative gain or loss previously recognised in the cash flow hedging reserve is transferred to the Statement of Profit and Loss upon the occurrence of the underlying transaction. If the forecasted transaction is no longer expected to occur, then the amount accumulated in cash flow hedging reserve is reclassified in the Statement of Profit and Loss.

B. Fair Value Hedge

The Company designates derivative contracts or non-derivative Financial Assets/Liabilities as hedging instruments to mitigate the risk of change in fair value of hedged item due to movement in interest rates, foreign exchange rates and commodity prices.

Changes in the fair value of hedging instruments and hedged items that are designated and qualify as fair value hedges are recorded in the Statement of Profit and Loss. If the hedging relationship no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised to Statement of Profit and Loss over the period of maturity.

iv. Derecognition of Financial Instruments

The Company derecognises a Financial Asset when the contractual rights to the cash flows from the Financial Asset expire or it transfers the Financial Asset and the transfer qualifies for derecognition under Ind AS 109. A Financial liability (or a part of a Financial liability) is derecognised from the Company's Balance Sheet when the obligation specified in the contract is discharged or cancelled or expires.

v. Offsetting

Financial Assets and Financial Liabilities are offset and the net amount is presented in the balance sheet when, and only when, the Company has a legally enforceable right to set off the amount and it intends, either to settle them on a net basis or to realise the asset and settle the liability simultaneously.

(r) Non-current Assets Held for Sale

Non-current assets are classified as held for sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use and sale is considered highly probable.

A sale is considered as highly probable when decision has been made to sell, assets are available for immediate sale in its present condition, assets

(Source: Annual reports for 2022-2023 of Reliance Industries Ltd.)

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

IND AS 32

IND AS 109

TEST YOUR KNOWLEDGE

Questions

1. As part of staff welfare measures, Y Co Ltd. has contracted to lend to its employees sums of money at 5% per annum rate of interest. The amounts lent are to be repaid in five equal instalments for principle along with the interest. The market rate of interest is 10% per annum for comparable loans. Y lent ₹ 1,600,000 to its employees on 1st January 20X1.

   Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for the year ended 31 December 20X1, for the transaction and also compute the value of loan initially to be recognised and amortised cost for all subsequent years.

   For the purpose of calculation, following discount factors at interest rate of 10% per annum may be adopted –

   At the end of year –

Year	Present value factor
1	.909
2	.827
3	.751
4	.683
5	.620

2. Wheel Co. Limited has a policy of providing subsidized loans to its employees for the purpose of buying or building houses. Mr. X, who's executive assistant to the CEO of Wheel Co. Limited, took a loan from the Company on the following terms:

- Interest rate: 4% for the first 400,000 and 7% for the next 600,000
- Start date: 1 January 20X1
- Tenure: 5 years
- Pre-payment: Full or partial pre-payment at the option of the employee
- The principal amount of loan shall be recovered in 5 equal annual instalments and will be first applied to 7% interest bearing principal
- The accrued interest shall be paid on an annual basis
- Mr. X must remain in service till the term of the loan ends

The market rate of a comparable loan available to Mr. X, is 12% per annum.

Following table shows the contractually expected cash flows from the loan given to Mr. X:

(amount in ₹)

		Inflows			
Date	**Outflows**	**Principal**	**Interest income 7%**	**Interest income 4%**	**Principal outstanding**
1-Jan-20X1	(1,000,000)				1,000,000
31-Dec-20X1		200,000	42,000	16,000	800,000
31-Dec-20X2		200,000	28,000	16,000	600,000
31-Dec-20X3		200,000	14,000	16,000	400,000
31-Dec-20X4		200,000	-	16,000	200,000
31-Dec-20X5		200,000	-	8,000	-

Mr. S, pre-pays ₹ 200,000 on 31 December 20X2, reducing the outstanding principal as at that date to ₹ 400,000.

Following table shows the actual cash flows from the loan given to Mr. X, considering the pre-payment event on 31 December 20X2:

(amount in ₹)

		Inflows			
Date	**Outflows**	**Principal**	**Interest income 7%**	**Interest income 4%**	**Principal outstanding**
1-Jan-20X1	(1,000,000)				1,000,000
31-Dec-20X1		200,000	42,000	16,000	800,000
31-Dec-20X2		400,000	28,000	16,000	400,000
31-Dec-20X3		200,000	-	16,000	200,000
31-Dec-20X4		200,000	-	8,000	-
31-Dec-20X5		-	-	-	-

Record journal entries in the books of Wheel Co. Limited considering the requirements of Ind AS 109.

3. Wheel Co. Limited borrowed ₹ 500,000,000 from a bank on 1 January 20X1. The original terms of the loan were as follows:

- Interest rate: 11%
- Repayment of principal in 5 equal instalments
- Payment of interest annually on accrual basis
- Upfront processing fee: ₹ 5,870,096

Effective interest rate on loan: 11.50%

On 31 December 20X2, Wheel Co. Limited approached the bank citing liquidity issues in meeting the cash flows required for immediate instalments and re-negotiated the terms of the loan with banks as follows:

- Interest rate 15%
- Repayment of outstanding principal in 10 equal instalments starting 31 December 20X3
- Payment of interest on an annual basis

Record journal entries in the books of Wheel Co. Limited till 31 December 20X3, after giving effect of the changes in the terms of the loan on 31 December 20X2

4. K Ltd. issued 500,000, 6% convertible debentures @ ₹ 10 each on 01 April 20X1. The debentures are due for redemption on 31 March 20X5 at a premium of 10%, convertible into 2,50,000 equity shares of Rs. 10 each i.e. to the extent of 50% and balance to be settled in cash to the debenture holders. The interest rate on equivalent debentures without conversion rights was 10%.

You are required to separate the debt and equity components at the time of issue and show the accounting entries in Company's books at initial recognition. The following present values of Re 1 at 6% and at 10% are provided:

Interest rate	Year 1	Year 2	Year 3	Year 4
6%	0.94	0.89	0.84	0.79
10%	0.91	0.83	0.75	0.68

5. On 1 April 20X1, an 8% convertible loan with a nominal value of ₹ 6,00,000 was issued at par. It is redeemable on 31 March 20X5 also at par. Alternatively, it may be converted into equity shares on the basis of 100 new shares for each ₹ 200 worth of loan.

An equivalent loan without the conversion option would have carried interest at 10%. Interest of ₹ 48,000 has already been paid and included as a finance cost.

Present value rates are as follows:

Year End	@ 8%	@ 10%
1	0.93	0.91
2	0.86	0.83
3	0.79	0.75
4	0.73	0.68

Explain how will the Company account for the above loan notes in the financial statements for the year ended 31 March 20X2?

6. On 1 April 20X1, Sun Limited guarantees a ₹ 10,00,000 loan of Subsidiary – Moon Limited, which Bank STDK has provided to Moon Limited for three years at 8%.

Interest payments are made at the end of each year and the principal is repaid at the end of the loan term.

If Sun Limited had not issued a guarantee, Bank STDK would have charged Moon Limited an interest rate of 11%. Sun Limited does not charge Moon Limited for providing the guarantee.

On 31 March 20X2, there is 1% probability that Moon Limited may default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited.

On 31 March 20X3, there is 3% probability that Moon Limited may default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited.

Provide the accounting treatment of financial guarantee as per Ind AS 109 in the books of Sun Ltd., on initial recognition and in subsequent periods till 31 March 20X3.

Answers

1. (i) **Calculation of initial measurement amount of loan to its employees:**

Year end	Cash flow		Total	PV factor	Present value
	Principal	Interest @ 5%			
20X1	320,000	80,000	400,000	.909	363,600
20X2	320,000	64,000	384,000	.827	317,568
20X3	320,000	48,000	368,000	.751	276,368
20X4	320,000	32,000	352,000	.683	240,416
20X5	320,000	16,000	336,000	.620	208,320
					1,406,272

(ii) **Calculation of amortised cost of loan to employees**

Year end	Amortised cost (opening balance)	Interest to be recognised	Repayment (including interest)	Amortised cost (closing balance)
20X1	1,406,272	140,627	400,000	1,146,899
20X2	1,146,899	114,690	384,000	877,589
20X3	877,589	87,759	368,000	597,348
20X4	597,348	59,735	352,000	305,083
20X5	305,083	30,917*	336,000	-

*305,083 x 10% = 30,508. Difference of ₹ 409 is due to approximation in computation.

(iii) **Journal Entries to be recorded of Y Ltd. for the year ended 31 December 20X1**

Date	Particulars		Debit	Credit
1 Jan 20X1	Staff loan A/c	Dr.	14,06,272	
	Prepaid staff cost A/c* [(1,600,000 – 1,406,272), Refer part (ii)]	Dr.	1,93,728	
	To Bank A/c			16,00,000
	(Being disbursement of loans to staff and excess loan balance over present value thereof in order to reflect the loan at its present value booked as prepaid staff cost)			

31 Dec 20X1	Staff loan A/c Dr.	1,40,627	
	To Interest expense A/c		1,40,627
	(Being interest accrued on loans to staff)		
31 Dec 20X1	Staff cost A/c Dr.	38,746	
	To Prepaid expense A/c		38,746
	(Being prepaid expense charged for the year against staff cost)		

* Where the difference between the amount given by the Company to its employees and its fair value represents another asset, then such asset shall be recognised. Accordingly, such difference is recognised as prepaid employee cost and amortised over the period of loan.

2. As per requirement of Ind AS 109, a financial instrument is initially measured and recorded at its fair value. Therefore, considering the market rate of interest of similar loan available to Mr. X is 12%, the fair value of the contractual cash flows shall be as follows:

	Inflows				
Date	**Principal**	**Interest income 7%**	**Interest income 4%**	**Discount factor @12%**	**PV**
31-Dec-20X1	200,000	42,000	16,000	0.8929	2,30,357
31-Dec-20X2	200,000	28,000	16,000	0.7972	1,94,515
31-Dec-20X3	200,000	14,000	16,000	0.7118	1,63,709
31-Dec-20X4	200,000	-	16,000	0.6355	1,37,272
31-Dec-20X5	200,000	-	8,000	0.5674	1,18,025
Total (fair value)					8,43,878

Benefit to Mr. X, to be considered a part of employee cost for Wheel Co. ₹ 1,56,121.

The deemed employee cost is to be amortised over the period of loan i.e. the minimum period that Mr. X must remain in service.

The amortization schedule of the ₹ 843,878 loan is shown in the following table:

Date	**Loan outstanding**	**Total cash inflows (principal repayment + interest**	**Interest @ 12%**
1-Jan-20X1	843,878		
31-Dec-20X1	687,143	258,000	101,265
31-Dec-20X2	525,600	244,000	82,457

31-Dec-20X3	358,672	230,000	63,072
31-Dec-20X4	185,713	216,000	43,041
31-Dec-20X5	(0)	208,000	22,287*

* Difference is due to approximation.

Journal Entries to be recorded at every period end:

a. 1 January 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan to employee A/c	Dr.	843,879	
Pre-paid employee cost A/c	Dr	156,121	
To Bank A/c			1,000,000
(Being loan asset recorded at initial fair value)			

b. 31 December 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	258,000	
To Interest income (profit and loss) @12% A/c			101,265
To Loan to employee A/c			156,735
(Being first instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)			
Employee benefit (profit and loss) A/c	Dr.	31,224	
To Pre-paid employee cost A/c			31,224
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)			

On 31 December 20X2, due to pre-payment of a part of loan by Mr. X, the carrying value of the loan shall be re-computed by discounting the future remaining cash flows by the original effective interest rate.

There shall be two sets of accounting entries on 31 December 20X2, first the realisation of the contractual cash flow as shown in (c) below and then the accounting for the pre-payment of ₹ 200,000 included in (d) below:

c. 31 December 20X2 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	244,000	
To Interest income (profit and loss) @12% A/c			82,457
To Loan to employee A/c			161,543
(Being second instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)			
Employee benefit (profit and loss) A/c	Dr.	31,224	
To Pre-paid employee cost A/c			31,224
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)			

Computation of new carrying value of loan to employee:

	Inflows				
Date	Principal	Interest income 7%	Interest income 4%	Discount factor @12%	PV
31-Dec-20X3	200,000	-	16,000	0.8929	192,857
31-Dec-20X4	200,000	-	8,000	0.7972	165,816
Total (revised carrying value)					358,673
Less: Current carrying value					525,601
Adjustment required					166,928

The difference between the amount of pre-payment and adjustment to loan shall be considered a gain, though will be recorded as an adjustment to pre-paid employee cost, which shall be amortised over the remaining tenure of the loan.

d. 31 December 20X2 prepayment–

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	200,000	
To Pre-paid employee cost A/c			33,072
To Loan to employee A/c			166,928
(Being gain to Wheel Co. Limited recorded as an adjustment to pre-paid employee cost)			

The amortisation schedule of the new carrying amount of loan shall be as follows:

Date	Loan outstanding	Total cash inflows (principal repayment + interest	Interest @ 12%
31-Dec-20X2	358,673		
31-Dec-20X3	185,714	216,000	43,041
31-Dec-20X4	-	208,000	22,286

Amortisation of employee benefit cost shall be as follows:

Date	Balance	Amortised to P&L	Adjustment
1-Jan-20X1	156,121		
31-Dec-20X1	124,897	31,224	
31-Dec-20X2	60,601	31,224	33,072
31-Dec-20X3	30,300	30,300	
31-Dec-20X4	-	30,300	

e. 31 December 20X3 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c Dr. To Interest income (profit and loss) @12% A/c To Loan to employee A/c (Being third instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)	216,000	 43,041 172,959
Employee benefit (profit and loss) A/c Dr To Pre-paid employee cost A/c (Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)	30,300	 30,300

f. 31 December 20X4 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c Dr. To Interest income (profit and loss) @12% A/c To Loan to employee A/c (Being last instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)	208,000	 22,286 185,714

Employee benefit (profit and loss) A/c	Dr.	30,300	
To Pre-paid employee cost A/c			30,300
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)			

3. On the date of initial recognition, the effective interest rate of the loan shall be computed keeping in view the contractual cash flows and upfront processing fee paid. The following table shows the amortisation of loan based on effective interest rate:

Date	Cash flows (principal)	Cash flows (interest and fee)	Amortised cost (opening + interest – cash flows)	Interest @ EIR (11.50%)
1-Jan-20X1	(500,000,000)	5,870,096	494,129,904	
31-Dec-20X1	100,000,000	55,000,000	395,954,843	56,824,939
31-Dec-20X2	100,000,000	44,000,000	297,489,650	45,534,807
31-Dec-20X3	100,000,000	33,000,000	198,700,959	34,211,310
31-Dec-20X4	100,000,000	22,000,000	99,551,570	22,850,610
31-Dec-20X5	100,000,000	11,000,000	(0)	11,448,430

a. 1 January 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	494,129,904	
To Loan from bank A/c			494,129,904
(Being loan recorded at its fair value less transaction costs on the initial recognition date)			

b. 31 December 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan from bank A/c	Dr.	98,175,061	
Interest expense (profit and loss)	Dr.	56,824,939	
To Bank A/c			155,000,000
(Being first instalment of loan and payment of interest accounted for as an adjustment to the amortised cost of loan)			

c. 31 December 20X2 – Before Wheel Co. Limited approached the bank –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Interest expense (profit and loss)	Dr.	45,534,807	
To Loan from bank A/c			1,534,807
To Bank A/c			44,000,000
(Being loan payment of interest recorded by the Company before it approached the Bank for deferment of principal)			

Upon receiving the new terms of the loan, Wheel Co. Limited, re-computed the carrying value of the loan by discounting the new cash flows with the original effective interest rate and comparing the same with the current carrying value of the loan. As per requirements of Ind AS 109, any change of more than 10% shall be considered a substantial modification, resulting in fresh accounting for the new loan:

Date	Cash flows (principal)	Interest outflow @15%	Discount factor	PV of cash flows
31-Dec-20X2	(400,000,000)			
31-Dec-20X3	40,000,000	60,000,000	0.8969	89,686,099
31-Dec-20X4	40,000,000	54,000,000	0.8044	75,609,805
31-Dec-20X5	40,000,000	48,000,000	0.7214	63,483,092
31-Dec-20X6	40,000,000	42,000,000	0.6470	53,053,542
31-Dec-20X7	40,000,000	36,000,000	0.5803	44,100,068
31-Dec-20X8	40,000,000	30,000,000	0.5204	36,429,133
31-Dec-20X9	40,000,000	24,000,000	0.4667	29,871,422
31-Dec-20Y0	40,000,000	18,000,000	0.4186	24,278,903
31-Dec-20Y1	40,000,000	12,000,000	0.3754	19,522,235
31-Dec-20Y3	40,000,000	6,000,000	0.3367	15,488,493
PV of new contractual cash flows discounted at 11.50%				451,522,791
Carrying amount of loan				397,489,650
Difference				54,033,141
Percentage of carrying amount				13.59%

Note: Calculation done above is on full decimal, though in the table discount factor is limited to 4 decimals.

Considering a more than 10% change in PV of cash flows compared to the carrying value of the loan, the existing loan shall be considered to have been extinguished and the new loan shall be accounted for as a separate financial liability. The accounting entries for the same are included below:

d. 31 December 20X2 – accounting for extinguishment

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan from bank (old) A/c	Dr.	397,489,650	
Loss on modification of loan (profit and loss)	Dr.	2,510,350	
To Loan from bank (new) A/c			400,000,000
(Being new loan accounted for at its principal amount in absence of any transaction costs directly related to such loan and correspondingly a de-recognition of existing loan)			

e. 31 December 20X3

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan from bank A/c	Dr.	40,000,000	
Interest expense (profit and loss)	Dr.	60,000,000	
To Bank A/c			100,000,000
(Being first instalment of the new loan and payment of interest accounted for as an adjustment to the amortised cost of loan)			

4. Computation of debt component of convertible debentures on 01 April 20X1

Particulars	Amount
Present value of principal amount repayable after 4 years	
(A) 5,000,000 x 50% x 1.10 x 0.68 (10% discount factor)	1,870,000
(B) Present value of interest [300,000 x 3.17] (4 years cumulative 10% discount factor)	951,000
Total present value of debt component (A) + (B)	2,821,000
Issue proceeds from convertible debentures	5,000,000
Value of equity component	2,179,000

Journal entry at initial recognition

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	5,000,000	
To 6% debenture A/c (liability component)			2,821,000
To 6% debenture A/c (equity component)			2,179,000
(Being disbursement recorded at fair value)			

5. **Step 1** There is an 'option' to convert the loans into equity i.e. the loan note holders do not have to accept equity shares; they could demand repayment in the form of cash.

Ind AS 32 states that where there is an obligation to transfer economic benefits there should be a liability recognised. On the other hand, where there is not an obligation to transfer economic benefits, a financial instrument should be recognised as equity.

In the above illustration we have both – 'equity' and 'debt' features in the instrument. There is an obligation to pay cash – i.e. interest at 8% per annum and a redemption amount – this is 'financial liability' or 'debt component'. The 'equity' part of the transaction is the option to convert. So it is a compound financial instrument.

Step 2 Debt element of the financial instrument so as to recognise the liability is the present value of interest and principal

The rate at which the same is to be discounted, is the rate of *equivalent* loan note *without* the conversion option would have carried interest at 10%, therefore this is the rate to be used for discounting

Step 3 Calculation of the debt element of the loan note as follows:

8% Interest discounted at a rate of 10% Present Value (6,00,000 x 8%)

S. No	Year	Interest amount	PVF	Amount
Year 1	20X2	48,000	0.91	43,680
Year 2	20X3	48,000	0.83	39,840
Year 3	20X4	48,000	0.75	36,063
				1,19,583
Year 4	20X5	648,000	0.68	4,40,640
Amount to be recognised as a liability				5,60,223

Initial proceeds	(6,00,000)
Amount to be recognised as equity	**39,777**

* In year 4, the loan note is redeemed therefore ₹ 6,00,000 + ₹ 48,000 = ₹ 6,48,000.

Step 4 The next step is to recognise the interest component equivalent to the loan that would carry if there was no option to cover. Therefore, the interest should be recognised at 10%. As on date ₹ 48,000 has been recognised in the statement of profit and loss i.e. 6,00,000 x 8% but we have discounted the present value of future interest payments and redemption amount using discount factors of 10%, so the finance charge in the statement of profit and loss must also be recognised at the same rate i.e. for the purpose of consistency.

The additional charge to be recognised in the income statement is calculated as:

Debt component of the financial instrument ₹ 5,60,000

Interest charge (5,60,000 x 10%)	₹ 56,000
Already charged to the income statement	(₹ 48,000)
Additional charge required	₹ 8,000

Journal Entries for recording additional finance cost for year ended 31 March 20X2

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Finance cost A/c Dr.	8,000	
To Debt component A/c		8,000
(Being interest recorded for difference between amount recorded earlier and that to be recorded per Ind AS 32)		

6. ***1 April 20X1***

A financial guarantee contract is initially recognised at fair value. The fair value of the guarantee will be the present value of the difference between the net contractual cash flows required under the loan, and the net contractual cash flows that would have been required without the guarantee.

Particulars	Year 1 (₹)	Year 2 (₹)	Year 3 (₹)	Total (₹)
Cash flows based on interest rate of 11% (A)	1,10,000	1,10,000	1,10,000	3,30,000
Cash flows based on interest rate of 8% (B)	80,000	80,000	80,000	2,40,000
Interest rate differential (A-B)	30,000	30,000	30,000	90,000
Discount factor @ 11%	0.901	0.812	0.731	
Interest rate differential discounted at 11%	27,030	24,360	21,930	73,320
Fair value of financial guarantee contract (at inception)				73,320

Journal Entry

Particulars		Debit (₹)	Credit (₹)
Investment in subsidiary	Dr.	73,320	
To Financial guarantee (liability)			73,320
(Being financial guarantee initially recorded)			

31 March 20X2

Subsequently at the end of the reporting period, financial guarantee is measured at the higher of:

- the amount of loss allowance; and
- the amount initially recognised less cumulative amortization, where appropriate.

At 31 March 20X2, there is 1% probability that Moon Limited may default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited. The 12-month expected credit losses are therefore ₹ 10,000 (Rs.10,00,000 x 1%).

The initial amount recognised less amortisation is ₹ 51,385 (₹ 73,320 + ₹ 8,065 (interest accrued based on EIR)) – ₹ 30,000 (benefit of the guarantee in year 1) Refer table below. The unwound amount is recognised as income in the books of Sun Limited, being the benefit derived by Moon Limited not defaulting on the loan during the period.

Year	Opening balance ₹	EIR @ 11%	Benefits provided ₹	Closing balance ₹
1	73,320	8,065	(30,000)	51,385
2	51,385	5,652	(30,000)	27,037
3	27,037	2,963*	(30,000)	-

* Difference is due to approximation

The carrying amount of the financial guarantee liability after amortisation is therefore ₹ 51,385, which is higher than the 12-month expected credit losses of ₹ 10,000. The liability is therefore adjusted to ₹ 51,385 (the higher of the two amounts) as follows:

Particulars		Debit (₹)	Credit (₹)
Financial guarantee (liability)	Dr.	21,935	
To Profit or loss			21,935
(Being financial guarantee subsequently adjusted)			

31 March 20X3

At 31 March 20X3, there is 3% probability that Moon Limited will default on the loan in the next 12 months. If Moon Limited defaults on the loan, Sun Limited does not expect to recover any amount from Moon Limited. The 12-month expected credit losses are therefore ₹ 30.000 (₹ 10,00,000 x 3%).

The initial amount recognised less accumulated amortisation is ₹ 27,037, which is lower than the 12-month expected credit losses (₹ 30,000). The liability is therefore adjusted to ₹ 30,000 (the higher of the two amounts) as follows:

Particulars		Debit (₹)	Credit (₹)
Financial guarantee (liability)	Dr.	21,385*	
To Profit or loss (Note)			21,385
(Being financial guarantee subsequently adjusted)			

* The carrying amount at the end of 31 March 20X2 = ₹ 51,385 less 12-month expected credit losses of ₹ 30,000.

NOTES

NOTES

CHAPTER 12

INDIAN ACCOUNTING STANDARD 103: BUSINESS COMBINATIONS



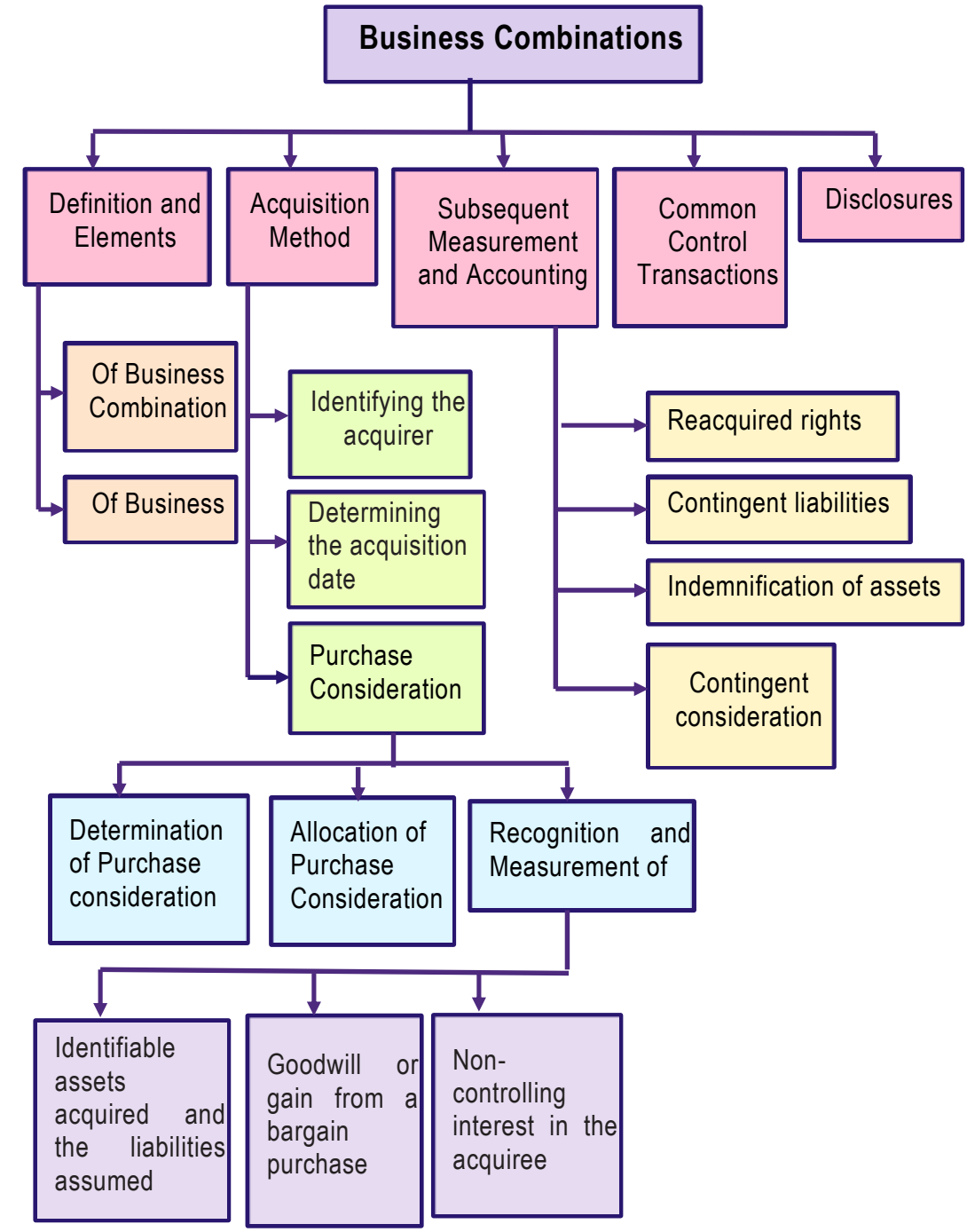
LEARNING OUTCOMES

After studying this chapter, you would be able to:

- Explain various terms used in Ind AS 103 "Business Combinations"
- Examine the key differences between Ind AS 103 and Accounting Standard 14
- Identify the acquiring enterprise
- Determine the acquisition date, purchase consideration under various situations and contingent consideration
- Allocate the purchase price
- Recognize the assets and liabilities of the acquired entity
- Examine the measurement principles
- Calculate goodwill or bargain purchase
- Evaluate contingent payments to employee shareholders and acquirer share-based payment awards exchanged for awards held by the acquiree's employees
- Integrate subsequent measurement and accounting principles for reacquired rights, contingent liabilities, indemnification assets and contingent consideration
- Appraise the disclosure requirements in case of Business Combination
- Account for distribution of non-cash assets to owners as dividend in accordance with Appendix A Distribution of Non-Cash Assets to Owners of Ind AS 10 Events after the Reporting Period.

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CHAPTER OVERVIEW



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1. INTRODUCTION

The necessity of a standard on Business Combination in India assumes importance considering the fact that Indian companies are increasingly stretching their business in foreign countries for best-fit business combinations. Presently in India, Accounting Standard (AS) 14 'Accounting for Amalgamation' lays out specific treatment for Amalgamation and AS 21, 'Consolidated Financial Statements' are applied for consolidation. However, it is not matching the global financial reporting standards requirements.

After convergence of IFRS as Ind AS, Ind AS 103 which is in line with IFRS 3 takes care of the global requirements in case of business combinations worldwide.

A **business combination** is a transaction in which the acquirer obtains control of another business (the acquiree).

The term **'business'** is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing ***goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.***

Business combinations are most common form of business transactions through which companies grow in size rather than organic activities.

Business combination or acquisition is different from asset acquisition. The following are the key differences in accounting of an asset acquisition and a business combination:

Particulars	Business Combination	Acquisition of group of assets under Ind AS
Intangible assets, including goodwill	Intangible assets are recognised at fair value, if they are separately identifiable. Goodwill is recognised as a separate asset.	Intangible assets acquired as part of a group of assets would be recognised and measured based on an allocation of the overall cost of the transaction with reference to their relative fair values. No goodwill would be recognised.
Transaction Costs	In a business combination, acquisition-related costs (including stamp duty) are expensed in the period in which	Transaction costs are capitalised as a component of the cost of the assets acquired.

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	such costs are incurred and are not included as part of the consideration transferred.	
Deferred Tax Accounting	Deferred taxes are recorded on temporary differences of assets acquired (other than goodwill) and liabilities assumed in a business combination.	Ind AS prohibits recognition of deferred taxes for temporary differences that arise upon initial recognition of an asset or liability in a transaction which (i) is not a business combination and (ii) at the time of the transaction, affects neither accounting nor taxable income. [Ind AS 12 paragraph 15]. Accordingly, no deferred taxes are recognised for temporary differences on asset acquisitions (on initial recognition).
Situations where the fair value of the assets acquired and liabilities assumed exceeds the fair value of consideration Transferred (referred to as gain on bargain purchases)	If the fair value of the assets acquired and liabilities assumed exceeds the fair value of the consideration transferred (plus the amount of non-controlling interest and the fair value of the acquirer's previously held equity interests in the acquiree), a gain is recognised by the acquirer in other comprehensive income and accumulate the same in equity as capital reserve.	The assets acquired and liabilities assumed are measured using an allocation of the fair value of consideration transferred based upon relative fair values. As a result, no gain is recognised for a bargain purchase.
Contingent liabilities assumed	To be recognised if represents present obligation that arises from past events and its fair value can be measured reliably with subsequent changes to profit or loss.	Not recognised, subject to Ind AS 37.

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Illustration 1: Asset acquisition

An entity acquires an equipment and a patent in exchange for ₹ 1,000 crore cash and land. The fair value of the land is ₹ 400 crore and its carrying value is ₹ 100 crore. Fair values of the equipment and patent are estimated to be ₹ 500 crore and ₹ 1,000 crore, respectively. The equipment and patent relate to a product that has just recently been commercialised. The market for this product is still developing.

Assume the entity incurred no transaction costs. For ease of convenience, the tax consequences on the gain have been ignored.

State how should the transaction be accounted for.

Solution

As per paragraph 2(b) of Ind AS 103, the standard does not apply to "the acquisition of an asset or a group of assets that does not constitute a business. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in Ind AS 38, Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill". In the given case, the acquisition of equipment and patent does not represent acquisition of a business as equipment and patent relate to a product that has just recently been commercialised.

The cost of the asset acquisition is determined based on the fair value of the assets given, unless the fair value of the assets received is more reliably determinable. In the given case, the fair value measurement of the land appears more reliable than the fair value estimate of the equipment and patent. Thus, the entity should record the acquisition of the equipment and patent as ₹ 1,400 crore (the total fair value of the consideration transferred).

Thus, the fair value of the consideration given, i.e., ₹ 1,400 crore is allocated to the individual assets acquired based on their relative estimated fair values. The entity should record a gain of ₹ 300 crore for the difference between the fair value and carrying value of the land.

The equipment is recorded at its relative fair value ((₹ 500 / ₹ 1,500) × ₹ 1,400 = ₹ 467 crore).

The patent is recorded at its relative fair value ((₹ 1,000 / ₹ 1,500) × ₹ 1,400 = ₹ 933 Crore).

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2. SCOPE UNDER IND AS 103

This Indian Accounting Standard applies to a transaction or other event that meets the definition of a business combination. This Indian Accounting Standard does not apply to:

(a) the formation of a joint arrangement.

(b) the acquisition of an asset or a group of assets that does not constitute a business i.e. it is an asset acquisition.

3. DEFINITION OF BUSINESS COMBINATION

Under Ind AS 103, Business combination occurs when an entity obtains **control** of a **business** by acquiring net assets or acquiring its significant equity interest. An entity can obtain control of a business by contract only in which case the acquirer would neither have acquired net assets nor equity interest. In such a case, while preparing balance sheet, controlling interest would be zero and non-controlling interest will be 100%.

- As such, two elements are required for a transaction to be a business combination under Ind AS 103:
  - the acquirer obtains control of an acquiree ("control" as defined in Ind AS 110); and
  - the acquiree is a business
- An acquirer might obtain control of an acquiree in a variety of ways, for example:
  - by transferring cash, cash equivalents or other assets (including net assets that constitute a business);
  - by incurring liabilities;
  - by issuing equity interests;
  - by providing more than one type of consideration; or
  - without transferring consideration, including by contract alone.
- A business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:
  - one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;

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- one combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners;
- all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or
- a group of former owners of one of the combining entities obtains control of the combined entity.



4. DEFINITION AND ELEMENTS OF BUSINESS

4.1 Definition of Business

As per paragraph B7 of the application guidance of Ind AS 103, a business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business.

Analysis: Ind AS 103 defines business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

For a transaction to meet the definition of a business combination (and for the acquisition method of accounting to apply), the entity must gain control of an integrated set of assets and activities that is more than a collection of assets or a combination of assets and liabilities. It will be straightforward in most cases to determine whether a business has been acquired. A business would normally be carrying out a continuing trade with identifiable revenue. This means that the assets or combination of assets and liabilities of the acquired entity interact with each other and, importantly, with the people who operate the assets as a business. However, determining whether a business has been acquired may not be easy and in some cases will require judgement.

4.2 Elements of Business

The three elements of a business are defined as follows:

(a) **Input**: Any economic resource that creates outputs or has the ability to contribute to the creation of outputs, when one or more processes are applied to it.

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Example:

Non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

(b) Process: Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates output or has the ability to contribute to the creations of outputs.

Example:

Strategic management processes, operational processes and resource management processes.

These processes typically are documented, but the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

(c) Output: The result of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities.

4.3 Further Assessment

To be capable of being conducted and managed for the purpose identified in the definition of a business, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs.

Therefore, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output.

Substantive Process:

To determine whether acquired process is substantive, following has to be considered:

(1) If a set of activities and assets does not have output at the acquisition date, an acquired process (or group of processes) shall be considered substantive only if-

(a) It is critical to the ability to develop or convert an acquired input or inputs into outputs; and

(b) The inputs acquired include both an organised workforce that has the necessary skills, knowledge, or experience to perform that process (or group of processes) and other inputs that the organised workforce could develop or convert into outputs.

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Those other inputs could include-

(i) Intellectual property that could be used to develop a good or service;

(ii) Other economic resources that could be developed to create outputs; or

(iii) Rights to obtain access to necessary materials or rights that enable the creation of future Outputs.

(2) If a set of activities and assets has outputs at the acquisition date, an acquired process (or group of processes) shall be considered substantive if, when applied to an acquired input or inputs, it-

(a) is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce with the necessary skills, knowledge, or experience to perform that process (or group of processes); or

(b) significantly contributes to the ability to continue producing outputs and-

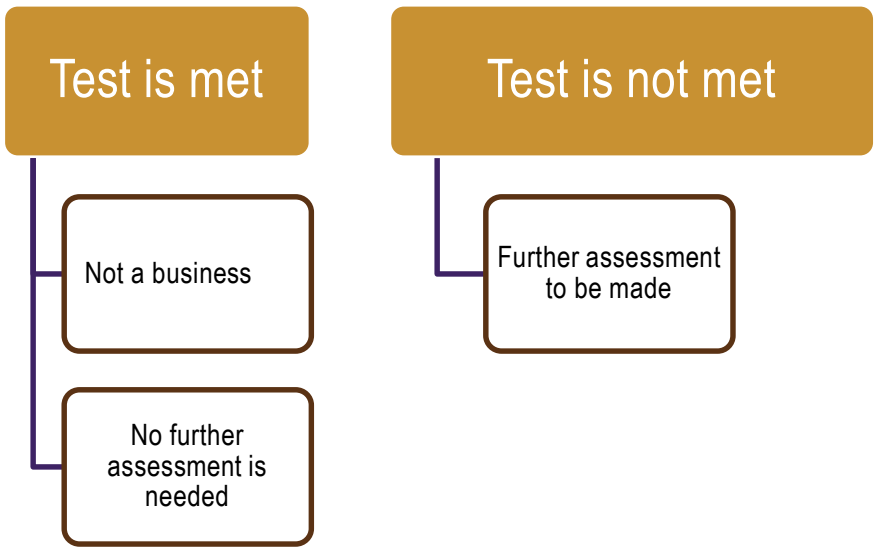
(i) is considered unique or scarce; or

(ii) cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

4.4 Concentration Test

As per paragraph B7A of the application guidance of Ind AS 103, an optional test (the concentration test) has been introduced to permit a simplified assessment of whether an acquired set of activities and assets is not a business.

On the basis of the above test, following will be the consequences:



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Following conditions should be present to meet concentration test:

As per paragraph B7A of the application guidance of Ind AS 103, the concentration test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. For the concentration test:

(a) gross assets acquired shall exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities;

(b) the fair value of the gross assets acquired shall include any consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) in excess of the fair value of net identifiable assets acquired.

(c) a single identifiable asset shall include any asset or group of assets that would be recognized and measured as a single identifiable asset in a business combination;

(d) if a tangible asset is attached to, and cannot be physically removed and used separately from, another tangible asset (or from an underlying asset subject to a lease, as defined in Ind AS 116, Leases), without incurring significant cost, or significant diminution in utility or fair value to either asset (for example, land and buildings), those assets shall be considered a single identifiable asset;

(e) when assessing whether assets are similar, an entity shall consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics);

(f) the following shall not be considered similar assets:

  (i) a tangible asset and an intangible asset;

  (ii) tangible assets in different classes unless they are considered a single identifiable asset in accordance with the criterion in subparagraph (d);

  (iii) identifiable intangible assets in different classes

  (iv) a financial asset and a non-financial asset;

  (v) financial assets in different classes; and

  (vi) identifiable assets that are within the same class of asset but have significantly different risk characteristics.

Notes:

1) Concentration test is optional test and the decision to apply is made on a transaction to transaction basis.

2) Does not prohibit an entity from performing a detailed test assessment using definition of business given in this standard.

3) 3 Step process for concentration test:

  a) Measure the Fair Value of Gross Assets acquired.

  b) Identify the single identifiable assets or group of similar identifiable asset.

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c) Determine if substantially all of the value determined in point (a) is concentrated in the value determined in point (b) then it is an asset acquisition otherwise needs to assess business definition as per Ind AS 103.

Fair value of gross assets shall be determined as follows (I + ii – iii):

i) Fair value of consideration transferred (including fair value of non-controlling interest and fair value of previously interest held)

ii) Fair value of liabilities assumed.

iii) Cash and cash equivalent and deferred tax assets and goodwill resulting from DTL's.

Example 1: On 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 x 30%)

Fair value of Entity A's previously held interest is ₹ 80 Crores (400 x 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.

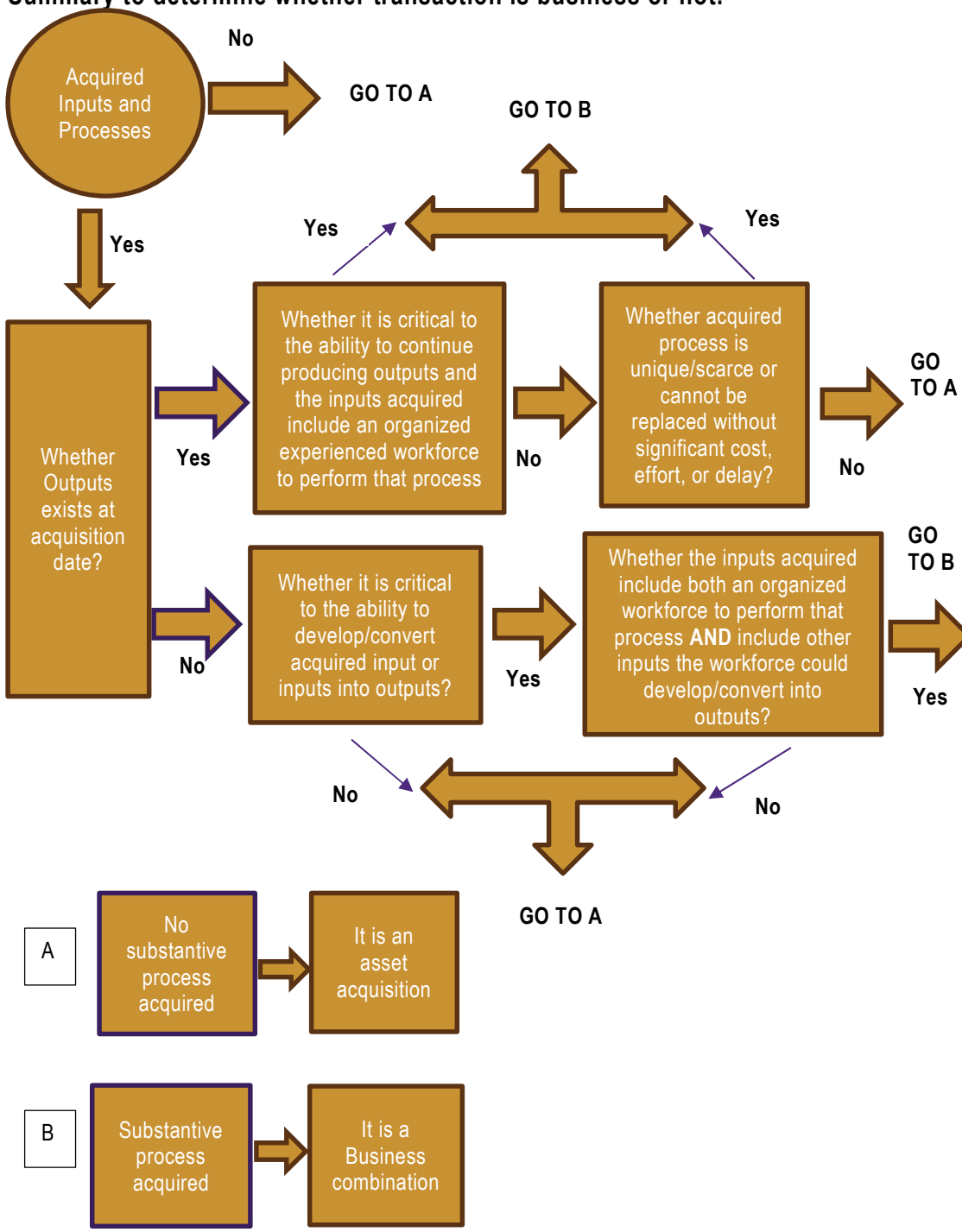
Fair value of gross assets acquired - ₹ 1,100 Crores

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). A Judgement is required to conclude on the word substantially as the same is not defined in the standard.

In our view we have considered 91% of the value as substantial to conclude the above transaction as asset acquisition.

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Summary to determine whether transaction is business or not:



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Example 2: Simple-business combination

Company X is a liquor manufacturer and has traded for a number of years. The company produces a wide variety of liquor and employs a workforce of machine operators, testers, and other operational, marketing and administrative staff. It owns and operates a factory, warehouse, machinery and holds raw material inventory and finished products.

On 1st January, 20X1, Company Y pays USD 80 million to acquire 100% of the ordinary voting shares of Company X. No other type of shares has been issued by the Company X. On the same day, the four main executive directors of the Company Y take on the same roles in the Company X.

In this case, it is clear that the Company X is a business. It operates a trade with a variety of assets that are used by its employees in a number of related activities. These assets and activities are necessarily integrated in order to create and sell the company's products. As per definition the above acquisition includes an input (including four main executive directors of Company X) and thus it can be concluded as the significant process acquired along with the other inputs.

Thus, Company Y obtains control on 1st January, 20X1 by acquiring 100% of the voting rights.

The application of the definition is less clear in situations as illustrated in the following examples:

Example 3: Investment in a development stage entity

Company D is a development stage entity that has not started revenue-generating operations. The workforce consists mainly of research engineers who are developing a new technology that has a pending patent application. Negotiations to license this technology to a number of customers are at an advanced stage. Company D requires additional funding to complete development work and commence planned commercial production.

The value of the identifiable net assets in Company D is ₹ 750 million. Company A pays ₹ 600 million in exchange for 60% of the equity of Company D (a controlling interest).

Although Company D is not yet earning revenues (an example of 'outputs') there are a number of indicators that it has a sufficiently integrated set of activities and assets that are capable of being managed to produce a return for investors. In particular, Company D:

- employs specialist engineers developing the know-how and design specifications of the technology.
- is pursuing a viable plan to complete the development work and commence production.
- has identified and will be able to access customers willing to buy the outputs.

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In addition, Company A has paid a premium (or goodwill) for its 60% interest. In the absence of evidence to the contrary, Company D is presumed to be a business.

Example 4: Acquisition of an entity holding investment properties

Company A acquires 100% of the equity and voting rights of Company P, a subsidiary of a property investment group. Company P owns three investment properties. The properties are single-tenant industrial warehouses subject to long-term leases. The leases oblige Company P to provide basic maintenance and security services, which have been outsourced to third party contractors. The administration of Company P's leases was carried out by an employee of its former parent company on a part-time basis but this individual does not transfer to the new owner.

In most cases, an asset or group of assets and liabilities that are being capable of generating revenues, combined with all or many of the activities necessary to earn those revenues, would constitute a business. However, investment property is a specific case in which earning a return for investors is a defining characteristic of the asset. Accordingly, revenue generation and activities that are specific and ancillary to an investment property and its tenancy agreements should therefore be given a lower 'weighting' in assessing whether the acquiree is a business.

Further process (i.e. Basic maintenance, security services and administration) is not critical to the ability to continue producing outputs. Also process (i.e. Basic maintenance, security services and administration) is not unique and it can be replaced easily without significant cost.

In our view the purchase of investment property with tenants and services that are purely ancillary to the property and its tenancy agreements should generally be accounted for as an asset purchase.

Example 5: Acquisition of an entity holding investment properties

Company A acquires 100% of the equity and voting rights of Company Q, which owns three investment properties. The properties are multi-tenant residential condominiums subject to short-term rental agreements that oblige Company Q to provide substantial maintenance and security services, which are outsourced with specialist providers. Company Q has five employees who deal directly with the tenants and with the outsourced contractors to resolve any non-routine security or maintenance requirements. These employees are involved in a variety of lease management tasks (e.g. identification and selection of tenants; lease negotiation and rent reviews) and marketing activities to maximise the quality of tenants and the rental income.

In this case, Company Q consists of a group of revenue-generating assets, together with employees and activities that clearly go beyond activities ancillary to the properties and their tenancy agreements.

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Further process (i.e. identification and selection of tenants; lease negotiation and rent reviews) is critical to the ability to continue producing outputs (i.e. in terms to maximise quality of tenants and the rental income).

The assets and activities are clearly integrated so Company Q is considered a business.

Example 6: Seller retains some activities and assets

Company S is a manufacturer of a wide range of products. The company's payroll and accounting system is managed as a separate cost centre, supporting all the operating segments and the head office functions.

Company A agrees to acquire the trade, assets, liabilities and workforce of the operating segments of Company S but does not acquire the payroll and accounting cost centre or any head office functions. Company A is a competitor of Company S.

In this case, the activities and assets within the operating segments are capable of being managed as a business and so Company A accounts for the acquisition as a business combination. The payroll, accounting cost centre and administrative head office functions are typically not used to create outputs and so are generally not considered an essential element in assessing whether an integrated set of activities and assets is a business or not.

Example 7: Acquisition of a shell company

Company A is a property development company with a number of subsidiary companies, each of which holds a single development. After completion of the development, Company A sells its equity investment because the applicable tax rate is lower than that applicable to the sale of the underlying property.

Company A is planning to start the development of a large new retail complex. Rather than incorporating a new company, Company A acquires the entire share capital of a 'shell' company.

The shell company does not contain an integrated set of activities and assets and so does not constitute a business. Consequently, Company A should account for the purchase of the shell company in the same way as the incorporation of a new subsidiary. In the consolidated financial statements, any costs incurred will be accounted for in accordance with their nature and applicable Ind AS. No goodwill is recognised.

Illustration 2

Company A is a pharmaceutical company. Since inception, the Company had been conducting in-house research and development activities through its skilled workforce and recently obtained an intellectual property right (IPR) in the form of patents over certain drugs. The Company's has a production plant that has recently obtained regulatory approvals. However, the Company has

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not earned any revenue so far and does not have any customer contracts for sale of goods. Company B acquires Company A.

Determine whether Company A constitute a business in accordance with Ind AS 103.

Solution

The definition of business requires existence of inputs and processes. In this case, the skilled workforce, manufacturing plant and IPR, along with strategic and operational processes constitutes the inputs and processes in line with the requirements of Ind AS 103.

When the said inputs and processes are applied as an integrated set, the Company A will be capable of producing outputs; the fact that the Company A currently does not have revenue is not relevant to the analysis of the definition of business under Ind AS 103. Basis this and presuming that Company A would have been able to obtain access to customers that will purchase the outputs, the present case can be said to constitute a business as per Ind AS 103.

*****

Illustration 3

Modifying the above illustration, if Company A had revenue contracts and a sales force, such that Company B acquires all the inputs and processes other than the sales force, then whether the definition of the business is met in accordance with Ind AS 103?

Solution

Though the sales force has not been taken over, however, if the missing inputs (i.e., sales force) can be easily replicated or obtained by the market participant to generate output, it may be concluded that Company A has acquired business. Further, if Company B is also into similar line of business, then the existing sales force of the Company B may also be relevant to mitigate the missing input. As such, the definition of business is met in accordance with Ind AS 103.

*****

5. THE ACQUISITION METHOD

The following key steps are involved in the acquisition accounting for business combinations:

Step 1: Identifying the acquirer.

Step 2: Determining the acquisition date.

Step 3: Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

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Step 4: Recognising and measuring goodwill or a gain from a bargain purchase.

Ask Following questions to account a business combination transaction:



6. IDENTIFYING ACQUIRING ENTERPRISE

6.1 The Acquiring Enterprise

All business combination within the scope of Ind AS 103 are accounted under the acquisition method (also known as purchase method). In order to apply the purchase method, the parties involved has to identify the acquirer i.e the entity that obtains the control of another entity. The entity on whom the control is established is termed as acquiree. This is because the acquiree's assets and liabilities are accounted as per the recognition and measurement principles of the standard.

The acquiring enterprise is the enterprise which obtains control and the determination of control is as per the guidance given in Ind AS 110. It may so happen that guidance in Ind AS 110 does not clearly indicate which of the combining entity is the acquirer. In such a case, Ind AS 103 provides additional guidance on identifying the acquirer.

As per Ind AS 110 'Consolidated Financial Statements', an investor controls an investee if and only if the investor has all the following:

(a) power over the investee;

(b) exposure, or rights, to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns.

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The above definition is very wide and control assessment does not depend only on voting rights instead it depends on the following as well:

- Potential voting rights;
- Rights of non-controlling shareholders; and
- Other contractual right of the investor if those are substantive in nature.

Control assessment has been discussed in detail in the chapter of Consolidated Financial Statements. One example on potential voting rights and its implication on assessment of control is provided below for the students to understand the concept of control.

In order to ascertain control do not look at the voting rights only. Evaluate other factors also like board control, potential voting rights etc.



Illustration 4: 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, the 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

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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.

*****

6.2 Acquisitions through payment of cash or incurring of liability

In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

6.3 Acquisitions through issue of equity instrument

In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Reverse acquisition has been dealt in a separate section of this chapter.

Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

a) ***The relative voting rights in the combined entity after the business combination:*** The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

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Illustration 5

Veera Limited and Zeera Limited are both in the business of manufacturing and selling of Lubricant. Shareholders of Veera Limited and Zeera Limited agreed to join forces to benefit from lower delivery and distribution costs. The business combination is carried out by setting up a new entity called Meera Limited that issues 100 shares to Veera Limited shareholders and 50 shares to Zeera Limited shareholders in exchange for the transfer of the shares in those entities. The number of shares reflects the relative fair values of the entities before the combination. Also respective company's shareholders get the voting rights in Meera Limited based on their respective shareholdings.

Determine the acquirer by applying the principles of Ind AS 103 'Business Combinations'

Solution

As per para B15 of Ind AS 103, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

The relative voting rights in the combined entity after the business combination - The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity.

Based on above mentioned para, acquirer shall be the either of the combining entities (i.e. Veera Limited or Zeera Limited) whose owners as a Group retain or receive the largest portion of the voting rights in the combined entity.

Hence in the above scenario Veera Limited shareholder gets 67% Share [(100/150) x100] and Zeera Limited shareholder gets 33.33% share in Meera Limited. Hence Veera Limited is acquirer as per the principles of Ind AS 103.

*****

b) ***The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest:*** The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

c) ***The composition of the governing body of the combined entity:*** The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

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d) ***The composition of the senior management of the combined entity:*** The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

e) ***The terms of the exchange of equity interests:*** The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

f) ***The acquirer is usually the combining entity*** whose relative size (measured in, for example, assets, revenues or profit) is significantly greater than that of the other combining entity or entities. In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.

Examples 8 & 9

8. Company A and Company B operate in power industry and both entities are operating entities. Company A has much larger scale of operations than Company B. Company B merges with Company A such that the shareholders of Company B would receive 1 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 20% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 80% of the capital in Company A.

In this transaction, Company A is the acquirer for the purposes of accounting for business combination as per Ind AS 103. This is because, by merging the entire shareholding of Company B, Company A has acquired control over Company B. Further, the shareholders of erstwhile Company B do not obtain control over Company A on account of shares received as part of purchase consideration, as they hold only 20% of the paid-up capital of Company A.

9. Company A and Company B operate in power industry and both entities are operating entities. Company A has much smaller scale of operations than Company B. Company B merges Company A such that the shareholders of Company B would receive 10 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 70% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 30% of capital of Company A. Post-acquisition, the management of Company B would manage the operations of the combined entity.

In this transaction, Company B is the acquirer for the purposes of accounting for business combination as per Ind AS 103. This is because, after merger, the shareholders of

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erstwhile Company B would have a controlling interest and management of the combined entity. As such, in substance, Company B has acquired control over Company A.

It is important to note that the Company B would be considered as an acquirer for accounting purposes only (i.e., accounting acquirer). For legal purposes as well as for reporting purposes, it is the Company A that would be considered as an acquirer (i.e., legal acquirer).

Appropriate identification of an acquirer is relevant, as the net assets of the accounting acquiree (rather than that of the accounting acquirer) are recognised at fair value.

Illustration 6

ABC Ltd. incorporated a company Super Ltd. to acquire 100% shares of another entity Focus Ltd. (and therefore to obtain control of the Focus Ltd.). To fund the purchase, Super Ltd. acquired a loan from XYZ Bank at commercial interest rates. The loan funds are used by Super Ltd. to acquire entire voting shares of Focus Ltd. at fair value in an orderly transaction. Post the acquisition, Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and also Super Ltd.'s management is in a power where it will be able to dominate the management of the Focus Ltd.

State whether Super Ltd. be identified as the acquirer in this business combination.

Solution

Paragraph 6 of Ind AS 103 states that for each business combination, one of the combining entities shall be identified as the acquirer.

While paragraph 7 states that the guidance in Ind AS 110 shall be used to identify the acquirer that is the entity that obtains control of another entity called the acquiree. If a business combination has occurred but applying the guidance in Ind AS 110 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 of Ind AS 103 shall be considered in making that determination.

Further, paragraph B15 provides that, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

(a) **The relative voting rights in the combined entity after the business combination:** The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of

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owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

(b) **The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest:** The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

(c) **The composition of the governing body of the combined entity:** The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

(d) **The composition of the senior management of the combined entity:** The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

(e) **The terms of the exchange of equity interests:** The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

The key drivers of the accounting are identifying the party on whose behalf the new entity has been formed and identifying the business acquired. In this scenario, as Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and has the ability to dominate the management of the Focus Ltd. Accordingly, Super Ltd. will be identified as the acquirer unless there are conditions to conclude to the contrary.

*****

6.4 Acquisition involving Shell Company and Reverse Acquisition

A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public entity is the **legal acquirer** because it issued its equity interests, and the private entity is the **legal acquiree** because its equity interests were acquired. However, application of the guidance given in above paragraph results in identifying:

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a) the public entity as the **acquiree** for accounting purposes (the accounting acquiree); and

b) the private entity as the **acquirer** for accounting purposes (the accounting acquirer).

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles of Ind AS 103, including the requirement to recognise goodwill, will apply.

Example 9: Reverse Acquisition

The Balance Sheets of Entity A and Entity B immediately before business acquisition are as follows:

	Amount (₹ in thousands)	
Particulars	**Entity A**	**Entity B**
Current Assets	600	800
Non Current Assets	1,200	2,900
Total Assets	1,800	3,700
Current Liabilities	400	200
Non - Current Liabilities	300	1200
Total Liabilities	700	1400
Equity		
30,000 Shares of ₹ 10 Each	300	
60,000 Shares of ₹ 10 Each		600
Retained Earnings	800	1700
Total Equity	1100	2300
Total Equity and Liability	1800	3700

On 31 March 20X1, Entity A issues 2.5 shares in exchange for each share of Entity B. All of entity B's shareholders exchange their shares. Therefore, Entity A issues 1,50,000 shares in exchange for all 60,000 shares of entity B. Entity A legally owns 100% of entity B.

The shareholders of Entity B own 83.33% (1,50,000/1,80,000) of the combined entity. The directors of entity B are appointed 6 out of 8 positions in combined entity's board. In accordance with Ind AS 103, Entity B (Legal Acquiree) is the accounting acquirer and Entity A (Legal Acquirer) is the accounting acquiree as Entity B shareholders control over combined entity.

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The quoted market price of Entity B's share as at 31st March, 20X1 is ₹ 105 per share and Entity A's share price as at 31st March, 20X1 is ₹ 20 per share.

Assume the fair value of Entity A's identifiable net assets as at 31st March, 20X1 are the same as carrying values and ignore tax effect.

The acquisition date fair value (i.e. at 31st March, 20X1) of the accounting acquirer equity instrument is generally used to determine the amount of consideration transferred for business combination. In this case it is 105 per share (Entity B).

So if the business combination had taken place in the form of Entity B issuing additional shares to Entity A's shareholders in exchange for their shares in Entity A, Entity B would have to issue 12,000 shares (30,000 / 2.5) for the ratio of ownership interest in the combined entity to be same. (12,000/72,000). Therefore, the consideration for the business combination effectively transferred by Entity B is ₹ 12,60,000 (12,000 Shares x ₹ 105).

Calculation of Goodwill:

Fair value of Assets less Liabilities Assumed (Entity A)	- ₹ 11,00,000
Consideration transferred (by Entity B)	- (₹ 12,60,000)
Goodwill	- ₹ 1,60,000

Example 11: New parent pays cash to effect a business combination

Company A decided to spin-off two of its existing businesses (currently housed in two separate entities, Company B and Company C). To facilitate the spin-off, Company A incorporates a new entity (Company D) with nominal equity and appoints independent directors to the board of Company D. Company D signs an agreement to purchase Companies B and C in cash, conditional on obtaining sufficient funding. To fund these acquisitions, Company D issues a prospectus offering to issue shares for cash.

At the conclusion of the transaction, Company D has owned 99% by the new investors with Company A retaining only a 1% non-controlling interest.

In this situation, a set of new investors paid cash to obtain control of Company D in an arm's length transaction. Company D is then used to effect the acquisition of 100% ownership of Companies B and C by paying cash. Company A relinquishes its control of Companies B and C to the new owners of Company D.

Although Company D is a newly formed entity, Company D is identified as the acquirer not only because it paid cash but also because the new owners of Company D have obtained control of Companies B and C from Company A.

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Identification of the acquiring enterprise is very critical and the accounting may change significantly if the accounting acquirer is different than legal acquirer. .

7. DETERMINING THE ACQUISITION DATE

The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree — the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

The acquisition date is a very important step in the business combination accounting because it determines when the acquirer recognises and measures the consideration, the assets acquired and liabilities assumed. The acquiree's results are consolidated from this date. The acquisition date materially impacts the overall acquisition accounting, including post-combination earnings.

Acquisition date will be the date on which the acquirer obtains control.

The acquisition date is often readily apparent from the structure of the business combinations and the terms of the sale and purchase agreement (if applicable) but this is not always the case.

Example 12

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

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

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

Illustration 7

Can an acquiring entity account for a business combination based on a signed non-binding letter of intent where the exchange of consideration and other conditions are expected to be completed with 2 months?

Solution

No. as per the requirement of the standard a non- binding Letter of Intent (LOI) does not effectively transfer control and hence this cannot be considered as the basis for determining the acquisition date.

*****

Illustration 8

On 1st April, X Ltd. agrees to acquire the share of B Ltd. in an all equity deal. As per the binding agreement X Ltd. will get the effective control on 1st April. However, the consideration will be paid only when the shareholders' approval is received. The shareholder's meeting is scheduled to happen on 30th April. If the shareholders' approval is not received for issue of new shares, then the consideration will be settled in cash.

Determine the acquisition date.

Solution

The acquisition date in the above case is 1st April. This is because, in the above scenario, even if the shareholders don't approve the shares, consideration will be settled through payment of cash.

*****

Illustration 9 : Business Combination without a Court approved scheme

ABC Ltd. acquired all the shares of XYZ Ltd. The negotiations had commenced on 1st January, 20X1 and the agreement was finalised on 1st March, 20X1. While ABC Ltd. obtains the power to control XYZ Ltd.'s operations on 1st March, 20X1, the agreement states that the acquisition is effective from 1st January, 20X1 and that ABC Ltd. is entitled to all profits after that date. In addition, the purchase price is based on XYZ Ltd.'s net asset position as at 1st January, 20X1.

Determine the date of acquisition.

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Solution

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

Further paragraphs 6 and 7 of Ind AS 110, Consolidated Financial Statements, inter alia, state that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Thus, an investor controls an investee if and only if the investor has all the following:

(a) power over the investee;

(b) exposure, or rights, to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns.

Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

Therefore, in this case, notwithstanding that the price is based on the net assets as at 1st January, 20X1 and that XYZ Ltd.'s shareholders do not receive any dividends after that date, the date of acquisition for accounting purposes will be 1st March, 20X1. It is only on 1st March, 20X1 and not 1st January, 20X1, that ABC Ltd. has the power to direct the relevant activities of XYZ Ltd. so as to affect its returns from its involvement with XYZ Ltd. Accordingly, the date of acquisition is 1st March, 20X1.

*****

Illustration 10 : Acquisition date- Regulatory approval

ABC Ltd. and XYZ Ltd. are manufacturers of rubber components for a particular type of equipment. ABC Ltd. makes a bid for XYZ Ltd.'s business and the Competition Commission of India (CCI) announces that the proposed transaction is to be scrutinised to ensure that competition laws are not breached. Even though the contracts are made subject to the approval of the CCI, ABC Ltd. and XYZ Ltd. mutually agree the terms of the acquisition and the purchase price before competition authority clearance is obtained.

Can the acquisition date in this situation be the date on which ABC Ltd. and XYZ Ltd. agree the terms even though the approval of CCI is awaited? Assume that the approval of CCI is substantive.

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Solution

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree — the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Since CCI approval is a substantive approval for ABC Ltd. to acquire control of XYZ Ltd.'s operations, the date of acquisition cannot be earlier than the date on which approval is obtained from CCI. This is pertinent given that the approval from CCI is considered to be a substantive process and accordingly, the acquisition is considered to be completed only on receipt of such approval.

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8. STEP ACQUISITIONS

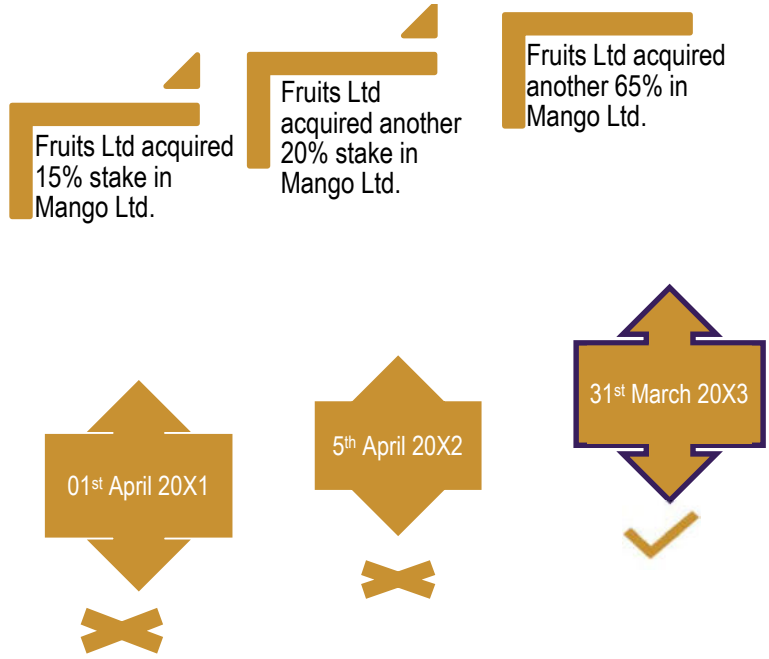
In the case an entity acquires an entity step by step through series of purchase then the acquisition date will be the date on which the acquirer obtains control. Till the time the control is obtained the Investment will be accounted as per the requirements of other Ind AS 109, if the investments are covered under that standard or as per Ind AS 28, if the investments are in Associates or Joint Ventures.

If a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

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Below is the example for acquisition of business in case of stake acquired in stages:



Control is acquired on 31st March 20X3 in above example because total stake as on that date will be 90%.

Assumption: Control is acquired in form of total stake, unless otherwise stated.

9. DETERMINATION OF THE PURCHASE CONSIDERATION

The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the total of the acquisition-date fair values of the assets (including cash) transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer. Examples of potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, *contingent consideration*, ordinary or preference equity instruments, options, warrants and member interests of *mutual entities*.

Exception to the fair value in determination of Purchase consideration

However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees that is included in consideration transferred in the business combination shall be measured in accordance with the requirements of Ind AS 102, Share Based payments.

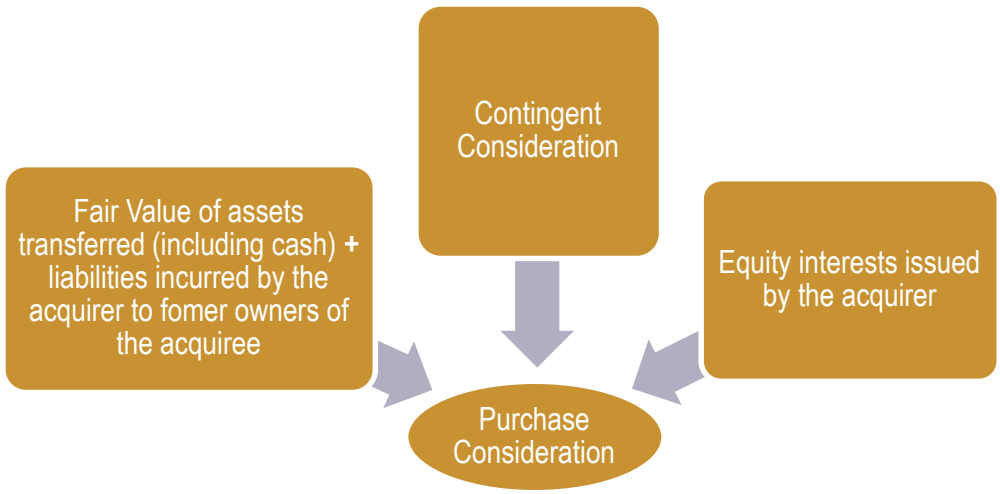
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The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, non-monetary assets or a business of the acquirer). If so, the acquirer shall remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognise the resulting gains or losses, if any, in the statement of profit and loss.

This means that if the acquirer has transferred a land as a part of the business combination arrangement to the owners of the acquiree then the fair value of the land will be considered in determining the fair value of the consideration. Consequently, the land will be de-recognised in the financial statements of the acquirer and the difference between the carrying amount of the land and the fair value considered for purchase consideration will be recorded in profit and loss.

However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognise a gain or loss in statement of profit and loss on assets or liabilities it controls both before and after the business combination. Although no gain or loss is recognised by the transferring entity, the asset transferred will affect the amount of NCI and goodwill that is recognised.

Purchase Consideration can be summarized as:



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9.1 A Business Combination achieved in Stages (Step Acquisition)

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date.

Example 13

On 31st December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 per cent interest in Entity B, which gives it control of Entity B. This transaction is referred as a business combination achieved in stages, sometimes also referred to as a step acquisition.

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. As per
Ind AS 109 or Ind AS 27, an entity can elect to measure investments in equity instruments at fair value through other comprehensive income. However, once elected all gains and losses on that investment even on sale is recognized in OCI. Therefore, if the investment is designated as fair value through OCI, the resulting gain or loss, if any, will be recognized in OCI.

When a party to a joint operation, obtains control of a joint operation business, the transaction will be considered as a business combination achieved in stages. The acquirer should re-measure its previously held interest in the joint operation at fair value at the acquisition date.

Illustration 11

On 1st April, 20X1, PQR Ltd. acquired 30% of the voting ordinary shares of XYZ Ltd. for ₹ 8,000 crore. PQR Ltd. accounts its investment in XYZ Ltd. using equity method as prescribed under Ind AS 28. At 31st March, 20X2, PQR Ltd. recognised its share of the net asset changes of XYZ Ltd. using equity accounting as follows:

	(₹ in crore)
Share of profit or loss	*700*
Share of exchange difference in OCI	*100*
Share of revaluation reserve of PPE in OCI	*50*

The carrying amount of the investment in the associate on 31st March, 20X2 was therefore ₹ 8,850 crore (8,000 + 700 + 100 + 50).

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On 1st April, 20X2, PQR Ltd. acquired the remaining 70% of XYZ Ltd. for cash ₹ 25,000 crore. The following additional information is relevant at that date:

	(₹ in crore)
Fair value of the 30% interest already owned	*9,000*
Fair value of XYZ's identifiable net assets	*30,000*

Determine the accounting such business combination.

Solution

Paragraph 42 of Ind AS 103 provides that in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in statement of profit and loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Applying the above, PQR Ltd. records the following entry in its consolidated financial statements:

		(₹ in crore)	
		Debit	Credit
Identifiable net assets of XYZ Ltd.	Dr.	30,000	
Goodwill (W.N.1)	Dr.	4,000	
Foreign currency translation reserve	Dr.	100	
PPE revaluation reserve	Dr.	50	
To Cash			25,000
To Investment in associate -XYZ Ltd.			8,850
To Retained earnings (W.N.2)			50
To Gain on previously held interest in XYZ recognised in Profit or loss (W.N.3)			250
(To recognise acquisition of XYZ Ltd.)			

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Working Notes:

1. Calculation of Goodwill

	₹ in crore
Cash consideration	25,000
Add: Fair value of previously held equity interest in XYZ Ltd.	9,000
Total consideration	34,000
Less: Fair value of identifiable net assets acquired	(30,000)
Goodwill	4,000

2. The credit to retained earnings represents the reversal of the unrealized gain of ₹ 50 crore in Other Comprehensive Income related to the revaluation of property, plant and equipment. In accordance with Ind AS 16, this amount is not reclassified to profit or loss.

3. The gain on the previously held equity interest in XYZ Ltd. is calculated as follows: ₹

	₹ in crore
Fair Value of 30% interest in XYZ Ltd. at 1st April, 20X2	9,000
Carrying amount of interest in XYZ Ltd. at 1st April, 20X2	(8,850)
	150
Unrealised gain previously recognised in OCI	100
Gain on previously held interest in XYZ Ltd. recognised in profit or loss	250

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9.2 A Business Combination achieved without the transfer of Consideration

An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include:

(a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

(b) Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.

(c) The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no

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equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

In a business combination achieved by contract alone, the acquirer shall attribute to the owners of the acquiree the amount of the acquiree's net assets recognised in accordance with this Indian Accounting Standard. In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer's post-combination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the non-controlling interest.

Illustration 12: Business Combination Achieved by Contract Alone

Sita Ltd and Beta Ltd decides to combine together for forming a Dual Listed Corporation (DLC). As per their shareholder's agreement, both the parties will retain original listing and Board of DLC will be comprised of 10 members out of which 6 members will be of Sita Ltd and remaining 4 board members will be of Beta Ltd.

The fair value of Sita Ltd is ₹ 100 crores and fair value of Beta Ltd is ₹ 80 crores. The fair value of net identifiable assets of Beta Limited is ₹ 70 crores. Assume non-controlling Interest (NCI) to be measured at fair value.

Determine the goodwill to be recognised on acquisition.

Solution

Sita Ltd has more Board members and thereby have majority control in DLC. Therefore, Sita Ltd is identified as acquirer and Beta Ltd as acquiree.

Since no consideration has been transferred, the goodwill needs to be calculated as the difference of Part A and Part B:

Part A:

1) Consideration paid by Acquirer. – Nil

2) Controlling Interest in Acquiree – ₹ 80 crores

3) Acquirer's previously held interest – Nil

Part B:

Fair value of net identifiable asset – ₹ 70 crores

Goodwill is recognised as ₹ 10 crores (80 crores – 70 crores) in business combination achieved through contract alone when NCI is measured at fair value.

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9.3 Direct Cost of Acquisition

The direct cost of acquisition is not included in the determination of the purchase consideration. Costs which includes like finder's fees, due diligence cost accounting, legal fees, investment banker fees, even bonuses paid to employees for doing a successful acquisition will not be included in the cost of acquisition.

Illustration 13

Should stamp duty paid on acquisition of land pursuant to a business combination be capitalised to the cost of the asset or should it be treated as an acquisition related cost and accordingly be expensed off?

Solution

As per Ind AS 103, the acquisition-related costs incurred by an acquirer to affect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to affect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception.

Note: The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The stamp duty payable for transfer of assets in connection with the business combination is an acquisition-related cost as described under paragraph 53 of Ind AS 103. Stamp duty is a cost incurred by the acquirer in order to affect the business combination and it is not part of the fair value exchange between the buyer and seller for the business. In such cases, the stamp duty is incurred to acquire the ownership rights in land in order to complete the process of transfer of assets as part of the overall business combination transaction, but it does not represent consideration paid to gain control over business from the sellers.

It may be noted that the accounting treatment of stamp duty incurred for separate acquisition of an item of property, plant and equipment (i.e. not as part of business combination) differs under Ind AS 16, Property, Plant and Equipment. Unlike Ind AS 16, the acquisition accounting as per Ind AS 103 requires assets and liabilities acquired in a business combination to be measured at fair value. While incurred in connection with a business combination, stamp duty does not increase the future economic benefits from the net assets comprising the business (which would be recognised at fair value) and hence cannot be capitalised. The examples of costs given in

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paragraph 53 is only an inclusive list; they are only indicative and do not preclude any other cost to be considered as acquisition-related cost. In the given case, the transfer of land and the related stamp duty is required to be accounted as part of the business combination transaction as per requirements of Ind AS 103 and not as a separate transaction under Ind AS.

Accordingly, stamp duty incurred in relation to land acquired as part of a business combination transaction are required to be recognised as an expense in the period in which the acquisition is completed and given effect to in the financial statements of the acquirer.

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Illustration 14

ABC Ltd. acquires PQR Ltd. on 30th June, 20X1. The assets acquired from PQR Ltd. include an intangible asset that comprises wireless spectrum license. For this intangible asset, ABC Ltd. is required to make an additional one-time payment to the regulator in PQR's jurisdiction in order for the rights to be transferred for its use.

Whether such additional payment to the regulator is an acquisition-related cost?

Solution

As per Ind AS 103, the acquisition-related costs incurred by an acquirer to affect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to affect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The payment to the regulator represents a transaction cost and will be regarded as acquisition related cost incurred to affect the business combination. Applying the requirements of para 53 of Ind AS 103, it should be expensed as it is incurred. Transfer of rights in the instant case cannot be construed to be separate from the business combination because the transfer of the rights to ABC Ltd. is an integral part of the business combination itself.

It may be noted that had the right been acquired separately (i.e. not as part of business combination), the transaction cost is required to be capitalised as part of the intangible asset as per the requirements of Ind AS 38, Intangible Assets.

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9.4 Contingent Consideration

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in accordance with the requirement of Ind AS 32 'Financial Instruments: Presentation', or other applicable Indian Accounting Standards. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

Fair value of the assets transferred or liability incurred should be measured on the acquisition date to determine the fair value. Any direct cost of acquisition should be recorded directly in profit and loss account and should not be included in purchase consideration.

Example 14:

Company A acquires Company B in April, 20X1 for cash. The acquisition agreement states that an additional ₹ 20 million of cash will be paid to B's former shareholders if B succeeds in achieving certain specified performance targets. A determines the fair value of the contingent consideration liability to be 15 million at the acquisition date. At a later date, the probability of meeting the said performance target becomes lower.

As certain consideration is based on achieving certain performance parameters in future, the consideration is contingent on achieving those parameters. As such, the transaction involves contingent consideration. Further, since the consideration is to be settled for a variable amount in cash, such consideration would be in the nature of financial liability rather than equity.

As at the acquisition date, the acquirer should consider the acquisition date fair value of contingent consideration as part of business combination. Accordingly, such recognition would increase goodwill (or reduce gain on bargain purchase, as the case may be).

In the above example, if the chance of meeting the performance criteria becomes less probable, then in such a case, the contingent consideration in the nature of financial liability should be remeasured and the impact for the change in the fair value should be recognised in statement of profit and loss.

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10. PURCHASE PRICE ALLOCATION

10.1 Recognition of Assets and Liabilities of the Acquired Entity

As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.

The most important principle in a purchase price allocation exercise is to recognize and measure all the assets and liabilities acquired on the acquisition date.

10.1.1 Recognition

Following conditions have to be considered while recognising the assets and liabilities of the acquire:

- To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards* issued by the Institute of Chartered Accountants of India at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post combination financial statements in accordance with other Ind AS.
- Acquirer should only record the assets and liabilities recorded as a part of the business combination which means only those assets and liabilities which have been assumed as a part of the business combination deal should only be recorded and not any other assets which are not related to the acquisition to which other applicable Ind AS should be applied.
- When the acquirer applies the recognition principle under business combination it may record certain assets and liabilities which the acquiree had not recorded earlier in their financial statements. For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the

* For this Standard, acquirers are required to apply the definitions of an asset and a liability given in *Framework for Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards* rather than the *Conceptual Framework for Financial Reporting under Indian Accounting Standards issued in 2021*.

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acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

There are certain exceptions to specific assets and liabilities which have been discussed below.

- The assets and liabilities have to be classified as per the requirement of applicable Ind AS which will depend on the contractual terms, economic conditions etc.
- In some situations, Ind AS provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:
    - ♦ classification of particular financial assets and liabilities as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income in accordance with Ind AS 109, Financial Instruments;
    - ♦ designation of a derivative instrument as a hedging instrument in accordance with Ind AS 109; and
    - ♦ assessment of whether an embedded derivative should be separated from a host contract in accordance with Ind AS 109 (which is a matter of 'classification' as this Ind AS uses that term).

The only exception to the above principle is that for lease contract (in which acquiree is the lessor as either an operating lease or a finance lease) and insurance contracts classification will be based on the basis of the conditions existing at inception and not on acquisition date. Therefore, they are not reassessed at the acquisition date, unless they are modified at that date.

10.2 Measurement Principle

The assets and liabilities recognized based on the aforesaid recognition principles has to be measured based on the following principles:

- The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.
- For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interest (under existing AS it is called as minority interest) in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:
    - ♦ fair value; or

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- ♦ The present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets

- All other components of non-controlling interests shall be measured at their acquisition date fair values, unless another measurement basis is required by Ind AS.

10.2.1 Exception to the recognition or measurement principle

The exception principles laid out in this standard for recognition or measurement of certain assets and liabilities are only limited to acquisition date accounting and may be different than the requirements of other accounting standards. The application of the above principles may result in two scenarios:

- An asset or liability which otherwise would not have been recorded gets recorded.
- The assets and liabilities are measured at a value other than the acquisition date fair values.

Items	Guidance under Ind AS 103
Contingent liability	Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, defines a contingent liability as: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: i. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or ii. the amount of the obligation cannot be measured with sufficient reliability. The requirements in Ind AS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to Ind AS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

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Summary of above:

Outcome	Ind AS 37	Business Combination
Possible obligation	Not recognised	Not recognised
Present obligation – not probable that an outflow of economic benefits will occur	Not recognised	Recognised if reliably measured
Present obligation – probable that an outflow of economic benefits will occur, but cannot be measured reliably	Not recognised	Not recognised

Example 15

A suit for damages worth ₹ 10 million was filed on Company B for alleged breach of certain contract provisions. Company B had disclosed the same as a contingent liability in its financial statements, as it considered that it is a present obligation for which it was not probable that the amount would be payable. Company A acquire Company B and determines the fair value of the contingent liability to be ₹ 2 million.

Company A would recognise ₹ 2 million in its financial statements as part of acquisition accounting, even if it is not probable that payment will be required to settle the obligation.

Income taxes	As per the requirement of Ind AS 12, no deferred tax consequence should be recorded on initial recognition of deferred tax **except** assets and liabilities acquired during business combination. Accordingly, the acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with Ind AS 12, Income Taxes. The acquirer shall account for the potential tax effects of temporary differences and carry forwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with Ind AS 12.
Employee benefits	The acquirer records the fair value of the obligations for any post retirement obligation as per the principles of Ind AS 19 which is an exception of the general fair value rule.
Indemnification assets	The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the

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	acquirer obtains an indemnification asset. The acquirer shall recognise an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts.

Example 16: IMP

Company A acquires Company B in a business combination on 1st April, 20X1. B is being sued by one of its customers for breach of contract for ₹ 250. The sellers of B provide indemnification to A for the reimbursement of any losses greater than ₹ 100. There are no collectability issues around this indemnification. At the acquisition date, Company A determined that there is a present obligation and therefore the fair value of the contingent liability of ₹ 250 is recognised by A in the acquisition accounting. In the acquisition accounting A also recognises an indemnification asset of ₹ 150 (₹ 250 – ₹ 100).

Illustration 15

ABC Ltd. acquired a beverage company PQR Ltd. from XYZ Ltd. At the time of the acquisition, PQR Ltd. is the defendant in a court case whereby certain customers of PQR Ltd. have alleged that its products contain pesticides in excess of the permissible levels that have caused them health damage.

PQR Ltd. is being sued for damages of ₹ 2 crore. XYZ Ltd. has indemnified ABC Ltd. for the losses, if any, due to the case for amount up to ₹ 1 crore. The fair value of the contingent liability for the court case is ₹ 70 lakh.

How should ABC Ltd. account for the contingent liability and the indemnification asset? What if the fair value of the liability is ₹ 1.2 crore instead of ₹ 70 lakh.

Solution

In the current scenario, ABC Ltd. measures the identifiable liability of entity PQR Ltd. at ₹ 70 lakh and also recognises a corresponding indemnification asset of ₹ 70 lakhs on its consolidated balance sheet. The net impact on goodwill from the recognition of the contingent liability and associated indemnification asset is nil.

However, in the case where the liability's fair value is more than ₹ 1 crore ie. ₹ 1.2 crore, the indemnification asset will be limited to ₹ 1 crore only.

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Illustration 16

ABC Ltd. pays ₹ 50 crore to acquire PQR Ltd. from XYZ Ltd. PQR Ltd. manufactured products containing fiber glass and has been named in 10 class actions concerning the effects of these fiber glass. XYZ Ltd. agrees to indemnify ABC Ltd. for the adverse results of any court cases up

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to an amount of ₹ 10 crore. The class actions have not specified amounts of damages and past experience suggests that claims may be up to ₹ 1 crore each, but that they are often settled for small amounts.

ABC Ltd. makes an assessment of the court cases and decides that due to the potential variance in outcomes, the contingent liability cannot be measured reliably and accordingly no amount is recognised in respect of the court cases.

How should indemnification asset be accounted for?

Solution

Since no liability is recognised in the given case, ABC Ltd. will also not recognise an indemnification asset as part of the business combination accounting.

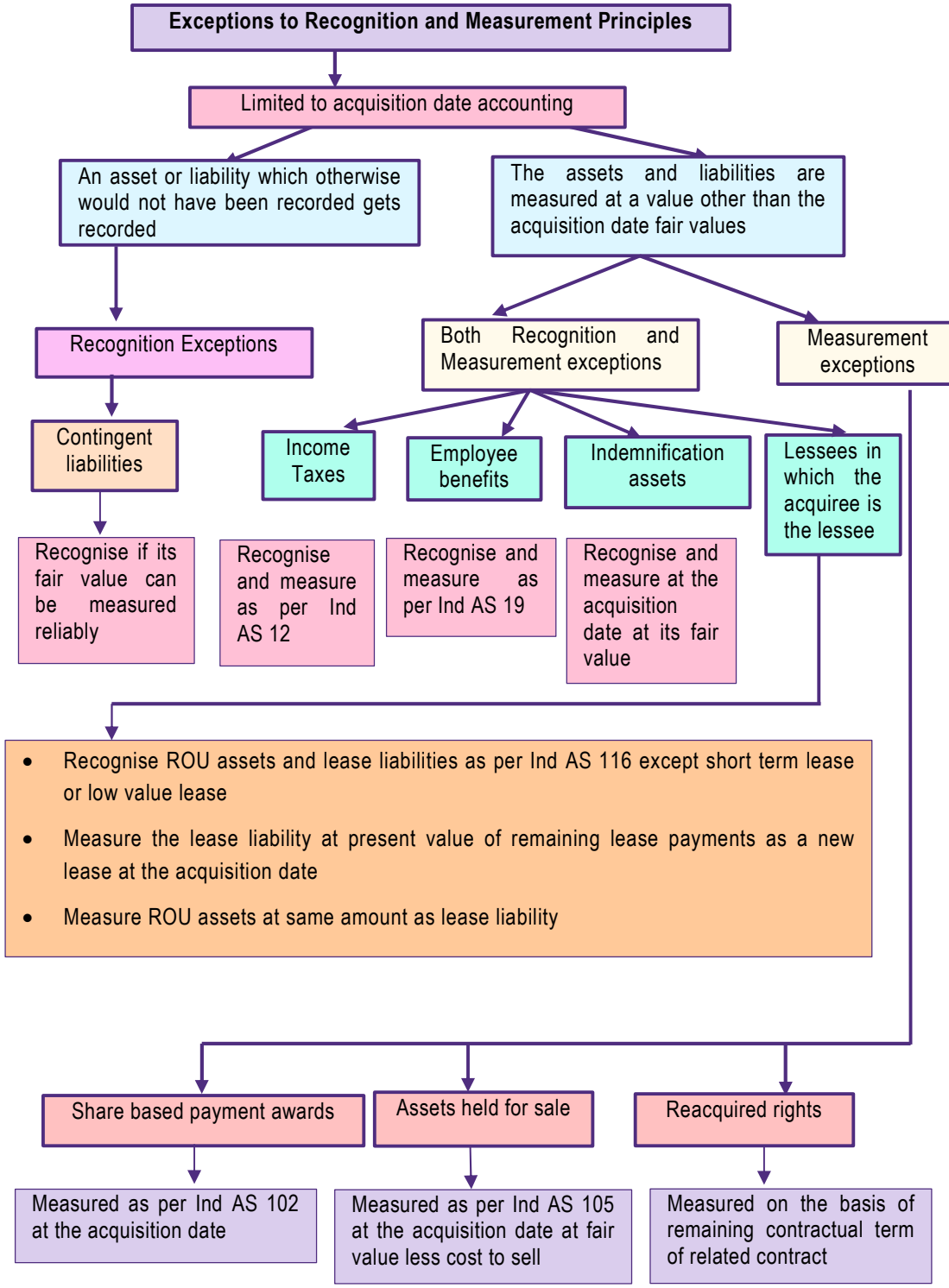
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Reacquired rights	These are the rights which the acquirer before acquisition may have granted to the acquiree to use certain assets which belongs to the acquirer. It does not matter whether the asset was recorded in the financial statement of the acquirer or not. For example, license to use the brand name, Franchisee rights etc. if an acquirer acquires an acquiree which had certain rights granted to it by the acquirer then the business combination results in settlement of the right and accordingly any settlement gain or loss should be considered as a separate transaction from business combination and will be recorded in the financial statement of the acquirer. The acquirer shall measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract without considering the effect of potential renewals.
Intangible assets	The acquirer shall record separately from Goodwill, the identifiable intangible acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion. (Refer a section below on intangible asset highlighting detailed guidance on recognition and measurement criteria)
Share based payment transactions	The acquirer shall measure a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer in accordance with the method in Ind AS 102, Share-based Payment, at the acquisition date.

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Assets held for sale	The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, at fair value less costs to sell in accordance with that Ind AS.
Leases	**Acquiree is a lessee** • The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with Ind AS 116. • The acquirer is not required to recognise right-of-use assets and lease liabilities for: (a) leases for which the lease term ends within 12 months of the acquisition date; or (b) leases for which the underlying asset is of low value. • The acquirer shall measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date. • The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms. **Acquiree is a lessor** In measuring the acquisition-date fair value of an asset, the acquirer shall take into account the terms of the lease. The acquirer does not recognise a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms.
Assembled workforce	The acquirer subsumes into Goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.

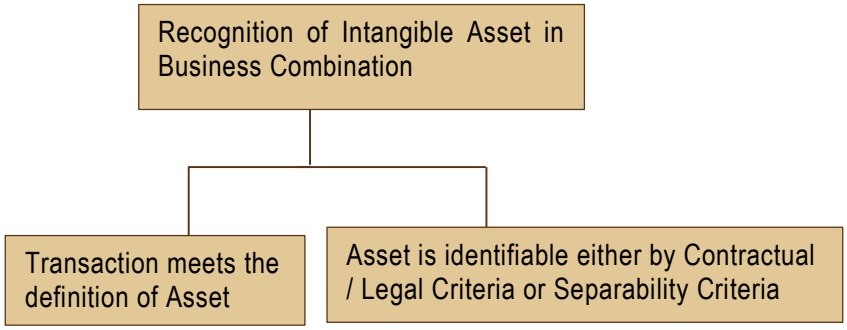
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10.3 Intangible Assets

As explained above an intangible asset should be recorded separately from Goodwill if either the separability criteria is met or it arises out of contractual legal criterion.



10.3.1 Contractual Legal criterion

An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.

For example:

a. an acquiree owns and operates a nuclear power plant. The licence to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognise the fair value of the operating licence and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

b. an acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future revenue in foreign exchange. Both the technology patent and the related licence agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related licence agreement separately from one another would not be practical.

10.3.2 Separability criteria

The separability criterion means that an acquired intangible asset is **capable** of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability. An intangible asset that the acquirer would be able to sell, license or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license or otherwise exchange it. An acquired intangible asset meets the separability criterion if there is

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evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.

Example 17:

Customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset or liability.

For example:

a. market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognise the depositor relationship intangible asset separately from goodwill.

b. an acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

Accordingly, as per the guidance above it follows that identification of intangible asset will be judgemental and will vary in each case.

Following are the possible sources of information and broad indicator to be used to identify any possible intangible separately from goodwill:

A. Internal sources:

- **Financial statements of the acquiree-**
  - significant R&D cost may be indicator that there may be possible technology related intangible.
  - Significant sales promotion or marketing cost- this is a strong indicator of marketing related intangible like distributor network, Marketing collaterals etc.

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- Customer acquisition cost- lot of companies spend money to acquire new customers like online e-commerce companies provide incentive to register a customer as a first- time user or download their app. This may be a strong indicator of existence of customer list as an intangible.

- **Share purchase agreement-** This can also be a strong indicator of existence of intangible in the form of any technical know-how, trademarks or patent which are included in the agreement.

- **Purpose of acquisition-** The reason for acquisition may also indicate the possible intangible to be recorded. For e.g. Coca Cola acquired Thumps Up with an intention to close the brand which will result in increase in its market share. Accordingly, this will also be a possible intangible asset.

Illustration 17

Company A, FMCG company acquires an online e-commerce company E, with the intention to start its retail business. The e-commerce company has over the period have 10 million registered users. However, the e-commerce company E does not have any intention to sell the customer list.

Should this customer list be recorded as an intangible in a business combination?

Solution

In this situation the customer database does not give rise to legal or contractual right. Accordingly, the assessment of its separability will be assessed. The database can be useful to other players and Company E has the ability to transfer this to them. Accordingly, the intention not to transfer will not affect the assessment whether to record this as an intangible or not. Hence customer list should be recorded as an intangible in a business combination.

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Illustration 18 IMP

ABC Ltd. a pharmaceutical group acquires XYZ Ltd. another pharmaceutical business. XYZ Ltd. has incurred significant research costs in connection with two new drugs that have been undergoing clinical trials. Out of the two drugs, one drug has not been granted necessary regulatory approvals. However, ABC Ltd. expects that approval will be given within two years. The other drug has recently received regulatory approval. The drugs' revenue-earning potential was one of the principal reasons why entity ABC Ltd. decided to acquire entity XYZ Ltd.

Whether the research and development on either of the drugs be recognised as an intangible asset in the books of ABC Ltd.?

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Solution

Ind AS 38, Intangible Assets provides explicit guidance on recognition of acquired in-process research and development.

Paragraph 21 of Ind AS 38 provides guidance regarding general recognition conditions which require it to be probable that expected future economic benefits will flow to the entity before an intangible asset can be recognised and for the cost to be measured reliably.

As per paragraph 33 of Ind AS 38, both of the standard's general recognition criteria, i.e. probability of benefits and reliable measurement, are always considered to be satisfied for intangible assets acquired in a business combination.

The fair value of an intangible asset reflects expectations about the probability of these benefits, despite uncertainty about the timing or the amount of the inflow. There will be sufficient information to measure the fair value of the asset reliably if it is separable or arises from contractual or other legal rights. If there is a range of possible outcomes with different probabilities, this uncertainty is taken into account in the measurement of the asset's fair value.

Paragraph 34 of Ind AS 38, provides that in accordance with this Standard and Ind AS 103, an acquirer recognises at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognised by the acquiree before the business combination.

This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset. An acquiree's in-process research and development project meets the definition of an intangible asset when it:

(a) meets the definition of an asset; and

(b) is identifiable, i.e. is separable or arises from contractual or other legal rights.

In accordance with above,

(i) The fair value of the first drug reflects the probability and the timing of the regulatory approval being obtained. As per the standard, the recognition criterion of probable future economic benefits is considered to be satisfied in respect of the asset acquired accordingly an asset is recognised. Subsequent expenditure on an in-process research or development project acquired separately is to be dealt with in accordance with paragraph 43 of Ind AS 38.

(ii) The rights to the second drug also meet the recognition criteria in Ind AS 8 and are recognised. The approval means it is probable that future economic benefits will flow to ABC Ltd. This will be reflected in the fair value assigned to the intangible asset.

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Thus, recognising in-process research and development as an asset on acquisition applies different criteria to those that are required for internal projects. The research costs of internal R&D projects may under no circumstances be capitalised as an intangible asset. It may be pertinent to note that entities will be required to recognise on acquisition some research and development expenditure that they would not have been able to recognise if it had been an internal project. Although the amount attributed to the project is accounted for as an asset, Ind AS 38 requires that any subsequent expenditure incurred after the acquisition of the project is to be accounted for in accordance with paragraphs 54 to 62 of Ind AS 38.

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10.3.3 Assembled workforce and other items that are not identifiable

The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date.

An assembled workforce does not represent the intellectual capital of the skilled workforce — the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.

The acquirer also subsumes into goodwill any value attributed to items that do not qualify as assets at the acquisition date. For example, the acquirer might attribute value to potential contracts the acquiree is negotiating with prospective new customers at the acquisition date. Because those potential contracts are not themselves assets at the acquisition date, the acquirer does not recognise them separately from goodwill. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding the events occurring shortly after the acquisition to determine whether a separately recognisable intangible asset existed at the acquisition date.

After initial recognition, an acquirer accounts for intangible assets acquired in a business combination in accordance with the provisions of Ind AS 38, Intangible Assets. However, as described in paragraph 3 of Ind AS 38, the accounting for some acquired intangible assets after initial recognition is prescribed by other Ind AS.

The identifiability criteria determine whether an intangible asset is recognised separately from goodwill. However, the criteria neither provides guidance for measuring the fair value of an intangible asset nor restrict the assumptions used in measuring the fair value of an intangible asset. For example, the acquirer would take into account the assumptions that market

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participants would use when pricing the intangible asset, such as expectations of future contract renewals, in measuring fair value. It is not necessary for the renewals themselves to meet the identifiability criteria.

10.4 Reacquired Rights

As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognises separately from goodwill.

If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss.

Illustration 19

Vadapav Ltd. is a successful company has number of own stores across India and also offers franchisee to other companies. Efficient Ltd. is one of the franchisee of Vadapav Ltd. and it operates number of store in south India. Vadapav Ltd. decided to acquire Efficient Ltd. due to its huge distribution network and accordingly purchased the outstanding shares on 1st April, 20X2. On the acquisition date, Vadapav Ltd. determines that the license agreement reflects current market terms.

Determine the accounting for franchisee right by Vadapav Ltd. at the time of acquisition of business.

Solution

Vadapav will record the franchisee right as an intangible asset (reacquired right) while doing purchase price allocation and since it is at market terms no gain or loss will be recorded on settlement.

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Illustration 20

ABC Ltd. acquires PQR Ltd. for a consideration of ₹ 1 crore. Four years ago, ABC Ltd. had granted a ten-year license allowing PQR Ltd. to operate in Europe. The cost of the license was ₹ 2,50,000. The contract allows either party to terminate the franchise at a cost of the unexpired initial fee plus 20%. At the date of acquisition, the settlement amount is ₹ 1,80,000 [(₹ 2,50,000 x 6/10) + 20%].

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ABC Ltd. has acquired PQR Ltd., because it sees high potential in the European market and wishes to exploit it. ABC Ltd. calculates that under current economic conditions and at current prices it could grant a six-year franchise for a price of ₹ 4,50,000.

How is the license accounted for as part of the business combination?

Solution

Paragraph B51 of Ind AS 103 provides that "the acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant)."

Further, paragraph B52 of Ind AS 103 provides that "if the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:

(a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.

(b) for a pre-existing contractual relationship, the lesser of (i) and (ii):

(i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)

(ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

If (ii) is less than (i), the difference is included as part of the business combination accounting.

The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements."

Based on the above in the instant case, the license is recognised at ₹ 4,50,000, the fair value at market rates of a license based on the remaining contractual life.

The gain or loss on settlement of the contract is the lower of:

- ₹ 3,00,000, which is the amount by which the right is unfavorable to ABC Ltd. compared to market terms. This is the difference between the amount that ABC Ltd. could receive for

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granting a similar right, ₹ 4,50,000, compared to the carrying value (or the unamortised value) that it was granted for, ₹ 1,50,000 (2,50,000 X 6/10).

- ₹ 1,80,000, which is the amount that ABC Ltd. would have to pay to terminate the right at the date of acquisition.

The loss on settlement of the contract is ₹ 1,80,000. Therefore, out of the ₹ 1 crore paid, ₹ 98.2 lakh is accounted for as consideration for the business combination and ₹ 1,80,000 is accounted for separately as a settlement loss on the re-acquired right.

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10.5 Goodwill – Recognition and Measurement

The acquirer shall recognise Goodwill as of the acquisition date measured as the excess of (a) over (b) below:

a) the aggregate of:

   i. the purchase consideration transferred at acquisition-date fair value;

   ii. the amount of any non-controlling interest in the acquiree measured in accordance with this Ind AS (refer non-controlling section); and

   iii. in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Ind AS.

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred. To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree in place of the acquisition-date fair value of the consideration transferred (paragraph 32(a)(i)).

10.6 Bargain Purchase

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the value of net assets acquired in a business combination exceeds the purchase consideration.

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The acquirer shall recognise the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve, if the reason for bargain purchase gain is clear and evidence exist. If there does not exist clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, then the gain shall be recognised directly in equity as capital reserve.

The gain shall be attributed to the acquirer and there will no allocation to the non-controlling shareholders.

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.

The Ind AS itself acknowledges that it is very rare that a bargain purchase in a business combination will arise and accordingly the standard re-emphasises the above point by requiring the entities to reassess and identify the clear reason why it is a bargain purchase business combination. For e.g. acquisition of business in a bankruptcy sale, or sale of business due to a regulatory requirement.

Example 18:

Entity X is one of the largest liquor manufacturing company in the world and it acquires another Entity Y which has significant presence in India and UK. However, the competition commission in UK has issued orders to sell one division of the UK assets of Entity Y in order to comply with the local competition regulation in UK within a specified timeline. Entity Z another boutique liquor manufacturer realises the opportunity and purchase the assets of Entity Y from Entity X.

In the given case above it is more likely than not that there could be an element of bargain purchase as the Entity X was under compulsion to sell the assets within a specified timeline.

As mentioned above before recognising a gain on a bargain purchase, the acquirer shall determine whether there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase. If such evidence exists, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review.

The acquirer shall then review the procedures used to measure the amounts this Ind AS requires to be recognised at the acquisition date for all of the following:

- the identifiable assets acquired and liabilities assumed;
- the non-controlling interest in the acquiree, if any;
- for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and
- the consideration transferred.

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The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

Illustration 21

On 1st January, 20X1, A Ltd. acquires 80 per cent of the equity interests of B Ltd. in exchange for cash of ₹ 15 crore. The former owners of B Ltd. were required to dispose off their investments in B Ltd. by a specified date, and accordingly they did not have sufficient time to find potential buyers. A qualified valuation professional hired by the management of A Ltd. measures the identifiable net assets acquired, in accordance with the requirements of Ind AS 103, at ₹ 20 crore and the fair value of the 20 per cent non-controlling interest in B Ltd. at ₹ 4.2 crore. How should A Ltd. recognise the above bargain purchase?

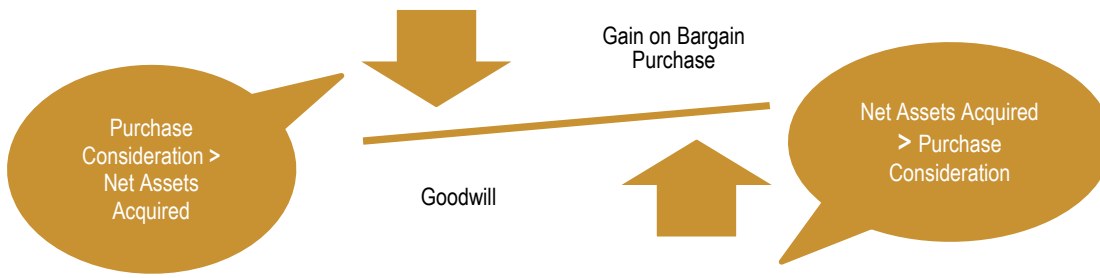
Solution

The amount of B Ltd.'s identifiable net assets i.e., ₹ 20 crore exceeds the fair value of the consideration transferred plus the fair value of the non-controlling interest in B Ltd. i.e. ₹ 19.2 crore. Therefore, A Ltd. should review the procedures it used to identify and measure the net assets acquired and the fair value of non-controlling interest in B Ltd. and the consideration transferred. After the review, A Ltd. decides that the procedures and resulting measures were appropriate. A Ltd. measures the gain on its purchase of the 80 per cent interest at ₹ 80 lakh, as the difference between the amount of the identifiable net assets which is ₹ 20 crore and the sum of purchase consideration and fair value of non-controlling interest, which is ₹ 19.2 crore (cash consideration of ₹ 15 crore and fair value of non-controlling interest of ₹ 4.2 crore).

Assuming there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, the gain on bargain purchase of 80 per cent interest calculated at ₹ 80 lakh, which will be recognised in other comprehensive income on the acquisition date and accumulated the same in equity as capital reserve.

If the acquirer chose to measure the non-controlling interest in B Ltd. on the basis of its proportionate share of identifiable net assets of the acquiree, the recognised amount of the non-controlling interest would be ₹ 4 crore (₹ 20 crore × 0.20). The gain on the bargain purchase then would be ₹ 1 crore (₹ 20 crore – (₹ 15 crore + ₹ 4 crore)).

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10.7 Measurement Period

Ind AS 103 provides a measurement period window wherein if all the required information is not available on the acquisition date then the entity will be required to do the purchase price allocation on a provision basis. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this Ind AS:

- the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;
- the consideration transferred for the acquiree (or the other amount used in measuring goodwill);
- in a business combination achieved in stages, the equity interest in the acquire previously held by the acquirer; and
- the resulting goodwill or gain on a bargain purchase.

Any change i.e. increase or decrease in the net assets acquired due to new information available during the measurement period which existed on the acquisition date will be adjusted against goodwill.

However, after the measurement period ends, any change in the value of assets and liabilities due to an information which existed on the valuation date will be accounted as an error as per Ind AS 8, Accounting policies, Changes in Accounting Estimates and Errors.

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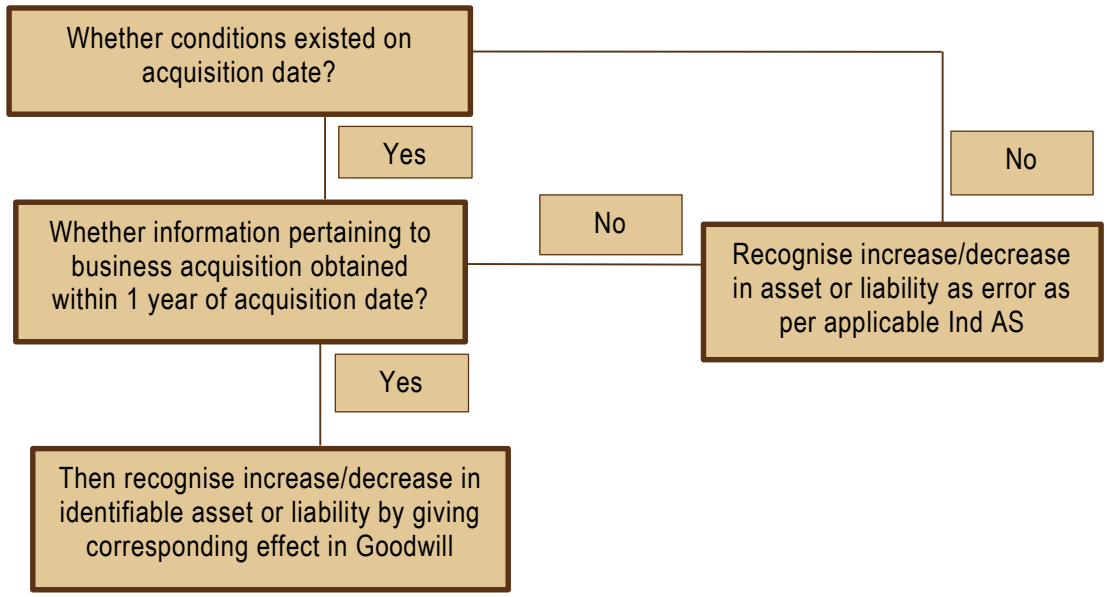


Illustration 22

Entity X acquired 100% shareholding of Entity Y on 1st April, 20X1 and had completed the preliminary purchase price allocation and accordingly recorded net assets of ₹ 100 million against the purchase consideration of 150 million. Entity Y had significant carry forward losses on which deferred tax asset was not recorded due to lack of convincing evidence on the acquisition date. However, on 31st March, 20X2, Entity Y won a significant contract which is expected to generate enough taxable income to recoup the losses. Accordingly, the deferred tax asset was recorded on the carry forward losses on 31st March, 20X2.

Whether the aforesaid losses can be adjusted with the Goodwill recorded based on the preliminary purchase price allocation?

Solution

No, as per the requirement of Ind AS 103, changes to the net assets are allowed which results from the discovery of a fact which existed on the acquisition date. However, change of facts resulting in recognition and de-recognition of assets and liabilities after the acquisition date will be accounted in accordance with other Ind AS. In the above scenario deferred tax asset was not eligible for recognition on the acquisition date and accordingly the new contract on 31st March, 20X2 will tantamount to change of estimate and accordingly will not impact the Goodwill amount.

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Illustration 23

ABC Ltd. acquires XYZ Ltd. in a business combination on 15th January, 20X1. Few days before the date of acquisition, one of XYZ Ltd.'s customers had claimed that certain amounts were due by XYZ Ltd. under penalty clauses for completion delays included in the contract.

ABC Ltd. evaluates the dispute based on the information available at the date of acquisition and concludes that XYZ Ltd. was responsible for at least some of the delays in completing the contract. Based on the evaluation, ABC Ltd. recognises ₹ 1 crore towards this liability which is its best estimate of the fair value of the liability to the customer based on the information available at the date of acquisition.

In October, 20X1 (within the measurement period), the customer presents additional information as per which ABC Ltd. concludes the fair value of liability on the date of acquisition to be ₹ 2 crore.

ABC Ltd. continues to receive and evaluate information related to the claim after October, 20X1. Its evaluation doesn't change till February, 20X2 (i.e. after the measurement period), when it concludes that the fair value of the liability for the claim at the date of acquisition is ₹ 1.9 crore. ABC Ltd. determines that the amount that would be recognised with respect to the claim under Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets as at February, 20X2 is ₹ 2.2 crore.

How should the adjustment to the provisional amounts be made in the financial statements during and after the measurement period?

Solution

The consolidated financial statements of ABC Ltd. for the year ended 31st March, 20X1 should include ₹ 1 crore towards the contingent liability in relation to the customer claim.

When the customer presents additional information in support of its claim, the incremental liability of ₹ 1 crore (₹ 2 crore – ₹ 1 crore) will be adjusted as a part of acquisition accounting as it is within the measurement period. In its financial statements for the year ending on 31st March, 20X2, ABC Ltd. will disclose the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, it will disclose that the comparative information for the year ending on 31st March, 20X1 is adjusted retrospectively to increase the fair value of the item of liability at the acquisition date by ₹ 1 crore, resulting in a corresponding increase in goodwill.

The information resulting in the decrease in the estimated fair value of the liability for the claim in February, 20X2 was obtained after the measurement period. Accordingly, the decrease is not recognised as an adjustment to the acquisition accounting. If the amount determined in

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accordance with Ind AS 37 subsequently exceeds the previous estimate of the fair value of the liability, then ABC Ltd. recognises an increase in the liability. As the change has occurred after the end of the measurement period, the increase in the liability amounting to ₹ 20 lakh (₹ 2.2 crore – ₹ 2 crore) is recognised in profit or loss.

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10.8 Determining what is part of the Business Combination Transaction

The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, i.e. amounts that are not part of the exchange for the acquiree. The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant Ind AS.

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

- a transaction that in effect settles pre-existing relationships between the acquirer and acquiree;
- a transaction that remunerates employees or former owners of the acquiree for future services; and
- a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, in determining whether the transaction is separate from Business combination:

I. **The reasons for the transaction**- Understanding the reasons why the parties to the combination (the acquirer and the acquiree and their owners, directors and managers -and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities

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assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

II. **Who initiated the transaction**—Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.

III. **The timing of the transaction**—The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

*****

Illustration 24

Progressive Ltd. is being sued by Regressive Ltd. for an infringement of its Patent. At 31st March, 20X2, Progressive Ltd. recognised a ₹ 10 million liability related to this litigation.

On 30th July, 20X2, Progressive Ltd. acquired the entire equity of Regressive Ltd. for ₹ 500 million. On that date, the estimated fair value of the expected settlement of the litigation is ₹ 20 million.

Recommend the accounting for such litigation liability at the time of business combination of Progressive Ltd. and Regressive Ltd.

Solution

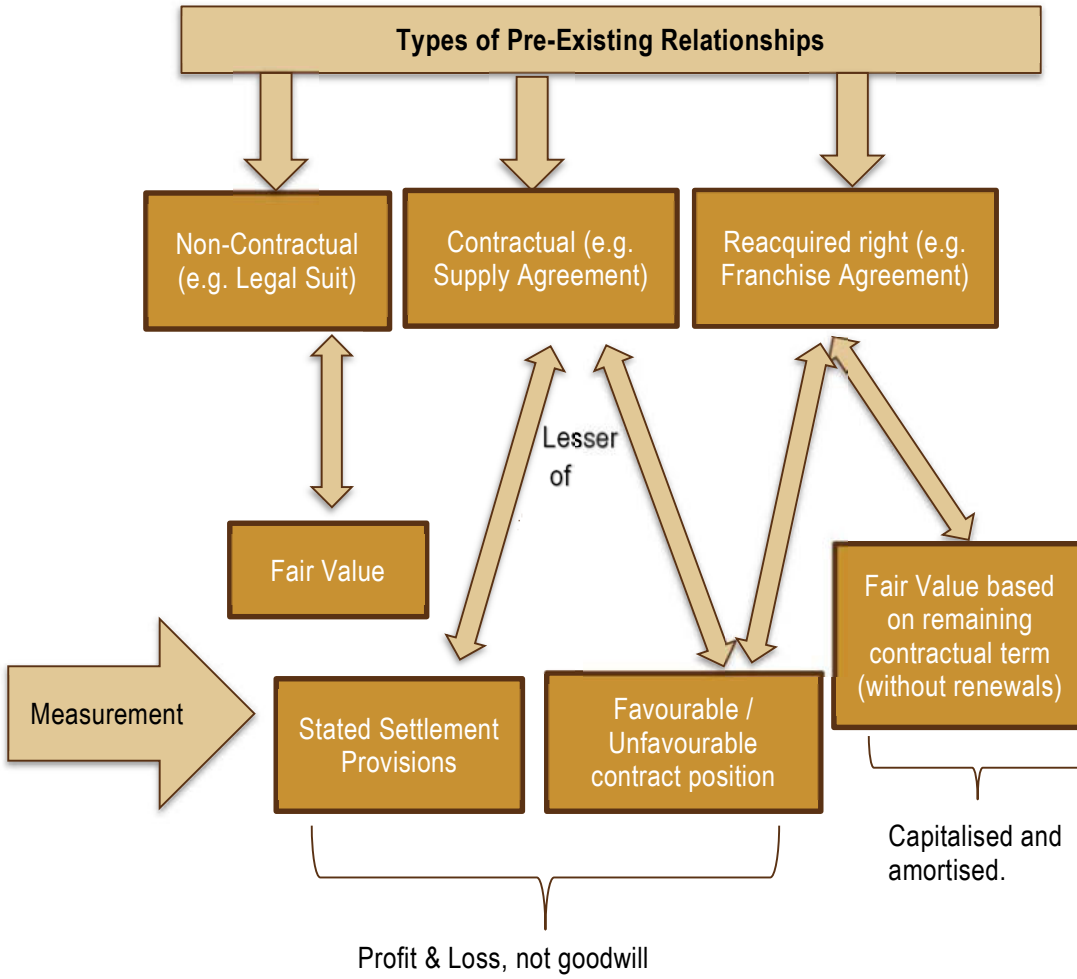
In the above scenario the litigation is in substance settled with the business combination transaction and accordingly ₹ 20 million being the fair value of the litigation liability will be considered as paid for settling the litigation claim and will be not included in the business

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combination. Accordingly, the purchase price will reduce by ₹ 20 million and the difference between ₹ 20 million and ₹ 10 million will be recorded in income statement of the Progressive limited as loss on settlement of the litigation.

*****

Summary of accounting for a pre-existing relationship:



10.9 Contingent Payments to Employees or Selling Shareholders

Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement

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includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a) **Continuing employment**—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.

b) **Duration of continuing employment** — If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, remuneration.

c) **Level of remuneration** — Situations in which employee remuneration (other than the contingent payments) is at a reasonable level in comparison with that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than remuneration.

d) **Incremental payments to employees** — If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration.

e) **Number of shares owned**—The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit sharing arrangement intended to provide remuneration for post-combination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The pre-acquisition ownership interests held by parties related to selling

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shareholders who continue as key employees, such as family members, should also be considered.

f) **Linkage to the valuation**—If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquire and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide remuneration.

g) **Formula for determining consideration**—The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to remunerate employees for services rendered.

h) **Other agreements and issues —** The terms of other arrangements with selling shareholders (such as agreements not to compete, executory contracts, consulting contracts and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognise separately in its post-combination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

Illustration 25 IMP

KKV Ltd acquires a 100% interest in VIVA Ltd, a company owned by a single shareholder who is also the KMP in the Company, for a cash payment of USD 20 million and a contingent payment of USD 2 million. The terms of the agreement provide for contingent payment 2 years after the acquisition if, the following conditions are met:

- *the EBIDTA margins of the Company after 2 years post-acquisition is 21%.*

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- *the former shareholder continues to be employed with VIVA Ltd for at least 2 years after the acquisition. No part of the contingent payment will be paid if the former shareholder does not complete the 2 year employment period.*

Determine the purchase consideration in the above case.

Solution

In the above scenario the former shareholder is required to continue in employment and the contingent consideration will be forfeited if the employment is terminated or if he resigns. Accordingly, only USD 20 million is considered as purchase consideration and the contingent consideration is accounted as employee cost and will be accounted as per the other Ind AS.

*****

Illustration 26 : Contingent consideration- Payments to employees who are former owners of acquiree

ABC Ltd. acquires all of the outstanding shares of XYZ Ltd. in a business combination. XYZ Ltd. had three shareholders with equal shareholdings, two of whom were also senior-level employees of XYZ Ltd. and would continue as employee post-acquisition of shares by ABC Ltd.

- *The employee shareholders each will receive ₹ 60,00,000 plus an additional payment of ₹ 1,50,00,000 to 2,00,00,000 based on a multiple of earnings over the next two years.*
- *The non-employee shareholders each receive ₹ 1,00,00,000.*

The additional payment of each of these employee shareholders will be forfeited if they leave the employment of XYZ Ltd. at any time during the two years following its acquisition by ABC Ltd. The salary received by them is considered reasonable remuneration for their services.

How much amount is attributable to post combination services?

Solution

Paragraph B55(a) of Ind AS 103 provides an indication that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services.

Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.

In accordance with the above, in the instant case, the additional consideration of ₹ 1,50,00,000 to ₹ 2,00,00,000 represents compensation for post-combination services, as the same represents that part of the payment which is forfeited if the former shareholder does not remain

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in the employment of XYZ Ltd. for two years following the acquisition - i.e., only ₹ 60,00,000 is attributed to consideration in exchange for the acquired business.

*****

10.10 Acquirer Share Based Payment Awards Exchanged for Awards held by the Acquiree's Employees

- An acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree.
- The above share-based payment awards will include vested and unvested shares.
- Exchanges of share options or other share-based payment awards in conjunction with a business combination are accounted for as modifications of share-based payment awards in accordance with Ind AS 102, Share based Payment.
- If the acquirer replaces the acquiree awards, either all or a portion of the market-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. Market based measure means that awards will be re-measured on the acquisition date as per the requirements of Ind AS 102.
- In situations in which acquiree awards would expire as a consequence of a business combination and if the acquirer replaces those awards when it is not obliged to do so, all of the market-based measure of the replacement awards shall be recognised as remuneration cost in the post-combination financial statements in accordance with Ind AS 102. That is to say, none of the market-based measure of those awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obliged to replace the acquiree awards if the acquiree or its employees have the ability to enforce replacement.

  For example, for the purposes of applying this guidance, the acquirer is obliged to replace the acquiree's awards if replacement is required by:

  (a) the terms of the acquisition agreement;

  (b) the terms of the acquiree's awards; or

  (c) applicable laws or regulations.
- To determine the portion of a replacement award that is part of the consideration transferred for the acquiree and the portion that is remuneration for post-combination service, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with Ind AS 102. The portion of the market-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to pre-combination service.
- The portion of the replacement award attributable to pre-combination service is the market-based measure of the acquiree award multiplied by the ratio of the portion of the vesting

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period completed to the greater of the total vesting period or the original vesting period of the acquiree award. The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in Ind AS 102.

- The portion of a non-vested replacement award attributable to post-combination service, and therefore recognised as remuneration cost in the post-combination financial statements, equals the total market-based measure of the replacement award less the amount attributed to pre-combination service. Therefore, the acquirer attributes any excess of the market-based measure of the replacement award over the market-based measure of the acquiree award to post-combination service and recognises that excess as remuneration cost in the post-combination financial statements.
- The acquirer shall attribute a portion of a replacement award to post-combination service if it requires post combination service, regardless of whether employees had rendered all of the service required for their acquiree awards to vest before the acquisition date.
- The portion of a non-vested replacement award attributable to pre-combination service, as well as the portion attributable to post-combination service, shall reflect the best available estimate of the number of replacement awards expected to vest.

Example 19

If the market-based measure of the portion of a replacement award attributed to pre-combination service is ₹ 100 and the acquirer expects that only 95 per cent of the award will vest, the amount included in consideration transferred in the business combination is ₹ 95.

- Changes in the estimated number of replacement awards expected to vest are reflected in remuneration cost for the periods in which the changes or forfeitures occur not as adjustments to the consideration transferred in the business combination. Similarly, the effects of other events, such as modifications or the ultimate outcome of awards with performance conditions, that occur after the acquisition date are accounted for in accordance with Ind AS 102 in determining remuneration cost for the period in which an event occurs.
- The same requirements for determining the portions of a replacement award attributable to pre-combination and post-combination service apply regardless of whether a replacement award is classified as a liability or as an equity instrument in accordance with the provisions of Ind AS 102. All changes in the market-based measure of awards classified as liabilities after the acquisition date and the related income tax effects are recognised in the acquirer's post-combination financial statements in the period(s) in which the changes occur.
- The income tax effects of replacement awards of share-based payments shall be recognised in accordance with the provisions of Ind AS 12, Income Taxes.

The above guidance on Share based payment as per the Ind AS 103 can be summarized as follows:

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ACQUIRER SHARE BASED PAYMENT AWARDS EXCHANGED FOR AWARDS HELD BY THE ACQUIREE'S EMPLOYEES

Business combination transaction
- An acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree

Nature of awards
- The above share based payment awards will include **vested and unvested** shares

Type of Accounting
- Exchanges of share options or other share-based payment awards in conjunction with a business combination are **accounted for as modifications of share-based payment awards** as per Ind AS 102

Objective of Accounting
- *To allocate the replacement award's value* between the amounts attributable to:
  - **pre-combination service** (treated as part of consideration transferred)
  - **post-combination service** (accounted for as compensation expense in the post combination financial statements)

Accounting

Pre-combination period service cost = Market-based measure of the acquiree award × Completed vesting period as on the acquisition date ÷ Greater of total original vesting period or total revised vesting period

Post-combination period service cost = Market-based measure of the replacement award − Amount attributed to pre-combination service

Market based measure means that awards will be re-measured on the acquisition date as per the requirements of Ind AS 102

Important Notes
- The acquirer shall attribute a portion of a replacement award to post-combination service if it requires post-combination service, regardless of whether employees had rendered all of the service required for their acquiree awards
- Changes in the estimated number of replacement awards expected to vest are **reflected in remuneration cost for the periods in which the changes or forfeitures occur not as adjustments to the consideration transferred in the business combination.**
- Modifications or the ultimate outcome of awards with performance conditions, that occur after the acquisition date are accounted for as per Ind AS 102 in determining **remuneration cost for the period in which an event occurs**
- Requirements for determining the portions of a replacement award attributable to pre-combination and post-combination service **apply regardless of whether a replacement award is classified as a liability or as an equity instrument** as per Ind AS 102
- Recognise income tax effects of replacement awards as per Ind AS 12

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Illustration 27

Green Ltd acquired Pollution Ltd. As a part of the arrangement Green Ltd. had to replace the Pollution Ltd.'s existing equity-settled award. The original awards specify a vesting period of five years. At the acquisition date, Pollution Ltd employees have already rendered two years of service.

As required, Green Ltd replaced the original awards with its own share-based payment awards (replacement award). Under the replacement awards, the vesting period is reduced to 2 year (from the acquisition date).

The value (market-based measure) of the awards at the acquisition date are as follows:

- *original awards: ₹ 500*
- *replacement awards: ₹ 600*

As of the acquisition date, all awards are expected to vest.

Determine the accounting for the above replacement award.

Solution

Pre-combination period

The value of the replacement awards will have to be allocated between the pre-combination and post combination period. As of the acquisition date, the fair value of the original award (₹ 500) will be multiplied by the service rendered upto acquisition date (2 years) divided by greater of original vesting period (5 years) or new vesting period (4 years). Accordingly, ₹ 500 x 2/5= ₹ 200 will be considered as pre-combination service and will be included in the purchase consideration.

Post- Combination period

The fair value of the award on the acquisition date is ₹ 600 which means the difference between the replacement award which is ₹ 600 and the amount allocated to pre-combination period (₹ 200) is ₹ 400 which will be now recorded over the remaining vesting period which is 2 years as an employee compensation cost.

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10.11 Non-replacement Awards

The acquiree may have outstanding share-based payment transactions that the acquirer does not exchange for its share-based payment transactions. If vested, those acquiree share-based

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payment transactions are part of the non-controlling interest in the acquiree and are measured at their market-based measure. If unvested, they are measured at their market-based measure as if the acquisition date were the grant date in accordance with paragraphs 19 and 30.

The market-based measure of unvested share-based payment transactions is allocated to the non-controlling interest on the basis of the ratio of the portion of the vesting period completed to the greater of the total vesting period and the original vesting period of the share-based payment transaction. The balance is allocated to post-combination service.

The above means that the acquiree's existing award will be settled in its own shares and the consequential shareholders will become the Non-controlling shareholders. The above principles can be summarized as follows:

Vested shares -

- the value credited to Share based payment reserve is classified as NCI.

Unvested-

- Pre-combination period is considered as a part of NCI
- Post-combination period- is recorded as employee cost and the credit forms part of the NCI in the balance sheet.

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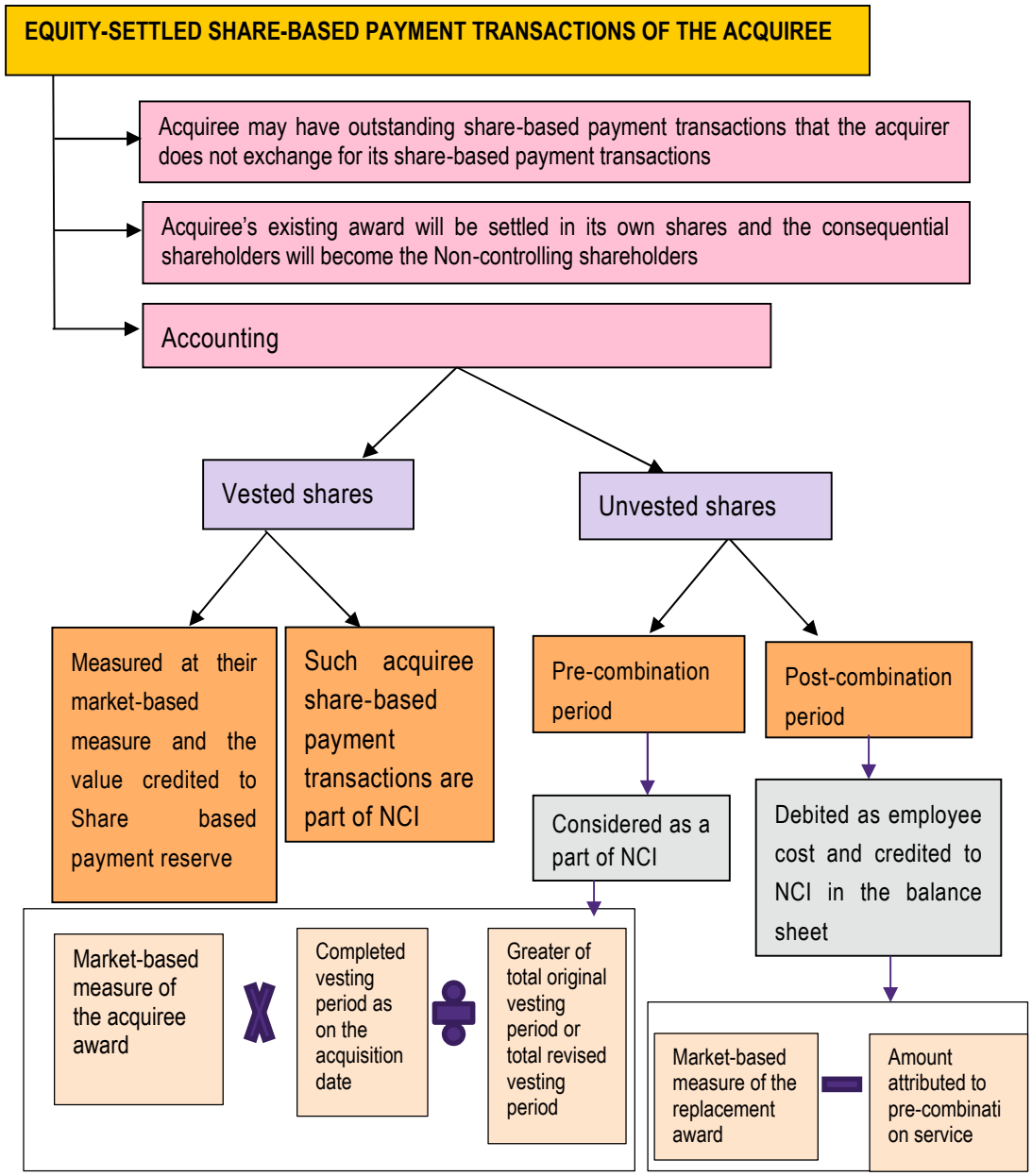


Illustration 28

P Ltd. a real estate company acquires Q Ltd. another construction company which has an existing equity settled share-based payment scheme. The awards vest after 5 years of employee service. At the acquisition date, Company Q's employees have rendered 2 years of service. None of the awards are vested at the acquisition date. P did not replace the existing share-based payment scheme but reduced the remaining vesting period from 3 years to 2 years. Company P determines that the market-based measure of the award at the acquisition date is

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₹ 500 (based on measurement principles and conditions at the acquisition date as per Ind AS 102).

Determine the accounting for market-based measure of the award.

Solution

The market-based measure or the fair value of the award on the acquisition date of 500 is allocated to NCI and post combination employee compensation expense. The portion allocable to pre-combination period is ₹ 500 x 2/5 = ₹ 200 which will be included in pre-combination period and is allocated to NCI on the acquisition date. The amount is computed based on original vesting period.

The remaining expense which is ₹ 500 – ₹ 200 = ₹ 300 is accounted over the remaining vesting period of 2 years as compensation expenses.

*****

10.12 Non-controlling Interest in an Acquiree

Ind AS 103 allows the acquirer to measure a non-controlling interest in the acquiree at its fair value at the acquisition date. Sometimes an acquirer will be able to measure the acquisition-date fair value of a non-controlling interest on the basis of a quoted price in an active market for the equity shares (ie those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the non-controlling interest using other valuation techniques.

The fair values of the acquirer's interest in the acquiree and the non-controlling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a non-controlling interest discount) in the per-share fair value of the non-controlling interest if market participants would take into account such a premium or discount when pricing the non-controlling interest.

Illustration 29

Classic Ltd. acquires 60% of the ordinary shares of Natural Ltd. a private entity, for ₹ 97.5 crore. The fair value of its identifiable net assets is ₹ 150 crore. The fair value of the 40% of the ordinary shares owned by non-controlling shareholders is ₹ 65 crore. Carrying amount of Natural Ltd.'s net assets is ₹ 120 crore.

Measure the non-controlling interest.

Solution

Paragraph 19 of Ind AS 103 states that for each business combination, the acquirer shall measure at the acquisition date components of non-controlling interest in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

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(a) fair value; or

(b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by Ind AS.

In accordance with above, non-controlling interests will be measured in either of the following manner:

(a) Non-controlling interests are measured at fair value

Under this method, goodwill represents the difference between the fair value of Natural Ltd. and the fair value of its identifiable net assets.

Thus, Classic Ltd. will recognise the business combination as follows: (₹ in crores)

Identifiable net assets at fair value	Dr.	150	
Goodwill*	Dr.	12.5	
To Non-controlling interest			65
To Investment in Natural Ltd.			97.5

*Note: Goodwill is calculated as 97.5 + 65 - 150 = 12.5 or 162.5 - 150 = 12.5

(b) Non-controlling interests are measured at proportionate share of identifiable net assets

Under this method, goodwill represents the difference between the total of the consideration transferred less the fair value of the acquirer's share of net assets acquired and liabilities assumed. The non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the Natural Ltd 's net assets in the event of liquidation (i.e. the ordinary shares) are measured at the non-controlling interest's proportionate share of the identifiable net assets of Natural Ltd.

Thus, Classic will recognise the business combination as follows:

(₹ in Crores)

Identifiable net assets at fair value	Dr.	150	
Goodwill*	Dr.	7.5	
To Non-controlling interest (40% x 150)			60
To Investment in Natural Ltd.			*97.5*

*Note: Goodwill is calculated as 97.5+60-150 = 7.5 or 97.5-(150 x 60%) = 7.5

*****

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11. SUBSEQUENT MEASUREMENT AND ACCOUNTING

In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable Ind AS for those items, depending on their nature. However, this Ind AS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:

a) reacquired rights;

b) contingent liabilities recognised as of the acquisition date;

c) indemnification assets; and

d) Contingent consideration.

11.1 Reacquired Rights

A reacquired right recognised as an intangible asset shall be amortised over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

11.2 Contingent Liabilities

After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:

(a) the amount that would be recognised in accordance with Ind AS 37; and

(b) the amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115, Revenue from Contracts with Customers.

11.3 Indemnification Assets

At the end of each subsequent reporting period, the acquirer shall measure an indemnification asset that was recognised at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's needs to do assessment of the collectability of the indemnification asset. The acquirer shall derecognise the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it.

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11.4 Contingent Consideration

Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date.

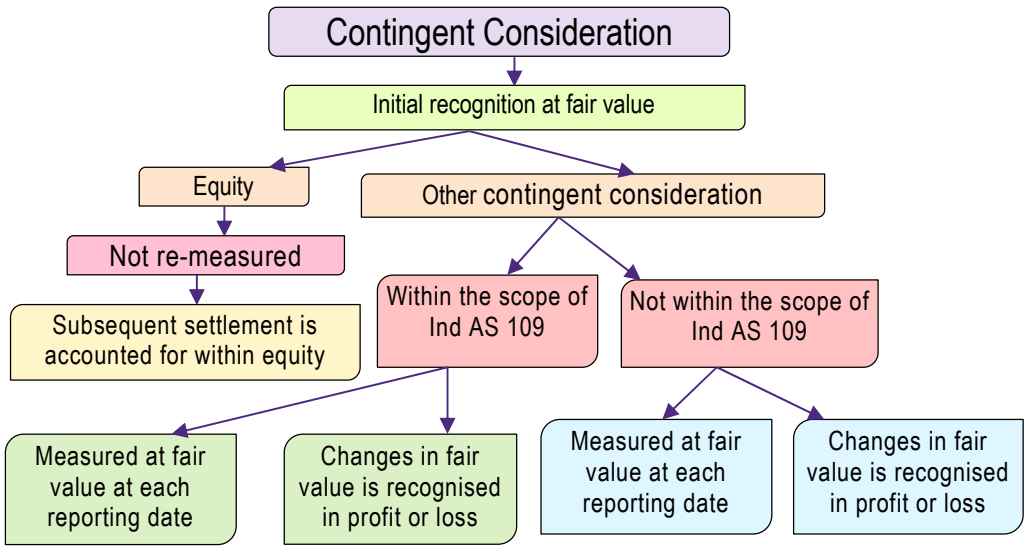
Such changes are measurement period adjustments to the extent it is on account of conditions which existed as of the acquisition date will be adjusted against goodwill. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

(a) Contingent consideration classified as equity shall not be re-measured and its subsequent settlement shall be accounted for within equity.

(b) Other contingent consideration that:

i. is within the scope of Ind AS 109 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss in accordance with Ind AS 109.

ii. is not within the scope of Ind AS 109 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss.



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12. DISCLOSURES

The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

a) during the current reporting period; or

b) after the end of the reporting period but before the financial statements are approved for issue.

Ind AS 103 requires detailed disclosures on Business Combination. The acquirer shall disclose the following information for each business combination that occurs during the reporting period:

a. the name and a description of the acquiree.

b. the acquisition date.

c. the percentage of voting equity interests acquired.

d. the primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree.

e. a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.

f. the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:

   I. cash;

   II. other tangible or intangible assets, including a business or subsidiary of the acquirer;

   III. liabilities incurred, for example, a liability for contingent consideration; and

   IV. equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of measuring the fair value of those instruments or interests.

g. for contingent consideration arrangements and indemnification assets:

   i. the amount recognised as of the acquisition date;

   ii. a description of the arrangement and the basis for determining the amount of the payment; and

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iii. an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

h. for acquired receivables:

i. the fair value of the receivables;

ii. the gross contractual amounts receivable; and

iii. the best estimate at the acquisition date of the contractual cash flows not expected to be collected. The disclosures shall be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables.

i. the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.

j. for each contingent liability recognised, the information required in paragraph 85 of Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets. If a contingent liability is not recognised because its fair value cannot be measured reliably, the acquirer shall disclose:

i. the information required by paragraph 86 of Ind AS 37; and

ii. the reasons why the liability cannot be measured reliably.

k. the total amount of goodwill that is expected to be deductible for tax purposes.

l. for transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination:

i. a description of each transaction;

ii. how the acquirer accounted for each transaction;

iii. the amounts recognised for each transaction and the line item in the financial statements in which each amount is recognised; and

iv. if the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement amount.

m. the disclosure of separately recognised transactions required by (l) shall include the amount of acquisition-related costs and, separately, the amount of those costs recognised as an expense and the line item or items in the statement of profit and loss in which those expenses are recognised. The amount of any issue costs not recognised as an expense and how they were recognised shall also be disclosed.

n. in a bargain purchase (see paragraphs 34–36A):

i. the amount of any gain recognised in other comprehensive income in accordance with paragraph 34;

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ii. the amount of any gain directly recognised in equity in accordance with paragraph 36A; and

iii. a description of the reasons why the transaction resulted in a gain in case of (i) above.

o. for each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date:

i. the amount of the non-controlling interest in the acquiree recognised at the acquisition date and the measurement basis for that amount; and

ii. for each non-controlling interest in an acquiree measured at fair value, the valuation technique(s) and significant inputs used to measure that value.

p. in a business combination achieved in stages:

i. the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and

ii. the amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination (see paragraph 42) and the line item in the statement of profit and loss in which that gain or loss is recognised.

q. Following additional information:

i. the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of profit and loss for the reporting period; and

ii. the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. This Ind AS uses the term 'impracticable' with the same meaning as in Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are approved for issue, the acquirer shall disclose the information required as above unless the initial accounting for the business combination is incomplete at the time the financial statements are approved for issue. In that situation, the acquirer shall describe which disclosures could not be made and the reasons why they cannot be made.

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To meet the objective of the Ind AS 103 disclosure requirements, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

a) if the initial accounting for a business combination is incomplete for particular assets, liabilities, non-controlling interests or items of consideration and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally

   i. the reasons why the initial accounting for the business combination is incomplete;

   ii. the assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete; and

   iii. the nature and amount of any measurement period adjustments recognised during the reporting period.

b) for each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires:

   i. any changes in the recognised amounts, including any differences arising upon settlement;

   ii. any changes in the range of outcomes (undiscounted) and the reasons for those changes; and

   iii. the valuation techniques and key model inputs used to measure contingent consideration.

c) for contingent liabilities recognised in a business combination, the acquirer shall disclose the information required by paragraphs 84 and 85 of Ind AS 37 for each class of provision.

d) a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period showing separately:

   i. the gross amount and accumulated impairment losses at the beginning of the reporting period.

   ii. additional goodwill recognised during the reporting period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations.

   iii. adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period

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iv. goodwill included in a disposal group classified as held for sale in accordance with Ind AS 105 and goodwill derecognised during the reporting period without having previously been included in a disposal group classified as held for sale

v. impairment losses recognised during the reporting period in accordance with Ind AS 36. (Ind AS 36 requires disclosure of information about the recoverable amount and impairment of goodwill in addition to this requirement.)

vi. net exchange rate differences arising during the reporting period in accordance with Ind AS 21, The Effects of Changes in Foreign Exchange Rates.

vii. any other changes in the carrying amount during the reporting period.

viii. the gross amount and accumulated impairment losses at the end of the reporting period.

e) the amount and an explanation of any gain or loss recognised in the current reporting period that both:

i. relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and

ii. is of such a size, nature or incidence that disclosure is relevant to understand the combined entity's financial statements.

The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or in previous reporting periods.

13. COMMON CONTROL TRANSACTIONS INCLUDING MERGER

Common control transaction accounting guidance is included in Appendix C of Ind AS 103.

13.1 Definitions

Transferor means an entity or business which is combined into another entity as a result of a business combination.

Transferee means an entity in which the transferor entity is combined.

Reserve means the portion of earnings, receipts or other surplus of an entity (whether capital or revenue) appropriated by the management for a general or a specific purpose other than provision for depreciation.

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Common control business combination means a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

13.2 Common Control Business Combinations

Common control business combinations will include transactions, such as transfer of subsidiaries or businesses, between entities within a group.

The extent of non-controlling interests in each of the combining entities before and after the business combination is not relevant in determining whether the combination involves entities under common control. This is because a partially-owned subsidiary is nevertheless under the control of the parent entity.

An entity can be controlled by an individual, or by a group of individuals acting together under a ***contractual arrangement***, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one having entities under common control.

A group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

Common control combinations are the most frequent. Broadly, these are transactions in which an entity obtains control of a business (hence a business combination) but both combining parties are ultimately controlled by the same party or parties both before and after the combination. These combinations often occur as a result of a group reorganisation in which the direct ownership of subsidiaries changes but the ultimate parent remains the same. However, such combinations can also occur in other ways and careful analysis and judgement are sometimes required to assess whether some combinations are covered by the definition (and the scope exclusion). In particular:

- an assessment is required as to whether common control is 'transitory' (if so, the combination is not a common control combination and Ind AS 103 applies). The term transitory is not explained in the standard. In our view it is intended to ensure that Ind AS 103 is applied when a transaction that will lead to a substantive change in control is structured such that, for a brief period before and after the combination, the entity to be acquired/sold is under common control. However, common control should not be considered transitory simply because a combination is carried out in contemplation of an initial public offering or sale of combined entities.

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- when a group of two or more individuals have control before and after the transaction, an assessment is needed as to whether they exercise control collectively as a result of a contractual agreement.

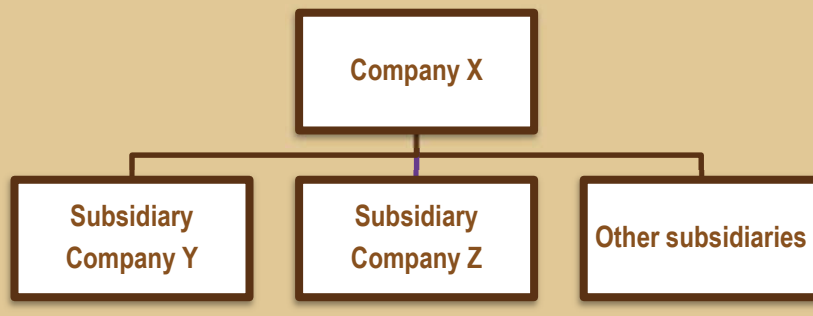
  Examples of common control transaction

  - ♦ Merger between fellow subsidiaries
  - ♦ Merger of subsidiary with parent
  - ♦ Acquisition of an entity from an entity within the same group
  - ♦ Bringing together entities under common control in a corporate legal structure

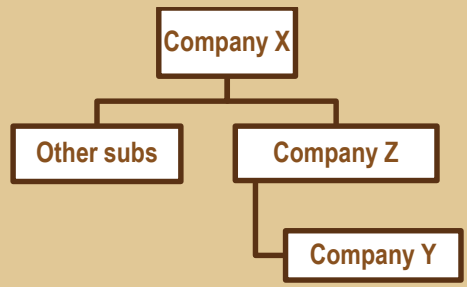
Illustration 30

Company X, the ultimate parent of a large number of subsidiaries, reorganises the retail segment of its business to consolidate all of its retail businesses in a single entity. Under the reorganisation, Company Z (a subsidiary and the biggest retail company in the group) acquires Company X's shareholdings in its one operating subsidiary, Company Y by issuing its own shares to Company X. After the transaction, Company Z will directly control the operating and financial policies of Company Y.

Before Reorganisation



After Reorganisation



Analyse the above transaction.

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Solution

In this situation, Company Z pays consideration to Company X to obtain control of Company Y. The transaction meets the definition of a business combination. Prior to the reorganisation, each of the parties are controlled by Company X. After the reorganisation, although Company Y is now owned by Company Z, all two companies are still ultimately owned and controlled by Company X. From the perspective of Company X, there has been no change as a result of the reorganisation. This transaction therefore meets the definition of a common control combination and is within the scope of Ind AS 103.

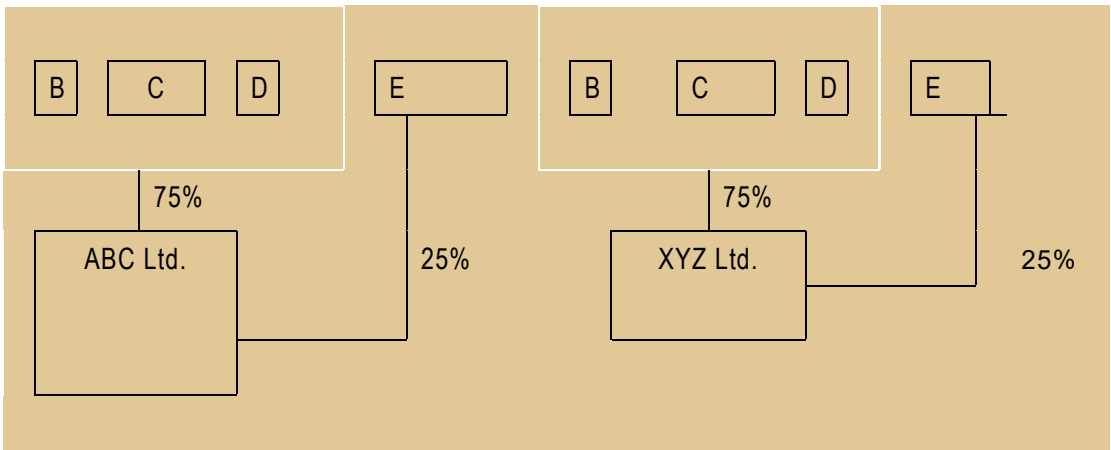
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Illustration 31

ABC Ltd. and XYZ Ltd. are owned by four shareholders B, C, D and E, each of whom holds 25% of the shares in each company. Shareholders B, C and D have entered into a shareholders' agreement in terms of governance of ABC Ltd. and XYZ Ltd. due to which they exercise joint control.

Determine whether ABC Ltd. and XYZ Ltd. are under common control.

Solution



Appendix C to Ind AS 103 defines common control business combination as a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraphs 6 and 7 of Appendix C to Ind AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one having

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entities under common control. Also, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

In the instant case, both ABC Ltd. and XYZ Ltd. are jointly controlled by group of individuals (B, C and D) as a result of contractual arrangement. Therefore, in the current scenario, ABC Ltd. and XYZ Ltd. are considered to be under common control.

*****

Illustration 32

ABC Ltd. and XYZ Ltd. are owned by four shareholders B, C, D and E, each of whom holds 25% of the shares in each company. However, there are no agreements between any of the shareholders that they will exercise their voting power jointly.

Determine whether ABC Ltd. and XYZ Ltd. are under common control.

Solution

Appendix C to Ind AS 103 defines 'Common control business combination' as business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

Further as per paragraphs 6 and 7 of Appendix C to Ind AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a control. Also a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

In the present case, there is no contractual arrangement between the shareholders who exercise control collectively over either company. Thus, ABC Ltd. and XYZ Ltd. are not considered to be under common control even if there is an established pattern of voting together.

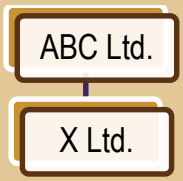
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Illustration 33

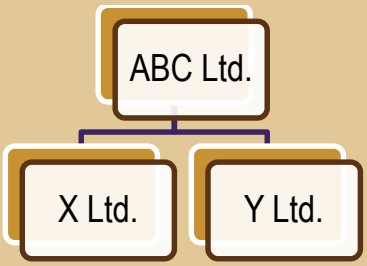
ABC Ltd. had a subsidiary, namely, X Ltd. which was acquired on 1st April, 2XX0. ABC Ltd. acquires all of the shares of Y Ltd. on 1st April, 2X17. ABC Ltd. transfers the shares in Y Ltd. to X Ltd. on 2nd April, 2X17. How should the above transfer of Y Ltd. into X Ltd. be accounted for in the consolidated financial statements of X Ltd.?

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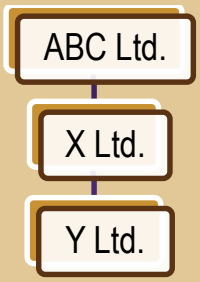
Before:



Intermediate:



After:



Solution

Appendix C to Ind AS 103 defines common control business combination as business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraph 7 of Appendix C to Ind AS 103, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

The term 'transitory' has been included as part of Appendix C to Ind AS 103.

The word 'transitory' has been included in the common control definition to ensure that acquisition accounting applies to those transactions that look as though they are combinations involving entities under common control, but which in fact represent genuine substantive business combinations with unrelated parties.

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Based on above, if the intermediate step had been omitted and instead X Ltd. had been the ABC group's vehicle for the acquisition of Y Ltd. - i.e. going straight to the 'after' position - then X Ltd. would have been identified as the acquirer.

Considering X Ltd. and Y Ltd. are under common control (with common parent), it might seem that acquisition accounting is not required because of the specific requirement for common control business combination. However, X Ltd. should be identified as the acquirer and should account for its combination with Y Ltd. using acquisition accounting. This is because X Ltd. would have applied acquisition accounting for Y Ltd. if X Ltd. had acquired Y Ltd directly rather than through ABC Ltd. Acquisition accounting cannot be avoided in the financial statements of X Ltd. simply by placing X Ltd. and Y Ltd. under the common control ABC Ltd shortly before the transaction.

*****

13.3 Method of Accounting for Common Control Business Combinations

Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interest method.

The pooling of interest method is considered to involve the following:

(i) The assets and liabilities of the combining entities are reflected at their carrying amounts.

(ii) No adjustments are made to reflect fair values or recognise any new assets or liabilities. The only adjustments that are made is to harmonise accounting policies.

(iii) The financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the earliest period presented in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.

The consideration for the business combination may consist of securities, cash or other assets. Securities shall be recorded at nominal value. In determining the value of the consideration, assets other than cash shall be considered at their fair values.

The balance of the retained earnings appearing in the financial statements of the transferor is aggregated with the corresponding balance appearing in the financial statements of the transferee. Alternatively, it is transferred to General Reserve, if any.

The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor. Thus, for example, the General Reserve of the transferor entity becomes the General Reserve of the transferee, the Capital Reserve of the transferor becomes the Capital Reserve of

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the transferee and the Revaluation Reserve of the transferor becomes the Revaluation Reserve of the transferee. As a result of preserving the identity, reserves which are available for distribution as dividend before the business combination would also be available for distribution as dividend after the business combination.

The difference, if any, between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.

The acid test in assessing common control transaction is that before and after the reorganisation the entity should be controlled by the same shareholders.

Illustration 34

How will the financial statement of the prior periods be restated under common control in the following scenarios:

a) Common Control period extends beyond the start of comparative period

XYZ Ltd acquired PQR Ltd in a common control transaction on 1 October 20X9. The year-end of XYZ Ltd is 31 March. Both XYZ Ltd and PQR Ltd have been controlled by shareholders since their incorporation.

b) Common Control period started in the comparative period

ABC Ltd acquired DEF Ltd in a common control transaction on 1st October 20X9. The year-end of ABC Ltd is 31st March. Both ABC Ltd and DEF Ltd are controlled by shareholder A. A made investment in ABC Ltd in 20X0 and made investment in DEF Ltd on 1st October 20X8.

Solution

Paragraph 9(iii) of Appendix C to Ind AS 103 states that the financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the preceding period in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.

a) In accordance with Paragraph 9(iii) above, the entity will be required to restate its financial statements as if the business combination had occurred from the beginning of the preceding period in the financial statements, accordingly in the present case XYZ Ltd will have to restate its comparatives for the financial year 20X8-20X9 as if the acquisition had occurred before 1st April 20X8. Additionally, the results of current year of PQR Ltd will be

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required to include XYZ's financial statements for the period from 1st April 20X9 to 30th September 20X9.

b) In accordance with paragraph 9(iii) above, ABC Ltd will have to restate its comparatives for the financial year ended 20X8-20X9 as if the acquisition had occurred on 1st October 20X8, but not earlier. Additionally, the results of current year of DEF Ltd will be required to include the financial statements of ABC Ltd for the period from 1 April 20X9 to 1st October 20X9.

*****

Illustration 35

Entity A owns 100% equity shares of entity B since 01.04.20X1. Entity A arranges loan funding from a financial institution in a new wholly owned subsidiary called "Entity C". The loan is used by Entity C to acquire 100% shareholding in entity B, for cash consideration of ₹ 2,00,000. Entity A applies Ind AS 103 to account for common control transactions and Entity C will adopt the same policy. Fair value of net identifiable assets is ₹ 1,50,000 and carrying value of net identifiable assets is ₹ 1,00,000.

How will Entity C apply acquisition accounting in its consolidated financial statements?

Solution:

As per para 2 of appendix C of Ind AS 103, Common control business combination means a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

In the above scenario, the Entity A controls Entity B before and after the acquisition. After acquisition, entity A controls entity B through entity C.

As per para 8 of appendix C of Ind AS 103, Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interest method.

As per para 9(i) of appendix C of Ind AS 103, the pooling of interest method is considered to involve the assets and liabilities of the combining entities are reflected at their carrying amounts.

Based on the above analysis, Entity C cannot be the acquirer. Entity A has created Entity C and is the seller, so Entity C has effectively been formed and issued shares to effect the business combination. Entity C is not a business and the transaction between entity B and Entity C is not a business combination. It is a reorganisation of entity B. As a result, entity B's assets and liabilities are included in Entity C consolidated financial statements at their pre-combination carrying amounts without a fair value uplift.

*****

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Illustration 36

Enterprise Ltd. has 2 divisions Laptops and Mobiles. Division Laptops has been making constant profits while division Mobiles has been invariably suffering losses.

On 31st March, 20X2, the division-wise draft extract of the Balance Sheet was: ***(₹ in crores)***

		Laptops	Mobiles	Total
Property, Plant and Equipment cost		250	500	750
Depreciation		(225)	(400)	(625)
Net Property, Plant and Equipment	(A)	25	100	125
Current assets:		200	500	700
Less: Current liabilities		(25)	(400)	(425)
	(B)	175	100	275
Total	(A+B)	200	200	400
Financed by:				
Loan funds		-	300	300
Capital : Equity ₹ 10 each		25	-	25
Surplus		175	(100)	75
		200	200	400

Division Mobiles along with its assets and liabilities was sold for ₹ 25 crores to Turnaround Ltd. a new company, who allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share to the members of Enterprise Ltd. in full settlement of the consideration, in proportion to their shareholding in the company. One of the members of Enterprise Ltd. was holding 52% shareholding of the Company.

Assuming that there are no other transactions, you are asked to:

(i) Pass journal entries in the books of Enterprise Ltd.

(ii) Prepare the Balance Sheet of Enterprise Ltd. after the entries in (i).

(iii) Prepare the Balance Sheet of Turnaround Ltd.

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Solution

Journal of Enterprise Ltd.

(₹ in crores)

			Dr.	Cr.
(1)	Loan Funds	Dr.	300	
	Current Liabilities	Dr.	400	
	Provision for Depreciation	Dr.	400	
	To Property, Plant and Equipment			500
	To Current Assets			500
	To Capital Reserve			100
	(Being division Mobiles along with its assets and liabilities sold to Turnaround Ltd. for ₹ 25 crores)			

Notes :

(1) Any other alternative set of entries, with the same net effect on various accounts, may be given by the students.

(2) In the given scenario, this demerger will meet the definition of common control transaction. Accordingly, the transfer of assets and liabilities will be derecognized and recognized as per book value and the resultant loss or gain will be recorded as capital reserve in the books of demerged entity (~~Enterprise Ltd~~).

Enterprise Ltd.

Balance Sheet after reconstruction *(₹ in crores)*

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		25
Current assets		
Other current assets		200
		225
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		25
Other equity (Surplus)		175
Liabilities		
Current liabilities		
Current liabilities		25
		225

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Notes to Accounts

		(₹ in crores)
1.	**Other Equity**	
	Surplus (175-100)	75
	Add: Capital Reserve on reconstruction	100
		175

Notes to Accounts: Consequent on transfer of Division Mobiles to newly incorporated company Turnaround Ltd., the members of the company have been allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share of Turnaround Ltd., in full settlement of the consideration in proportion to their shareholding in the company.

Balance Sheet of Turnaround Ltd.

(₹ in crores)

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		100
Current assets		
Other current assets		500
		600
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	10
Other equity	2	(110)
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings		300
Current liabilities		
Current liabilities		400
		600

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Notes to Accounts

		(₹ in crores)
1.	**Share Capital:**	
	Issued and Paid-up capital	
	1 crore Equity shares of ₹ 10 each fully paid up	10
	(All the above shares have been issued for consideration other than cash, to the members of Enterprise Ltd. on takeover of Division Mobiles from Enterprise Ltd.)	
2.	**Other Equity:**	
	Securities Premium	15
	Capital reserve [25- (600 – 700)]	(125)
		(110)

Working Note:

In the given case, since both the entities are under common control, this will be accounted as follows:

- All assets and liabilities will be recorded at book value
- Identity of reserves to be maintained.
- No goodwill will be recorded.
- Securities issued will be recorded as per the nominal value.

Illustration 37

Maxi Mini Ltd. has 2 divisions - Maxi and Mini. The draft information of assets and liabilities as at 31st October, 20X2 was as under:

		Maxi division	Mini division	Total (in crores)
Property, Plant and Equipment				
Cost		*600*	*300*	*900*
Depreciation		*(500)*	*(100)*	*(600)*
W.D.V.	*(A)*	*100*	*200*	*300*
Current assets		*400*	*300*	*700*
Less: Current liabilities		*(100)*	*(100)*	*(200)*
	(B)	*300*	*200*	*500*
Total	*(A+B)*	*400*	*400*	*800*

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Financed by :			
Loan funds (A)	–	100	100
(secured by a charge on property, plant and equipment)			
Own funds:			
Equity capital			50
(fully paid up ₹ 10 per share)			
Other Equity	-	-	650
(B)	?	?	700
Total (A+B)	400	400	800

It is decided to form a new company Mini Ltd. to take over the assets and liabilities of Mini division.

Accordingly, Mini Ltd. was incorporated to take over at Balance Sheet figures, the assets and liabilities of that division. Mini Ltd. is to allot 5 crore equity shares of ₹ 10 each in the company to the members of Maxi Mini Ltd. in full settlement of the consideration. The members of Maxi Mini Ltd. are therefore to become members of Mini Ltd. as well without having to make any further investment.

(a) You are asked to pass journal entries in relation to the above in the books of Maxi Mini Ltd. and Mini Ltd. Also show the Balance Sheets of the 2 companies as on the morning of 1st November, 20X2, showing corresponding previous year's figures.

(b) The directors of the 2 companies ask you to find out the net asset value of equity shares pre and post demerger.

(c) Comment on the impact of demerger on "share holders wealth".

Solution

Demerged Company: Mini Division of "Maxi Mini Ltd"

Resulting Company: "Mini Ltd."

(a) Journal of Maxi Mini Ltd. (Demerged Company)

		(₹ in crores)	
		Dr.	Cr.
Current liabilities A/c	Dr.	100	
Loan fund (secured) A/c	Dr.	100	
Provision for depreciation A/c	Dr.	100	
Loss on reconstruction (Balancing figure)	Dr.	300	
To Property, Plant and Equipment A/c			300

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To Current assets A/c		300
(Being the assets and liabilities of Mini division taken out of the books on transfer of the division to Mini Ltd., the consideration being allotment to the members of the company of one equity share of ₹ 10 each of that company at par for every share held in the company vide scheme of reorganisation)		

Note: Any other alternatives set of entries, with the same net effect on various accounts, may be given by the students. In the absence of additional information on fair value of the assets transferred it has been assumed that the group of shareholders control both the demerged and the resultant entity. It is expected that students should evaluate all reorganization from common control parameters and aptly highlight the assumptions in the note while solving the question.

Journal of Mini Ltd.

		(₹ in crores)	
		Dr.	***Cr.***
Property, Plant and Equipment (300-100) A/c	Dr.	200	
Current assets A/c	Dr.	300	
To Current Liabilities A/c			100
To Secured loan funds A/c			100
To Equity share capital A/c			50
To Capital reserve			250
(Being the assets and liabilities of Mini division of Maxi Mini Ltd. taken over and allotment of 5 crores equity shares of ₹ 10 each at part as fully paid up to the members of Maxi Mini Ltd.)			

Maxi Mini Ltd.
Balance Sheet as at 1st November, 20X2

₹ in crore

ASSETS	**Note No.**	**After Reconstruction**	**Before Reconstruction**
Non-current assets			
Property, Plant and Equipment	2	100	300

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Current assets			
Other current assets		400	700
		500	1,000
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		50	50
Other equity	1	350	650
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings		-	100
Current liabilities			
Current liabilities		100	200
		500	1,000

Notes to Accounts

		After Reconstruction	*Before Reconstruction*
1.	**Other Equity**		
	Other Equity	650	650
	Less: Loss on reconstruction	(300)	–
		350	650
2.	**Property, Plant and Equipment**	600	900
	Less: Depreciation	(500)	(600)
		100	300

Notes to Accounts: Consequent on reconstruction of the company and transfer of Mini division to newly incorporated company Mini Ltd., the members of the company have been allotted 5 crores equity shares of ₹ 10 each at part of Mini Ltd. The demerged entity and the resultant entity are common control and accordingly the transaction has been accounted at book values of the assets transferred in both the entity.

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Mini Ltd.

Balance Sheet as at 1st November, 20X2 *₹ in crore*

ASSETS	Note No.	After reconstruction
Non-current assets		
Property, Plant and Equipment		200
Current assets		
Other current assets		300
		500
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		50
Other equity (capital reserve)		250
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings		100
Current liabilities		
Current liabilities		100
		500

Notes to Account

	(₹ in crores)
1. Share Capital:	
Issued and paid up:	
5 crores Equity shares of ₹ 10 each fully paid up	50
(All the above shares have been issued for consideration other than cash, to the members of Maxi Mini Ltd., on takeover of Mini division from Maxi Mini Ltd.)	

(b) Net asset value of an equity share

	Pre-demerger		*Post-demerger*
Maxi Mini Ltd. :	$\frac{₹\ 700\ \text{crores}}{5\ \text{crores}}$	= 140	$\frac{₹\ 400\ \text{crores}}{5\ \text{crores}}$ = ₹ 80
Mini Ltd.:			$\frac{₹\ 300\ \text{crores}}{5\ \text{crores}}$ = ₹ 60

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(c) Demerger into two companies has had no impact on "net asset value" of shareholding. Pre-demerger, it was ₹ 140 per share. After demerger, it is ₹ 80 plus ₹ 60 i.e. ₹ 140 per original share.

It is only yield valuation that is expected to change because of separate focusing on two distinct businesses whereby profitability is likely to improve on account of demerger.

*****

Illustration 38

AX Ltd. and BX Ltd. amalgamated from 1st January, 20X2. A new Company ABX Ltd. with shares of ₹ 10 each was formed to take over the businesses of the existing companies.

Summarized Balance Sheet as on 31-12-20X1

₹ in '000

ASSETS	Note No.	AX Ltd	BX Ltd
Non-current assets			
Property, Plant and Equipment		8,500	7,500
Financial assets			
Investment		1,050	550
Current assets			
Inventory		1,250	2,750
Financial assets			
Trade receivables		1,800	4,000
Cash and Cash equivalent		450	400
		13,050	15,200
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		6,000	7,000
Other equity	1	3,050	2,700
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings (12% Debentures)		3,000	4,000
Current liabilities			
Financial liabilities			
Trade payables		1,000	1,500
		13,050	15,200

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Note:

1.	Other equity	AX Ltd	BX Ltd
	General Reserve	*1,500*	*2,000*
	Profit & Loss	*1,000*	*500*
	Investment Allowance Reserve	*500*	*100*
	Export Profit Reserve	*50*	*100*
		3,050	*2,700*

ABX Ltd. issued a requisite number of shares to discharge the claims of the equity shareholders of the transferor companies. Also new debentures were issued in exchange of the old series of both the companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd:

a. *Assuming that both the entities are under common control*

b. *Assuming BX Ltd is a larger entity and their management will take control of the entity ABX Ltd.*

The fair value of net assets of AX and BX limited are as follows:

Assets	AX Ltd. ('000)	BX Ltd. ('000)
Property, Plant and Equipment	*9,500*	*1,000*
Inventory	*1,300*	*2,900*
Fair value of the business	*11,000*	*14,000*

Solution

(a) 1. Calculation of Purchase Consideration

		AX Ltd.		BX Ltd.
		₹ '000		₹ '000
Assets taken over:				
Property, Plant and Equipment		85,00		75,00
Investment		10,50		5,50
Inventory		12,50		27,50
Trade receivables		18,00		40,00
Cash & Cash equivalent		4,50		4,00

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Gross Assets		130,50		152,00
Less : Liabilities				
12% Debentures	30,00		40,00	
Trade payables	10,00	(40,00)	15,00	(55,00)
Net Assets taken over		90,50		97,00
Less: Other Equity:				
General Reserve	15,00		20,00	
P & L A/c	10,00		5,00	
Investment Allowance Reserve	5,00		1,00	
Export Profit Reserve	50	(30,50)	1,00	(27,00)
Purchase Consideration		60,00		70,00

Total Purchase Consideration = 130,00 (60,00 of AX Ltd. & 70,00 of BX Ltd.)

2. Discharge of Purchase Consideration

No. of shares to be issued to AX Ltd =

$$\frac{\text{Net Assets taken over of AX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}} \times \text{Purchase Consideration}$$

No. of shares to be issued to BX Ltd =

$$\frac{\text{Net Assets taken over of BX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}} \times \text{Purchase Consideration}$$

	AX Ltd. *₹ '000*	*BX Ltd.* *₹ '000*
$130,00 \times \frac{90,50}{187,50} = 6,27,500$	62,75	
* Equity shares of ₹ 10 each		
$130,00 \times \frac{97,00}{187,50} = 6,72,500$		67,25
Equity shares of ₹ 10 each		

* The total purchase consideration is to be discharged by ABX Ltd. in such a way that the rights of the shareholders of AX Ltd. and BX Ltd. remain unaltered in the future profits of ABX Ltd.

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Balance Sheet of ABX Ltd. as on 1.1.20X2 *₹ in '000*

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		16,000
Financial assets		
Investments		1,600
Current assets		
Inventory		4,000
Trade receivable		5,800
Cash and Cash equivalent		850
		28,250
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	13,000
Other equity	2	5,750
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings	3	7,000
Current liabilities		
Trade payable		2,500
		28,250

Notes to Accounts

		(₹ 000)	*(₹ 000)*
1.	**Share Capital**		
	13,00,000 Equity Shares of ₹ 10 each		130,00
2.	**Other Equity**		
	General Reserve (15,00 + 20,00)	35,00	
	Profit & Loss (10,00 + 5,00)	15,00	
	Investment Allowance Reserve (5,00 + 1,00)	6,00	
	Export Profit Reserve (50 + 1,00)	1,50	57,50
3.	**Long Term Borrowings**		
	12% Debentures		70,00

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(b) Assuming BX Ltd is a larger entity and their management will take the control of the entity ABX Ltd.

In this case BX Ltd. and AX Ltd. are not under common control and hence accounting prescribed under Ind AS 103 for business combination will be applied. A question arises here is who is the accounting acquirer ABX Ltd which is issuing the shares or AX Ltd. or BX Ltd. As per the accounting guidance provided in Ind AS 103, sometimes the legal acquirer may not be the accounting acquirer. In the given scenario although ABX Ltd. is issuing the shares but BX Ltd. post-merger will have control and is bigger in size which is a clear indicator that BX Ltd. will be an accounting acquirer. This can be justified by the following table: **(In '000s)**

	AX Ltd.	BX Ltd.
Fair Value	11,000	14,000
Value per share	10	10
No. of shares	1,100	1,400
i.e. Total No. of shares in ABX Ltd. = 2,500 thousand shares		
Thus, % Held by each Company in Combined Entity	44%	56%

Note: It is a case of Reverse Acquisition.

Accordingly, BX Ltd. assets will be recorded at historical cost in the merged financial statements.

(1) Calculation of Purchase Consideration (All figures are in thousands)

We need to calculate the number of shares to be issued by BX Ltd. to AX Ltd. to maintain the same percentage i.e. 56%:

Thus, 700 thousand shares of BX Ltd. (given in the balance sheet) represents 56%. This means that total no. of shares would be 1,250 thousand shares ie 700 thousand shares / 56%.

This implies BX Ltd. would need to issue 550 thousand shares (1,250 less 700) to AX Ltd.

Purchase Consideration = 550 thousand shares x ₹ 20 per share (ie. 14,000 thousand / 700 thousand shares) = ₹ 11,000 thousand.

Balance Sheet of ABX Ltd. as on 1.1.20X2 *₹ in '000*

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment (9,500 + 7,500)		17,000

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Goodwill (Refer Working Note)		900
Financial assets		
Investment (1,050 + 550)		1,600
Current assets		
Inventory (1,300 + 2,750)		4,050
Trade receivables (1,800 + 4,000)		s 5,800
Cash and Cash equivalent (450 + 400)		850
		30,200
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	12,500
Other equity	2	8,200
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings (12% Debentures)	3	7,000
Current liabilities		
Trade payables		2,500
		30,200

Notes to Accounts

		(₹ 000)	*(₹ 000)*
1.	**Share Capital**		
	1,250,000 Equity Shares of ₹ 10 each (700,000 to BX Ltd and 550,000 as computed above to AX LTD)		1,25,00
2.	**Other Equity**		
	General reserve of BX Ltd	20,00	
	P&L of BX Ltd	5,00	
	Export Profit Reserve of BX Ltd	1,00	
	Investment Allowance Reserve of BX Ltd	1,00	
	Security Premium (550 shares x 10)	5,500	8,200
3.	**Long Term Borrowings**		
	12% Debentures		70,00

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Working Note:

Goodwill Computation:

Assets:	**₹ in 000s**
Property, Plant and Equipment	9,500
Investment	1,050
Inventory	1,300
Trade Receivable	1,800
Cash & Cash Equivalent	450
Total Assets	14,100
Less : Liabilities:	
Borrowings	3,000
Trade Payable	1,000
Net Assets	10,100
Purchase Consideration	11,000
Goodwill	900

*****

Illustration 39

On 9th April, 20X2, Shyam Ltd. a listed company started to negotiate with Ram Ltd, which is an unlisted company about the possibility of merger. On 10th May, 20X2, the board of directors of Shyam Ltd. authorized their management to pursue the merger with Ram Ltd. On 15th May, 20X2, management of Shyam Ltd. offered management of Ram Ltd. 12,000 shares of Shyam Ltd. against their total share outstanding. On 31st May, 20X2, the board of directors of Ram Ltd accepted the offer subject to shareholder's vote. On 2nd June, 20X2 both the companies jointly made a press release about the proposed merger.

On 10th June, 20X2, the shareholders of Ram Ltd approved the terms of the merger. On 15th June, the shares were allotted to the shareholders of Ram Ltd.

The market price of the shares of Shyam Ltd was as follows:

Date	***Price per share***
9th April	*70*
10th May	*75*
15th May	*60*
31st May	*70*
2nd June	*80*
10th June	*85*
15th June	*90*

What is the acquisition date and what is purchase consideration in the above scenario?

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Solution

As per paragraph 8 of Ind AS 103, the acquirer shall identify the acquisition date, which is the date on which it obtains control of the aquiree. In the above scenario, the acquisition date will the date on which the shares were allotted to the shareholders of Ram Ltd. Although the shareholder approval was obtained on 10th June, 20X2 but the shares were issued only on 15th June, 20X2. Accordingly, the purchase consideration will be on the basis of ₹ 90 ie. the market price on that date. Hence total purchase consideration would be ₹ 10,80,000 (ie 12,000 shares x ₹ 90).

*****

Illustration 40 **IMP** *New- part-2 me around 01:00:00*

The balance sheet of Professional Ltd. and Dynamic Ltd. as of 31st March, 20X2 is given below:

₹ in lakhs

Assets	Professional Ltd	Dynamic Ltd
Non-Current Assets:		
Property, plant and equipment	300	500
Investment	400	100
Current assets:		
Inventories	250	150
Financial assets		
Trade receivables	450	300
Cash and cash equivalents	200	100
Others	400	230
Total	2,000	1,380
Equity and Liabilities		
Equity		
Share capital- Equity shares of ₹ 100 each of Dynamic Ltd. and ₹ 10 each of Professional Ltd.	500	400
Other Equity	810	225
Non-Current liabilities:		
Financial liabilities		
Long term borrowings	250	200
Long term provisions	50	70
Deferred tax	40	35

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Current Liabilities:		
Financial liabilities		
Short term borrowings	*100*	*150*
Trade payables	*250*	*300*
Total	*2,000*	*1,380*

Other information

a. *Professional Ltd. acquired 70% shares of Dynamic Ltd. on 1st April, 20X2 by issuing its own shares in the ratio of 1 share of Professional Ltd. for every 2 shares of Dynamic Ltd. The fair value of the shares of Professional Ltd was ₹ 40 per share.*

b. *The fair value exercise resulted in the following: (all nos. in Lakh)*

   a. *Fair value of PPE on 1st April, 20X2 was ₹ 350 lakhs.*

   b. *Professional Ltd also agreed to pay an additional payment as consideration that is higher of ₹ 35 lakh and 25% of any excess profits in the first year, after acquisition, over its profits in the preceding 12 months made by Dynamic Ltd. This additional amount will be due after 2 years. Dynamic Ltd has earned ₹ 10 lakh profit in the preceding year and expects to earn another ₹ 20 Lakh.*

   c. *In addition to the above, Professional Ltd also agreed to pay one of the founder shareholders a payment of ₹ 20 lakh provided he stays with the Company for two years after acquisition.*

   d. *Dynamic Ltd had a certain equity settled share-based payment award (original award) which was replaced by the new awards issued by Professional Ltd. As per the original terms, the vesting period was 4 years and as of the acquisition date the employees of Dynamic Ltd have already served 2 years of service. As per the replaced awards the vesting period has been reduced to one year (one year from the acquisition date). The fair value of the award on the acquisition date was as follows:*

      i. *Original award- ₹ 5 lakh*

      ii. *Replacement award-₹ 8 lakh.*

   e. *Dynamic Ltd had a lawsuit pending with a customer who had made a claim of ₹ 50 lakh. Management reliably estimated the fair value of the liability to be ₹ 5 lakh.*

   f. *The applicable tax rate for both entities is 30%.*

You are required to prepare opening consolidated balance sheet of Professional Ltd as on 1st April, 20X2. Assume 10% discount rate.

Date of Acquation=Date of Accounting --> Bussiness combination
Date of Acquation < Date of Accounting --> CFS

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Solution

Consolidated Balance Sheet of Professional Ltd as on 1st April, 20X2 (₹ in Lakhs)

	Amount
Assets	
Non-Current Assets:	
Property, plant and equipment	650
Investment	500
Current assets:	
Inventories	400
Financial assets:	
Trade receivables	750
Cash and cash equivalents	300
Others	630
Total	3,230
Equity and Liabilities	
Equity	
Share capital- Equity shares of ₹ 10 each	514
Other Equity	1,128.62
NCI	154.95
Non-Current liabilities:	
Long term borrowings	450
Long term provisions (50+70+28.93)	148.93
Deferred tax	28.5
Current Liabilities:	
Short term borrowings	250
Trade payables	550
Provision for Law suit Damages	5
Total	3,230

Notes:

a. As per Ind AS 103, the acquirer is required to record the assets and liabilities acquired at their respective fair value. Accordingly, the PPE of Dynamic Ltd. will be recorded at ₹ 350 lakhs.

b. The value of replacement award is allocated between consideration transferred and post combination expense. The portion attributable to purchase consideration is determined based on the fair value of the replacement award for the service rendered till the date of

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the acquisition. Accordingly, ₹ 2.5 lakhs (5 x 2/4) is considered as a part of purchase consideration and is credited to Professional Ltd equity as this will be settled in its own equity. Since the fair value of the award on the acquisition date is ₹ 8 lakhs, the balance of ₹ 5.5 lakhs (8 – 2.5) will be recorded as employee expense in the books of Dynamic Ltd over the remaining life, which is 1 year in this scenario. (Para B59 of Ind AS 103)

c. There is a difference between contingent consideration and deferred consideration. In the given case, ₹ 35 lakhs is the minimum payment to be paid after 2 years and accordingly will be considered as deferred consideration. The other element is if a company meet certain target then they will get 25% of that or ₹ 35 lakhs whichever is higher. In the given case, the minimum what is expected to be paid has been considered and the fair value of the contingent consideration has been considered as zero. The impact of time value on deferred consideration has been given @ 10%.

d. The additional consideration of ₹ 20 lakhs to be paid to the founder shareholder is contingent to him/her continuing in employment and hence this will be considered as employee compensation and will be recorded as post combination expenses in the income statement of Dynamic Ltd.

Working Notes:

1. Computation for Purchase consideration

Particulars		Amount
Share capital of Dynamic Ltd		4,00,00,000
Number of shares	4,00,000	
Shares to be issued 2:1	2,00,000	
Fair value ₹ per share		40
		₹ in lakhs
PC (2,00,000 x 70% x ₹ 40 per share) (A)		56.00
Deferred consideration after discounting ₹ 35 lakhs for 2 years @ 10% (B)		28.93
Replacement award Market based measure of the acquiree award (5) x ratio of the portion of the vesting period completed (2) / greater of the total vesting period (3) or the original vesting period (4) of the acquiree award i.e. (5 x 2/4) (C)		2.50
PC in lakhs (A+B+C)		87.43

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2. Allocation of Purchase price

Particulars	Book value (A)	Fair value (B)	FV adjustment (A-B)
Property, plant and equipment	500	350	(150)
Investment	100	100	-
Inventories	150	150	-
Financial assets:			-
Trade receivables	300	300	-
Cash and cash equivalents	100	100	-
Others	230	230	
Less: Long term borrowings	(200)	(200)	-
Long term provisions	(70)	(70)	-
Deferred tax	(35)	(35)	-
Short term borrowings	(150)	(150)	-
Trade payables	(300)	(300)	-
Contingent liability	-	(5)	(5)
Net assets (X)	625	470	(155)
Deferred tax Asset on FV adjustment (155 x 30%) (Y)		46.50	155
Net assets (X+Y)		516.5	
Non-controlling interest (516.50 x 30%) rounded off		154.95	
Purchase consideration (PC)		87.43	
Capital Reserve (Net assets – NCI – PC)		274.12	

3. Computation of consolidated amounts of Consolidated financial statements

	Professional Ltd.	*Dynamic Ltd. (pre-acquisition)*	*PPA Allocation* Fair value adjustment	*Total*
Assets				
Non-Current Assets:				
Property, plant and equipment	300	500	(150)	650
Investment	400	100		500

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Current assets:				
Inventories	250	150		400
Financial assets:				
Trade receivables	450	300		750
Cash and cash equivalents	200	100		300
Others	400	230		630
Total	2,000	1,380	(150)	3230

Equity and Liabilities				
Equity				
Share capital- Equity shares of ₹ 10 each	500			
Shares allotted to Dynamic Ltd. (2,00,000 x 70% x ₹ 10 per share)			14	514
Other Equity	810			
Replacement award (W.N.1)			2.5	2.5
Security Premium (2,00,000 shares x 70% x ₹ 30) (W.N.1)			42	42
Capital Reserve (W.N.2)			274.12	274.12
Non-controlling interest (W.N.2)	0		154.95	154.95
Non-Current liabilities:				
Financial liabilities				
Long term borrowings	250	200		450
Long term provisions (W.N.1)	50	70	28.93	148.93
Deferred tax (W.N.2)	40	35	(46.5)	28.5
Current Liabilities:				
Financial liabilities				
Short term borrowings	100	150		250
Trade payable	250	300	0	550
Liability for lawsuit damages			5	5
Total	2,000	755	475	3230

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14. EXTRACTS FROM THE FINANCIAL STATEMENTS OF LISTED ENTITIES

Relevant Extracts from Financial Statements of selected Listed Companies:

1. Annual Report of Hindustan Unilever Ltd. for the year ending 31 March 2021: Amalgamation of GlaxoSmithKline Consumer Healthcare Ltd.:

Disclosure in Standalone Financial Statements:

Amalgamation of GlaxoSmithKline Consumer Healthcare Limited

On 1st April, 2020, the Company completed the merger of GlaxoSmithKline Consumer Healthcare Limited ['GSK CH'] via an all-equity merger under which 4.39 shares of HUL (the Company) were allotted for every share of GSK CH. With this merger the Company acquired the business of GSK CH including the Right to Use asset of brand Horlicks and Intellectual property rights of brands like Boost, Maltova and Viva. The Company also acquired the Horlicks intellectual property rights, being the legal rights to the Horlicks brand for India from GlaxoSmithKline Plc.

The scheme of merger("scheme") submitted by the Company was approved by Hon'ble National Company Law Tribunal by its order dated 24th September, 2019 (Mumbai bench) and 12th March, 2020 (Chandigarh bench). The Board of Directors approved the scheme between the Company and GSK CH, on 1st April, 2020. The scheme was filed with Registrar of Companies on the same date. Accordingly, 1st April, 2020 is considered as the acquisition date, i.e. the date on which control is transferred to the Company.

The merger was in line with HUL's strategy to build a sustainable and profitable Foods & Refreshment (F&R) business in India by leveraging the megatrend of health and wellness. GSK CH was one of the key players in this category with iconic brands such as 'Horlicks' and 'Boost' and comprised of a wide product portfolio.

The merger has been accounted for using the acquisition accounting method under Ind AS 103 – Business Combinations. All identified assets acquired, and liabilities assumed on the date of merger were recorded at their fair value.

(A) Purchase consideration transferred:

The total consideration paid was ₹40,242 crores which comprised of shares of the Company, valued based on the share price of the Company on the completion date. Refer to the details below:

As per the scheme, the Company issued its shares in favour of existing shareholders of GSK CH such that 4.39 of Company's shares were allotted for every share of GSK CH as below.

Total number of GSK CH shares outstanding	4,20,55,538
Total number of Company's shares issued to GSK CH shareholders i.e. 4.39 of Company's shares per share of GSK CH	18,46,23,812
Value of the Company share (closing price of the Company share on NSE as on 1st April, 2020)	2,179.65
Total consideration paid to acquire GSK CH (₹ crores)	**40,242**

(a) Total costs relating to the issuance of shares amounting to ₹44 crores have been recognised against equity.

(b) Transaction cost of ₹146 crores that were not directly attributable to the issue of shares are included under exceptional items in the standalone Statement of Profit and Loss.

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(All amounts in ₹ crores, unless otherwise stated)

NOTE 40 BUSINESS COMBINATION (CONTINUED)

(B) Details of major assets acquired, and liabilities assumed:

	Amount
Specified Tangible Asset	
Property, Plant and Equipment	
Owned Assets	1,133
Leased Assets	76
Capital Work-in-progress	30
Specified Intangibles Assets	
Right of Use Horlicks	19,274
Boost Trademark	4,800
Others	62
Other Assets	
Trade and other receivables	651
Inventories	470
Cash and cash equivalents	300
Bank Balances other than cash and cash equivalents	3,855
Indemnification asset	608
Tax assets	186
Total identifiable assets (A)	**31,445**
Specified liabilities	
Trade payables	533
Other liabilities	400
Provision for employee benefits	86
Other Provisions (including ₹64 crores provision created against contingent liabilities)	343
Direct Tax Provision against contingent liabilities	974
Deferred tax labilities	6,132
Total identifiable liabilities (B)	**8,468**
Total identifiable net assets acquired (A) - (B)	22,977
Goodwill	17,265
Total Net Assets	**40,242**

The main assets acquired were Right to use Horlicks and Boost brand which were valued using the income approach model by estimating future cashflows generated by these assets and discounting them to present value using rates in line with a market participant expectation.

In addition, as applicable, Property plant & equipment have been valued using the market comparison technique and replacement cost method.

The gross contractual value and fair value of trade and other receivables as at the dates of acquisition amounted to ₹651 crores which is expected to be fully recoverable.

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(All amounts in ₹ crores, unless otherwise stated)

(C) Acquisition of Horlicks Brand:

The Company also acquired the Horlicks intellectual property rights (IPR), being the legal rights to the Horlicks brand for India from GlaxoSmithKline Plc for a consideration of ₹3,045 crores. The transaction has been accounted as an asset acquisition in line with Ind AS 38 (Intangible asset).

The Company incurred transaction cost of ₹91 crores for the above asset acquisition which was capitalised along with Horlicks IPR. Total value of ₹3,136 crores is recognised under Intangible assets in the standalone financial statements.

(D) Goodwill:

Goodwill of ₹17,265 crores was recognised upon giving effect to the Scheme of Merger, which primarily can be attributable to the synergies expected to be achieved from integrating GSK CH into the Company's existing business and the value of GSK CH India's overlapping distribution network and assembled workforce i.e. the value of the acquired experienced and skilled employees, who have been instrumental to the GSK CH success.

Pursuant to amendment by Finance Act, 2021, Goodwill has been held as non-tax deductible asset effective 1st April, 2020.

(E) Details of contingent liabilities recognised:

GSK CH had direct/indirect tax related matters under litigation, for which contingent liability was determined amounting to ₹3,583 crores. Provision for these contingencies have been created at a fair value of ₹1,038 crores. There are several matters being disputed and, in each case, we believe that the likelihood that the Company will ultimately prevail is more likely than not. We expect that most of these disputes will not be resolved for several years. Further the Company has recognised Indemnification assets of ₹608 crores.

GlaxoSmithKline Plc, GlaxoSmithKline Pte. Ltd., Horlicks Ltd and the Company have entered into a contract to indemnify the Company for any exposure in relation to select taxation matters for a period of 10 years from date of acquisition i.e. till 31st March, 2030 and for a maximum value of USD 150 million.

(F) Analysis on cash flows of acquisition:

Purchase cost of Brand Horlicks of ₹3,045 crores and related transaction cost of ₹91 crores is included under Cash flow from investing activities.

Transaction cost attributable to issuance of equity shares ₹44 crores is included under cash flows from investing activities.

Transaction cost of ₹146 crores that were not directly attributable to the issue of shares are included under cash flow from operating activities.

(G) Impact of acquisition on the results

For the 12 months ended 31st March, 2021, GSK CH contributed revenue of ₹4,752 crores, EBITDA of ₹1,512 crores and EBIT of ₹1,406 crores to the Company's results.

Comparable period

The results for the year ended 31st March, 2021 include the impact of the acquisitions of VWash and GSK CH and accordingly are not comparable with previous year to that extent.

(Source: Annual report for 2020-2021 of Hindustan Unilever Ltd.)

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2. *Annual Report of Larsen and Toubro Ltd. for the year ending 31 March 2020: Acquisition of Majority Stake in Mindtree Ltd.:*

Stake in Mindtree acquired through further acquisition: 28.86% existing stake + 31.20% acquired through open offer:

Notes forming part of the Consolidated Financial Statements (contd.)

NOTE [44]

Disclosure pursuant to Ind AS 103 "Business Combinations":

(a) Acquisition of Mindtree Limited:

(i) Pursuant to completion of Open Offer on July 2, 2019, the Company acquired 60.06% stake in Mindtree Limited, which is a multinational information technology and outsourcing company headquartered in Bengaluru, India and New Jersey, USA. The stake was acquired in stages through direct share purchase, open market purchases and open offer.

The acquisition is in line with the Company's strategy of expanding its asset light services business portfolio.

(ii) Assets acquired and liabilities recognised on the date of acquisition are as follows:

₹ crore

	Mindtree Limited	
Assets		
Non-current assets		
Customer relationships	2826.40	
Customer contracts	189.20	
Trade names	297.00	
Property, plant and equipment	377.70	
Fair value of land/building over book value	177.78	
Other non-current assets	974.95	4843.03
Current assets		
Trade receivables	1315.30	
Cash and bank balances	190.00	
Other current assets	1314.40	2819.70
Total Assets		7662.73
Liabilities		
Non-current liabilities		
Deferred tax liabilities	1126.18	
Other non-current liabilities	512.30	1638.48
Current Liabilities		
Trade payables	235.00	
Other current financial liabilities	294.10	
Other current liabilities	400.44	
Contingent liability taken over [Note(vi)]	26.85	956.39
Total Liabilities		2594.87
Net Assets acquired		5067.86

(iii) Calculation of Goodwill:

₹ crore

	Mindtree Limited
Purchase consideration for 31.20% stake purchased in open offer (A)	5038.57
Fair valuation of existing 28.86% stake (B)	4333.96
Total consideration (C)=(A+B)	9372.53
Add: Non-controlling interest	2023.88
Less: Fair value of net assets acquired	5067.86
Goodwill	6328.55

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Notes forming part of the Consolidated Financial Statements (contd.)

NOTE [44] *(contd.)*

(iv) Goodwill is attributable to future growth of business out of synergies from this acquisition and assembled workforce. The goodwill is not deductible for income tax purposes.

(v) The transaction cost of ₹ 96.39 crore *(including ₹ 12.12 crore in previous year)* have been expensed in the Statement of Profit and Loss .

(vi) Contingent liability of ₹ 26.85 crore has been recognised in respect of certain claims (mainly tax disputes) which have not been acknowledged as debt.

(vii) The non-controlling interest (39.94% ownership in Mindtree Limited) recognised at the acquisition date was measured at proportionate share of Mindtree Limited's net assets.

(viii) The Company fair valued its acquisition date stake of 28.86% as on July 2, 2019 and consequently, a loss of ₹ 329.89 crore was recognised in other comprehensive income.

(ix) Mindtree Limited has reported revenue of ₹ 5917.18 crore and profit after tax of ₹ 538.17 crore from the date of acquisition till March 31, 2020. Had the entity been acquired from April 1, 2019, it would have reported revenue of ₹ 7764.25 crore and profit after tax of ₹ 630.87 crore during 2019-20.

(x) Out of the ₹ 1315.30 crore trade receivables acquired, ₹ 1249.54 crore have been collected during the year.

(Source: Annual reports for 2020-2021 of Larsen and Turbo td.)

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3. Annual Report of Larsen and Toubro Ltd. for the year ending 31 March 2020: Acquisition of Majority Stake in L&T Gulf Private Ltd.:

Notes forming part of the Consolidated Financial Statements (contd.)

NOTE [44] *(contd.)*

(d) Acquisition of further stake in L&T Gulf Private Limited

(i) On November 20, 2019, the Group has acquired further 50% stake in L&T Gulf Private Limited. The entity has become a wholly owned subsidiary. It operates in the Hydrocarbon segment.

(ii) Assets acquired and liabilities recognised on the date of acquisition are as follows:

₹ crore

	L&T Gulf Private Limited	
Assets		
Non-current assets		
Property, plant and equipment	0.41	
Deferred tax assets	0.48	
Other non-current assets	0.85	1.74
Current assets		
Trade receivables	4.66	
Cash and bank balances	19.76	
Other current assets	3.47	27.89
Total Assets		29.63
Liabilities		
Current liabilities		
Trade payables	3.43	
Other current liabilities	1.78	5.21
Total Liabilities		5.21
Net Assets acquired		24.42

(iii) Calculation of Goodwill:

₹ crore

	L&T Gulf Private Limited
Purchase consideration paid in cash for 50% stake (A)	25.00
Fair valuation of existing 50% stake (B)	25.00
Total (C=A+B)	50.00
Less: Fair value of net assets acquired	24.42
Goodwill	25.58

(iv) Goodwill is attributable to future growth of business out of synergies from this acquisition and assembled workforce. The goodwill is not deductible for income tax purposes.

(v) The entity has reported revenue of ₹ 12.13 crore and profit after tax of ₹ 8.65 crore from the date of acquisition till March 31, 2020. Had the entity been acquired from April 1, 2019, it would have reported revenue of ₹ 14.76 crore and profit after tax of ₹ 1.63 crore during 2019-20.

(vi) Out of ₹ 4.66 crore of trade receivables acquired, ₹ 3.40 crore have been collected during the year.

(e) The Hon'ble National Company Law Tribunal, Chennai Bench vide order dated March 10, 2020 and the Hon'ble National Company Law Tribunal, Mumbai Bench vide order dated April 24, 2020 have approved the scheme of amalgamation of L&T Shipbuilding Ltd (wholly-owned subsidiary) with the Company ('the Scheme'), the appointed date being April 1, 2019. Accordingly, the effect of the Scheme has been given in the standalone financials of the Company for the year 2019-20 and 2018-19.

(f) The Hon'ble National Company Law Tribunal, Mumbai Bench vide its order dated April 23, 2020 approved the composite scheme of arrangement between L&T Realty Limited, L&T Construction Equipment Limited and L&T Construction Machinery Limited (all wholly-owned subsidiaries of the Company) and their respective shareholders and creditors ('the Scheme'), the appointed date being April 1, 2018. Accordingly, the effect of the Scheme has been given in the standalone financials of the respective companies for the year 2019-20 and 2018-19.

(Source: Annual reports for 2019-2020 of Larsen and Turbo Ltd.)

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15. SIGNIFICANT DIFFERENCES BETWEEN IND AS 103 AND AS 14

- **Under the existing Indian GAAP**, there is no comprehensive standard that addresses accounting for acquisitions where one entity obtains control of another entity. The accounting for such transactions is largely dependent on the form of the acquisition. For example, the accounting treatment may differ depending on whether the acquired company is retained as a separate legal entity or whether it is legally merged with the acquirer.

  To add to the complexity and confusion, if the acquired company is merged with the acquirer through a court-approved scheme, the scheme itself may prescribe an accounting treatment that is required to be followed, which may be in variation with the accounting standards. Indian GAAP still permits the use of the pooling-of-interest method whereby the entire transaction is accounted based on carrying values and no goodwill arises.

  Further, the current principles (AS 21, Consolidated Financial Statements) provide guidance on accounting for acquisition of a subsidiary in the entity's consolidated financial statements by adding, on a line-by-line basis, all assets and liabilities of the acquiree at the carrying values as appearing in the acquiree' s financial statement (subject to adjustment for alignment of accounting policies).

- **Under Ind AS 103,** Business Combination, is a more widely used term than just in relation to mergers and amalgamations and encompasses a wide range of arrangements (unless excluded from scope of Ind AS 103). Ind AS 103 provides principles for identifying what constitutes a business combination, prescribes the accounting treatment for business combinations with greater emphasis on the use of fair values in accounting for a business combination.

  The core principle of Ind AS 103 requires an acquirer of a business to recognise the assets acquired and the liabilities assumed at their acquisition date fair values and to disclose information that enables users to evaluate the nature and financial effects of the acquisition.

S. No.	Basis	Ind AS	Accounting Standards
1.	**Applicability**	Ind AS 103 applies to all types of business combinations (as defined in the standard) except formation of joint venture and acquisition of assets which do not constitute business. Ind AS 103 is wider in scope	AS 14 deals with amalgamation and mergers.

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2.		Ind AS 103 prescribes only the acquisition method for every business combination, except for business combinations involving entities or businesses under common control which shall be accounted for using the pooling of interests method.	Under AS 14, there are two methods of accounting for amalgamation *viz* the pooling of interest method and the purchase method. (Paragraph 7 of AS 14)
3.	**Effective date**	As per Ind AS 103, the date on which the acquirer obtains control of the acquiree is the acquisition date i.e. Effective date.	AS 14 mentions but does not define date of amalgamation. In practice generally the date of amalgamation / acquisition mentioned in the court scheme (the Appointed date) is considered as the acquisition date.
4.	**Valuation base**	Ind AS 103 requires the acquired identifiable assets liabilities and non-controlling interest to be recognised at fair value under acquisition method. (Paragraphs 18-19 of Ind AS 103)	Under AS 14, the acquired assets and liabilities are recognised at their existing book values or at fair values under the purchase method. (Paragraph 12 of AS 14)
5.	**Accounting of non-controlling interest / minority interest**	Ind AS 103 requires that for each business combination, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. (Paragraph 19 of Ind AS 103)	AS 21 states that the minority interest is the amount of equity attributable to minorities at the date on which investment in a subsidiary is made and it is shown outside shareholders' equity. (Paragraph 13(e) of AS 21)
6.	**Amortisation of Goodwill**	Under Ind AS 103, the goodwill is not amortised but tested for impairment on annual basis in accordance with Ind AS 36.	AS 14 requires that the goodwill arising on amalgamation in the nature of purchase is amortised over a period not exceeding five years.
7.	**Reverse acquisition**	Ind AS 103 provides guidance on accounting for reverse acquisitions.	AS 14 does not deal with the same.

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8.	**Contingent consideration**	Ind AS 103 deals with the contingent consideration in case of business combination, i.e., an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met.	AS 14 does not provide specific guidance on this aspect.
9.	**Bargain purchase gain / capital reserve and its presentation**	Ind AS 103 requires bargain purchase gain arising on business combination to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. (Paragraph 34 of Ind AS 103)	Under AS 14, the excess amount is treated as capital reserve under the head reserves and surplus. (Paragraph 17 of AS 14)
	Accounting for common control transactions	Appendix C of Ind AS 103 deals with accounting for common control transactions, which prescribes pooling of interest method of accounting, which is different from accounting for other business combinations as prescribed under Ind AS 103.	AS 14 does not differentiate and prescribe accounting for such transactions different from other amalgamations.

16. CARVE OUT IN IND AS 103 FROM IFRS 3

As per IFRS: IFRS 3 requires bargain purchase gain arising from a business combination to be recognised in profit or loss as income.

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Carve out: Ind AS 103 requires the bargain purchase gain to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. A similar carve-out is made in Ind AS 28, Investments in Associates and Joint Ventures.

Reasons: Since bargain purchase gain occurs at the time of acquiring a business, these are considered as capital reserve in continuation of the practice then prevailing in the Indian GAAP.

17. CARVE-IN IN IND AS 103 FROM IFRS 3

As per IFRS: IFRS 3 excludes from its scope business combinations of entities under common control.

Carve-in: Appendix C of Ind AS 103, *Business Combinations* gives guidance in this regard. Therefore, this is additional guidance under Ind AS that is not available under IFRS Standards.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Company A and Company B are in power business. Company A holds 25% of equity shares of Company B. On 1st November, Company A obtains control of Company B when it acquires a further 65% of Company B's shares, thereby resulting in a total holding of 90%. The acquisition had the following features:

   - **Consideration:** Company A transfers cash of ₹ 59,00,000 and issues 1,00,000 shares on 1st November. The market price of Company A's shares on the date of issue is ₹ 10 per share.
   - **Contingent consideration:** Company A agrees to pay additional consideration of ₹ 7,00,0g12000 if the cumulative profits of Company B exceed ₹ 70,00,000 over the next two years. At the acquisition date, it is not considered probable that the extra consideration will be paid. The fair value of the contingent consideration is determined to be ₹ 3,00,000 at the acquisition date.
   - **Transaction costs:** Company A pays acquisition-related costs of ₹ 1,00,000.
   - **Non-controlling interests (NCI):** The fair value of the NCI is determined to be ₹ 7,50,000 at the acquisition date based on market prices. Company A elects to measure non-controlling interest at fair value for this transaction.
   - **Previously held non-controlling equity interest:** Company A has owned 25% of the shares in Company B for several years. At 1st November, the investment is included in Company A's consolidated balance sheets at ₹ 6,00,000, accounted for using the equity method; the fair value is ₹ 20,00,000.

   The fair value of Company B's net identifiable assets at 1st November is ₹ 60,00,000, determined in accordance with Ind AS 103.

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Determine the accounting under acquisition method for the business combination by Company A.

2. On 31st December, 20X1, Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

   The fair value of each ordinary share of Entity B at 31st December, 20X1 is ₹ 40. The quoted market price of Entity A's ordinary shares at that date is ₹ 16.

   The fair values of Entity A's identifiable assets and liabilities at 31st December, 20X1 are the same as their carrying amounts, except that the fair value of Entity A's non- current assets at 31st December, 20X1 is ₹ 1,500.

   The balance sheets of Entity A and Entity B immediately before the business combination are:

	Entity A (legal parent, accounting acquiree)	Entity B (legal subsidiary, accounting acquirer)
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	700	1,700
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600
Total shareholders' equity	1,100	2,000
Total liabilities and shareholders' equity	1,800	3,700

   Assume that Entity B's earnings for the annual period ended 31st March, 20X1 were ₹ 600 and that the consolidated earnings for the annual period ended 31st March, 20X2 were ₹ 800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the annual period ended 31st March, 20X1 and during the period from 1st January, 20X1 to the date of the reverse acquisition on 31st December, 20X1.

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Calculate the fair value of the consideration transferred measure goodwill and prepare consolidated balance sheet as on 31st December, 20X1.

3. **Scenario 1: New information on the fair value of an acquired loan**

Bank F acquires Bank E in a business combination in October, 20X1. The loan by Bank E to Borrower B is recognised at its provisionally determined fair value. In December 20X1, F receives Borrower B's financial statements for the year ended 30th September, 20X1, which indicate significant decrease in Borrower B's income from operations. Basis this, the fair value of the loan to B at the acquisition date is determined to be less than the amount recognised earlier on a provisional basis.

Scenario 2: Decrease in fair value of acquired loan resulting from an event occurring during the measurement period.

Bank F acquires Bank E in a business combination in October, 20X1. The loan by Bank E to Borrower B is recognised at its provisionally determined fair value. In December 20X1, F receives information that Borrower B has lost its major customer earlier that month and this is expected to have a significant negative effect on B's operations.

Comment on the treatment done by Bank F.

4. Company A acquired 90% equity interest in Company B on 1st April, 20X1 for a consideration of ₹ 85 crores in a distress sale. Company B did not have any instrument recognised in equity. The Company appointed a registered valuer with whose assistance, the Company valued the fair value of NCI and the fair value identifiable net assets at ₹ 15 crores and ₹ 100 crores respectively.

Find the value at which NCI has to be shown in the financial statements.

5. On 1st April, 20X1, Company A acquired 5% of the equity share capital of Company B for 1,00,000. A accounts for its investment in B at Fair Value through OCI (FVOCI) under Ind AS 109, *Financial Instruments: Recognition and Measurement*. At 31st March, 20X2, A carried its investment in B at fair value and reported an unrealised gain of ₹ 5,000 in other comprehensive income, which was presented as a separate component of equity. On 1st April, 20X2, A obtains control of B by acquiring the remaining 95 percent of B.

Comment on the treatment to be done based on the facts given in the question.

6. Company A acquires 70 percent of Company S on 1st January, 20X1 for consideration transferred of ₹ 5 million. Company A intends to recognise the NCI at proportionate share of fair value of identifiable net assets. With the assistance of a suitably qualified valuation professional, A measures the identifiable net assets of B at ₹ 10 million. A performs a review and determines that the business combination did not include any transactions that should be accounted for separately from the business combination.

State whether the procedures followed by A and the resulting measurements are appropriate or not. Also calculate the bargain purchase gain in the process

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7. Entity A and entity B provide construction services in India. Entity A is owned by a group of individuals, none of whom has control and does not have a collective control agreement. Entity B is owned by a single individual, Mr. Ram. The owners of entities A and B have decided to combine their businesses. The consideration will be settled in shares of entity B. Entity B issues new shares, amounting to 40% of its issued share capital, to its controlling shareholder, Mr. Ram. Mr. Ram then transfers the shares to the owners of entity A in exchange for their interest in entity A. At this point Mr. Ram controls both entities A and B, owning 100% of entity A and 71.42% of entity B. Mr. Ram had a controlling interest in both entity A and entity B before and after the contribution.

   Is the combination of entities A and B a combination of entities under common control?

8. On 1 April 20X1, Alpha Ltd. acquires 80 percent of the equity interest of Beta Pvt. Ltd. in exchange for cash of ₹ 300. Due to legal compulsion, Beta Pvt. Ltd. had to dispose of their investments by a specified date. Therefore, they did not have sufficient time to market Beta Pvt. Ltd. to multiple potential buyers. The management of Alpha Ltd. initially measures the separately recognizable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirement of Ind AS 103. The identifiable assets are measured at ₹ 500 and the liabilities assumed are measured at ₹ 100. Alpha Ltd. engages on independent consultant, who determined that the fair value of 20 per cent non-controlling interest in Beta Pvt. Ltd. is ₹ 84.

   Alpha Ltd. reviewed the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non controlling interest in Beta Pvt. Ltd. and the consideration transferred. After the review, it decided that the procedures and resulting measures were appropriate.

   Calculate the gain or loss on acquisition of Beta Pvt. Ltd. and also show the journal entries for accounting of its acquisition. Also calculate the value of the non-controlling interest in Beta Pvt. Ltd. on the basis of proportionate interest method, if alternatively applied?

9. ABC Ltd. prepares consolidated financial statements upto 31st March each year. On 1st July 20X1, ABC Ltd. acquired 75% of the equity shares of JKL Ltd. and gained control of JKL Ltd. the issued shares of JKL Ltd. is 1,20,00,000 equity shares. Details of the purchase consideration are as follows:

   - On 1st July, 20X1, ABC Ltd. issued two shares for every three shares acquired in JKL Ltd. On 1st July, 20X1, the market value of an equity share in ABC Ltd. was ₹ 6.50 and the market value of an equity share in JKL Ltd. was ₹ 6.
   - On 30th June, 20X2, ABC Ltd. will make a cash payment of ₹ 71,50,000 to the former shareholders of JKL Ltd. who sold their shares to ABC Ltd. on 1st July, 20X1. On 1st July, 20X1, ABC Ltd. would have to pay interest at an annual rate of 10% on borrowings.

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- On 30th June, 20X3, ABC Ltd. may make a cash payment of ₹ 3,00,00,000 to the former shareholders of JKL Ltd. who sold their shares to ABC Ltd. on 1st July, 20X1. This payment is contingent upon the revenues of ABC Ltd. growing by 15% over the two-year period from 1st July, 20X1 to 30th June, 20X3. On 1st July, 20X1, the fair value of this contingent consideration was ₹ 2,50,00,000. On 31st March, 20X2, the fair value of the contingent consideration was ₹ 2,20,00,000.

On 1st July, 20X1, the carrying values of the identifiable net assets of JKL Ltd. in the books of that company was ₹ 6,00,00,000. On 1st July, 20X1, the fair values of these net assets was ₹ 7,00,00,000. The rate of deferred tax to apply to temporary differences is 20%.

During the nine months ended on 31st March, 20X2, JKL Ltd. had a poorer than expected operating performance. Therefore, on 31st March, 20X2 it was necessary for ABC Ltd. to recognise an impairment of the goodwill arising on acquisition of JKL Ltd., amounting to 10% of its total computed value.

Compute the impairment of goodwill in the consolidated financial statements of ABC Ltd. under both the methods permitted by Ind AS 103 for the initial computation of the non-controlling interest in JKL Ltd. at the acquisition date.

10. How should contingent consideration payable in relation to a business combination be accounted for on initial recognition and at the subsequent measurement as per Ind AS in the following cases:

On 1st April 20X1, A Ltd. acquires 100% interest in B Ltd. As per the terms of agreement the purchase consideration is payable in the following 2 tranches:

a. an immediate issuance of 10 lakhs shares of A Ltd. having face value of ₹ 10 per share;

b. a further issuance of 2 lakhs shares after one year if the profit before interest and tax of B Ltd. for the first year following acquisition exceeds ₹ 1 crore.

   i. The fair value of the shares of A Ltd. on the date of acquisition is ₹ 20 per share. Further, the management has estimated that on the date of acquisition, the fair value of contingent consideration is ₹ 25 lakhs.

   ii. During the year ended 31st March 20X2, the profit before interest and tax of B Ltd. exceeded ₹ 1 crore. As on 31st March 20X2, the fair value of shares of A Ltd. is ₹ 25 per share.

   iii. Continuing with the fact pattern in (a) above except for:

c. The number of shares to be issued after one year is not fixed.

d. Rather, A Ltd. agreed to issue variable number of shares having a fair value equal to ₹ 40 lakhs after one year, if the profit before interest and tax for the first year following acquisition exceeds ₹ 1 crore. A Ltd. issued shares with ₹ 40 lakhs after a year.

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11. As part of its business expansion strategy, KK Ltd. is in process of setting up a pharma intermediates business which is at very initial stage. For this purpose, KK Ltd. has acquired on 1st April, 20X1, 100% shares of ABR Ltd. that manufactures pharma intermediates. The purchase consideration for the same was by way of a share exchange valued at ₹ 35 crores. The fair value of ABR Ltd.' s net assets was ₹ 15 crores, but does not include:

(i) A patent owned by ABR Ltd. for an established successful intermediate drug that has a remaining life of 8 years. A consultant has estimated the value of this patent to be ₹ 10 crores. However, the outcome of clinical trials for the same are awaited. If the trials are successful, the value of the drug would fetch the estimated ₹ 15 crores.

(ii) ABR Ltd. has developed and patented a new drug which has been approved for clinical use. The cost of developing the drug was ₹ 12 crores. Based on early assessment of its sales success, the valuer has estimated its market value at ₹ 20 crores.

(iii) ABR Ltd.'s manufacturing facilities have received a favourable inspection by a government department. As a result of this, the Company has been granted an exclusive five-year license to manufacture and distribute a new vaccine. Although the license has no direct cost to the Company, its directors believe that obtaining the license is a valuable asset which assures guaranteed sales and the value for the same is estimated at ₹ 10 crores.

KK Ltd. has requested you to suggest the accounting treatment of the above transaction under applicable Ind AS.

12. imp H Ltd. acquired equity shares of S Ltd., a listed company, in two tranches as mentioned in the below table:

Date	Equity stake purchased	Remarks
1st November, 20X6	15%	The shares were purchased based on the quoted price on the stock exchange on the relevant dates.
1st January, 20X7	45%	

Both the above-mentioned companies have Rupees as their functional currency. Consequently, H Ltd. acquired control over S Ltd. on 1st January, 20X7. Following is the Balance Sheet of S Ltd. as on that date:

Particulars	Carrying value (₹ in crore)	Fair value (₹ in crore)
ASSETS:		
Non-current assets		

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(a) Property, plant and equipment	40.0	90.0
(b) Intangible assets	20.0	30.0
(c) Financial assets		
- Investments	100.0	350.0
Current assets		
(a) Inventories	20.0	20.0
(b) Financial assets		
- Trade receivables	20.0	20.0
- Cash held in functional currency	4.0	4.0
(c) Other current assets		
Non-current asset held for sale	4.0	4.5
TOTAL ASSETS	208	
EQUITY AND LIABILITIES:		
Equity		
(a) Share capital (face value ₹ 100)	12.0	50.4
(b) Other equity	141.0	Not applicable
Non-current liabilities		
(a) Financial liabilities		
- Borrowings	20.0	20.0
Current liabilities		
(a) Financial liabilities		
- Trade payables	28.0	28.0
(b) Provision for warranties	3.0	3.0
(c) Current tax liabilities	4.0	4.0
TOTAL EQUITY AND LIABILITIES	208.0	

Other information:

Following is the statement of contingent liabilities of S Ltd. as on 1st January, 20X7:

Particulars	Fair value (₹ in crore)	Remarks
Law suit filed by a customer for a claim of ₹ 2 crore	0.5	It is not probable that an outflow of resources embodying economic benefits will be required to settle the claim. Any amount which would be paid

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		in respect of law suit will be tax deductible.
Income tax demand of ₹ 7 crore raised by tax authorities; S Ltd. has challenged the demand in the court.	2.0	It is not probable that an outflow of resources embodying economic benefits will be required to settle the claim.

In relation to the above-mentioned contingent liabilities, S Ltd. has given an indemnification undertaking to H Ltd. up to a maximum of ₹ 1 crore.

₹ 1 crore represents the acquisition date fair value of the indemnification undertaking.

Any amount which would be received in respect of the above undertaking shall not be taxable.

The tax bases of the assets and liabilities of S Ltd. is equal to their respective carrying values being recognised in its Balance Sheet.

Carrying value of non-current asset held for sale of ₹ 4 crore represents its fair value less cost to sell in accordance with the relevant Ind AS.

In consideration of the additional stake purchased by H Ltd. on 1st January, 20X7, it has issued to the selling shareholders of S Ltd. 1 equity share of H Ltd. for every 2 shares held in S Ltd. Fair value of equity shares of H Ltd. as on 1st January, 20X7 is ₹ 10,000 per share.

On 1st January, 20X7, H Ltd. has paid ₹ 50 crore in cash to the selling shareholders of S Ltd. Additionally, on 31st March, 20X9, H Ltd. will pay ₹ 30 crore to the selling shareholders of S Ltd. if return on equity of S Ltd. for the year ended 31st March, 20X9 is more than 25% per annum. H Ltd. has estimated the fair value of this obligation as on 1st January, 20X7 and 31st March, 20X7 as ₹ 22 crore and ₹ 23 crore respectively. The change in fair value of the obligation is attributable to the change in facts and circumstances after the acquisition date.

Quoted price of equity shares of S Ltd. as on various dates is as follows:

As on November, 20X6 ₹ 350 per share

As on 1st January, 20X7 ₹ 395 per share

As on 31st March, 20X7 ₹ 420 per share

On 31st May, 20X7, H Ltd. learned that certain customer relationships existing as on 1st January, 20X7, which met the recognition criteria of an intangible asset as on that date, were not considered during the accounting of business combination for the year ended 31st March, 20X7. The fair value of such customer relationships as on 1st January, 20X7

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was ₹ 3.5 crore (assume that there are no temporary differences associated with customer relations; consequently, there is no impact of income taxes on customer relations).

On 31st May, 20X7 itself, H Ltd. further learned that due to additional customer relationships being developed during the period 1st January, 20X7 to 31st March, 20X7, the fair value of such customer relationships has increased to ₹ 4 crore as on 31st March, 20X7.

On 31st December, 20X7, H Ltd. has established that it has obtained all the information necessary for the accounting of the business combination and that more information is not obtainable.

H Ltd. and S Ltd. are not related parties and follow Ind AS for financial reporting. Income tax rate applicable is 30%.

You are required to provide your detailed responses to the following, along with reasoning and computation notes:

(a) What should be the goodwill or bargain purchase gain to be recognised by H Ltd. in its financial statements for the year ended 31st March, 20X7. For this purpose, measure non-controlling interest using proportionate share of the fair value of the identifiable net assets of S Ltd.

(b) Will the amount of non-controlling interest, goodwill, or bargain purchase gain so recognised in (a) above change subsequent to 31st March, 20X7? If yes, provide relevant journal entries.

(c) What should be the accounting treatment of the contingent consideration as on 31st March, 20X7?

13. Company X is engaged in the business of exploration & development of Oil & Gas Blocks.

Company X currently holds participating interest (PI) in below mentioned producing Block as follows:

Block Name	Company X	Company Y	Company Z	Total
AWM/01	30%	60%	10%	100%

For the above Block, Company X, Y & Z has entered into unincorporated Joint Arrangement.

Company Y is the Operator of the Block AWM/01. Company X & Company Z are the Joint Operators. Company Y incurs all the expenditure on behalf of Joint Venture and raise cash call to Company X & Company Z at each month end in respect of their share of expenditure incurred in Joint Venture. All the manpower and requisite facilities / machineries owned by the Joint venture and thereby owned by all the Joint Operators.

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For past few months, due to liquidity issues, Company Z defaulted in payment of cash calls to operators. Therefore, company Y (Operator) has issued notice to company Z for withdrawal of their participating right from on 01.04.20X1. However, company Z has filed the appeal with arbitrator on 30.04.20X1.

Financial performance of company Z did not improve in subsequent months and therefore company Z decided to withdraw participating interest rights from Block AWM/01 and entered into sale agreement with Company X & Company Y. As per the terms of the agreement, dated 31.5.20X1, Company X will receive 33.33% share & Company Y will receive 66.67% share of PI rights owned by Company Z.

Company X is required to pay ₹ 1 Lacs against 33.33% share of PI rights owned by Company Z.

After signing of sale agreement, Operator (company Y) approach government of India for modification in PSC (Production Sharing Contract) i.e. removal of Company Z from PSC of AWM/01 and government has approved this transaction on 30.6.20X1. Government approval for the modification in PSC is essential, given the industry in which the joint operators operate.

Balance sheet of Company X & Company Z are as follows:

Particulars	Company X		Company Z	
	31.5.20X1 ₹	30.6.20X1 ₹	31.5.20X1 ₹	30.6.20X1 ₹
Assets				
Non-Current Assets				
Property, Plant & Equipment	5,00,000	10,00,000	1,50,000	3,00,000
Right of Use Asset	1,00,000	2,00,000	10,000	20,000
Development CWIP	50,000	1,00,000	50,000	1,00,000
Financial Assets				
Loan receivable	25,000	50,000	25,000	50,000
Total Non-Current Assets	**6,75,000**	**13,50,000**	**2,35,000**	**4,70,000**
Current assets				
Inventories	1,00,000	2,00,000	15,000	30,000
Financial Assets				
Trade receivables	1,50,000	3,00,000	50,000	1,00,000
Cash and cash equivalents	2,00,000	4,00,000	1,00,000	2,00,000
Other Current Assets	2,25,000	50,000	25,000	50,000
Total Current Assets	**6,75,000**	**9,50,000**	**1,90,000**	**3,80,000**
Total Assets	**13,50,000**	**23,00,000**	**4,25,000**	**8,50,000**

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Equity and Liabilities				
Equity				
Equity share capital	3,00,000	3,00,000	1,00,000	1,00,000
Other equity	2,00,000	3,00,000	75,000	2,50,000
Total Equity	**5,00,000**	**6,00,000**	**1,75,000**	**3,50,000**
Liabilities				
Non-Current Liabilities				
Provisions	4,00,000	8,00,000	1,00,000	2,00,000
Other Liabilities	1,50,000	3,00,000	50,000	1,00,000
Total Non-Current Liabilities	**5,50,000**	**11,00,000**	**1,50,000**	**3,00,000**
Current Liabilities				
Financial Liabilities				
Trade Payables	3,00,000	6,00,000	1,00,000	2,00,000
Total Current Liabilities	**3,00,000**	**6,00,000**	**1,00,000**	**2,00,000**
Total Liabilities	**13,50,000**	**23,00,000**	**4,25,000**	**8,50,000**

Additional Information:

1. Fair Value of PPE & Development CWIP owned by Company Z as per Market participant approach is ₹ 5,00,000 & ₹ 2,00,000 respectively.
2. Fair Value of all the other assets and liabilities acquired are assumed to be at their carrying values (except cash & cash equivalent). Cash and cash equivalents of Company Z are not to be acquired by Company X as per the terms of agreement.
3. Tax rate is assumed to be 30%.
4. As per Ind AS 111, it is a joint operation whereby every operator records their share of assets and liabilities in their books.

You need to determine the following:

1. Whether the above acquisition falls under business or asset acquisition as defined under business combination standard Ind AS 103?
2. Determine the acquisition date in the above transaction?
3. Prepare Journal entries for the above-mentioned transaction?
4. Draft the Balance Sheet for Company X based on your analysis in Part 1 above as at acquisition date.

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14. Entity X acquired entity Y in a business combination as per Ind AS 103. There is an existing share-based plan in entity Y with a vesting condition for 3 years in which 2 years have already lapsed at the date of such business acquisition. Entity X agreed to replace the existing award for the employees of combined entity. The details are as below –

Acquisition date fair value of share-based payment plan	₹ 300
Number of years to vest after acquisition	1 year
Fair Value of award which replaces existing plan	₹ 400

Calculate the share-based payment values?

Answers

1. ***Identify the acquirer***

In this case, Company A has paid cash consideration to shareholders of Company B. Further, the shares issued to Company B pursuant to the acquisition do not transfer control of Company A to erstwhile shareholders of Company B. Therefore, Company A is the acquirer and Company B is the acquiree.

Determine acquisition date

As the control over the business of Company B is transferred to Company A on 1st November, that date is considered as the acquisition date.

Determine the purchase consideration

The purchase consideration in this case will comprise the following:

Cash consideration	₹ 59,00,000
Equity shares issued (1,00,000 x 10 i.e., at fair value)	₹ 10,00,000
Contingent consideration (at fair value)	₹ 3,00,000
Fair value of previously held interest	₹ 20,00,000

As such, the total purchase consideration is ₹ 92,00,000.

Acquisition cost incurred by and on behalf of the Company A for acquisition of Company B should be recognised in the Statement of profit and loss. As such, an amount of ₹ 1,00,000 should be recognised in Statement of profit and loss.

Determine fair value of identifiable assets and liabilities

The fair value of identifiable net assets is determined at ₹ 60,00,000.

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Measure NCI

The management has decided to recognise the NCI at its fair value. As such, the NCI will be recognised at ₹ 7,50,000.

Re-measure previously held interests in case business combination is achieved in stages

In this case, the control has been acquired in stages i.e., before acquisition to control, the Company A exercised significant influence over Company B. As such, the previously held interest should be measured at fair value and the difference between the fair value and the carrying amount as at the acquisition date should be recognised in Statement of Profit and Loss. As such, an amount of ₹ 14,00,000 (i.e., 20,00,000 less 6,00,000) will be recognised in Statement of profit and loss.

Determination of goodwill or gain on bargain purchase

Goodwill should be calculated as follows:

	(₹)
Total consideration	92,00,000
Recognised amount of any non-controlling interest	7,50,000
Less: Fair value of Company B's net identifiable assets	(60,00,000)
Goodwill	**39,50,000**

2. Identifying the acquirer

As a result of Entity A issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (i.e., 150 of the 250 total issued shares). The remaining 40 per cent are owned by Entity A's shareholders. Thus, the transaction is determined to be a reverse acquisition in which Entity B is identified as the accounting acquirer while Entity A is the legal acquirer.

Calculating the fair value of the consideration transferred

If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B — 60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is ₹ 1,600 (40 shares with a fair value per share of ₹ 40).

The fair value of the consideration effectively transferred should be based on the most reliable measure. Here, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair

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value of the shares in Entity B, and the consideration is measured using the market price of Entity A's 100 shares with a fair value per share of ₹ 16.

Measuring goodwill

Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognised identifiable assets and liabilities, as follows:

	₹	₹
Consideration effectively transferred		1,600
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill		300

Consolidated balance sheet at 31st December, 20X1

The consolidated balance sheet immediately after the business combination is:

	₹
Non-current assets [3,000 + 1,500]	4,500
Goodwill	300
Current assets [700 + 500]	1,200
Total assets	6,000
Shareholders' equity	
Issued equity 250 ordinary shares [600 + 1,600]	2,200
Retained earnings	1,400
Total shareholders' equity	3,600
Non-current liabilities [1,100 + 400]	1,500
Current liabilities [600 + 300]	900
Total liabilities	2,400
Total liabilities and shareholders' equity	6,000

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The amount recognised as issued equity interests in the consolidated financial statements (₹ 2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (600) and the fair value of the consideration effectively transferred (₹ 1,600). However, the equity structure appearing in the consolidated financial statements (i.e., the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to affect the combination.

3. **Scenario 1:** The new information obtained by F subsequent to the acquisition relates to facts and circumstances that existed at the acquisition date. Accordingly, an adjustment (i.e., decrease) to in the provisional amount should be recognised for loan to B with a corresponding increase in goodwill.

Scenario 2: Basis this, the fair value of the loan to B will be less than the amount recognised earlier at the acquisition date. The new information resulting in the change in the estimated fair value of the loan to B does not relate to facts and circumstances that existed at the acquisition date, but rather is due to a new event i.e., the loss of a major customer subsequent to the acquisition date. Therefore, based on the new information, F should determine and recognise an allowance for loss on the loan in accordance with Ind AS 109, *Financial Instruments: Recognition and Measurement*, with a corresponding charge to profit or loss; goodwill is not adjusted.

4. In this case, Company A has the option to measure NCI as follows:

- Option 1: Measure NCI at fair value i.e., ₹ 15 crores as derived by the valuer;
- Option 2: Measure NCI as proportion of fair value of identifiable net assets i.e., ₹ 10 crores (100 crores x 10%)

5. At the acquisition date A recognises the gain of ₹ 5,000 in OCI as the gain or loss is not allowed to be recycled to income statement as per the requirement of Ind AS 109. A's investment in B would be at fair value and therefore does not require remeasurement as a result of the business combination. The fair value of the 5 percent investment (1,05,000) plus the fair value of the consideration for the 95 percent newly acquired interest is included in the acquisition accounting.

6. The amount of B's identifiable net assets exceeds the fair value of the consideration transferred plus the fair value of the NCI in B, resulting in an initial indication of a gain on a bargain purchase. Accordingly, A reviews the procedures it used to identify and measure the identifiable net assets acquired, to measure the fair value of both the NCI and the consideration transferred, and to identify transactions that were not part of the business combination.

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Following that review, A concludes that the procedures followed and the resulting measurements were appropriate.

	(₹)
Identifiable net assets	1,00,00,000
Less: Consideration transferred	(50,00,000)
NCI (10 million x 30%)	(30,00,000)
Gain on bargain purchase	20,00,000

7. No. This is not a business combination of entities under common control. Mr. Ram's control of both entities before the business combination was transitory. The substance of the transaction is that entity B has obtained control of entity A. Entity B accounts for this transaction as a business combination under Ind AS 103 using acquisition accounting.

8. The amount of Beta Pvt. Ltd. identifiable net assets [₹ 400, calculated as ₹ 500 - ₹ 100) exceeds the fair value of the consideration transferred plus the fair value of the non controlling interest in Beta Pvt. Ltd. [₹ 384 calculated as 300 + 84]. Alpha Ltd. measures the gain on its purchase of the 80 per cent interest as follows:

		₹ in lakh
Amount of the identifiable net assets acquired (₹ 500 - ₹ 100)		400
Less: Fair value of the consideration transferred for Alpha Ltd. 80 per cent interest in Beta Pvt. Ltd.	300	
Add: Fair value of non controlling interest in Beta Pvt. Ltd.	84	(384)
Gain on bargain purchase of 80 per cent interest		16

Journal Entry

		₹ in lakh	₹ in lakh
Identifiable assets acquired	Dr.	500	
To Cash			300
To Liabilities assumed			100
To OCI/Equity-Gain on the bargain purchase			16
To Equity-non controlling interest in Beta Pvt Ltd.			84

If the acquirer chose to measure the non controlling interest in Beta Pvt. Ltd. on the basis of its proportionate interest in the identifiable net assets of the acquire, the recognized

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amount of the non controlling interest would be ₹ 80 (₹ 400 x 0.20). The gain on the bargain purchase then would be ₹ 20 (₹ 400- (₹ 300 + ₹ 80)

9. Computation of goodwill impairment

	NCI at fair value	NCI at of net assets
	₹ in '000	₹ in '000
Cost of investment		
Share exchange (12,000 x 75% x 2/3 x ₹ 6.50)	39,000	39,000
Deferred consideration (7,150 / 1.10)	6,500	6,500
Contingent consideration	25,000	25,000
Non-controlling interest at date of acquisition:		
Fair value – 3000 x ₹ 6	18,000	
% of net assets – 68,000 (Refer W.N.) x 25%		17,000
Net assets on the acquisition date (Refer W.N.)	(68,000)	(68,000)
Goodwill on acquisition	20,500	19,500
Impairment @ 10%	2,050	1,950

Working Note:

Net assets on the acquisition date	₹ '000
Fair value at acquisition date	70,000
Deferred tax on fair value adjustments [20% x (70,000 – 60,000)]	(2,000)
	68,000

10. Paragraph 37 of Ind AS 103, inter alia, provides that the consideration transferred in a business combination should be measured at fair value, which should be calculated as the sum of (a) the acquisition-date fair values of the assets transferred by the acquirer, (b) the liabilities incurred by the acquirer to former owners of the acquiree and (c) the equity interests issued by the acquirer.

Further, paragraph 39 of Ind AS 103 provides that the consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

With respect to contingent consideration, obligations of an acquirer under contingent consideration arrangements are classified as equity or a liability in accordance with

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Ind AS 32 or other applicable Ind AS, i.e., for the rare case of non-financial contingent consideration. Paragraph 40 provides that the acquirer shall classify an obligation to pay contingent consideration that meets the definition of a financial instrument as a financial liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of Ind AS 32, Financial Instruments: Presentation. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met. Paragraph 58 of Ind AS 103 provides guidance on the subsequent accounting for contingent consideration.

(i) In the given case the amount of purchase consideration to be recognized **on initial recognition** shall be as follows:

	₹
Fair value of shares issued (10,00,000 x ₹20)	2,00,00,000
Fair value of contingent consideration	25,00,000
Total purchase consideration	2,25,00,000

Subsequent measurement of contingent consideration payable for business combination

In general, an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Ind AS 32 describes an equity instrument as one that meets both of the following conditions:

(a) There is no contractual obligation to deliver cash or another financial asset to another party, or to exchange financial assets or financial liabilities with another party under potentially unfavorable conditions (for the issuer of the instrument).

(b) If the instrument will or may be settled in the issuer's own equity instruments, then it is:

(i) a non-derivative that comprises an obligation for the issuer to deliver a fixed number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or other financial assets for a fixed number of its own equity instruments.

In the given case, given that the acquirer has an obligation to issue fixed number of shares on fulfilment of the contingency, the contingent consideration will be classified as equity as per the requirements of Ind AS 32.

As per paragraph 58 of Ind AS 103, contingent consideration classified as equity should not be re-measured and its subsequent settlement should be accounted for within equity.

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Here, the obligation to pay contingent consideration amounting to ₹ 25,00,000 is recognized as a part of equity and therefore not re-measured subsequently or on issuance of shares.

(ii) The amount of purchase consideration to be recognized **on initial recognition** shall be as follows:

	₹
Fair value of shares issued (10,00,000 x ₹20)	2,00,00,000
Fair value of contingent consideration	25,00,000
Total purchase consideration	2,25,00,000

Subsequent measurement of contingent consideration payable for business combination

The contingent consideration will be classified as liability as per Ind AS 32.

As per paragraph 58 of Ind AS 103, contingent consideration not classified as equity should be measured at fair value at each reporting date and changes in fair value should be recognized in profit or loss.

As at 31 March 20X2, (being the date of settlement of contingent consideration), the liability would be measured at its fair value and the resulting loss of ₹ 15,00,000 (₹ 40,00,000 – ₹ 25,00,000) should be recognized in the profit or loss for the period. A Ltd. would recognize issuance of 160,000 (`40,00,000/25) shares at a premium of ₹ 15 per share.

11. As per para 13 of Ind AS 103 'Business Combination', the acquirer's application of the recognition principle and conditions may result in recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements. This may be the case when the asset is developed by the entity internally and charged the related costs to expense.

Based on the above, the company can recognise following Intangible assets while determining Goodwill / Bargain Purchase for the transaction:

(i) Patent owned by ABR Ltd.: The patent owned will be recognised at fair value by KK Ltd. even though it was not recognised by ABR Ltd. in its financial statements. The patent will be amortised over the remaining useful life of the asset i.e. 8 years. Since the company is awaiting the outcome of the trials, the value of the patent cannot be estimated at ₹ 15 crore and the extra ₹ 5 crore should only be disclosed as a Contingent Asset and not recognised.

(ii) Patent internally developed by ABR Ltd.: As per para 18 of Ind AS 103 'Business Combination', the acquirer shall measure the identifiable assets acquired and the

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liabilities assumed at their acquisition date fair values. Since the patent developed has been approved for clinical use, it is an identifiable asset, hence the same will be measured at fair value ie ₹ 20 crore on the acquisition date.

(iii) **Grant of Licence to ABR Ltd. by the Government:** As regards to the five-year license, applying para 18 of Ind AS 103, grant asset will be recognised at fair value on the acquisition date by KK Ltd. On acquisition date, the fair value of the license is ₹ 10 crore. However, since the question does not mention about the fair value of the identifiable liability with respect to grant of license for the acquirer, it is assumed that no conditions with respect to compliance of grant (if any) have been passed to the acquirer. Hence, the fair value of the liability with respect to grant, for acquirer would be nil. Only, the grant asset (license) would be recognised at ₹ 10 crore in the books of acquirer KK Ltd.

Hence the revised working would be as follows:

	₹
Fair value of net assets of ABR Ltd.	15 crore
Add: Patent (10 + 20)	30 crore
Add: License	10 crore
Less: Grant for License	(Nil)
	55 crores
Purchase Consideration	(35 crores)
Bargain purchase	20 crore

12. **(i)** As an only exception to the principle of classification or designation of assets as they exist at the acquisition date is that for lease contract and insurance contracts classification which will be based on the basis of the conditions existing at inception and not on acquisition date.

Therefore, H Ltd. would be required to retain the original lease classification of the lease arrangements and thereby recognise the lease arrangements as finance lease.

(ii) The requirements in Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', do not apply in determining which contingent liabilities to recognise as of the acquisition date as per Ind AS 103 'Business Combination'. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to Ind AS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be

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required to settle the obligation. Hence H Ltd. will recognize contingent liability of ₹ 2.5 cr.

Since S Ltd. has indemnified for ₹ 1 cr., H Ltd. shall recognise an indemnification asset at the same time for ₹ 1 cr.

As per the information given in the question, this indemnified asset is not taxable. Hence, its tax base will be equal to its carrying amount. No deferred tax will arise on it.

(iii) As per Ind AS 103, non-current assets held for sale should be measured at fair value less cost to sell in accordance with Ind AS 105 'Non-current Assets Held for Sale and Discontinued Operations'. Therefore, its carrying value as per balance sheet has been considered in the calculation of net assets.

(iv) Any equity interest in S Ltd. held by H Ltd. immediately before obtaining control over S Ltd. is adjusted to acquisition-date fair value. Any resulting gain or loss is recognised in the profit or loss of H Ltd.

Calculation of purchase consideration as per Ind AS 103 ₹ in crore

Investment in S Ltd.			
On 1st Nov. 20X6	15%	[(12/100) x ₹ 395 x 15%]	7.11
On 1st Jan. 20X7	45%		
Own equity given		12 x 100 x ₹ 10,000 x 45% x 1/2	270.00
Cash			50.00
Contingent consideration			22.00
			349.11

(v) Calculation of deferred tax on assets and liabilities acquired as part of the business combination, including current tax and goodwill.

Item	**₹ in crore**				
	Book value	**Fair value**	**Tax base**	**Taxable (deductible) temporary difference**	**Deferred tax assets (liability) @ 30%**
Property, plant and equipment	40	90	40	50	(15)
Intangible assets	20	30	20	10	(3)
Investments	100	350	100	250	(75)

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Inventories	20	20	20	-	-
Trade receivables	20	20	20	-	-
Cash held in functional currency	4	4	4	-	-
Non-current asset held for sale	4	4	4	-	-
Indemnified asset	-	1	-	-	-
Borrowings	20	20	20	-	-
Trade payables	28	28	28	-	-
Provision for warranties	3	3	3	-	-
Current tax liabilities	4	4	4	-	-
Contingent liability		0.5	-	(0.5)	0.15
Deferred tax Liability					(92.85)

(vi) Calculation of identifiable net assets acquired

	₹ in crore	₹ in crore
Property, plant and equipment	90	
Intangible assets	30	
Investments	350	
Inventories	20	
Trade receivables	20	
Cash held in functional currency	4	
Non-current asset held for sale	4	
Indemnified asset	1	
Total asset		519
Less: Borrowings	20	
Trade payables	28	
Provision for warranties	3	
Current tax liabilities	4	
Contingent liability (2 + 0.5)	2.50	
Deferred tax liability (W.N.2)	92.85	(150.35)
Net identifiable assets		368.65

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(a) Calculation of NCI by proportionate share of net assets

Net identifiable assets of S Ltd. on 1.1.20X7 (Refer W.N.(vi)) = 368.65 crore

NCI on 1.1.20X7 = 368.65 crore x 40% = 147.46 crore

Calculation of Goodwill as per Ind AS 103

Goodwill on 1.1.20X7 = Purchase consideration + NCI – Net assets

= 349.11 + 147.46 – 368.65 = 127.92 crore

(b) As per para 45 of Ind AS 103 'Business Combination', if the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete.

During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

Further, as per para 46 of Ind AS 103, the measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognised for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this Ind AS:

(a) the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;

(b) .....

(c) ……; and

(d) the resulting goodwill or gain on a bargain purchase.

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Para 48 states that the acquirer recognises an increase (decrease) in the provisional amount recognised for an identifiable asset (liability) by means of a decrease (increase) in goodwill.

Para 49 states that during the measurement period, the acquirer shall recognise adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date.

Para 50 states that after the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with Ind AS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

On 31st December, 20X7, H Ltd. has established that it has obtained all the information necessary for the accounting of the business combination and the more information is not obtainable. Therefore, the measurement period for acquisition of S Ltd. ends on 31st December, 20X7.

On 31st May, 20X7 (ie within the measurement period), H Ltd. learned that certain customer relationships existing as on 1st January, 20X7 which met the recognition criteria of an intangible asset as on that date were not considered during the accounting of business combination for the year ended 31st March, 20X7. Therefore, H Ltd. shall account for the acquisition date fair value of customer relations existing on 1st January, 20X7 as an identifiable intangible asset. The corresponding adjustment shall be made in the amount of goodwill.

Accordingly, the amount of goodwill will be changed due to identification of new asset from retrospective date for changes in fair value of assets and liabilities earlier recognised on provisional amount (subject to meeting the condition above for measurement period). NCI changes would impact the consolidated retained earnings (parent's share). Also NCI will be increased or decreased based on the profit during the post-acquisition period.

Journal Entry

Customer relationship	Dr.	3.5 crore	
To NCI			1.4 crore
To Goodwill			2.1 crore

However, the increase in the value of customer relations after the acquisition date shall not be accounted by H Ltd., as the customer relations developed after 1st January, 20X7 represents internally generated intangible assets which are not eligible for recognition on the balance sheet.

(c) Since the contingent considerations payable by H Ltd is not classified as equity and is within the scope of Ind AS 109 'Financial Instruments', the changes in the fair value

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shall be recognised in profit or loss. Change in Fair value of contingent consideration (23-22) ₹ 1 crore will be recognized in the Statement of Profit and Loss.

13. (1) Ind AS 103 defines business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

For a transaction to meet the definition of a business combination (and for the acquisition method of accounting to apply), the entity must gain control of an integrated set of assets and activities that is more than a collection of assets or a combination of assets and liabilities.

To be capable of being conducted and managed for the purpose identified in the definition of a business, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs.

Therefore, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output.

In the aforesaid transaction, Company X acquired share of participating rights owned by Company Z for the producing Block (AWM/01). The output exist in this transaction (Considering AWM/01) is a producing block. Also all the manpower and requisite facilities / machineries are owned by Joint venture and thereby all the Joint Operators. Hence, acquiring participating rights tantamount to acquire inputs (Expertise Manpower & Machinery) and it is critical to the ability to continue producing outputs. Thus, the said acquisition will fall under the Business Acquisition and hence standard Ind AS 103 is to be applied for the same.

(2) As per paragraph 8 of Ind AS 103, acquisition date is the date on which the acquirer obtains control of the acquiree. Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date. Since government of India (GOI) approval is a substantive approval for Company X to acquire control of Company Z's operations, the date of acquisition cannot be earlier than the date on which approval is obtained from GOI. This is pertinent given that the approval from GOI is considered to be a substantive process and accordingly, the acquisition is considered to be completed only on receipt of such approval. Hence acquisition date in the above scenario is 30.6.20X1.

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(3) **Journal entry for acquisition**

Particulars		Amount (₹)	Amount (₹)
Property Plant & Equipment	Dr.	1,66,650	
Right-of-use Asset	Dr.	6,666	
Development CWIP	Dr.	66,660	
Financial Assets - Loan Receivables	Dr.	16,665	
Inventories	Dr.	9,999	
Trade Receivables	Dr.	33,330	
Other Current Assets	Dr.	16,665	
To Provisions			66,660
To Other Liabilities			33,330
To Trade Payables			66,660
To Deferred Tax Liability			29,997
To Cash & Cash Equivalent (purchase consideration)			1,00,000
To Gain on bargain purchase (Other Comprehensive Income)			19,988
(Being assets acquired and liabilities assumed from Company Z recorded at fair value along gain on bargain purchase)			

(4) **Balance Sheet of Company X as at 30.6.20X1**

(Pre & Post Acquisition of PI rights pertaining to Company Z)

Particulars	Pre-Acquisition	Adjustments	Post-Acquisition
	30.6.20X1		30.6.20X1
Assets			
Non - Current Assets			
Property Plant & Equipment	10,00,000	1,66,650	11,66,650
Right of Use Asset	2,00,000	6,666	2,06,666
Development CWIP	1,00,000	33,330	1,66,660
Financial Assets			
Loan receivable	50,000	16,665	66,665
Total Non-Current Assets	**13,50,000**		**16,06,641**

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Current assets			
Inventories	2,00,000	9,999	2,09,999
Financial Assets			
Trade receivables	3,00,000	33,330	3,33,330
Cash and cash equivalents	4,00,000	(1,00,000)	3,00,000
Other Current Assets	50,000	16,665	66,665
Total Current Assets	**9,50,000**		**9,09,994**
Total Assets	**23,00,000**		**25,16,635**
Equity and Liabilities			
Equity			
Equity share capital	3,00,000		3,00,000
Other equity	3,00,000		3,00,000
Capital Reserve (OCI)		19,988	19,988
Total Equity	**6,00,000**		**6,19,988**
Liabilities			
Non-Current Liabilities			
Provisions	8,00,000	66,660	8,66,660
Other Liabilities	3,00,000	33,330	3,33,330
Deferred Tax Liability		29,997	29,997
Total Non-Current Liabilities	**11,00,000**		**12,29,987**
Current Liabilities			
Financial liabilities			
Trade Payables	6,00,000	66,660	6,66,660
Total Current Liabilities	**6,00,000**		**6,66,660**
Total Equity and Liabilities	**23,00,000**		**25,16,635**

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Working Notes

1. **Determination of Company Z's balance acquired by Company X on 30.6.20X1 (Acquisition Date)**

Particulars	As per Company Z Books 30.6.20X1	Carrying Value 33.33% Share	Acquisition Date Value	Remarks
	₹	₹	₹	
Assets				
Non-Current Assets				
Property Plant & Equipment	3,00,000	99,990	1,66,650	Note 1
Right of Use Asset	20,000	6,666	6,666	
Development CWIP	1,00,000	33,330	66,660	Note 2
Financial Assets				
Loan receivable	50,000	16,665	16,665	
Total Non-Current Assets	**4,70,000**	**1,56,651**	**2,56,641**	
Current assets				
Inventories	30,000	9,999	9,999	
Financial Assets				
Trade receivables	1,00,000	33,330	33,330	
Cash and cash equivalents	2,00,000	66,660	66,660	
Other Current Assets	50,000	16,665	16,665	
Total Current Assets	**3,80,000**	**1,26,654**	**1,26,654**	
Liabilities				
Non-Current Liabilities				
Provisions	2,00,000	66,660	66,660	
Other Liabilities	1,00,000	33,330	33,330	
Total Non-Current Liabilities	**3,00,000**	**99,990**	**99,990**	
Current Liabilities				
Financial liabilities				
Trade Payables	2,00,000	66,660	66,660	
Total Current Liabilities	**2,00,000**	**66,660**	**66,660**	

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Note 1: Fair Value of PPE:

Fair Value of PPE in Company Z Books	₹ 5,00,000
33.33% Share acquired by Company X	₹ 1,66,650

Note 2: Fair Value of Development CWIP:

Fair Value of PPE in Company Z Books	₹ 2,00,000
33.33% Share acquired by Company X	₹ 66,660

2. Computation Goodwill/Bargain Purchase Gain

Particulars	**As at 30.6.20X1 (₹)**
Total Non - Current Assets	2,56,641
Total Current Assets (Except Cash & Cash Equivalent of ₹ 66,660) (1,26,654 – 66,660)	59,994
Total Non-Current Liabilities	(99,990)
Total Current Liabilities	(66,660)
Total Deferred Tax Liability (Refer Working note 3)	(29,997)
Net Assets Acquired	**1,19,988**
Less: Consideration Paid	(1,00,000)
Gain on Bargain Purchase (To be transferred to OCI)	**19,988**

*In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the value of net assets acquired in a business combination exceeds the purchase consideration. The acquirer shall recognise the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve, if the reason for bargain purchase gain is clear and evidence exist. If there does not exist clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, then the gain shall be recognised directly in equity as capital reserve. Since in above scenario it is clearly evident that due to liquidity issues, Company Z has to withdraw their participating right from AWM/01. The said bargain purchase gain should be transferred to other comprehensive income on the acquisition date.

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3. Computation of Deferred Tax Liability arising on Business Combination

Particulars	Acquisition Date Value (₹)
Total Non - Current Assets	2,56,641
Total Current Assets (Except Cash & Cash Equivalent of ₹ 66,660)	59,994
Total Non-Current Liabilities	(99,990)
Total Current Liabilities	(66,660)
Net Assets Acquired at Fair Value	**1,49,985**
Book value of Net Assets Acquired	(49,995)
Temporary Difference	**99,990**
DTL @ 30% on Temporary Difference	**29,997**

Note: As per Ind AS 103, in case an entity acquires another entity step by step through series of purchase then the acquisition date will be the date on which the acquirer obtains control. Till the time the control is obtained the investment will be accounted as per the requirements of other Ind AS 109, if the investments are covered under that standard or as per Ind AS 28, if the investments are in Associates or Joint Ventures.

If a business combination is achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

Since in the above transaction, company X does not hold any prior interest in Company Z & company holds only 30% PI rights in Block AWM/01 trough unincorporated joint arrangement, this is not a case of step acquisition.

14. Pre-acquisition period = 2

Post-acquisition period = 1

Total fair value at acquisition date = ₹ 300

Value to be recorded as per business combination under Ind AS 103 = ₹ 300/3 x 2 = ₹ 200

Value to be recorded as per Ind AS 102 (**A**) = ₹ 300/3 x 1 = ₹ 100

Fair value of the replacement of such award = ₹ 400

Difference from acquisition date fair value (**B**) = ₹ 400 – ₹ 300 = ₹ 100

Total value to be accounted over vesting period as per Ind AS 102 = A + B

= ₹ 100 + ₹ 100 = ₹ 200

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NOTES

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CHAPTER 13

CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS OF GROUP ENTITIES



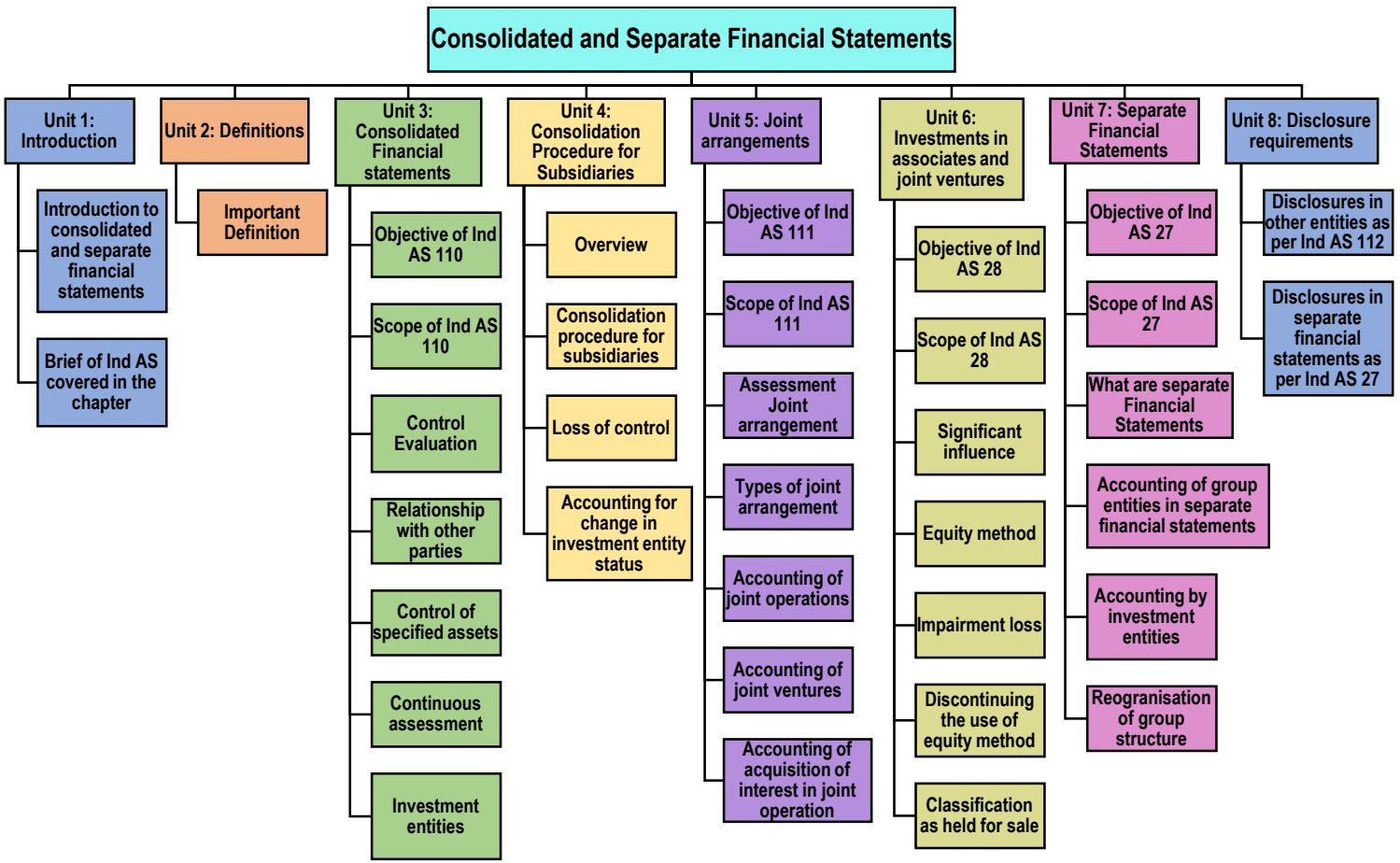
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the scope and objective of various Ind AS related to preparation of consolidated and separate financial statements
- Comprehend the concepts of control evaluation over an investee
- Analyse whether an entity is an investment entity
- Learn consolidation procedure for subsidiaries and accounting of non-controlling interests
- Determine whether an entity is a joint arrangement and if yes then whether that joint arrangement is a joint operation or joint venture
- Assess whether an investor has significant influence over an investee to treat that investee as an associate
- Learn what is the equity method of accounting and how it is applied in accounting of associates and joint ventures in the consolidated financial statements
- Gain knowledge of what are separate financial statements and how to account for the investments in subsidiaries, associates and joint ventures in separate financial statements of the investor
- Understand the disclosure requirements with respect to interests in other entities in the consolidated and separate financial statements.

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CHAPTER OVERVIEW



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UNIT 1:
INTRODUCTION TO CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

1.1 INTRODUCTION

Consolidated and Separate Financial Statements of Group Entities

Consolidated financial statements present the financial position of an entire group including the parent and its group companies. Whereas the separate financial statements present the financial position of a single entity for which the financial statements are prepared.

Various stakeholders such as investors, promoters, lenders, government authorities, etc. are more interested in referring to the consolidated financial statements for their decision-making purpose as consolidated financial statements provide a complete overview of the operations and profitability of the entire group which is controlled by the parent rather than just looking at the separate financial statements of the parent. Also, in current business scenario, various large corporates frequently do business restructuring or expansion by creating more group companies in order to achieve benefits like tax savings, operational efficiency, etc. Hence, in such circumstances the consolidated financial statements are imperative to have a complete understanding of the profitability and financial position of the entire group.

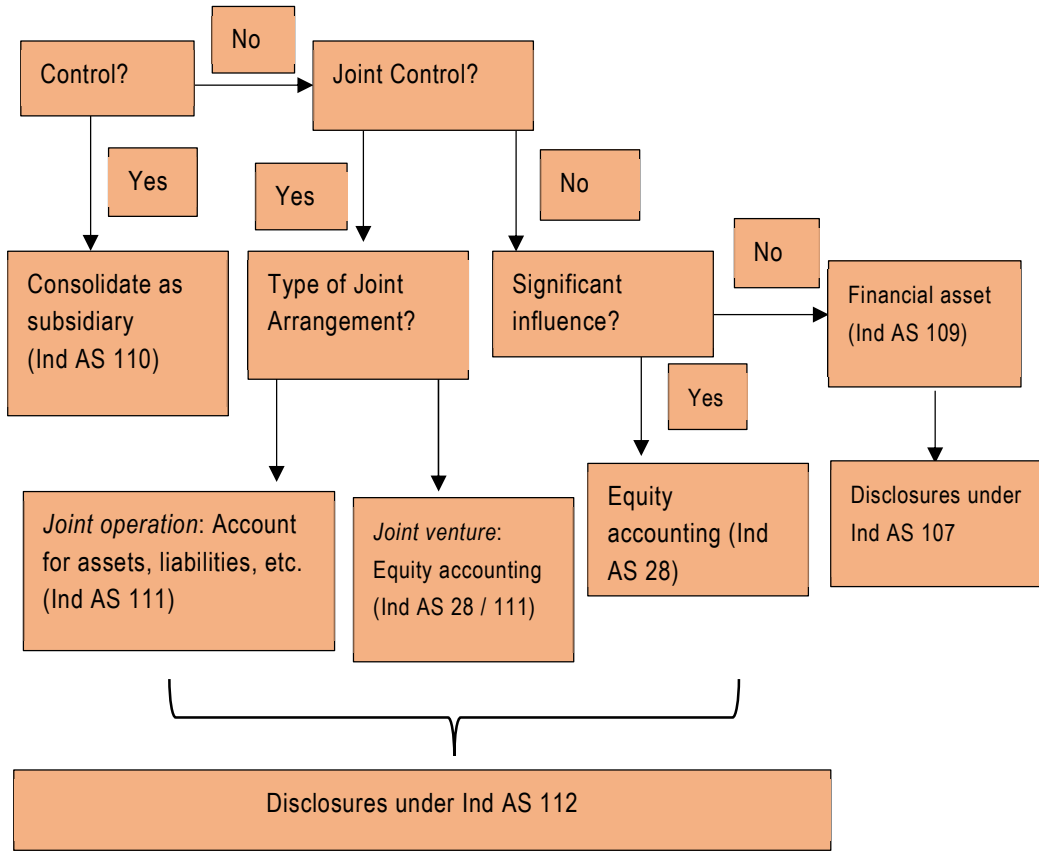
1.2 IND AS COVERED IN THE CHAPTER

In this study material, following Ind AS are covered related to the preparation of consolidated and separate financial statements of group entities:

- Ind AS 110 *'Consolidated Financial Statements'*: This Ind AS provides the criteria for evaluation of whether an entity controls one or more other entities to treat them as subsidiaries of the entity. It also explains the procedures for preparation of consolidated financial statements including the requirements for elimination of inter-company transactions, accounting of non-controlling interests, accounting of loss of control over subsidiaries and many more. The principles of control evaluation are covered in unit 3 of this chapter and principles of consolidation procedures are covered in unit 4 of this chapter.
- Ind AS 111 *'Joint Arrangements'*: This Ind AS explains the principles of determining whether an investment by an entity in an arrangement with one or more other parties can be treated as a joint arrangement or not. Also, it explains how to classify such joint arrangement between joint operation and joint venture. The principles of this Ind AS are covered in unit 5 of this chapter.

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- Ind AS 28 *'Investments in Associates and Joint Ventures'*: This Ind AS describes the principles of determining whether an investor has significant influence over an investee whereby the investee will be treated as an associate of the investor. Further, this Ind AS explains the principles of application of equity method of accounting for accounting of investments in associates and joint ventures in the consolidated financial statements. The principles of this Ind AS are covered in unit 6 of this chapter.
- Ind AS 27 *'Separate Financial Statements'*: This Ind AS prescribes the principles of accounting and disclosure of investment in subsidiaries, associates and joint ventures in the separate financial statements of an entity. The principles of accounting of investments in subsidiaries, associates and joint ventures are covered in unit 7 of this chapter and principles of disclosures of investments in subsidiaries, associates and joint ventures are covered in unit 8 of this chapter.
- Ind AS 112 *'Disclosures of Interests in Other entities'*: This Ind AS provides the requirements for an entity to disclose certain information in its financial statements with respect to its interests in other entities. The requirements of this Ind AS are covered in unit 8 of this chapter.



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UNIT 2: IMPORTANT DEFINITIONS

Following are the definitions of some of the important terms used across the chapter.

- **Associate:** An associate is an entity over which the investor has significant influence.
- **Consolidated Financial Statements:** The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.
- **Control over an investee:** An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
- **Group:** A parent and its subsidiaries.
- **Joint arrangement**: A joint arrangement is an arrangement of which two or more parties have joint control.
- **Joint control:** Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
- **Joint operation:** A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
- **Joint venture:** A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
- **Non-controlling interest:** Equity in a subsidiary not attributable, directly or indirectly, to a parent.
- **Parent:** An entity that controls one or more entities.
- **Power:** Existing rights that give the current ability to direct the relevant activities.
- **Separate financial statements:** Separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with Ind AS 109 *'Financial Instruments'*.
- **Significant influence:** Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
- **Subsidiary:** An entity that is controlled by another entity.

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UNIT 3:
IND AS 110: CONSOLIDATED FINANCIAL STATEMENTS

3.1 OBJECTIVE OF IND AS 110

The objective of Ind AS 110 is to provide principles of when an entity should prepare consolidated financial statements and how those consolidated financial statements should be prepared. In particular, Ind AS 110 provides following principles for presentation and preparation of consolidated financial statements:

- A parent that controls one or more subsidiaries should prepare consolidated financial statements
- Guidance on how to apply the principles of control evaluation to determine whether an investor has control over an investee to be able to consolidate that investee
- Principles around accounting requirements for consolidated financial statements
- Definition of an investment entity and consolidation exemptions applicable to them

The principles mentioned above are discussed in this unit except the accounting requirements for consolidated financial statements which is discussed in Unit 4.

Further, Ind AS 110 does not deal with the accounting requirements for business combinations and their effects on consolidation, including goodwill arising on a business combination. Hence, such requirements are also not discussed in this study material. Refer study material 'Business Combination and Corporate Restructuring' for discussion on the same.

3.2 SCOPE OF IND AS 110

Ind AS 110 requires that an entity that is a parent should prepare consolidated financial statements. However, there are certain exemptions and exceptions to this as follows:

Exemption

As per paragraph 4(a) of Ind AS 110, a parent entity that meets **all** of the following conditions need **not present** consolidated financial statements:

(i) The entity is a wholly owned or partly owned subsidiary of another entity and all the owners of the entity are informed, and they do not object to the entity not preparing consolidated financial statements

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(ii) The debt or equity instruments of the entity are not traded in a public market (whether domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)

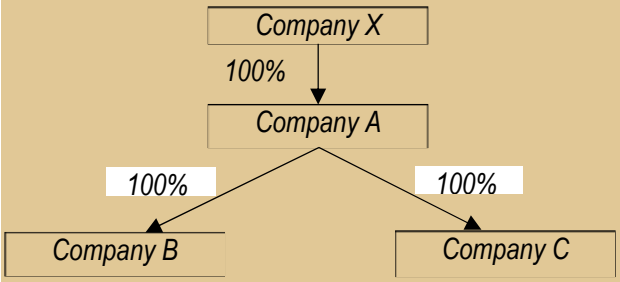
(iii) The entity has not filed nor is it in the process of filing its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market

(iv) The entity's ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110

Illustration 1: Exception to prepare consolidated financial statements

Scenario A:

Following is the structure of a group headed by Company X:



Company X is a listed entity in India and prepares consolidated financial statements as per the requirements of Ind AS. Company A is an unlisted entity and it is not in the process of listing any of its instruments in public market. Company X does not object to Company A not preparing consolidated financial statements.

Whether Company A is required to prepare consolidated financial statements as per the requirements of Ind AS 110?

Scenario B:

Assume the same facts as per Scenario A except, Company X is a foreign entity and is listed in stock exchange of a foreign country and it prepares its financial statements as per the generally accepted accounting principles (GAAP) applicable to that country.

Will your answer be different in this case?

Scenario C:

Assume the same facts as per Scenario A except, 100% of the investment in Company A is held by Mr. X (an individual) instead of Company X.

Will your answer be different in this case?

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Solution:

Scenario A:

In this case, Company A satisfies all the conditions for not preparing consolidated financial statements i.e. it is not a listed entity nor it is in the process of listing, the parent of Company A prepares consolidated financial statements as per Ind AS which is available for public use and parent of Company A does not object Company A not preparing consolidated financial statements.

Hence, Company A is not required to prepare consolidated financial statements.

Scenario B:

In this case, the consolidated financial statements of parent of Company A are not prepared under Ind AS. Hence Company A cannot avail the exemption from preparation of consolidated financial statements.

Scenario C:

In this case, Mr. X (an individual) would not be preparing its financial statements as per the requirements of Ind AS which is available for public use.

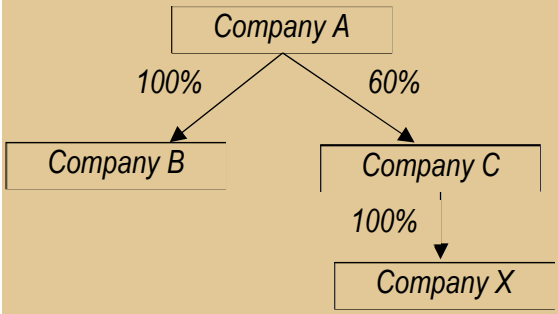
Hence Company A cannot avail the exemption from preparation of consolidated financial statements.

*****

Illustration 2: Exception to prepare consolidated financial statements

Scenario A:

Following is the structure of a group headed by Company A.



Company A is a listed entity in India and prepares consolidated financial statements as per the requirements of Ind AS. Company C is an unlisted entity and it is not in the process of listing any of its instruments in public market. 60% of the equity share capital of Company C is held by Company A and balance 40% equity share capital is held by other outside investors. Company A does not object to Company C not preparing consolidated financial statements.

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Whether Company C is required to prepare consolidated financial statements as per the requirements of Ind AS 110?

Scenario B:

Assume the same facts as per Scenario A except, the balance 40% of the equity share capital of Company C is held by Company B.

State whether C Limited is required to inform its other owner B Limited (owning 40%) of its intention to not prepare consolidated financial statements as mentioned in paragraph 4(a)(i)?

Solution:

Scenario A:

Company C is a partly owned subsidiary of Company A. In such case, Company C should inform the other 40% equity shareholders about Company C not preparing consolidated financial statements and if they do not object then only Company C can avail the exemption from preparing consolidated financial statements.

Scenario B:

In this scenario, Company C is 100% held by Company A (60% direct investment and 40% investment through Company B). Hence, Company C is not required to inform to Company B of not preparing consolidated financial statements and can avail the exemption from preparing the consolidated financial statements.

*****

Exception 1

Ind AS 110 does not apply to post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19 *'Employee Benefits'* applies. Therefore, an entity which has set up such plans should not consolidate them.

Example 1

Company A has set up an Employee Gratuity Plan trust for the purpose of giving gratuity benefits to its employees. The gratuity benefit given by the company is a post-employee benefit plan which is accounted as per Ind AS 19 (refer Unit 1 of Chapter 9 for the accounting of employee benefit plans as per Ind AS 19). So, Company A is not required to evaluate whether it controls the trust and should not consolidate it.

Exception 2

An investment entity (explained in section 3.7 of this Unit) that is required to measure all of its subsidiaries at fair value through profit or loss need not present consolidated financial statements. This exception is further explained subsequently in this unit.

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Note:

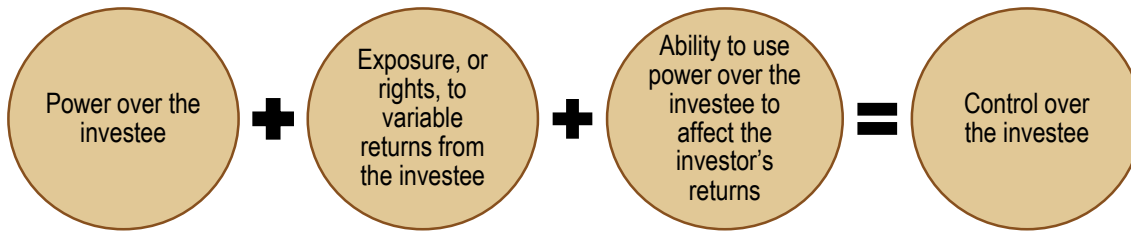
It may be noted that the Indian GAAP (i.e. the accounting standards under The Companies (Accounting Standards) Rules, 2021) contained two exceptions from consolidation, which **are no longer applicable under Ind AS**:

- When control is intended to be temporary; or
- When the subsidiary operates under severe long-term restrictions

3.3 CONTROL EVALUATION

As per Ind AS 110, an investor needs to determine whether it controls an investee and if yes then the investor would be treated as a parent and the investee would be treated as a subsidiary of the parent.

An investor controls an investee if and only if the investor has **all of the following three elements**:



After doing an initial assessment of control over an investee, the investor should reassess the control over the investee when there are changes to one or more of the three elements of control mentioned above.

Further, there may be situations where the investor is not the only one who control the investee and it may need to act in co-operation with any other entity. There may also be a situation where there is no investor who individually controls the investee. In such scenario, the investor would account for the interest in such investees in accordance with other applicable Ind AS such as Ind AS 111 for joint arrangement (discussed in Unit 5 of this Chapter), Ind AS 28 for investments in associates (discussed in Unit 6 of this Chapter) or Ind AS 109 for financial instruments (discussed in Chapter 12).

Each of the elements of control evaluation are explained below.

3.3.1 Power

What is power?

The first criterion of control evaluation is to determine whether the investor has power over the investee. An investor gets power over an investee if it has three elements:

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A. **existing rights** that give it

B. the **current ability**

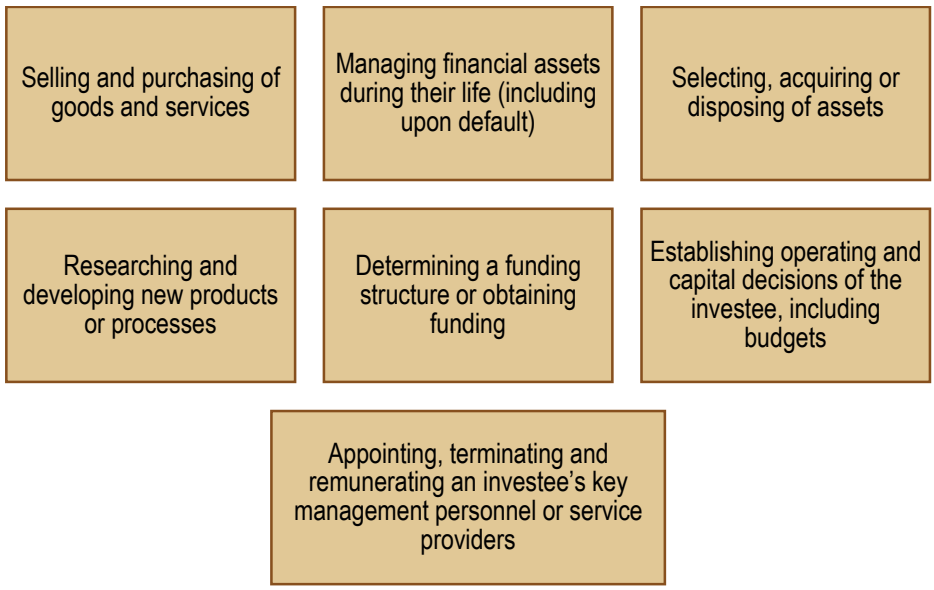
C. to direct the **relevant activities** of the investee.

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change. We will move in a reverse order to understand the meaning of 'power' in the context of Ind AS 110. In other words, we will first learn what are 'relevant activities', then we will move to understand what is intended to be covered within the scope of 'current ability' and finally, we will link this understanding with the concept of 'rights'.

How to identify the relevant activities and how the decisions about those activities are made?

Relevant activities are the activities of investee that significantly affect the investee's returns. For a detailed understanding of what encompasses 'returns', please refer to section 3.3.2.

There may be range of operating and financing activities that would significantly affect the returns of an investee. Examples of activities related to operating and financing activities that can be relevant activities include, but not limited to:



The power to direct the relevant activities can be shared by multiple parties but those rights may not meet the definition of joint control.

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Example 2

Five parties each own 20 per cent of entity Z, and each has one seat on entity Z's board of directors. All strategic operating and financing decisions (ie decisions in respect of the activities that significantly affect the returns of entity Z) require the consent of any four of the five directors. The five parties do not jointly control entity Z because unanimous consent is not required for decisions relating to the activities of entity Z that significantly affect its returns. Nevertheless, it is clear that the power to direct the activities of entity Z is shared and no single party controls entity Z.

There may be another situation where two or more investors have the rights to unilaterally direct different relevant activities of an investee. In such situation, one has to decide which activities can most significantly affect the returns of the investee and the investor having the ability to direct those activities would be considered to have power over the investee. The investors shall reconsider this assessment in case there is change in the facts or circumstances.

Illustration 3: Different investors have ability to direct different relevant activities

A Ltd. and B Ltd. set up a new company C Ltd. to construct and operate a toll road. A Ltd. is responsible for the construction of the toll road, which is expected to take two years. Thereafter, B Ltd. has authority on all matters related to toll road operation.

Is it possible for B Ltd. to have power over C Ltd. during the construction phase, even though A Ltd. is responsible for construction and has authority to make decisions that need to be made during the construction phase?

Solution

B Ltd. may power during the construction phase, even though it cannot yet exercise its decision-making rights during construction. The investor that has the ability to direct the activities that most significantly affect the returns of the investee has power over the investee. Consideration should be given to the factors that determine profit margin, revenue and valuation of C Ltd. For example, the construction of the road may be under the strict supervision and precise requirements of the regulator say State Road Transport Corporation (SRTC).

A Ltd. will recover its costs plus a fixed percentage of margin. That margin will be returned through adjustment of the amount of tolls that will flow to A Ltd., so that A Ltd. has first call on the cash flows generated by tolls. B Ltd. will manage the toll road operations, including maintenance, and will be able to claim a management fee equivalent to any residual cash in the entity after all operating expenses have been paid, including payments to A Ltd.

Assume that B Ltd. has the ability to set tolls (and not SRTC). In this scenario, A Ltd. merely works like a contractor, earning a fixed margin, and probably a financing income for financing the construction. A Ltd. does not take much of a risk on the cash flows, because the residual risks and rewards belong to B Ltd. Consequently, B Ltd. controls C Ltd. from its inception.

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Illustration 4: Determining the relevant activities

A Ltd. is an asset manager of a venture capital fund i.e. Fund X. Out of the total outstanding units of the fund, 10% units are held by A Ltd. and balance 90% units are held by other investors. Majority of the unitholders of the fund have right to appoint a committee which will manage the day-to-day administrative activities of the fund. However, the decisions related to the investments / divestments to be done by Fund X is taken by asset manager i.e. A Ltd. Based on above, who has power over Fund X?

Solution:

In this case, A Ltd. is able to direct the activities that can most significantly affect the returns of Fund X. Hence, A Ltd. has power over the investee. However, this does not mean that A Ltd. has control over the fund and consideration will have to be given to other elements of control evaluation as well i.e. exposure to variable returns and link between power and exposure to variable returns.

*****

Current ability to direct relevant activities

An investor would have current ability to direct relevant activities if that investor were able to make decisions at the time those decisions need to be taken. An investor can have the current ability to direct the activities of an investee even if it does not actively direct the activities of the investee.

Having the current ability to direct the activities of an investee is not limited to being able to act today. There may be steps to be taken in order to act - for example, an investor may need to initiate a meeting before it can exercise its voting or other rights that give it power. However, such a delay would not prevent the investor from having power, assuming that there are no other barriers that would prevent the investor from exercising its rights when it chooses to do so.

For some investees, particularly those with most of their operating and financing decisions predetermined, decisions that significantly affect the returns of the investee are not made continuously. Such decisions may be made only if particular events occur or circumstances arise. For such investees, having the ability to make those decisions if and when they arise is a source of a current ability to direct the relevant activities.

It must be borne in mind that the current ability to direct the activities of an investee would, in all cases, arise from rights (voting rights, potential voting rights, rights within other arrangements or a combination of these).

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with

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the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

Illustration 5: Current ability to direct the relevant activities

An investment vehicle (the investee) is created and financed with a debt instrument held by an investor (the debt investor) and equity instruments held by a number of other investors. The equity tranche is designed to absorb the first losses and to receive any residual return from the investee. One of the equity investors who holds 30 per cent of the equity is also the asset manager.

The investee uses its proceeds to purchase a portfolio of financial assets, exposing the investee to the credit risk associated with the possible default of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee.

The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (ie when the value of the portfolio is such that the equity tranche of the investee has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor.

Based on the above, who has power over the investment vehicle?

Solution:

Managing the investee's asset portfolio is the relevant activity of the investee.

The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value.

The asset manager and the debt investor each need to determine whether they are able to direct the activities that most significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

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3.3.1.1 Rights that give power to an investor

Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities.

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The rights that give an investor power over an investee can differ investee by investee. Following are some of the examples (not an exhaustive list) of various forms of rights that, either individually or in combination with other rights, can give power to an investor:

Form of right	Illustration
Voting rights or potential voting rights of an investee (this is further explained subsequently in this unit).	An investor holding majority of the equity share capital of an investee. Concepts of power through voting or potential voting rights are further discussed in detail in section 3.3.1.3 of this unit.
Rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities.	An investor having right to appoint majority of the members of the Board of Director who have power to take decisions related to relevant activities.
Rights to appoint or remove another entity that directs the relevant activities.	Right with an investor to appoint or remove an asset manager who takes decisions related to investments / divestments by a venture capital fund.
Rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor.	Right with an investor to direct the investee to sell all of its outputs to a group company of the investor at the price determined by investor
Other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.	Right related to relevant activities given to a single investor by all other investors through a shareholders' agreement

In most of the case where the investee has a range of relevant activities and decisions are required to be taken on a continuous basis for those activities then it will be voting or similar rights that give an investor power over the investee.

3.3.1.1A Substantive rights vs Protective Rights

For the purpose of determination of power over an investee, an investor shall consider only those rights which are substantive. Protective rights are not considered for the determination of power. Below table summarises the difference between substantive rights and protective rights:

Substantive rights	Protective rights
Substantive rights can give the investor power over the investee.	Protective rights do not give investor power over the investee.

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Substantive rights relate to the relevant activities of the investee.	Protective rights relate to protect the interest of the party holding those rights without giving the holder the right over the relevant activities of the investee.

Both the above rights are discussed below in detail.

1. Substantive rights

For a right to be substantive, the holder must have the practical ability to exercise that right.

Assessment of whether the rights are substantive requires judgement taking into consideration all the facts and circumstances. Following are some of the factors (not an exhaustive list) that should be considered while assessing whether the rights are substantive or not:

a) Whether there are any **barriers** that prevent the holder from exercising the rights. Example of such barriers (not an exhaustive list) can be as follows:

- Financial penalties and incentives
- High exercise or conversion price
- Terms and conditions that make it unlikely that the rights would be exercised, like, conditions that narrowly limit the timing of their exercise
- The absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights.
- The inability of the holder of the rights to obtain the information necessary to exercise its rights.
- Operational barriers or incentives. For example, in case of a venture capital fund managed by an asset manager, there is absence of other managers willing or able to provide specialised services or provide the services and take on other interests held by the existing manager.
- legal or regulatory requirements. For example, where a foreign investor is prohibited from exercising its rights

b) When the exercise of rights requires **agreement of more than one party**, or when the rights are **held by more than one party**, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive.

An independent board of directors may serve as a mechanism for numerous investors to act collectively in exercising their rights.

c) Whether the party or parties that hold the rights would **benefit from the exercise of those rights**. For example, the holder of potential voting rights in an investee shall consider the

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exercise or conversion price of the instrument. The potential voting rights are more likely to be substantive when the exercise price is lower than the market price or when there are other synergies anticipated between the investor and the investee.

Below are some illustrations that explain the above factors of determining whether the rights held by investors are substantive or not:

Illustration 5: Voting rights are substantive or not

Scenario A:

Following is the voting power holding pattern of B Ltd.

- *10% voting power held by A Ltd.*
- *90% voting power held by 9 other investor each holding 10%*

All the investors have entered into a management agreement whereby they have granted the decision-making powers related to the relevant activities of B Ltd. to A Ltd. for a period of 5 years.

After 2 years of the agreement, the investors holding 90% of the voting powers have some disputes with A Ltd. and they want to take back the decision-making rights from A Ltd. This can be done by passing a resolution with majority of the investors voting in favour of the removal of rights from A Ltd. However, as per the termination clause of the management agreement, B Ltd. will have to pay a huge penalty to A Ltd. for terminating the agreement before its stated term.

Whether the rights held by investors holding 90% voting power are substantive?

Scenario B:

Assume the same facts as per Scenario A except, there is no penalty required to be paid by B Ltd. for termination of agreement before its stated term. However, instead of all other investors, there are only 4 investors holding total 40% voting power that have disputes with A Ltd. and want to take back decision-making rights from A Ltd.

Whether the rights held by investors holding 40% voting power are substantive?

Solution:

Scenario A:

If the investors holding 90% of the voting power exercise their right to terminate the management agreement, then it will result in B Ltd. having to pay huge penalty which will affect the returns of B Ltd. This is a barrier that prevents such investors from exercising their rights and hence such rights are not substantive.

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Scenario B:

To take back the decision-making rights from A Ltd., investors holding majority of the voting power need to vote in favour of removal of rights from A Ltd. However, the investors having disputes with A Ltd. do not have majority voting power and hence the rights held by them are not substantive.

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Illustration 6: Potential voting rights are substantive or not

Scenario A:

An investor is holding 30% of the voting power in ABC Ltd. The investor has been granted an option to purchase 30% more voting power from other investors. However, the exercise price of the option is too high compared to the current market price of ABC Ltd. because ABC Ltd. is incurring losses since last 2 years and it is expected to continue to incur losses in future period as well. Whether the right held by the investor to exercise purchase option is substantive?

Scenario B:

Assume the same facts as per Scenario A except, the option price is in line with the current market price of ABC Ltd. and ABC Ltd. is making profits. However, the option can be exercised in next 1 month only and the investor is not in a position to arrange for the require amount in 1 month's time to exercise the option. Whether the right held by the investor to exercise purchase option is substantive?

Scenario C:

Assume the same facts as per Scenario A except, ABC Ltd. is making profits. However, the current market price of ABC Ltd. is not known since the ABC Ltd. is a relatively new company, business of the company is unique and there are no other companies in the market doing similar business. Hence the investor is not sure whether to exercise the purchase option. Whether the right held by the investor to exercise purchase option is substantive?

Solution:

Scenario A:

The right to exercise purchase option is not substantive since the option exercise price is too high as compared to current market price of ABC Ltd.

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Scenario B:

The right to exercise purchase option is not substantive since the time period for the investor to arrange for the requisite amount for exercising the option is too narrow.

Scenario C:

The right to exercise purchase option is not substantive. This is because the investor is not able to obtain information about the market value of ABC Ltd. which is necessary in order to compare the option exercise price with market price so that it can decide whether the exercise of purchase option would be beneficial or not.

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Illustration 7: Removal rights are substantive or not

A venture capital fund is managed by an asset manager who has right to take the investment and divestments decisions related to the fund corpus. The asset manager is also holding some stake in the fund. The other investors of the fund have right to remove the asset manager.

However, in the present scenario, there is absence of other managers who are willing or able to provide specialised services that the current asset manager is providing and purchase the stake that the current asset manager is holding in the fund. Whether the removal rights available with other investors are substantive?

Solution:

If the other investors exercise their removal rights, then it will impact the operations of the fund and ultimately the returns of the fund since there is no substitute of the current asset manager available who can manage the corpus of the fund. Hence the removal rights held by other investors are not substantive.

*****

For a right to be substantive, it should be exercisable when decisions about the direction of the relevant activities need to be made. In most of the cases a right, to be a substantive right, rights need to be currently exercisable. However, there may be some situations where a right can be substantive, even though it may not be currently exercisable.

Example 3

In case of an investor currently holding only 30% voting rights in a company has an option to purchase additional 40% voting rights to increase its voting rights to 70%. The option can be exercised within next 25 days. Also, there is a meeting of shareholding scheduled to be held after 30 days to take decision about relevant activities of the company. In such case, even though the

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investor is not currently holding majority voting power, it can exercise the purchase option and increase its voting power to 70% by the time when the decisions about the relevant activities are to be made. Hence such rights are substantive rights.

An investor may be directing relevant activities of an investee and the evidence of that can help determine whether the investor has power. However, such evidence is not, in itself, conclusive in determining whether the investor has power over an investee.

While assessing the power, an investor should also consider the substantive rights held by other investors. The other investors may not be able to initiate the decisions about relevant activities on their own, but the rights held by them to approve or block any decision may prevent the investor from taking decision about relevant activities.

Example 4

In case of a company with 5 investors, a meeting of the investors to take decisions about relevant activities can be called if at least 2 members are in favour of calling the meeting. However, to pass any decision in the meeting, unanimous consent of all investors is required. Hence, in such case a single investor may not be able to initiate the meeting, but his consent is required to pass any decision in the meeting.

2. Protective rights

Protective rights are the rights designed to **protect the interest of the party** holding those rights **without giving that party power** over the entity to which those rights relate.

Such rights mainly **relate to fundamental changes** to the activities of an investee or apply in exceptional circumstances. However, not all the rights that apply in exceptional circumstances or are contingent on future events are protective rights. Protective rights do not give its holder power or prevent another party from having power over an investee. The examples of protective rights include, but not limited to, following:

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- A right exercisable by an investor only in the event of a fraud or default by other investors having power to take decisions about relevant activities
- *A lender's right to appoint its nominee director in the Board of a borrower to ensure the borrower do not engage in any activities that significantly increase the credit risk of borrower
- Rights held by minority shareholders to approve decisions related to capital expenditure greater than required in normal course of business or to approve issue of equity or debt instruments
- A lender's right to seize the assets of a borrower if the borrower defaults in repayment of loan instalments
- Rights of investors to approve or block decisions related to change in the name of the investee, amendment to constitutional documents of the investee to enter into a new business, change in the registered office of the investee, etc.

***Note:** The 2nd right (illustrated above) is not protective in all circumstances. So far as the nomination doesn't result in majority control over the Board, it can be considered protective.

The effect of substantive and protective rights is summarised below:

Type of rights held by investor		Type of rights held by other parties		Conclusion on 'power'?
Substantive	+	Protective	=	Investor has power
Protective	+	Substantive	=	Other parties have power
Substantive	+	Substantive	=	Further evaluation needed

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Franchises

Apart from the examples of protective rights mentioned above, one more example can be of rights of a franchisor in a franchise agreement. In a franchise agreement, the investee i.e. the franchisee usually give the franchisor the rights that are related to protect the franchise brand. Following are some of the salient features of a franchise arrangement which indicates that the rights of a franchisor in a franchise agreement are protective rights:

Salient features of a franchise agreement that indicate that rights of franchisor are protective rights			
Franchisor's right do not give it ability to direct the relevant activities of franchisee	Other parties have current ability to direct the relevant activities of the franchisee	Franchisor's rights do not affect the rights of others to take decisions about relevant activities	Franchisee operates the business for its own account

Note: Control over fundamental decisions as the legal form of the franchisee and its funding structure may be determined by parties other than the franchisor and may significantly affect the returns of the franchisee. The lower the level of financial support provided by the franchisor and the lower the franchisor's exposure to variability of returns from the franchisee the more likely it is that the franchisor has only protective rights.

Illustration 8: Protective rights of a franchisor

ABC Ltd. is a manufacturer of branded garments and is the owner of Brand X. PQR Ltd. has entered into a franchise agreement with ABC Ltd. to allow PQR Ltd. to set up a retail outlet to sell the products of Brand X.

As per the agreement, PQR Ltd. will set up the retail outlet from its own funds, decide the capital structure of the entity, hire employees and their remuneration, select vendors for acquiring capital items, etc. However, ABC Ltd. will give certain operating guidelines like the interior of the retail outlet, uniform of the employees and other such guidelines to protect the brand name of ABC Ltd.

Whether the rights held by ABC Ltd. protective or substantive?

Solution:

The activities that most significantly affect the returns of PQR Ltd. are the funding and capital structure of PQR Ltd., hiring of employees and their remuneration, vendors for capital items, etc. which are exercisable by PQR Ltd. Further, the retails outlet is being set up by PQR Ltd. without

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any financial support from ABC Ltd. The rights available with ABC Ltd. are to protect the brand name of ABC Ltd. and such rights do not affect the ability of PQR Ltd. to take decisions about relevant activities. Hence, the rights held by ABC Ltd. are protective rights.

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3.3.1.3 Voting rights

Generally, an investor gets power over an investee by way of voting rights that allow it to direct the relevant activities.

However, there can be situations where voting rights (even if the investor holds majority of them) do not give investor power over the investee. This can be in the following situations:

- Voting rights are not substantive (as discussed above).
- If another entity has existing rights that provide that entity with the right to direct the relevant activities and that entity is not an agent of the investor, the investor does not have power over the investee

Even if the voting rights do not give power to an investor, there can be other rights which would give an entity power over the investee. In this section we will discuss various scenarios of power through voting rights and power other than through voting rights.

3.3.1.3.1 Power through voting rights

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

A. Power with a majority of the voting rights

An investor that holds more than half of the voting rights of an investee has power in the following situations:

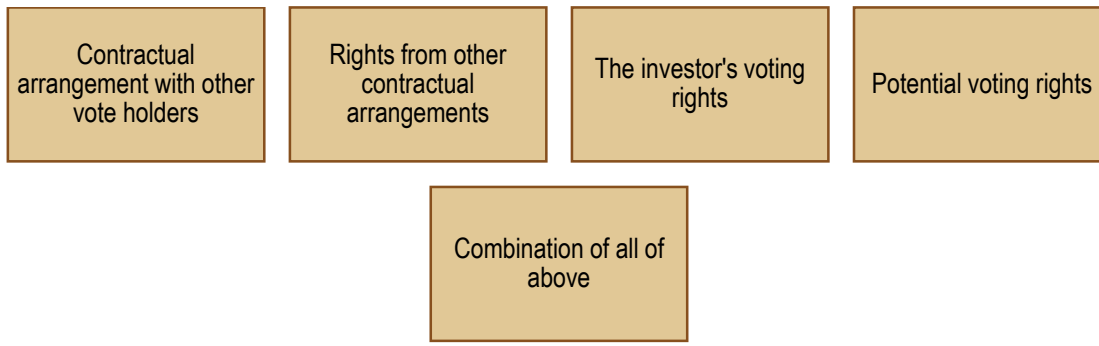
The relevant activities are directed by a vote of the holder of the majority of the voting rights	OR	A majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights

For example, in case of a company where the decisions related to relevant activities are taken by Board of Directors of the company and the Board members are appointed by shareholder holding majority of the voting rights. Then the shareholder holding majority of the voting rights has power over the company.

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B. Power without a majority of voting rights

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. Following are the examples of power without majority voting rights:



Contractual arrangement with other vote holders

An investor, who is not holding voting rights that are sufficient to given it power over the investee, may enter into a contract with other vote holders to give the investor rights to exercise voting rights which are **sufficient to have power over the investee**. In such case, the investor would direct the other vote holders on how they should vote whereby the investor gets power to direct the decision related to relevant activities.

Rights from other contractual arrangements

Apart from holding voting rights, an investor might be having decisions-making rights related to relevant activities of the investee pursuant to a contractual arrangement. Such **contractual rights in combination with voting rights** may give investor power to direct the relevant activities like manufacturing process of the investee or other operating and financing activities of the investee.

However, in the absence of any other rights, economic dependence of an investee on the investor (such as relations of a supplier with its main customer) does not lead to the investor having power over the investee.

The investor's voting rights

There may be certain situations where even though an investor is not holding majority of the voting rights, but the voting rights held by it are **sufficient to give it practical ability** to have power over the investee unilaterally. Generally, this is termed as de-facto control.

In assessing the sufficiency of the voting rights of an investor, one should consider the **size of the investor's holding of voting rights** relative to the size and dispersion of holdings of the other vote holders. This is interpreted as follows:

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Particulars	Higher number or size	Lower number or size
Number of voting rights held by investor	More likely to have power	Less likely to have power
Size of investor's voting rights relative to voting rights held by other holders	More likely to have power	Less likely to have power
Number of parties required to outvote the investor	More likely to have power	Less likely to have power

Illustration 9: Voting rights of investor are sufficient to give it power

An investor holds 45% of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. Whether the investor holding 45% voting right have power over the investee?

Solution:

On the basis of the absolute size of its holding by the investor and the relative size of the voting rights held by other shareholders, it is more likely that the investor would have power over the investee.

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Illustration 10: Voting rights of investor are sufficient to give it power

ABC Ltd. holds 40% of the voting rights of XYZ Ltd. The remaining voting rights are held by 6 other shareholders, each individually holding 10% each. Whether the investor holding 40% voting right have power over the investee?

Solution:

In this case, it is less likely that ABC Ltd. will have power over XYZ Ltd. since the size of the number of shareholders required to outvote ABC Ltd. is not so high. Additional facts and circumstances should also be considered to determine whether ABC Ltd. has power or not.

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Apart from the size of the investor's voting rights, one should also consider the i) potential voting rights held by investor or other vote holders or parties (discussed subsequently in this section) and ii) rights arising from other contractual arrangements (already discussed above) to determine whether the investor's voting rights are sufficient to give it power over the investee.

Ind AS 110 provides that when the decisions related to relevant activities of an investee are taken by **majority vote holders** and the investor holds sufficiently more voting rights compared to other vote holders and the other shareholdings are widely dispersed then it may be clear from the above

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factors i.e. i) size of the investor's voting rights, ii) potential voting rights and iii) other contractual arrangements that investor has power over the investee. In such case, there is no need to consider other factors to evaluate who has power over the investee.

- For examples, in the illustration 9 discussed above, the investor holding 45% of voting rights may, on the basis of the absolute size of its holding and the relative size of the other shareholdings, conclude it has power over the investee without the need to consider any other evidence of power.
- However, in illustration 10 above, the absolute size of the ABC Ltd.'s holding and the relative size of the other shareholdings alone are not conclusive in determining whether ABC Ltd. has power over the investee and hence additional facts and circumstances need to be considered.

When it is not clear from the three factors of sufficiency of voting rights of an investor discussed above, the investor should consider additional facts and circumstances such as the **voting patterns at previous shareholders' meetings** to determine whether investor has power over the investee.

Illustration 11: Voting patterns at previous shareholders' meetings

An investor holds 35% of the voting rights of an investee. Three other shareholders each hold 5% of the voting rights of the investee. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders' meetings — 75% of the voting rights of the investee have been cast at recent relevant shareholders' meetings.

Whether the investor's voting rights are sufficient to give it power to direct the relevant activities of the investee?

Solution:

In this case, the active participation of the other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

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Ind AS 110 provides that if it is not clear from the above factors of sufficiency of voting rights of an investor that investor has power then the investor does not control the investee.

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Potential voting rights

Potential voting rights are rights to obtain voting rights of an investee, such as those arising from **convertible instruments or options or forward contracts**. Those potential voting rights are considered only if the rights are substantive as per the guidance discussed earlier.

When considering potential voting rights, an investor shall consider the purpose and design of the instrument giving those rights as well as any other benefits that the investor would get from the exercise of those rights.

Potential voting rights are to be considered in combination with voting or other decisions-making rights that the investor might have to assess whether investor has power or not.

Illustration 12: Potential voting rights

Investor A and two other investors each hold a third of the voting rights of an investee. The investee's business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price. The conversion rights are substantive. If the debt were converted, investor A would hold 60% of the voting rights of the investee. Investor A would benefit from realising synergies if the debt instruments were converted into ordinary shares. Whether investor A has power over the investee?

Solution:

Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities.

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3.3.1.3.2 Power other than through voting rights

When voting rights cannot have a significant effect on an investee's returns, such as when voting rights relate to administrative tasks only the investor shall consider following factors to determine whether it has power over the investee:

- Purpose and design of the investee
- Contractual arrangements
- Special relation between investor and investee

Purpose and design of the investee

Evaluation of purpose and design of the investee helps in:

- identification of relevant activities of the investee,
- how decisions about the relevant activities are made,
- who has the current ability to direct those activities, and
- who receives returns from those activities.

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In assessing the purpose and design of an investee, an investor shall consider its **involvement and decisions made at the time of design of the investee** and evaluate whether such involvement provide the investor with rights that are sufficient to give it power. Being involved in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee.

Illustration 13: Purpose and design of the investee

PQR Ltd. has entered into a contract with a state government to construct a power plant and distribute the electricity generated from the plant to the households of the state. For this, PQR Ltd. has set up a new entity XYZ Ltd. PQR Ltd. was involved in the design of XYZ Ltd. The decisions related to the relevant activities of XYZ Ltd. i.e. how much electricity to generate or the price at which units of electricity to be sold to customers, etc. are not determined by the voting rights. Whether PQR Ltd. has power over XYZ Ltd.?

Solution:

PQR Ltd. was involved in the design of XYZ Ltd. Accordingly, its involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee. However, being involved in the design of XYZ Ltd. alone is not sufficient to give PQR Ltd. control over XYZ Ltd. and hence other facts and circumstances, such as other contractual arrangements, should also be considered.

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Contractual arrangements

An investor shall consider contractual arrangements such as call rights, put rights and liquidation rights that give it explicit or implicit decision-making rights that are closely related to the relevant activities of the investee even though they may occur outside the legal boundaries of the investee.

For some investees, decisions about relevant activities are required to be taken only when particular circumstances arise or events occur. The investee may be designed so that the direction of its activities and its returns are predetermined unless and until those particular circumstances arise or events occur. In this case, only those decisions that are required to be taken when those circumstances or events occur would significantly affect its returns and thus be relevant activities. However, it is not necessary for those circumstance or events to actually occur to establish that investor has power over the investee. The fact that the investor has rights to take those decisions whenever required is sufficient to establish power.

Illustration 14: Rights contingent upon future events

An investee's only business activity, as specified in its founding documents, is to purchase receivables and service them on a day-to-day basis for its investors. Following is the relevant fact pattern:

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- *The servicing on a day-to-day basis includes the collection and passing on of principal and interest payments as they fall due.*
- *Upon default of a receivable the investee automatically puts the receivable to an investor as agreed separately in an agreement between the investee and the investor.*
- *The only relevant activity is managing the receivables upon default because it is the only activity that can significantly affect the investee's returns.*
- *Managing the receivables before default is not a relevant activity because the activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them on to investors.*

Whether the investor has power over the investee?

Solution:

In this question, the design of the investee ensures that the investor has decision-making power only in case of default of a receivable. The terms of the agreement between investee and investor are integral to the overall transaction and the establishment of the investee. Therefore, the terms of the agreement together with the founding documents of the investee lead to the conclusion that the investor has power over the investee even though the investor takes ownership of the receivables only upon default and manages the defaulted receivables outside the legal boundaries of the investee.

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An investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to variability of returns and thus increase the incentive for the investor to obtain rights sufficient to give it power. Therefore, a commitment to ensure that an investee operates as designed may be an indicator that the investor has power, but does not, by itself, give an investor power, nor does it prevent another party from having power.

Illustration 15: Commitment to ensure that an investee operates as designed

A Ltd. is a manufacturer of pharmaceutical products. A Ltd. has invested in share capital of B Ltd. which is a manufacturer of packing material for pharmaceutical products. A Ltd.'s requirements of packing materials for its products are entirely supplied by B Ltd. A Ltd. is not purchasing the packing materials from any other vendors because the materials supplied by other vendors are of inferior quality. Whether A Ltd. has power over B Ltd.?

Solution:

A Ltd. would be the most affected by the operations of B Ltd. since it is dependent on B Ltd. for the supply of packing materials. Therefore A Ltd. would be committed to ensure that B Ltd. operates as designed. This can be an indicator of A Ltd. having power over B Ltd. But it has to consider other facts and circumstances as well to conclude whether it control B Ltd. or not.

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Special relation between investor and investee

Ind AS 110 recognises that the control assessment process described above will not always yield a clear conclusion. To assist in reaching a conclusion in marginal situations, the Standard includes guidance on:

- Evidence of possible power
- Indicators of possible power
- Incentives to obtain power

In some circumstances it may be difficult to determine whether an investor's rights are sufficient to give it power over an investee. In such cases, paragraph B18 of Ind AS 110 provides guidance to enable the assessment of power whereby the investor shall consider **evidence** of whether it has the **practical ability to direct** the relevant activities unilaterally. Following are some of the examples of such evidences:

Evidence	Illustration
The investor can appoint or approve the investee's key management personnel who can direct the relevant activities	An investor holds 40% of the voting rights of an investor. However, the investor has right to appoint majority of the board members of investee and the decisions of relevant activities of investee are taken by its board.
The investor can direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor	A Ltd. and B Ltd. both holds 50% each of voting rights of an investee and also have right to appoint 2 members each in board of investee. The decision of relevant activities of investee are taken in board meetings by majority members. A Ltd. also has right to appoint a chairman of the board who will have a casting vote in case of a deadlock situation.
The investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights.	X Ltd. has invested in the share capital of P Ltd. Apart from A Ltd. there are 4 other investors in P Ltd. Each investor has right to appoint one member on the board of P Ltd. who will have right to direct the relevant activities of P Ltd. Out of the 4 other investors, 2 investors are related parties of X Ltd. and hence X Ltd. can direct them to appoint their representative on the board as per X Ltd.'s choice. Accordingly, X Ltd. can appoint majority of the members of the board of P Ltd.

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The investee's key management personnel are related parties of the investor	The chief executive officer of the investee and the chief executive officer of the investor are the same person.
The majority of the members of the investee's governing body are related parties of the investor.	The majority of the board members of the investee are also the board members of the investor.

As per paragraph B19 of Ind AS 110, sometimes there will be **indications** that the investor has a special relationship with the investee, which suggests that the **investor has more than a passive interest in the investee**. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that investor has power over an investee. However, having more than a passive interest in the investee may indicate that the investor has other related rights sufficient to give it power over an investee. For example, the following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate power:

Investee's key management personnel who can direct the relevant activities are current or previous employees of the investor

Investee's operations are dependent on the investor such as in following situations:

- Dependence to fund a significant portion of its operations.
- Guarantee a significant portion of the investee's obligations.
- Dependence for critical services, technology, supplies or raw materials.
- Assets such as licences or trademarks that are critical to investee's operations are controlled by investor
- Dependence on for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations.

A significant portion of the investee's activities either involve or are conducted on behalf of the investor

Investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights.

- For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.

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Further, paragraph B20 of Ind AS 110 provides that the greater an investor's exposure, or rights, to variability of returns from its involvement with an investee, the greater is the **incentive** for the investor to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of returns is an indicator that the investor may have power. However, the extent of the investor's exposure does not, in itself, determine whether an investor has power over the investee.

When the factors set out in paragraph B18 and the indicators set out in paragraphs B19 and B20 of Ind AS 110 are considered together with an investor's rights, greater weight shall be given to the evidence of power described in paragraph B18.

3.3.2 Exposure, or rights, to variable returns from an investee

When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to 'variable returns' from its involvement with the investee.

Variable returns are returns that are not fixed and have the **potential to vary as a result of the performance of an investee**. Variable returns can be only positive, only negative or both positive and negative. It should be noted that the term used is 'returns' and not 'benefits' which are often interpreted as implying only positive returns.

An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the **substance of the arrangement** and regardless of the legal form of the returns.

- For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of control evaluation because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (i.e. how variable those returns are) depends on the credit risk of the bond.
- Similarly, fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee.
- However, a non-refundable income received from the investee which is not impacted by the credit risk or performance of the investee can be considered as a fixed return.

It must also be noted that the term 'returns' includes within its scope both (a) direct returns (which are mostly financial returns), as well as (b) synergistic returns, which are more indirect.

Following are some of the examples of variable returns:

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Variable returns from an investee		
Dividends, other distributions of economic benefits from an investee (eg interest from debt securities) Changes in the value of the investor's investment in that investee.	- Remuneration for servicing an investee's assets or liabilities - Fees and exposure to loss from providing credit or liquidity support - Residual interests in the investee's assets and liabilities on liquidation - Tax benefits - Access to future liquidity	Returns that are not available to other interest holders For example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other

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).

Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, holders of non-controlling interests can share in the profits or distributions of an investee.

Reputational risk

During the financial crisis, some financial institutions provided funding or other support to securitisation or investment vehicles because they established or promoted those vehicles. Rather than allowing them to fail and facing a loss of reputation, the financial institutions stepped in, and in some cases took control of the vehicles. Having reputational risk in isolation is not an appropriate basis for consolidation. The term 'reputational risk' relates to the risk that failure of an investee would damage an investee's reputation and, therefore, that of an investor or sponsor, compelling the investor or sponsor to provide support to an investee in order to protect its reputation, even though the investor or sponsor has no legal or contractual requirement to do so.

Reputational risk is part of an investor's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. Therefore, when assessing control, reputational risk is a factor to consider along with other facts and circumstances. It is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor power over an investee.

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3.3.3 Link between power and returns

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.

Thus, an investor with decision-making rights shall **determine whether it is a principal or an agent**. An investor shall also determine whether another entity with decision-making rights is acting as an agent for the investor. An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)). An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

An investor may delegate its decision-making authority to an agent on some specific issues or on all relevant activities. When assessing whether it controls an investee, the investor shall treat the decision-making rights delegated to its agent as held by the investor directly.

A decision maker shall consider the overall **relationship between itself, the investee being managed and other parties involved** with the investee, in particular all the factors below, in determining whether it is an agent:

The scope of the decision-making authority	Rights held by other parties	Remuneration from the investee	Exposure to variable returns from other interests in the investee

Different weightings shall be applied to each of the factors on the basis of particular facts and circumstances.

The scope of the decision-making authority

The scope of a decision maker's decision-making authority is evaluated by considering:

(a) the activities that are permitted according to the decision-making agreement(s) and specified by law, and

(b) the discretion that the decision maker has when making decisions about those activities.

A decision maker shall consider the purpose and design of the investee, the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved and the level of involvement the decision maker had in the design of an investee. For example, if a decision maker is significantly involved in the design of the investee (including in determining the scope of decision-making authority), that involvement may indicate that the decision maker had the opportunity and incentive to obtain rights that result in the decision maker having the ability to direct the relevant activities.

Rights held by other parties

Substantive removal or other rights may indicate that the decision maker is an agent.

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Removal rights

Removal rights are rights to deprive the decision-maker of its decision-making authority.

The removal rights held by other should be considered as follows:

Single party holds substantive removal rights and can remove the decision maker **without cause**, this, in isolation, is **sufficient to conclude** that the decision maker is an **agent**.

If **more than one party holds such rights** (and no individual party can remove the decision maker without the agreement of other parties) those rights are **not, in isolation, conclusive** in determining that a decision maker is an agent.

The **greater the number of parties** required to act together to exercise removal rights and the **greater the magnitude** of, and variability associated with, the decision maker's **other economic interests** (ie remuneration and other interests), the **less the weighting** that shall be placed on removal rights.

Other substantive rights

If other parties hold substantive rights that can restrict the decision maker from exercising its discretion shall be considered in similar manner to removal right when evaluating whether the decision maker is an agent.

For example, a decision maker that is required to obtain approval from a small number of other parties for its actions is generally an agent.

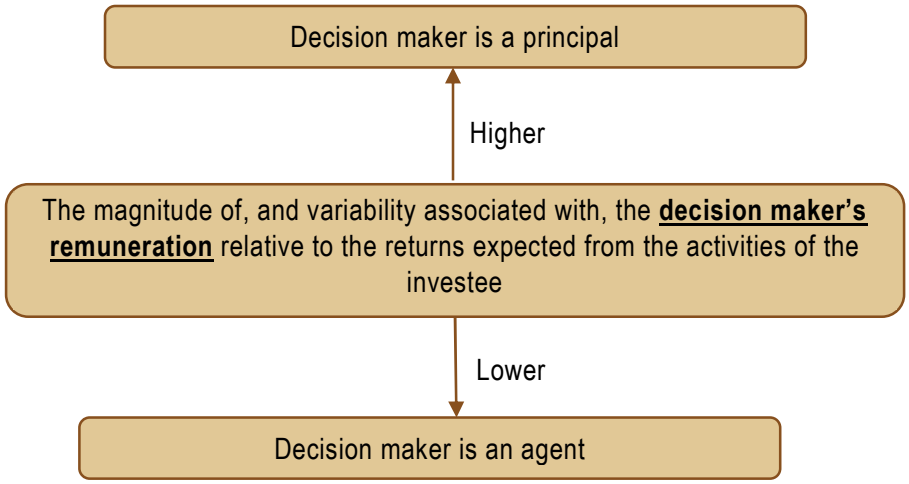
Consideration of the rights held by other parties shall include an assessment of any rights exercisable by an investee's board of directors (or other governing body) and their effect on the decision-making authority.

For example, if board of directors (which is appointed by other investors) of an investee has right to remove the decision maker without cause than the decision maker is an agent.

Remuneration from the investee

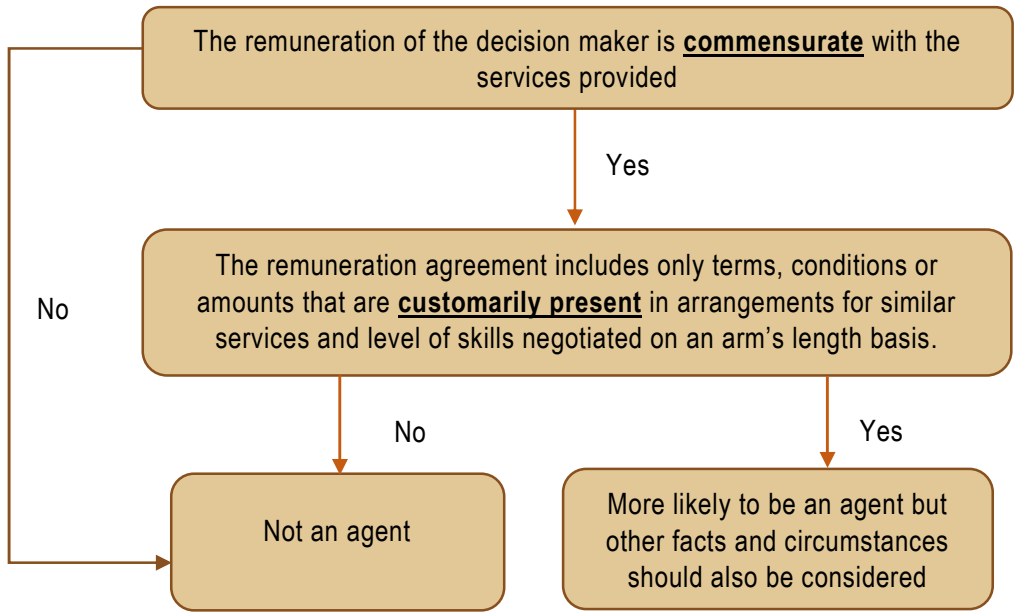
The relationship between the remuneration of a decision maker and it being an agent is explained below:

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For example, if a variation in investee's returns by 1% causes variation in decision maker's remuneration from investee by less than 1% then the decision maker can be an agent. However, if a variation in investees returns by 1% causes variation in decision maker's remuneration from investee by more than 1% then the decision maker can be a principal.

Further, in determining whether it is a principal or an agent the decision maker shall also consider following conditions:



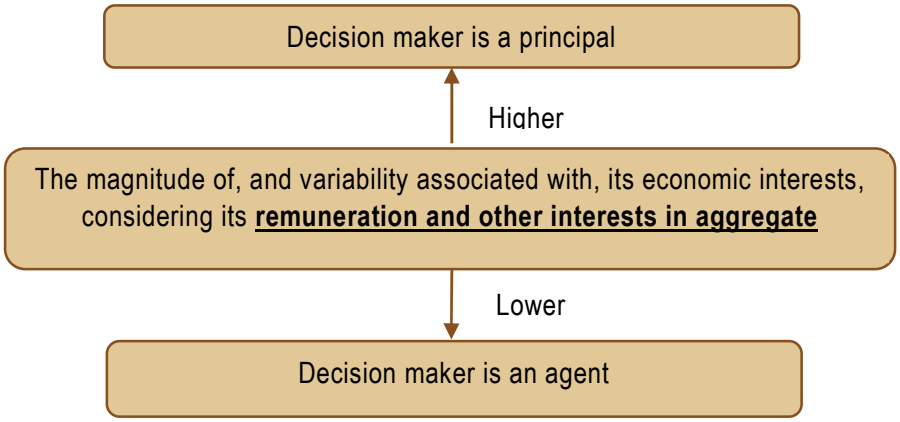
Exposure to variable returns from other interests in the investee

A decision maker that holds other interests in an investee (like investments in the investee or provides guarantees with respect to the performance of the investee), shall consider its exposure

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to variability of returns from those interests in assessing whether it is an agent. **Holding other interests in an investee indicates that the decision maker may be a principal.**

In evaluating the exposure to variability of returns, the decision maker shall consider the magnitude of variability as follows:



It is to be noted that here the decision maker needs to consider the remuneration and other interests in aggregate. Hence, even though in case the decision maker had concluded in the initial assessment about remuneration that it is an agent, it needs to again consider remuneration in the assessment of exposure to variable returns.

Apart from the magnitude of exposure to variable returns, decision maker shall also consider whether its exposure to **variability of returns is different from that of the other investors**. If yes, then whether this might influence its actions. **For example,** this might be the case when a decision maker holds subordinated interests in, or provides other forms of credit enhancement to, an investee.

The decision maker shall evaluate its **exposure relative to the total variability** of returns of the investee. This evaluation is made primarily on the basis of returns expected from the activities of the investee but **shall not ignore** the decision maker's **maximum exposure to variability** of returns of the investee through other interests that the decision maker holds.

For example, if a variation in investees returns by 1% causes variation in decision maker's returns from investee by less than 1%. However, a variation in investee's returns by ₹ 100 causes variation in decision maker's returns from investee by ₹ 150 because of significant variation in the market price of the equity shares of the investee.

Illustration 16: Link between power and returns

A decision maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to investors as an investment in a

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diversified portfolio of equity securities of publicly traded entities. Following is the relevant fact pattern related to fund manager:

- *Within the defined parameters, the fund manager has discretion about the assets in which to invest.*
- *The fund manager has made a 10% pro rata investment in the fund and receives a market-based fee for its services equal to 1% of the net asset value of the fund.*
- *The fees are commensurate with the services provided.*
- *The fund manager does not have any obligation to fund losses beyond its 10% investment.*

The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that would affect the decision-making authority of the fund manager but can redeem their interests within particular limits set by the fund.

Whether the fund manager controls the fund?

Solution:

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund — the investors do not hold substantive rights that could affect the fund manager's decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a pro rata investment in the fund. The remuneration and its investment expose the fund manager to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

In this case, consideration of the fund manager's exposure to variability of returns from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

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Illustration 17: Link between power and returns

A decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided.

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager

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is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal.

The above fact pattern and analysis applies to various scenarios described below. Each scenario is considered in isolation. Determine whether the fund manager control the fund?

Scenario A

The fund manager also has a 2% investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2% investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Scenario B

The fund manager has a more substantial pro rata investment in the fund but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Scenario C

The fund manager has a 20% pro rata investment in the fund but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Solution:

Scenario A

The fund manager's 2% investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. In this example, although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Scenario B

In this scenario, the other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund

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manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal.

For example, having considered its remuneration and the other factors, the fund manager might consider a 20% investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e. if the remuneration or other factors are different), control may arise when the level of investment is different.

Scenario C

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20% investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager — the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In this scenario, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

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Illustration 18: Link between power and returns

An investee is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual returns of the investee.

The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio.

On formation, the equity instruments represent 10% of the value of the assets purchased. A decision maker (the asset manager) manages the active asset portfolio by making investment decisions within the parameters set out in the investee's prospectus. For those services, the asset manager receives a market-based fixed fee (i.e. 1% of assets under management) and performance-related fees (i.e. 10% of profits) if the investee's profits exceed a specified level.

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The fees are commensurate with the services provided. The asset manager holds 35% of the equity in the investee. The remaining 65% of the equity, and all the debt instruments, are held by a large number of widely dispersed unrelated third-party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

Does the asset manager control the investee?

Solution:

The asset manager is paid fixed and performance-related fees that are commensurate with the services provided. The remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund. The asset manager has exposure to variability of returns from the activities of the fund because it holds 35% of the equity and from its remuneration.

Although operating within the parameters set out in the investee's prospectus, the asset manager has the current ability to make investment decisions that significantly affect the investee's returns -the removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the fund from its equity interest, which is subordinate to the debt instruments. Holding 35% of the equity creates subordinated exposure to losses and rights to returns of the investee, which are of such significance that it indicates that the asset manager is a principal. Thus, the asset manager concludes that it controls the investee.

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Following table summarises the above illustrations on link between power and returns by highlighting each of the factors for evaluating link between power and returns:

<table>
<tr><th>Illustration</th><th>Scope of the decision-making authority</th><th>Removal rights held by others</th><th>Remuneration from the investee</th><th>Variable returns from other interests</th><th>Conclusion</th></tr>
<tr><td>16</td><td>Narrowly defined</td><td>No such rights</td><td>1% of the net asset value of the fund</td><td>10% investment in the fund</td><td>Agent</td></tr>
<tr><td>17 (A)</td><td rowspan="2">Extensive decision-making authority</td><td rowspan="2">Removal for cause by simple majority</td><td rowspan="2">1% of assets under management and 20% of all the fund's</td><td>2% investment in the fund</td><td>Agent</td></tr>
<tr><td>17 (B)</td><td>20% investment in the fund</td><td>Principal</td></tr>
</table>

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17 (C)		Removal without cause by board	profits if a specified profit level is achieved	20% investment in the fund	Agent
18	Decisions within the parameters set out in the investee's prospectus	Removal without cause by simple majority of widely dispersed investors	1% of assets under management and 10% of profits if the profits exceed a specified level	35% of equity in the investee	Principal

Illustration 19: Link between power and returns

A decision maker (the sponsor) sponsors a fund, which issues short-term debt instruments to unrelated third-party investors. The transaction was marketed to potential investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. Various transferors sell high quality medium-term asset portfolios to the fund. Each transferor services the portfolio of assets that it sells to the fund and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralisation of the assets transferred to the fund. The sponsor establishes the terms of the fund and manages the operations of the fund for a market-based fee. The fee is commensurate with the services provided. The sponsor approves the sellers permitted to sell to the fund, approves the assets to be purchased by the fund and makes decisions about the funding of the fund. The sponsor must act in the best interests of all investors.

The sponsor is entitled to any residual return of the fund and also provides credit enhancement and liquidity facilities to the fund. The credit enhancement provided by the sponsor absorbs losses of up to 5% of all of the fund's assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor. Whether the sponsor has control over the fund?

Solution:

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of returns from the activities of the fund because of its rights to any residual returns of the fund and the provision of credit enhancement and liquidity facilities (i.e. the fund is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the fund, the sponsor has extensive decision-

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making authority that gives it the current ability to direct the activities that most significantly affect the fund's returns (i.e. the sponsor established the terms of the fund, has the right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the fund (for which new investment must be found on a regular basis)). The right to residual returns of the fund and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of returns from the activities of the fund that is different from that of the other investors. Accordingly, that exposure indicates that the sponsor is a principal and thus the sponsor concludes that it controls the fund. The sponsor's obligation to act in the best interest of all investors does not prevent the sponsor from being a principal.

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3.4 RELATIONSHIP WITH OTHER PARTIES

When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor's behalf i.e. they are **'de facto agents'** of the investor. The determination of whether other parties are acting as de facto agents requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor.

A de factor agent relationship **does not require a contractual arrangement** between the investor and the de facto agent.

A party is a de facto agent when the investor has, or those that direct the activities of the investor have, the **ability to direct that party** to act on the investor's behalf.

An investor shall consider its de facto agent's decision-making rights and its indirect exposure, or rights, to variable returns through the de facto agent **together with its own** when assessing control of an investee.

Further, having a de facto agent does not necessarily mean that the investor controls the investee. The investor still needs to perform the control evaluation as per the detailed guidance discussed above.

When assessing control, an investor would consider its de facto agent's decision-making rights and exposure (or rights) to variable returns together with its own as if the rights were held by the investor directly.

Example 5

An investor holds 30% voting powers in an investee. One of the fellow subsidiaries of the investor also holds 30% voting powers of the investee. If the investor believes that if has the ability to direct the fellow subsidiary to act on behalf of the investor while exercising its voting rights, then the investor may conclude that the fellow subsidiary is a de facto agent of the investor. Accordingly, investor would be able to control the investee with ability to use 60% of the voting

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rights. However, in case the fellow subsidiary holds just 10% voting rights of the investee then the investor would not be able to control the investee with just 40% voting rights (30% held by investor itself and 10% owned by de facto agent).

Following are the examples of other parties that, by the nature of their relationship, might act as de facto agents for the investor:

- Investor's related parties
- A party that received its interest in the investee as a contribution or loan from the investor
- A party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except in case investor and other party have right of prior approval and rights are based on mutually agreed terms)
- A party that cannot finance its operations without subordinated financial support from the investor
- Investee for which the majority of the members of board or similar body are the same as those of the investor
- A party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

Parties mentioned above are not necessarily de facto agents of the investor. However, the investor needs to evaluate whether the parties following in the above categories are the de facto agents or not.

3.5 CONTROL OF SPECIFIED ASSETS

An investor shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity. A deemed separate entity is often called a **'silo'**.

An investor shall treat a portion of an investee as a deemed separate entity if and only if the following condition is satisfied:

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Determination of whether a portion of an investee is a deemed separate entity		
Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee.	Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets.	In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

Thus, in substance, all the assets, liabilities and equity of that deemed separate entity are **ring-fenced** from the overall investee.

For example, an investee is a mutual fund and under the investee there are multiple sub-funds established with different investment objectives like debt-oriented funds, equity-oriented funds, etc. In such case, an assessment should be made as to whether the sub-funds are deemed separate entities as per the conditions mentioned above.

When the conditions mentioned above are satisfied, an investor shall assess **whether it controls the silo** by applying the guidance of control evaluation i.e. whether the investor has power over the silo, exposure or rights to variable returns from involvement with silo and whether it can use that power to affect the returns of the silo.

If the investor controls the silo, the investor shall consolidate that silo. In that case, other parties exclude that silo when assessing control of, and in consolidating, the investee.

For example, continuing with the above example on identification of a silo, if one of the sub-funds is treated as a silo then the investor that controls that silo will consolidate that sub-fund. Other parties who control other sub-funds will exclude the sub-fund controlled by the investor in their control evaluation and consolidation.

3.6 CONTINUOUS ASSESSMENT

An investor shall reassess whether it controls an investee **if facts and circumstances indicate that there are changes** to one or more of the three elements of control i.e. power, exposure or rights to variable returns and link between power and variable returns.

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An investor should reassess the control over an investee in following situations:

Situation	Example
A change in how power over an investee can be exercised	Changes to decision-making rights whereby the relevant activities are no longer directed through voting rights, but instead other agreements, like contracts, give another party or parties power over the investee
An event can cause an investor to gain or lose power over an investee without the investor being involved in that event	An investor can gain power over an investee because decision-making rights held by another party or parties that previously prevented the investor from controlling an investee have lapsed
Changes affecting exposure, or rights, to variable returns from involvement with an investee	An investor that has power over an investee can lose control of an investee if the investor ceases to be entitled to receive variable returns or to be exposed to obligations (e.g. if a contract to receive performance-related fees is terminated).
Assessment to act as an agent or principal has changed. Changes in the overall relationship between the investor and other parties can mean that an investor no longer acts as an agent, even though it has previously acted as an agent, and vice versa.	If changes to the rights of the investor, or of other parties, occur, the investor shall reconsider its status as a principal or an agent.

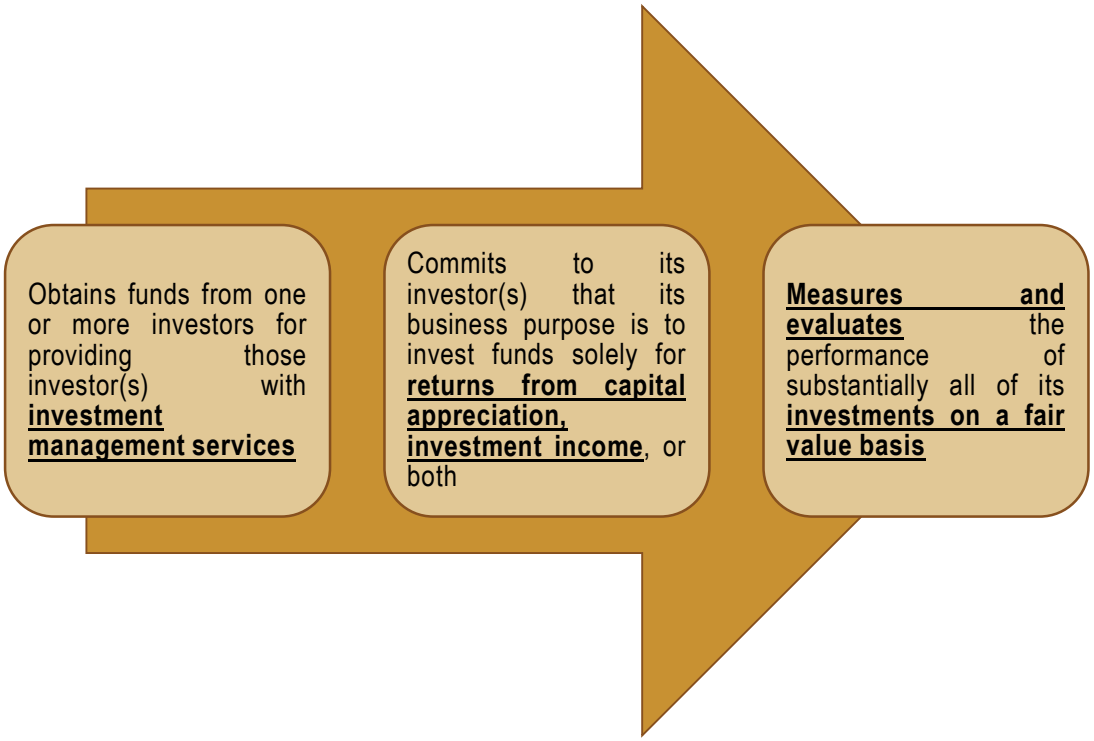
An investor's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (e.g. a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control or changes the overall relationship between a principal and an agent.

3.7 INVESTMENT ENTITIES

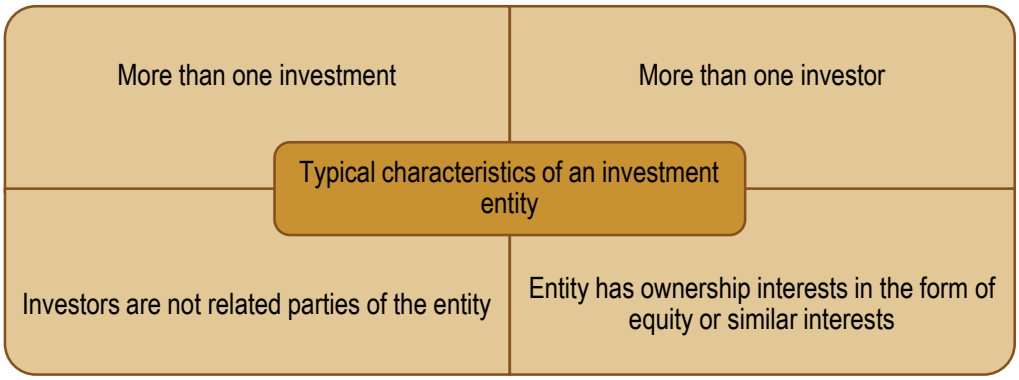
3.7.1 Determining whether an entity is an investment entity

A parent shall determine whether it is an investment entity. An entity is an investment entity if it fulfils **all the following conditions**:

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In assessing whether an entity meets the definition of investment entity as above, the entity shall consider whether it has the following typical characteristics of an investment entity:



The absence of one or more of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity but indicates that additional judgement is required in determining whether the entity is an investment entity.

If facts and circumstances indicate that there are **changes** to one or more of the three elements that make up the definition of an investment entity or the typical characteristics of an investment entity, a parent shall **reassess whether it is an investment entity**.

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Following is the detailed discussion on two of the three elements of the definition of an investment entity (business purpose and fair value measurement) and the typical characteristics of an investment entity. As regards the first element, i.e. provision of investment management services, that essentially differentiates an investment entity from other entities.

3.7.1.1 Business Purpose

The definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both.

Documents or other evidence that indicate the entity's investment objectives are include:

- offering memorandum of the entity
- publications distributed by the entity and other corporate
- partnership documents of the entity
- manner in which the entity presents itself to other parties (such as potential investors or potential investees)

For example, an entity may present its business as providing medium-term investment for capital appreciation. In contrast, an entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees has a business purpose that is inconsistent with the business purpose of an investment entity, because the entity will earn returns from the development, production or marketing activity as well as from its investments.

Apart from the business purpose of investing for capital appreciation and investment income, an **investment entity may provide investment-related services** (e.g. investment advisory services, investment management, investment support and administrative services), to third parties as well as to its investors, even if those activities are substantial to the entity, subject to the entity continuing to meet the definition of an investment entity.

An investment entity may also participate in the following **investment-related activities** if these activities are **undertaken to maximise the investment return** (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity:

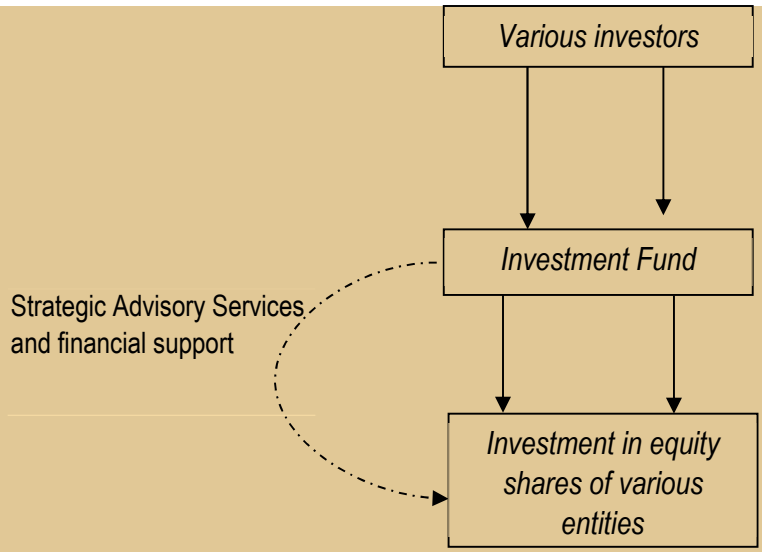
a) providing management services and strategic advice to an investee; and

b) providing financial support to an investee, such as a loan, capital commitment or guarantee.

Illustration 20: Business purpose of an investment entity

An asset manager has set up and investment fund for the purpose of acquiring capital contributions from various investors (by issuing them units in the fund) and investing those contributions in the equity share capital of various entities for the purpose of earning capital appreciation on those investments. Following is the existing structure of the fund.

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Apart from the investments in various entities, the investment fund also provides its investee the strategic advisory services so that it can result in increase in the capital appreciation from investments in those investees. It also provides its investees financial support in the form of loan to provide them with funds for acquiring capital assets. The investment fund does not hold such investments for a period longer than 5 years. The investment fund measures and evaluate the performance of the investments on fair value basis.

Whether the investment fund can be treated as an investment entity?

Solution:

Out of the three elements of the definition of an investment entity, the investment fund fulfils the two elements very clearly i.e. it obtains fund from more than one investor for providing investment management services and measures and evaluates its investments on fair value basis.

The typical characteristics of an investment entity are also present in the structure of the investment fund i.e. more than one investment, more than one investor, investors are unrelated and investment fund issues units in the fund to the investors.

With respect to the business objective of the investment fund, the objective is to earn capital appreciation from its investments. The strategic advisory services and financial support provided to investees are extended with the intention of earning higher capital appreciation from the investees. However, judgement should to be applied that these do not represent substantial business activity or a separate substantial source of income for the investment fund. If the investment fund concludes that these services and financial support to investees are not substantial business activity and substantial source of income for the investment fund, then only the investment fund can be treated as an investment entity.

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3.7.1.2 Exit strategies

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 realise capital appreciation from substantially all of its equity investments and non-financial asset investments.

An investment entity shall also have an exit strategy for any debt instruments that have the potential to be held indefinitely, for example perpetual debt investments. The entity need not document specific exit strategies for each individual investment but shall identify different **potential strategies for different types or portfolios of investments**, including a substantive time frame for exiting the investments. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.

Exit strategies can vary by type of investment.

- **For investments in private equity securities**, examples of exit strategies include an initial public offering, a private placement, a trade sale of a business, distributions (to investors) of ownership interests in investees and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee).
- **For equity investments that are traded in a public market**, examples of exit strategies include selling the investment in a private placement or in a public market.
- **For real estate investments**, an example of an exit strategy includes the sale of the real estate through specialized property dealers or the open market.

An investment entity may have an **investment in another investment entity** that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the **investment entity investor need not have an exit strategy** for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.

Illustration 21: Exit strategies of an investment entity

ABC Ltd. Is established with primary objective of investing in the equity shares of various entities across various industries based on the detailed research about each industry and entities within that industry being done by the investment manager of the company.

The investment manager decides the timing as to when the investments should be made considering the current market situation. Sometimes, the investment manager decides to invest the idle funds into short-term to medium-term debt instruments with fixed maturity. The exit strategies are in place for the investments done in equity shares but the same is not there for investments done in debt instruments.

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Determine whether the entity fulfils the exit strategy condition of being classified as investment entity?

Solution:

The exit strategies are in place for investments done in equity shares. But not in place for investments done in debt instruments. However, it should be noted that the debt instruments have fixed maturity period and they cannot be held for indefinite period. Hence, there is no need for having exit strategies for such instruments. Accordingly, the exit strategy condition is fulfilled for being classified as investment entity.

*****

3.7.1.3 Earnings from investments

To be an investment entity, an entity must commit to its investors that its business purpose is to invest funds solely for **returns from capital appreciation, investment income**, or both.

An entity is **not an investment entity if** the entity, or another member of the group containing the entity **obtains**, or has the objective of obtaining, **other benefits from the entity's investments** that are not available to other parties unrelated to the investee.

Such other benefits include following:

Acquisition, use, exchange or exploitation of the **processes, assets or technology of an investee**. This would include the entity or another group member having disproportionate, or exclusive, rights to acquire assets, technology, etc. of any investee

Joint arrangements or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services;

Financial guarantees or assets provided by an investee for borrowing arrangements of the entity or another group member (however, an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings)

An **option held by a related party** of the entity **to purchase**, from that entity or another group member, an **ownership interest** in an investee of the entity;

Transactions (except as mentioned in next paragraph) between the entity or another group member and an investee that are

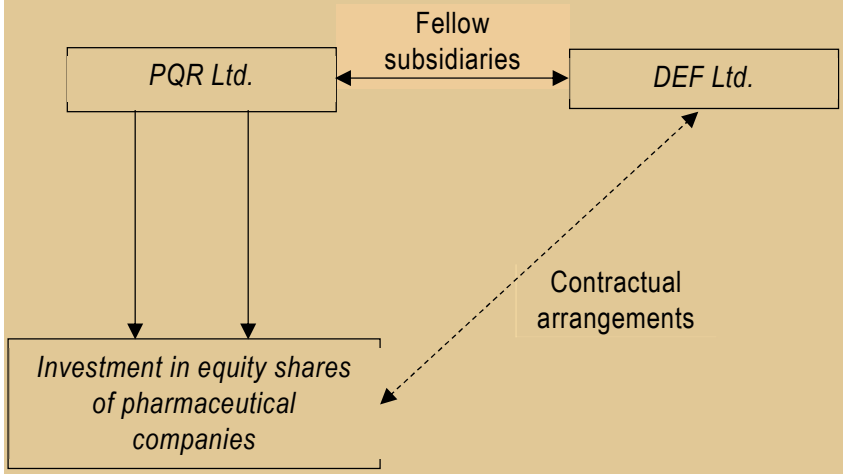
- on terms that are unavailable to unrelated parties; or
- not at fair value; or
- represent a substantial portion of the investee's or the entity's or other group entities' business

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An investment entity may have a strategy to invest in more than one investee in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income from those investees. An entity is not disqualified from being classified as an investment entity merely because such investees trade with each other.

Illustration 22: Earnings from investments of an investment entity

PQR Ltd. is established with primary objective of investing in the equity shares of various pharmaceutical companies which are involved in the research and development of medicine for a critical illness. DEF Ltd. is a fellow subsidiary of PQR Ltd. and DEF Ltd. has entered into contractual arrangements with all the investees of PQR Ltd. that in case they are successful in developing the medicine then they will transfer the patent and distribution rights for that medicine to DEF Ltd. at less then market price. This arrangement is explained in following diagram:



Determine whether PQR Ltd. can be classified as investment entity?

Solution:

PQR Ltd. and DEF Ltd. are part of same group. Further, DEF Ltd. have exclusive right to acquire the patent and distributions rights from the investees of PQR Ltd. and that too at less than the market price. Hence, the related party of PQR Ltd. is in position to obtain benefits other than capital appreciation and investment income from the investees that are not available to other parties unrelated to the investee. Accordingly, PQR Ltd. cannot be classified as investment entity.

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3.7.1.4 Fair value measurement

An essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis, because **using fair value results in more relevant information** than, for example, consolidating its subsidiaries or

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using the equity method for its interests in associates or joint ventures. In order to demonstrate that it meets this element of the definition, an investment entity:

Provides investors with **fair value information and measures substantially all of its investments at fair value** whenever fair value is required or permitted in accordance with Ind ASs	AND	**Reports fair value information** internally to the entity's key management personnel, who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

In order to meet the requirement of measuring investments at fair value, an investment entity would:

a) elect the exemption from applying the equity method in Ind AS 28 for its investments in associates and joint ventures (exemptions from applying the equity method is discussed in detail in unit 6); and

b) measure its financial assets at fair value using the requirements in Ind AS 109.

An investment entity may have some non-investment assets, such as a 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**.

3.7.1.5 More than one investment

An investment entity **typically holds several investments** to diversify its risk and maximise its returns. An entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments.

There may be times when the entity holds a single investment. However, **holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity**. For example, an investment entity may hold only a single investment when the entity:

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is in its **start-up period** and has not yet identified suitable investments and, therefore, has not yet executed its investment plan

has **not yet** made other investments to **replace those it has disposed** of

is **established to pool investors' funds** to invest in a single investment when that investment is unobtainable by individual investors (e.g. when the required minimum investment is too high for an individual investor)

is in the process of **liquidation**

3.7.1.6 More than one investor

An investment entity would have **several investors who pool their funds** to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income.

Alternatively, an investment entity may be formed by, or for, a **single investor that represents or supports the interests of a wider group of investors** (e.g. a pension fund, government investment fund or family trust).

There may also be times when the entity temporarily has a single investor. For example, an **investment entity may have only a single investor** when the entity:

(a) is within its **initial offering period**, which has not expired and the entity is actively identifying suitable investors;

(b) has not yet **identified suitable investors to replace ownership interests** that have been redeemed; or

(c) is in the process of **liquidation**

3.7.1.7 Unrelated investors

An investment entity has **several investors that are not related parties** of the entity or other members of the group containing the entity. Having unrelated investors would make it **less likely** that the entity, or other members of the group containing the entity, would **obtain benefits other than capital appreciation or investment income.**

However, an entity may still qualify as an investment entity even though its investors are related to the entity.

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For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

3.7.1.8 Ownership interests

An investment entity is typically, but is not required to be, a separate legal entity. Ownership interests in an investment entity are typically in the form of **equity or similar interests** (e.g. partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. However, **having different classes of investors**, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, **does not preclude an entity from being an investment entity**.

Example 6

An entity has issued two types of equity shares to its investors i.e. class A shares and class B shares. Holders of class A shares are entitled to receive 10% of the profits of the entity at the end of each year. After distribution of such amount, the balance amount is distributed proportionately between holders of class A shares and class B shares. Such method of distribution of profits to shareholders would not preclude the entity from being an investment entity if other conditions are satisfied.

In addition, an entity that has significant **ownership interests in the form of debt** that, in accordance with other applicable Ind AS, does not meet the definition of equity, may still qualify as an investment entity, **provided that the debt holders are exposed to variable** returns from changes in the fair value of the entity's net assets.

Example 7

An entity has issued compulsorily convertible bonds with fixed interest payments to the investors. Such bonds are convertible into variable numbers of equity shares and hence classified as financial liability in accordance with Ind AS 32 *'Financial Instruments: Presentation'*. The compulsorily convertible bonds expose the investors to variable returns because after conversion, the investors will have rights in the net assets of the entity which is dependent on the fair value of investments done by the entity.

3.7.2 Exemptions to investment entities

An investment entity **shall**

- **not consolidate its subsidiaries** or apply Ind AS 103 *'Business Combinations'* when it obtains control of another entity; **and**
- **measure an investment in a subsidiary at fair value through profit or loss** in accordance with Ind AS 109.

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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 Ind AS 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. This is explained in following diagram form:

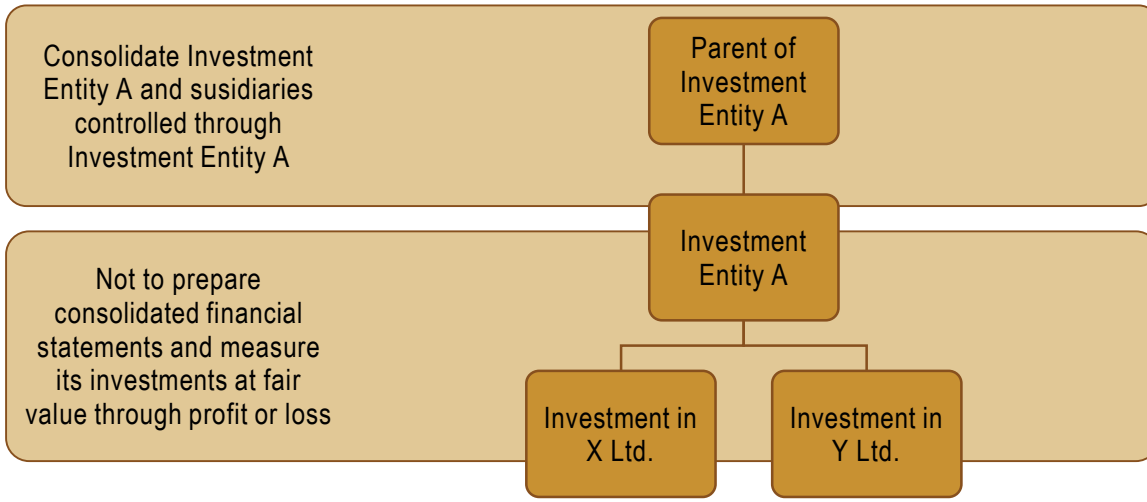


Illustration 23

HTF Ltd. was formed by T Ltd. to invest in technology start-up companies for capital appreciation. T Ltd. holds 70 percent interest in HTF Ltd. and controls HTF Ltd. The other 30 percent ownership interest in HTF Ltd. is owned by 10 unrelated investors. T Ltd. holds options to acquire investments held by HTF Ltd., at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of T Ltd. No plans for exiting the investments have been identified by HTF Ltd. HTF Ltd. is managed by an investment adviser that acts as agent for the investors in HTF Ltd.

Determine whether HTF Ltd. is an investment entity or not.

Solution:

Even though HTF Ltd.'s business purpose is investing for capital appreciation and it provides investment management services to its investors, HTF Ltd. is not an investment entity because of the following arrangements and circumstances:

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(a) T Ltd., the parent of HTF Ltd. holds options to acquire investments in investees held by HTF Ltd. if the assets developed by the investees would benefit the operations of T Ltd. This provides a benefit in addition to capital appreciation or investment income; and

(b) the investment plans of HTF Ltd. do not include exit strategies for its investments, which are equity investments. The options held by T Ltd. are not controlled by HTF Ltd. and do not constitute an exit strategy.

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UNIT 4:
CONSOLIDATION PROCEDURE FOR SUBSIDIARIES

4.1 OVERVIEW

The consolidated financial statement includes following:

- Consolidated balance sheet
- Consolidated statement of profit and loss
- Consolidated statement of changes in equity
- Consolidated cash flow statement
- Consolidated notes to the financial statements

When a company is required to prepare consolidated financial statements, the company shall mutatis mutandis follow the requirements of Division II of Schedule III to the Companies Act, 2013 as applicable to a company in the preparation of balance sheet, statement of changes in equity and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Ind AS. In addition, the company shall disclose additional information as required by Ind AS 27 and Ind AS 112 (Refer Unit 8).

4.2 CONSOLIDATION PROCEDURE FOR SUBSIDIARIES

Consolidation of an investee shall begin **from the date the investor obtains control** of the investee and cease when the investor loses control of the investee.

Following are the key concepts relating to preparation of consolidated financial statements:

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Calculation of goodwill / capital reserve and determination of non-controlling interest on the date of acquisition of control over a subsidiary
Calculation of goodwill / capital reserve when the interest in subsidiary is acquired on different dates (i.e. step acquisition)
How to account for control obtained over a subsidiary without transfer of consideration?
Requirement to have uniform accounting policies
How the income and expense of a subsidiary should be measured for while consolidating them in the parent's consolidated financial statements?
How the potential voting rights held in subsidiary should be accounted?
How to deal with different reporting periods of parent and subsidiary?
Dividend from subsidiary: How to account for it and its impact on non-controlling interest?
Requirement to eliminate intra-group transaction and elimination of unrealised profit / loss
Allocating share in profit / loss to non-controlling interest and accounting of change in the proportion held by controlling and non-controlling interests
Preparation of consolidated financial statements using all the above principles
How to account for chain-holding under consolidation?

Each of the above concepts are explained in detail below. When a parent loses control over a subsidiary, it will stop consolidating that subsidiary. The principles of accounting in case of loss of control over a subsidiary are discussed in section 4.3 below.

4.2.1 Calculation of goodwill / capital reserve and determination of non-controlling interest on the date of acquisition of control over a subsidiary

The guidance related to calculation of goodwill / capital reserve on acquisition of a subsidiary is provided in **Ind AS 103** *'Business Combinations'*. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

Calculation of goodwill

An entity that acquires interest in a subsidiary shall recognise goodwill on the acquisition date. Goodwill is measured as the **excess of (a) over (b)** below:

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a) The aggregate of

   a. the consideration transferred measured in accordance with Ind AS 103, which generally requires acquisition-date fair value; and

   b. the amount of any non-controlling interest in the acquiree measured in accordance with Ind AS 103;

   c. in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree

b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with Ind AS 103. (Ind A S103 requires the net assets acquired to be measured at fair value except in case of a common control business combination transaction. Such transaction is explained in more detail in chapter 13).

Calculation of capital reserve

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the amount in b) mentioned above exceeds the aggregate of the amounts specified in a) above. If that excess remains after applying certain requirements of paragraph 36 of Ind AS 103, then the acquirer shall recognise the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve. The gain shall be attributed to the acquirer. In all other cases, the excess of b) over a) above shall be recognised directly in equity as a capital reserve.

Measurement of non-controlling interest

Non-controlling interest is the equity **not attributable, directly or indirectly, to a parent**.

Non-controlling interest in the acquiree are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation.

For each business combination, the acquirer shall **measure at the acquisition date** components of non-controlling interest that give the holder ownership interest in the acquiree at either:

a) Fair value or

b) The present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets

Summary of calculation of goodwill / capital reserve

To summarise, following steps are involved in calculation of goodwill / capital reserve:

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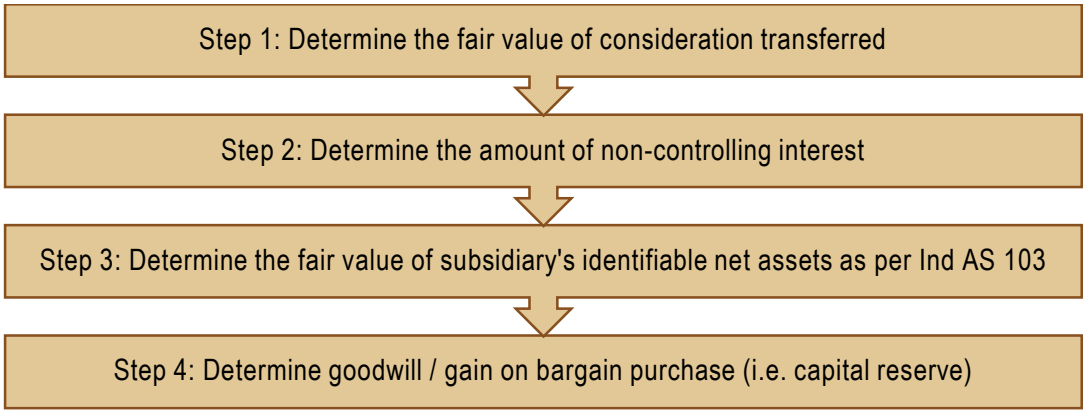


Illustration 1: Determination of goodwill

A Limited acquires 80% of B Limited by paying cash consideration of ₹ 120 crore. The fair value of non-controlling interest on the date of acquisition is ₹ 30 crore. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 130 crore. Determine the value of goodwill and pass the journal entry.

Solution:

The amount of non-controlling interest can be measured as per i) Fair value method or ii) Proportionate share method (i.e. proportionate share in the net identifiable assets of the acquiree). The value of goodwill will be different under both the methods. The goodwill is calculated as per both the methods below:

Fair value method	**₹ crore**
Fair value of consideration transferred	120
Fair value of non-controlling interest	30
	150
Value of subsidiary's identifiable net assets as per Ind AS 103	(130)
Goodwill	**20**
Proportionate share method	**₹ crore**
Fair value of consideration transferred	120
Proportional share of non-controlling interest in the net identifiable assets of acquiree (130 x 20%)	26
	146
Value of subsidiary's identifiable net assets as per Ind AS 103	(130)
Goodwill	**16**

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Journal Entries

Fair value method		₹ crore	
		Dr.	Cr.
Net identifiable assets	Dr.	130	
Goodwill	Dr.	20	
To Cash			120
To Non-controlling interest			30
Proportionate share method		**₹ crore**	
		Dr.	Cr.
Net identifiable assets	Dr.	130	
Goodwill	Dr.	16	
To Cash			120
To Non-controlling interest			26

*****

Illustration 2: Determination of goodwill

Ram Ltd. acquires 60% of Raja Ltd. by paying cash consideration of ₹ 750 lakh (including control premium). The fair value of non-controlling interest on the date of acquisition is ₹ 480 lakh. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 1,000 lakh. Determine the value of goodwill and pass the journal entry.

Solution:

The amount of non-controlling interest can be measures wither as per i) Fair value method or ii) Proportionate share method (i.e. proportionate share in the net identifiable assets of the acquiree). The value of goodwill will be different under both the methods. The goodwill is calculated as per both the methods below:

Fair value method	₹ lakh
Fair value of consideration transferred	750
Fair value of non-controlling interest	480
	1,230
Value of subsidiary's identifiable net assets as per Ind AS 103	(1,000)
Goodwill	**230**

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Proportionate share method	₹ lakh
Fair value of consideration transferred	750
Proportional share of non-controlling interest in the net identifiable assets of acquiree (1,000 x 40%)	400
	1,150
Value of subsidiary's identifiable net assets as per Ind AS 103	(1,000)
Goodwill	**150**

Journal Entries

Fair value method		₹ lakh	
		Dr.	Cr.
Net identifiable assets	Dr.	1,000	
Goodwill	Dr.	230	
To Cash			750
To Non-controlling interest			480
Proportionate share method		**₹ lakh**	
		Dr.	Cr.
Net identifiable assets	Dr.	1,000	
Goodwill	Dr.	150	
To Cash			750
To Non-controlling interest			400

*****

Illustration 3: Determination of gain on bargain purchase

X Ltd. acquires 80% of Y Ltd. by paying cash consideration of ₹ 400 lakh. The fair value of non-controlling interest on the date of acquisition is ₹ 100 lakh. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 520 lakh. Determine the value of gain on bargain purchase and pass the journal entry.

Solution:

The amount of non-controlling interest can be measured as per i) Fair value method or ii) Proportionate share method (i.e. proportionate share in the net identifiable assets of the acquiree). The value of gain on bargain purchase will be different under both the methods. The gain is calculated as per both the methods below:

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Fair value method	₹ lakh
Fair value of consideration transferred	400
Fair value of non-controlling interest	100
	500
Value of subsidiary's identifiable net assets as per Ind AS 103	(520)
Gain on bargain purchase	**(20)**
Proportionate share method	₹ lakh
Fair value of consideration transferred	400
Proportional share of non-controlling interest in the net identifiable assets of acquiree (520 x 20%)	104
	504
Value of subsidiary's identifiable net assets as per Ind AS 103	(520)
Gain on bargain purchase	**(16)**

Journal Entries

Fair value method		₹ lakh	
		Dr.	Cr.
Net identifiable assets	Dr.	520	
To Cash			400
To Gain on bargain purchase*			20
To Non-controlling interest			100

Proportionate share method		₹ lakh	
		Dr.	Cr.
Net identifiable assets	Dr.	520	
To Cash			400
To Gain on bargain purchase*			16
To Non-controlling interest			104

* Gain on bargain purchase is either recognised in OCI or is recognised directly in equity as a capital reserve.

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Illustration 4: Determination of goodwill when there is no non-controlling interest

M Ltd. acquires 100% of N Ltd. by paying cash consideration of ₹ 100 lakh. The value of subsidiary's identifiable net assets as per Ind AS 103 is ₹ 80 lakh. Determine the value of goodwill.

Solution:

The value of goodwill is calculated as follows:

Determination of goodwill	**₹ lakh**
Fair value of consideration transferred	100
Value of subsidiary's identifiable net assets as per Ind AS 103	(80)
Goodwill	**20**

*****

4.2.2 Calculation of goodwill / capital reserve when the interest in subsidiary is acquired on different dates (i.e. step acquisition)

An entity may be holding some equity interest in a subsidiary immediately before it obtained control over the subsidiary.

Example 1

On 1 April 20X1, A Ltd. Was holding 25% stake in B Ltd. On that date, A Ltd. Acquired further 40% stake in B Ltd. And thereby obtained control over B Ltd.

Such transaction is referred to as business combination achieved in stages or also referred to as step acquisition.

In a business combination achieved in stages, the acquirer shall **remeasure its previously held equity interest** in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

A change from holding a non-controlling investment in an entity to obtaining control of that entity is a significant change in the nature of and economic circumstances surrounding that investment. That change warrants a change in the classification and measurement of that investment. Once it obtains control, the acquirer is no longer the owner of a non-controlling investment asset in the acquiree. The acquirer therefore ceases its accounting for an investment asset and begins reporting in its financial statements the underlying assets, liabilities and results of operations of the acquiree. In effect, the acquirer exchanges its status as an owner of an investment asset in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity (acquiree) and the right to direct how the acquiree and its management use those assets in its operations. In a business combination achieved in stages, the acquirer derecognises its investment asset in an entity in its consolidated financial statements when it achieves control.

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Thus, it is appropriate to recognise any resulting gain or loss in profit or loss at the acquisition date.

In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income (refer Chapter 12 which contains guidance on accounting for investments in equity instruments which are measured at fair value through other comprehensive income). If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest. In other words, the gains or losses from changes in the fair value accumulated in other comprehensive income would never be reclassified to profit or loss but may be transferred into the retained earnings on 'deemed disposal' of the investment, which is consistent with the accounting in case of 'actual disposal' of such an investment.

Illustration 5: Step acquisition

RS Ltd. holds 30% stake in PQ Ltd. This investment in PQ Ltd. is accounted as an investment in associate in accordance with Ind AS 28 and the carrying value of such investment in ₹ 100 lakh. RS Ltd. purchases the remaining 70% stake for a cash consideration of ₹ 700 lakh. The fair value of previously held 30% stake is measured to be ₹ 300 lakh on the date of acquisition of 70% stake. The value of PQ Ltd.'s identifiable net assets as per Ind AS 103 on that date is ₹ 800 lakh. How should RS Ltd. account for the business combination?

Solution:

The amount of goodwill is calculated as follows:

Determination of goodwill	**₹ lakh**
Fair value of consideration transferred	700
Fair value of previously held equity interest	300
	1,000
Value of subsidiary's identifiable net assets as per Ind AS 103	(800)
Goodwill	**200**

RS Ltd. should record the difference between the fair value of previously held equity interest in the subsidiary and the carrying value of that interest in the profit or loss i.e. ₹ 200 lakh (300 – 100) should be recognised in profit or loss.

Journal entries

Fair value method		**₹ lakh**	
		Dr.	Cr.
Net identifiable assets	Dr.	800	

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Goodwill	Dr.	200	
To Cash			700
To Investment in associate			100
To Gain on fair valuation of previously held equity interest			200

*****

4.2.3 Control obtained over a subsidiary without the transfer of consideration

An acquirer sometimes obtains control of an acquiree without transferring consideration. Such circumstances include:

(a) The **acquiree repurchases** a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

(b) **Minority veto rights lapse** that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.

(c) The acquirer and acquiree agree to combine their businesses **by contract** alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

In a business combination achieved without the transfer of consideration, "acquisition-date fair value of the consideration transferred" in the formula for measurement of goodwill or gain on bargain purchase is substituted by "acquisition-date fair value of its interest in the acquiree". In other words, the acquirer shall remeasure its existing equity interest in the acquiree at its acquisition date fair value (and recognise the gain or loss on such remeasurement in profit or loss or other comprehensive income, as the case may be) and use that to compute goodwill or gain on bargain purchase.

In a business combination achieved by contract alone, the acquirer shall attribute to the owners of the acquiree (i.e. those holding equity interests) the amount of the acquiree's net assets recognised in accordance with Ind AS 103. In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer's post-combination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the non-controlling interest.

Example 2

A Ltd. obtained control over B Ltd. by contract alone. There is no stake in B Ltd. held by A Ltd. So, while preparing the consolidated financial statements, A Ltd. will attribute 100% of the net assets of B Ltd. to the non-controlling interest.

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4.2.4 Uniform accounting policies

A parent shall prepare consolidated financial statements using uniform accounting policies for **like transactions and other events in similar circumstances**.

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

Example 3

A Ltd. (a company incorporated and registered in India) has a subsidiary B Inc. (a company incorporated and registered in United States). A Ltd. follows Ind AS for the preparation of its financial statements. However, B Inc. follows generally accepted accounting principles in United States (US GAAP). Hence, while using B Inc.'s financial statements for the purpose of preparing consolidated financial statements of A Ltd., appropriate adjustments should be made to B Inc.'s financial statements to convert its US GAAP financial statements to Ind AS financial statements.

Illustration 6: Uniform accounting policies

PQR Ltd. is the subsidiary company of MNC Ltd. In the individual financial statements prepared in accordance with Ind AS, PQR Ltd. has adopted Straight-line method (SLM) of depreciation and MNC Ltd. has adopted written-down value method (WDV) for depreciating its property, plant and equipment. As per Ind AS 110, Consolidated Financial Statements, a parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

How will these property, plant and equipment be depreciated in the consolidated financial statements of MNC Ltd. prepared as per Ind AS?

Solution:

As per paragraph 60 and 61 of Ind AS 16, 'Property, Plant and Equipment', a change in the method of depreciation shall be accounted for as a change in an accounting estimate as per Ind AS 8 *'Accounting Policies, Changes in Accounting Estimates and Errors'*.

Therefore, the selection of the method of depreciation is an accounting estimate and not an accounting policy.

The entity should select the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method should be applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits in separate financial statements as well as consolidated financial statements.

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Therefore, there can be different methods of estimating depreciation for property, plant and equipment, if their expected pattern of consumption is different. The method once selected in the individual financial statements of the subsidiary should not be changed while preparing the consolidated financial statements.

Accordingly, in the given case, the property, plant and equipment of PQR Ltd. (subsidiary company) may be depreciated using straight line method and property, plant and equipment of parent company (MNC Ltd.) may be depreciated using written down value method, if such method closely reflects the expected pattern of consumption of future economic benefits embodied in the respective assets.

*****

Illustration 7: Uniform accounting policies

H Limited has a subsidiary, S Limited and an associate, A Limited. The three companies are engaged in different lines of business.

These companies are using the following cost formulas for their valuation in accordance with Ind AS 2 'Inventories'.

Name of the Company	*Cost formula used*
H Limited	*FIFO*
S Limited, A Limited	*Weighted average cost*

Whether H Limited is required to value inventories of S Limited and A Limited also using FIFO formula in preparing its consolidated financial statements?

Solution:

Paragraph 19 of Ind AS 110 states that a parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

Paragraph B87 of Ind AS 110 states that if a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

It may be noted that the above mentioned paragraphs require an entity to apply uniform accounting policies "for like transactions and events in similar circumstances". If any member of the group follows a different accounting policy for like transactions and events in similar circumstances, appropriate adjustments are to be made in preparing consolidated financial statements.

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Paragraph 5 of Ind AS 8 defines accounting policies as "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements."

Ind AS 2 requires inventories to be measured at the lower of cost and net realisable value.

Paragraph 25 of Ind AS 2 states that the cost of inventories shall be assigned by using FIFO or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Elaborating on the requirements of paragraph 25, paragraph 26 of Ind AS 2 illustrates that inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

Paragraph 36(a) of Ind AS 2 requires disclosure of "the accounting policies adopted in measuring inventories, including the cost formula used". Thus, as per Ind AS 2, the cost formula applied in valuing inventories is also an accounting policy.

As mentioned earlier, as per Ind AS 2, different cost formulas may be justified for inventories of a different nature or use. Thus, if inventories of S Limited and A Limited differ in nature or use from inventories of H Limited, then use of cost formula (weighted average cost) different from that applied in respect of inventories of H Limited (FIFO) in consolidated financial statements may be justified. In other words, in such a case, no adjustment needs to be made to align the cost formula applied by S Limited and A Limited to cost formula applied by H Limited.

*****

4.2.5 Measurement of income and expense of subsidiary

An entity includes the income and expenses of a subsidiary in the consolidated financial statements **from the date it gains control** until the date when the entity ceases to control the subsidiary.

Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date.

Example 4

On the date of acquisition of control by A Ltd over B Ltd., the fair value of B Ltd.'s property, plant and equipment were ₹ 100 lakh and such assets are recorded in the consolidated financial statements of A Ltd. at that value. However, the carrying value of such assets in the books of B Ltd. on the date of acquisition were ₹ 80 lakh. Hence, for the purpose consolidated financial statements, the depreciation expense should be computed based on ₹ 100 lakh and not ₹ 80 lakh.

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4.2.6 Accounting of potential voting rights held in subsidiary

When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and **does not reflect the possible exercise or conversion of potential voting rights** and other derivatives. Such instruments with potential voting rights are **accounted as per Ind AS 109.**

However, there can be some cases where an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns. Accordingly, Ind AS 109 is not applied to instruments containing potential voting rights in such circumstances.

- This can be the situation where, **for example**, an investor currently holds 60% of the voting power of an investee (and hence controls the investee) has a purchase option to acquire additional 20% voting power in the investee and the terms of the contract provides that the investor will also get the returns on the underlying shares even for the period prior to the date of actual exercise of the option.

4.2.7 Reporting period of parent and subsidiary

The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the **same reporting date**.

When the end of the reporting period of the parent is different from that of a subsidiary (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.

If it is impracticable to do so, the parent shall consolidate the financial information of the subsidiary using the **most recent financial statements** of the subsidiary adjusted for the **effects of significant transactions or events** that occur between the date of those financial statements and the date of the consolidated financial statements. In any case, the difference between the date of the subsidiary's financial statements and that of the consolidated financial statements **shall be no more than three months**.

The length of the reporting periods and any difference between the dates of the financial statements shall be the same from period to period. This means that if the financial statements of a subsidiary used for consolidation in previous periods were ending on different dates than that

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of the parent whereas the financial statements used for current period end on the same date as that of the parent then the comparatives for previous period should be restated to have comparison of equivalent periods.

Illustration 8: Different reporting dates

How should assets and liabilities be classified into current or non-current in consolidated financial statements when parent and subsidiary have different reporting dates?

Solution:

Paragraphs B92 and B93 of Ind AS 110 require subsidiaries with reporting period end different from parent, to provide additional information or details of significant transactions or events if it is impracticable to provide additional information to enable the parent entity to consolidate such financial information at group's reporting period end.

The appropriate classification of the assets and liabilities as current or non-current in the consolidated financial statements has to be determined by reference to the reporting period end of the group. Accordingly, when a subsidiary's financial statements are for a different reporting period end, it is necessary to review the subsidiary's balance sheet to ensure that items are correctly classified as current or non-current as at the end of the group's reporting period.

For example, a subsidiary with the financial year end of 31st December, 20X1 has a payable outstanding that is due for payment on 1st January, 20X3, and has accordingly classified it as non-current in its balance sheet. The financial year end of the parent's consolidated financial statements is 31st March 20X2. Due to the time lag, the subsidiary's payable falls due within 12 months from the end of the parent's reporting period.

Accordingly, in this case, the payable should be classified as a current liability in the consolidated financial statements of the parent because the amount is repayable within nine months of the end of the parent's reporting period.

*****

Illustration 9: Different reporting dates

A Limited, an Indian Company has a foreign subsidiary, B Inc. Subsidiary B Inc. has taken a long-term loan from a foreign bank, which is repayable after the year 20X9. However, during the year ended 31st March, 20X2, it breached one of the conditions of the loan, as a consequence of which the loan became repayable on demand on the reporting date. Subsequent to year end but before the approval of the financial statements, B Inc. rectified the breach and the bank agreed not to demand repayment and to let the loan run for its remaining period to maturity as per the original loan terms. While preparing its standalone financial statements as per IFRS, B Inc. has classified this loan as a current liability in accordance with IAS 1 'Presentation of Financial Statements'.

Whether A limited is required to classify such loan as current while preparing its consolidated financial statement under Ind AS?

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Solution:

As per paragraph 74 of Ind AS 1, where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

The above position under Ind AS 1 differs from the corresponding position under IAS 1. As per paragraph 74 of IAS 1, when an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the recognized on of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.

Accordingly, the loan liability recognized as current liability by B Inc. in its standalone financial statements prepared as per IFRS, should be aligned as per Ind AS in the consolidated financial statements of A Limited and should be classified as non-current in the consolidated financial statements of A Limited in accordance with Ind AS 1.

*****

4.2.8 Accounting of dividend from subsidiary and its impact on non-controlling interest

As per para 5.7.1A of Ind AS 109, dividends are recognized in profit or loss by an investor entity only when:

- The entity's **right to receive** payment of the dividend is established,
- It is **probable** that the economic benefits associated with the dividend will flow to the entity, and
- the amount of the dividend can be **measured reliably**.

As per para 12 of Ind AS 27, an entity shall recognize a dividend from a subsidiary in its separate financial statements when its right to receive the dividend is **established**.

As per the Companies Act, 2013, the entity's right to receive the dividend is established when it is declared by the shareholders in the annual general meeting of the company.

An investor should recognise a dividend from a subsidiary, a joint venture or an associate as income in its separate financial statements. As per Ind AS 36, declaration of dividend by a subsidiary, associate or joint venture coupled with a few more evidence is an indication of impairment of investment.

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Illustration 10: Dividend proposed by subsidiary

XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st April, 20X1 for ₹ 1,40,000. The issued capital of ABC Ltd., on 1st April, 20X1 was ₹ 1,00,000 and the balance in the Statement of Profit and Loss was ₹ 60,000.

For the year ending on 31st March, 20X2 ABC Ltd. has earned a profit of ₹ 20,000 and later on it declared and paid a dividend of ₹ 30,000.

Assume, the fair value of non-controlling interest is same as the fair value on a per-share basis of the purchased interest#. All net assets are identifiable net assets, there are no non-identifiable assets. The fair value of identifiable net assets is ₹ 1,50,000.

Show by an entry how the dividend should be recorded in the books of XYZ Ltd. Whenever it is received after approval in the ensuing annual general meeting.

What is the amount of non-controlling interest as on 1st April, 20X1 (using Fair value Method) and 31st March, 20X2? Also pass a journal entry on the acquisition date.

(#This assumption is only for illustration purpose. However, in practical scenarios the fair value of NCI will be different than the fair value of the controlling interest.)

Solution:

XYZ Ltd.'s share of dividend ₹ 30,000 x 80% = ₹ 24,000.

		₹	
		Dr.	Cr.
Bank	Dr.	24,000	
To Profit & Loss A/c			24,000

Calculation of Non- controlling interest and Journal Entry

NCI on 1st April 20X1 = 20% of the fair value on a pre-share basis of the purchased interest.

= 20% x ₹ 1,75,000 (W.N.1) = ₹ 35,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	
		Dr.	Cr.
Identifiable net assets	Dr.	1,50,000	
Goodwill (Balancing Figure)	Dr.	25,000	
To Cash			1,40,000
To NCI			35,000

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Working Note 1

Fair value on a per-share basis of the purchased interest / Fair Value of Identifiable net assets

= consideration transferred x 100/80

= 1,40,000 x 100/80 = ₹ 1,75,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

= 35,000 + (20,000 X 20%) = ₹ 39,000

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received in the annual general meeting.

*****

Illustration 11: Dividend proposed by subsidiary

From the facts given in the above illustration, calculate the amount of non-controlling interest as on 1st April, 20X1 (Using NCI's proportionate share method) and 31st March, 20X2.

Also pass a journal entry on the acquisition date.

Solution:

NCI on 1st April 20X1 = 20% of the fair value on identifiable assets.

= 20% x ₹ 1,50,000 = ₹ 30,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	
		Dr.	Cr.
Identifiable net assets	Dr.	1,50,000	
Goodwill (Balancing Figure)	Dr.	20,000	
To Cash			1,40,000
To NCI			30,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

= 30,000 + (20,000 X 20%) = ₹ 34,000

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received in the annual general meeting.

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Illustration 12: Dividend proposed by subsidiary

The facts are same as in the above illustration except that the fair value of net identifiable asset is ₹ 1,60,000. Calculate NCI and Pass Journal Entry on the acquisition date

Note: Use fair value method for 31st March 20X1.

Solution:

Calculation of Non- controlling interest and Journal Entry

NCI on 1st April 20X1 = 20% of the fair value on a pre-share basis of the purchased interest.

= 20% x ₹ 1,75,000 (W.N.1) = ₹ 35,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	
		Dr.	Cr.
Identifiable net assets	Dr.	1,60,000	
Goodwill (Balancing Figure)	Dr.	15,000	
To Cash			1,40,000
To NCI			35,000

Working Note

Fair value on a per-share basis of the purchased interest / Fair Value of Identifiable net assets

= consideration transferred x 100/80

= 1,40,000 x 100/80 = ₹ 1,75,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

= 35,000 + (20,000 x 20%) = ₹ 39,000

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

*****

Illustration 13: Dividend proposed by subsidiary

The facts are same as in the above illustration except that the fair value of net identifiable asset is ₹ 1,60,000. Calculate NCI and Pass Journal Entry on the acquisition date. Use NCI's proportionate share method for 31st March 20X1.

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Solution:

NCI on 1st April 20X1 = 20% of the fair value on identifiable assets.

= 20% x ₹ 1,60,000 = ₹ 32,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	
		Dr.	Cr.
Identifiable net assets	Dr.	1,60,000	
Goodwill (Balancing Figure)	Dr.	12,000	
To Cash			1,40,000
To NCI			32,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

= 32,000 + (20,000 X 20%) = ₹ 36,000

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

*****

4.2.9 Elimination of intra-group transactions

In order to present financial statements for the group in a consolidated format, the effect of transactions between group entities should be eliminated. Intra – group balances and intra – group transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intra – group transactions should also be eliminated unless cost cannot be recovered.

Liabilities due to one group entity by another will be set off against the corresponding asset in the other group entity's financial statements; sales made by one group entity to another should be excluded from turnover and from purchase (or related head) or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying entity has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets are reduced to cost to the group.

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For transactions between group entities, unrealized profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and Property, Plant and Equipment, Intangible Assets and Investment Property, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

4.2.9.1 Unrealised profit on inventories

Where a group entity sells goods to another, the selling entity, as a separate legal entity, records profits made on those sales. If these goods are still held in inventory by the buying entity at the year end, however, the profit recorded by the selling entity, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealized profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

4.2.9.2 Unrealised profit on transfer of non-current assets

Similar to the treatment described above for unrealized profits in inventories, unrealized inter-company profits arising from intra-group transfers of Property, Plant and Equipment, Intangible Assets and Investment Property are also eliminated from the consolidated financial statements.

4.2.9.3 Unrealised losses

Unrealised losses resulting from intra-group transactions that are deducted in arriving at the carrying amount of assets are also eliminated **unless cost cannot be recovered**.

Illustration 14: Elimination of intra-group profit on sale of assets by a subsidiary to its parent

A parent owns 60% of a subsidiary. The subsidiary sells some inventory to the parent for ₹ 35,000 and makes a profit of ₹ 15,000 on the sale. The inventory is in the parent's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution:

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000 (₹ 35,000 - ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

		₹' 000	
		Dr.	Cr.
Consolidated revenue	Dr.	35	
To Cost of sales			20
To Inventory			15

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The reduction of group profit of ₹ 15,000 is allocated between the parent company and non-controlling interest in the ratio of their interests 60% and 40%.

*****

Illustration 15: Elimination of intra-group profit on sale of assets by a parent to its subsidiary

In the above illustration, assume that it is the parent that makes the sale. The parent owns 60% of a subsidiary. The parent sells some inventory to the subsidiary for ₹ 35,000 and makes a profit of ₹ 15,000. On the sale the inventory is in the subsidiary's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution:

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000 (₹ 35,000 - ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

The double entry on consolidation is as follows:

		₹' 000	
		Dr.	Cr.
Consolidated revenue	Dr.	35	
To Cost of sales			20
To Inventory			15

In this case, since it is the parent that has made the sale, the reduction in profit of ₹ 15,000 is allocated entirely to the parent company.

*****

Illustration 16: Inventories of subsidiary out of purchases from the parent

A Ltd, a parent company sold goods costing ₹ 200 lakh to its 80% subsidiary B Ltd. at ₹ 240 lakh. 50% of these goods are lying at its stock. B Ltd. has measured this inventory at cost i.e. at ₹ 120 lakh. Show the necessary adjustment in the consolidated financial statements (CFS). Assume 30% tax rate.

Solution:

A Ltd. shall reduce the inventories of ₹ 120 lakh of B Ltd., by ₹ 20 lakh in CFS. This will increase expenses and reduce consolidated profit by ₹ 20 lakh. It shall also create deferred tax asset of ₹ 6 lakh since accounting base of inventories (₹ 100 lakh) is lower than its tax base (₹ 120 lakh).

*****

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Illustration 17: Inventories of parent out of purchases from the subsidiary

Ram Ltd., a parent company purchased goods costing ₹ 100 lakh from its 80% subsidiary Shyam Ltd. at ₹ 120 lakh. 50% of these goods are lying at the godown. Ram Ltd. has measured this inventory at cost i.e. at ₹ 60 lakh. Show the necessary adjustment in the consolidated financial statements (CFS). Assume 30% tax rate.

Solution:

Ram Ltd. shall reduce the inventories of ₹ 60 lakh of Shyam Ltd., by ₹ 10 lakh in CFS. This will increase expenses and reduce consolidated profit by ₹ 10 lakh. It shall also create deferred tax asset of ₹ 3 lakh since accounting base of inventories (₹ 50 lakh) is lower than its tax base (₹ 60 lakh).

*****

Illustration 18: Property, plant and equipment (PPE) sold by parent to subsidiary

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:

		₹' lakh	
		Dr.	Cr.
Consolidated revenue	Dr.	120	
To Cost of sales			100
To PPE			18
To Depreciation			2

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4.2.10 Allocating share in profit / loss to non-controlling interest and change in the proportion held by controlling and non-controlling interest

A parent shall present non-controlling interests in the consolidated balance sheet **within equity**, **separately from the equity of the owners of the parent**.

4.2.10.1 Allocating share in profit / loss to non-controlling interests

An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests **even if this results in the non-controlling interests having a deficit balance**.

Illustration 19: Attribution of profit / loss to non-controlling interest

A Ltd. acquired 70% equity shares of B Ltd. on 1.4.20X1 at cost of ₹ 10,00,000 when B Ltd. had an equity share capital of ₹ 10,00,000 and other equity of ₹ 80,000. In the four consecutive years, B Ltd. fared badly and suffered losses of ₹ 2,50,000, ₹ 4,00,000, ₹ 5,00,000 and ₹ 1,20,000 respectively. Thereafter in 20X5-20X6, B Ltd. experienced turnaround and registered an annual profit of ₹ 50,000. In the next two years i.e. 20X6-20X7 and 20X7-20X8, B Ltd. recorded annual profits of ₹ 1,00,000, and ₹ 1,50,000 respectively. Show the non-controlling interests and goodwill at the end of each year for the purpose of consolidation. Assume that the assets are at fair value. Ignore impairment of goodwill.

Solution:

₹

Year	Profit / (Loss)	Non-controlling interest (30%)	Additional consolidated P&L (Dr.) / Cr.	Goodwill
At the time of acquisition in 20X1		3,24,000 (W.N.)		2,44,000(W.N.)
20X1-20X2	(2,50,000)	(75,000)	(1,75,000)	2,44,000
		2,49,000		
20X2-20X3	(4,00,000)	(1,20,000)	(2,80,000)	2,44,000
		1,29,000		
20X3-20X4	(5,00,00)	(1,50,000)	(3,50,000)	2,44,000
		(21,000)		
20X4-20X5	(1,20,000)	(36,000)	(84,000)	2,44,000
		(57,000)		

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20X5-20X6	50,000	15,000	35,000	2,44,000
		(42,000)		
20X6-20X7	1,00,000	30,000	70,000	2,44,000
		(12,000)		
20X7-20X8	1,50,000	45,000	1,05,000	2,44,000
		33,000		

Working note:

Calculation of non-controlling interest:	₹
Share capital	10,00,000
Other equity	80,000
Total	10,80,000
NCI (30% x 10,80,000)	3,24,000

NCI is measured at NCI's proportionate share of the acquiree's identifiable net assets. (Considering the carrying amount of share capital & other equity to be fair value)

Calculation of Goodwill:	₹
Consideration	10,00,000
Non-controlling interest	3,24,000
Less: Net Assets	(10,80,000)
Goodwill	2,44,000

*****

Illustration 20: Non-controlling interest and goodwill

From the following data, determine in each case:

1) *Non-controlling interest at the date of acquisition (using proportionate share method) and at the date of consolidation*

2) *Goodwill or Gain on bargain purchase.*

3) *Amount of holding company's share of profit in the Consolidated Balance Sheet assuming holding company's own retained earnings to be ₹ 2,00,000 in each case*

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Case	Subsidiary Company	% of shares owned	Cost	Date of Acquisition 1.04.20X1		Consolidation date 31.03.20X2	
				Share Capital [A]	Retained earnings [B]	Share Capital [C]	Retained earnings [D]
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000
Case 2	B	85%	1,04,000	1,00,000	30,000	1,00,000	20,000
Case 3	C	80%	56,000	50,000	20,000	50,000	20,000
Case 4	D	100%	1,00,000	50,000	40,000	50,000	56,000

The company has adopted an accounting policy to measure Non-controlling interest at NCI's proportionate share of the acquiree's identifiable net assets. It may be assumed that the fair value of acquiree's net identifiable assets is equal to their book values.

Solution:

(1) Non-controlling Interest = the equity in a subsidiary not attributable, directly or indirectly, to a parent. Equity is the residual interest in the assets of an entity after deducting all its liabilities i.e. in this given case Share Capital + Balance in Statement of Profit & Loss (Assuming it to be the net aggregate value of identifiable assets in accordance with Ind AS)

	% shares owned by NCI [E]	Non-controlling interest as at the date of acquisition [E] X [A + B]	Non-controlling interest as at the date of consolidation [E] X [C + D]
Case 1 [100-90]	10%	15,000	17,000
Case 2 [100-85]	15%	19,500	18,000
Case 3 [100-80]	20%	14,000	14,000
Case 4 [100-100]	Nil	Nil	Nil

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(3) Calculation of Goodwill or Gain on bargain purchase

	Consideration [G]	Non-controlling interest [H]	Net Identifiable assets [A] + [B] = [I]	Goodwill [G] + [H] – [I]	Gain on bargain Purchase [I] – [G] – [H]
Case 1	1,40,000	15,000	1,50,000	5,000	-
Case 2	1,04,000	19,500	1,30,000	-	6,500
Case 3	56,000	14,000	70,000	Nil	Nil
Case 4	1,00,000	0	90,000	10,000	-

(4) On 31.03.20X2 in each case the following amount shall be added or deducted from the balance of holding Co.'s Retained earnings.

	% Share Holding [K]	Retained earnings as on 31.03.20X1 [L]	Retained earnings as on consolidation Date [M]	Retained earnings post-acquisition [N] = [M] – [L]	Amount to be added/(deducted) from holding's Retained earnings [O] = [K] X [N]
1	90%	50,000	70,000	20,000	18,000
2	85%	30,000	20,000	(10,000)	(8,500)
3	80%	20,000	20,000	Nil	Nil
4	100%	40,000	56,000	16,000	16,000

*****

If a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by non-controlling interests, the entity shall compute its share of profit or loss after adjusting for the dividends on such shares, whether or not such dividends have been declared.

Example 5

R Ltd. holds 80% stake on Y Ltd. Y Ltd. has also issued 10% cumulative preference shares worth ₹ 10,00,000 to the non-controlling interest. During the year, Y Ltd. earned profit of ₹ 5,00,000. Y Ltd. has not declared any dividend on cumulative preference share for current year. Ignore requirements of irredeemable preference shares.

In such case, the profit attributable to R Ltd. for current year would be as follows:

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	₹
Total profit of Y Ltd.	5,00,000
Dividend on preference shares (10,00,000 x 10%)	(1,00,000)
Net profit	4,00,000
Profit attributable to R Ltd. (4,00,000 x 80%)	**3,20,000**

4.2.10.2 Change in the proportion held by controlling and non-controlling interests

A parent's ownership interest may change without a loss of control, for example, in following situations:

- Parent buys shares from non-controlling interest (say, increase in stake from 60% to 70%)
- Parent sells shares to non-controlling interest (say, decrease in stake from 70% to 60%)
- Subsidiary issues new shares to non-controlling interest in a capital raising exercise resulting in dilution in stake of parent

Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are **equity transactions** (i.e. transactions with owners in their capacity as owners).

Example 6

M Ltd. holds 70% stake in N Ltd. Now if M Ltd. purchases additional 10% stake in N Ltd. or sells 10% of its existing stake (i.e. without losing control) then it is an equity transaction.

When the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise **directly in equity** any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Further, it must be noted that due to such changes in controlling and non-controlling interests, no changes are made to subsidiary's assets (including goodwill) and liabilities. It is again emphasized that no gain or loss is recognized in such transactions.

Illustration 21: Sale of 20% interest in a wholly- owned subsidiary

Entity P sells a 20% interest in a wholly owned subsidiary to outside investors for ₹ 100 lakh in cash. The carrying value of the subsidiary's net assets is ₹ 300 lakh, including goodwill of ₹ 65 lakh from the subsidiary's initial acquisition.

Pass journal entries to record the transaction.

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Solution:

The accounting entry in the consolidated financial statements recorded on the disposition date for the 20% interest sold as follows:

		₹ lakh	
		Dr.	Cr.
Cash	Dr.	100	
To Non-controlling interest (20% x 300 lakh)			60
To Other Equity (Gain on sale of interest in subsidiary)			40

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between amount by which NCI (60 lakh) is adjusted and fair value of consideration received (100 lakh) to be attributed to parent in other equity ie. 40 lakh.

*****

Illustration 22: Acquisition of additional stake in a subsidiary

Entity A acquired 60% of entity B two years ago for ₹ 6,000. At that time, entity B's fair value was ₹ 10,000. It had net assets with a fair value of ₹ 6,000 (which is assumed same as book value). Goodwill of ₹ 2,400 was recorded (being ₹ 6,000 – (60% x ₹ 6,000). On 1 October 20X0, entity A acquires a further 20% interest in entity B, taking its holding to 80%. At that time the fair value of entity B is ₹ 20,000 and entity A pays ₹ 4,000 for the 20% interest. At the time of the purchase the fair value of entity B's net assets is ₹ 12,000 and the carrying amount of the non- controlling interest is ₹ 4,000.

Pass journal entries to record the transaction.

Solution:

The accounting entry recorded for the purpose of the non- controlling interest is as follows:

		₹	
		Dr.	Cr.
Non-controlling interest (4,000 ÷ 40 x 20)	Dr.	2,000	
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	2,000	
To Cash			4,000

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between amount by which NCI (₹ 2,000) is adjusted and fair value of consideration received (₹ 4,000) to be attributed to parent in other equity i.e. ₹ 2,000.

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Note: This illustration mentions two types of fair values:

- Fair value of Entity B, and
- Fair value of net assets of Entity B

It should be borne in mind that the two fair values are different concepts. The former is used only for the purpose of determining the consideration to be paid for purchase of equity interests. It can be seen that for the initial stake purchase, Entity A paid 60% of the "fair value of Entity B" i.e. 60% of ₹ 10,000 = ₹ 6,000. Further, for the second purchase transaction, Entity A paid 20% of the "fair value of Entity B" i.e. 20% of ₹ 20,000 = ₹ 4,000.

The latter i.e. fair value of net assets of Entity B is used for the purpose of accounting. It can be seen that the goodwill arising on acquisition of Entity B is determined as difference between consideration paid i.e. ₹ 6,000 and Entity A's share in fair value of net assets of Entity B on date of acquisition i.e. 60% of ₹ 6,000 = ₹ 6,000 minus ₹ 3,600 = ₹ 2,400. The fair value of net assets after the date of acquisition (i.e. ₹ 12,000 in this illustration) is not relevant for accounting purposes.

*****

Illustration 23: Acquisition of additional stake in a subsidiary

A Ltd. acquired 10% additional shares of its 70% subsidiary. The following relevant information is available in respect of the change in non-controlling interest on the basis of Balance Sheet finalized as at 1.4.20X0:

	₹ in thousand
Separate financial statements	***As at 31.3.20X0***
Investment in subsidiary (70% interest) – at cost	*14,000*
Purchase price for additional 10% interest	*2,600*
Consolidated financial statements	
Non-controlling interests (30%)	*6,600*
Consolidated profit & loss account balance	*2,000*
Goodwill	*600*

The reporting date of the subsidiary and the parent is 31 March 20X0. Prepare note showing adjustment for change of non-controlling interest. Should goodwill be adjusted for the change?

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Solution:

The following accounting entry is passed:

		₹ '000	
		Dr.	Cr.
Non-controlling interest (6,600 ÷ 30 x 10)	Dr.	2,200	
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	400	
To Cash			2,600

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between amount by which NCI (₹ 22,00,000) is adjusted and fair value of consideration received (₹ 26,00,000) to be attributed to parent in other equity i.e. ₹ 4,00,000.

Consolidated goodwill is not adjusted.

*****

Illustration 24: Acquisition of additional stake in a subsidiary

A Ltd. acquired 70% shares of B Ltd. on 1.4.20X0 when the fair value of net assets of B Ltd. was ₹ 200 lakh. During 20X0-20X1, B Ltd. made profit of ₹ 100 lakh. Individual and consolidated balance sheets as at 31.3.20X1 are as follows: *₹ lakh*

	A	B	Group
Assets			
Goodwill			10
PPE	627	200	827
Financial assets:			
Investments	150		
Cash	200	30	230
Other current assets	23	70	93
	1,000	**300**	**1160**
Equity and liability			
Share capital	200	100	200
Other equity	800	200	870
Non-controlling interest			90
	1,000	**300**	**1160**

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A Ltd. acquired another 10% stake in B Ltd. on 1.4.20X1 at ₹ 32 lakh. The proportionate carrying amount of the non-controlling interest is ₹ 30 lakh. Show the individual and consolidated balance sheet of the group immediately after the change in non-controlling interest.

Solution:

₹ lakh

	A	B	Workings	Group
Assets				
Goodwill				10
PPE	627	200		827
Financial assets:				
Investments (150+32)	182			
Cash* (200-32)	168	30	(200+30)-32)	198
Other current assets	23	70		93
	1,000	**300**		**1,128**
Equity and liability				
Share capital	200	100		200
Other equity	800	200	870-2	868
Non-controlling interest			90-30	60
	1,000	**300**		**1,128**

*Cash has been adjusted through Individual Balance Sheet.

Journal Entry

₹ lakh

		Dr.	Cr.
Non-controlling interest (90 ÷ 30 x 10)	Dr.	30	
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	2	
To Cash			32

*****

Illustration 25: Reduction in interest in subsidiary

Amla Ltd. purchased a 100% subsidiary for ₹ 10,00,000 at the end of 20X1 when the fair value of the subsidiary Lal Ltd.'s net asset was ₹ 8,00, 000.

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The parent sold 40% of its investment in the subsidiary in March 20X4 to outside investors for ₹ 9,00,000. The parent still maintains a 60% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is ₹ 18,00,000 (including net assets of ₹ 16,00,000 & goodwill of ₹ 2,00,000).

Calculate gain / loss on sale of interest in subsidiary as at 31st March 20X4.

Solution:

As per Ind AS 110, a change in ownership that does not result in a loss of control is equity transaction. The identifiable net assets (including goodwill) remain unchanged and any difference between the amount by which the non-controlling interest is recorded (including the non-controlling interest portion of goodwill) and a fair value of the consideration received is recognized directly in equity and attributed to the controlling interest. For disposals that do not result in the loss of control, the change in the non-controlling interest is recorded at its proportionate interest of the carrying value of the subsidiary.

Gain on the sale of the investment of ₹ 5,00,000 in parent's separate financial statements calculated as follows:

	₹' 000
Sale proceeds	900
Less: Cost of investment in subsidiary (10,00,000 x 40%)	(400)
Gain on sale in the parent's separate financial statements	500

As discussed above, the group's consolidated income statement for 31st March 20X4 would show no gain on the sale of the interest in the subsidiary. Instead, the difference between the fair value of the consideration received and the amount by which the non-controlling interest is recorded is recognized directly in equity.

	₹' 000
Sale proceeds	900
Less: Recognition of non-controlling interest (18,00,000 x 40%)	(720)
Credit to other equity	180

The entry recognized in the consolidated accounts under Ind AS 110 is:

		₹' 000	
		Dr.	Cr.
Cash	Dr.	900	
To Non-controlling interest			720
To Other Equity (Gain on sale of interest in subsidiary)			180

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The difference between the gain in the parent's income statement and the increase reported in the group's consolidated equity is ₹ 3,20,000. This difference represents the share of post-acquisition profits retained in the subsidiary ₹ 3,20,000 [(that is, 18,00,000 – 10,00,000) x 40%] that have been reported in the group's income statement up to the date of sale.

*****

Illustration 26: Reduction in interest in subsidiary

Entity A sells 30% interest in its wholly-owned subsidiary to outside investors in an arm 's length transaction for ₹ 500 crore in cash and retains a 70% controlling interest in the subsidiary. At the time of the sale, the carrying value of the subsidiary's net assets in the consolidated financial statements of Entity A is ₹ 1,300 crore, additionally, there is a goodwill of ₹ 200 crore that arose on the subsidiary's acquisition. Entity A initially accounted for NCI representing present ownership interests in the subsidiary at fair value and it recognises subsequent changes in NCI in the subsidiary at NCI's proportionate share in aggregate of net identifiable assets and associated goodwill. How should Entity A account for the transaction?

Solution:

As per paragraph 23 of Ind AS 110, changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners). Thus, changes in ownership interest that do not result in loss of control do not impact goodwill associated with the subsidiary or the statement of profit and loss.

Paragraph B96 of Ind AS 110 states that when the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Thus, at the time of sale of 30% of its equity interest, consolidated financial statements include an amount of ₹ 1,500 crore in respect of the subsidiary. Accordingly, in the present case, the accounting entry in the consolidated financial statements on the date of sale of the 30% interest would be as follows:

		₹ in crore	
		Dr.	Cr.
Cash	Dr.	500	
To Non-controlling interest (1,500 x 30%)			450
To Other Equity (Gain on sale of interest in subsidiary)			50

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Illustration 27: Treatment of goodwill and non-controlling interest where a parent holds an indirect interest in a subsidiary

A parent company (entity A) has an 80% owned subsidiary (entity B). Entity B makes an acquisition for cash of a third company (entity C), which it then wholly owns. Goodwill of ₹ 1,00,000 arises on the acquisition of entity C.

How should that goodwill be reflected in consolidated financial statement of entity A? Should it be reflected as

a) 100% of the goodwill with 20% then being allocated to the non- controlling interest, or

b) 80% of the goodwill that arises?

Solution:

Assuming that entity B prepares consolidated financial statements, 100% of the goodwill would be recognized on the acquisition of entity C in those financial statements. Entity A should reflect 100% of goodwill and allocate 20% to the non- controlling interest in its consolidated financial statements. This is because the non-controlling interest is a party to the transaction and the goodwill forms part of the net assets of the sub group (in this case, the sub group being the group headed by entity B).

*****

4.2.11 Preparation of consolidated financial statements after applying above principles

In this section we will discuss how the full set of consolidated financial statements is prepared after applying the consolidation principles discussed above.

4.2.11.1 Preparation of consolidated balance sheet

- Assets and outside liabilities of the subsidiary company are combined with those of the parent company. Appropriate intra group elimination adjustments as explained in section 4.2.9 above are recognised.
- The equity share capital of the subsidiary and investment of parent company are eliminated and goodwill / capital reserve and non-controlling interest are recognised.
- The parent's share in post-acquisition profits of the subsidiary company (added to appropriate concerned account of the parent company) are accounted in consolidated balance sheet.

4.2.11.2 Preparation of consolidated profit & loss

- The items of income and expenses are added on line by line basis.

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- Intra-group transactions are eliminated in full (e.g. sales made by parent to a subsidiary which is recorded as purchase by subsidiary are eliminated from the consolidated profit & loss by reducing both sales of parent and purchase of subsidiary) – refer section 4.2.9 above.

4.2.11.3 Preparation of consolidated cash flows

- Items of cash flow from various activities are to be added on line by line basis and from the consolidated items, inter-company transactions should be eliminated.

4.2.12 Chain-holding under consolidation

4.2.12.1 Meaning of chain control

A parent company can establish control over subsidiary directly or indirectly. Chain-holding refers to situations wherein a parent is controlling a subsidiary indirectly, i.e., having a controlling interest over a company indirectly. This may happen in number of ways, for example, parent company (P Ltd.) holding controlling interest in a subsidiary (S1 Ltd.), which in turn is holding a controlling interest in another company (S2 Ltd.). In this case, P Ltd. is having an indirect control over S2 Ltd. through its direct subsidiary S1 Ltd.

4.2.12.2 Consolidation procedures in case of chain-holding

Holding in subsidiary may be of various structures like:

Situation 1: Sub-subsidiaries

Parent P → 80% → Subsidiary 1 → 60% → Sub-subsidiary (S2)

In the above case, P holds a controlling interest in S1 which in turn holds a controlling interest in S2.

Analysis:

1. P owns 80% of 60% = 48% of S2
2. The non-controlling interest (NCI) in S1 owns 20% of 60% = 12% of S2
3. The non-controlling interest (NCI) in S2 itself owns the remaining 40% of the S2 equity.

S2 is nevertheless a sub-subsidiary of P, because it is a subsidiary of S1 which in turn is a subsidiary of P. The chain of control thus makes S2 sub-subsidiary of P which owns only 48% of its equity.

Date of effective control:

The date the sub-subsidiary (S2) comes under the control of the holding company is either:

1. The date P acquired S1 if S1 already holds shares in S2, or
2. If S1 acquires shares in S2 later, i.e. after the acquisition by P in S1, then such date of acquisition by S1.

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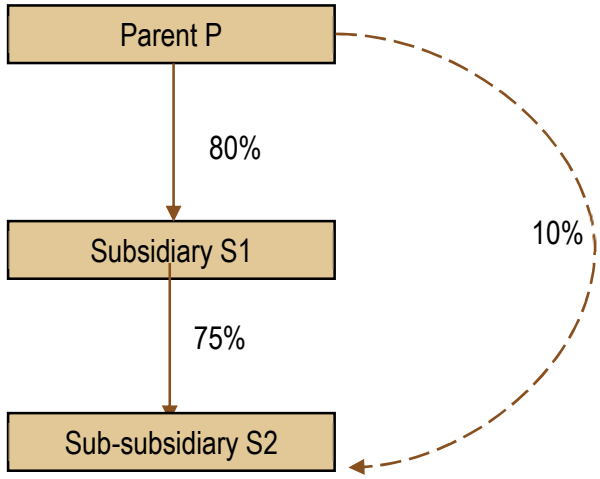
Points to remember:

The dates of acquisition and the order in which the group is built up should be considered while identifying as to which balances to select as the pre-acquisition reserves of the sub-subsidiary.

Care must be taken when consolidating sub-subsidiaries, because (usually) either:

1. The parent company acquired the subsidiary before the subsidiary bought the sub-subsidiary
2. The parent holding company acquired the subsidiary after the subsidiary bought the sub-subsidiary
3. Depending on whether (1) or (2) is the case, the retained earnings of the subsidiary at acquisition will be different.

Situation II: Direct holdings in sub-subsidiaries:



In this case, S2 is a sub-subsidiary of P with additional shares held directly by P.

In the above case, there is:

1.	**Direct** non-controlling share (NCI) in S1 of	20%	
2.	**Direct** non-controlling share (NCI) in S2 of (25-10)	15%	
3.	**Indirect** non-controlling share (NCI) in S2 of 20% x 75%	15%	30%

Analysis:

The effective interest in SS is:

Group (80% x 75%)	60% interest
Direct holding	10%
	70%

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Thus NCI 30%

100%

Note: Once we have ascertained the structure and non-controlling interest, we can proceed as we do for case A.

Illustration 29: Chain holding

Prepare the consolidated Balance Sheet as at 31st March, 20X2 of a group of companies comprising P Limited, S Limited and SS Limited. Their balance sheets on that date are given below: *₹ in lakhs*

	P Ltd.	S Ltd.	SS Ltd.
Assets			
Non-Current Assets			
Property, Plant and Equipment	320	360	300
Investment:			
32 lakh shares in S Ltd.	340		
24 lakh shares in SS Ltd.		280	
Current Assets			
Inventories	220	70	50
Financial Assets			
Trade Receivables	260	100	220
Bills Receivables	72	-	30
Cash in hand and at Bank	228	40	40
	1440	850	640
Equity and Liabilities			
Shareholder's Equity			
Share Capital (₹ 10 per share)	600	400	320
Other Equity			
Reserves	180	100	80
Retained earnings	160	50	60
Current Liabilities			
Financial Liabilities			
Trade Payables	470	230	180
Bills Payable			

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P Ltd.		*70*	
SS Ltd.	*30*	*-*	*-*
	1440	***850***	***640***

The following additional information is available:

(i) P Ltd. holds 80% shares in S Ltd. and S Ltd. holds 75% shares in SS Ltd. Their holdings were acquired on 30th September, 20X1.

(ii) The business activities of all the companies are not seasonal in nature and therefore, it can be assumed that profits are earned evenly throughout the year.

(iii) On 1st April, 20X1 the following balances stood in the books of S Ltd. and SS Ltd.

₹ in Lakhs

	S Limited	SS Limited
Reserves	*80*	*60*
Retained earnings	*20*	*30*

(iv) ₹ 10 lakhs included in the inventory figure of S Ltd, is inventory which has been purchased from SS Ltd at cost plus 25%.

(v) The parent company has adopted an accounting policy to measure non-controlling interest at fair value (quoted market price) applying Ind AS 103. Assume market prices of S Ltd and SS Ltd are the same as respective face values.

Solution:

Consolidated Balance Sheet of the Group as at 31st March, 20X2

Particulars	Note No.	₹ in lakh
ASSETS		
Non-current assets		
Property, plant and equipment	1	980
Current assets		
(a) Inventory	2	338
(b) Financial assets		
Trade receivable	3	580
Bills receivable	4	2
Cash and cash equivalent	5	308

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Total assets		**2,208**
EQUITY & LIABILITIES		
Equity attributable to owners of parent		
Share Capital		600
Other Equity		
Reserve (W.N.5)		194
Retained Earnings (W.N.5)		179.8
Capital Reserve (W.N.3)		188
Non-controlling interests (W.N.4)		166.2
Total equity		**1,328**
LIABILITIES		
Non-current liabilities		Nil
Current liabilities		
(a) Financial Liabilities		
(i) Trade payables	6	880
Total liabilities		880
Total equity and liabilities		**2,208**

Notes to Accounts (₹ in lakh)

1.	**Property Plant & Equipment**		
	P Ltd.	320	
	S Ltd.	360	
	SS Ltd.	300	980
2.	**Inventories**		
	P Ltd.	220	
	S Ltd. (70-2)	68	
	SS Ltd.	50	338
3.	**Trade Receivable**		
	P Ltd.	260	
	S Ltd.	100	
	SS Ltd.	220	580

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4.	**Bills Receivable**		
	P Ltd. (72-70)	2	
	SS Ltd. (30-30)	-	2
5.	**Cash & Cash equivalents**		
	P Ltd.	228	
	S Ltd.	40	
	SS Ltd.	40	308
6.	**Trade Payables**		
	P Ltd.	470	
	S Ltd.	230	
	SS Ltd.	180	880

Working Notes:

1. Analysis of Reserves and Surplus **(₹ in lakh)**

		S Ltd.		SS Ltd.
Reserves as on 31.3.20X1		80		60
Increase during the year 20X1-20X2	20		20	
Increase for the half year till 30.9.20X1		10		10
Balance as on 30.9.20X1 (A)		**90**		**70**
Total balance as on 31.3.20X2		100		80
Post-acquisition balance		**10**		**10**
Retained Earnings as on 31.3.20X1		20		30
Increase during the year 20X1-20X2	30		30	
Increase for the half year till 30.9.20X1		15		15
Balance as on 30.9.20X1 (B)		**35**		**45**
Total balance as on 31.3.20X2		50		60
Post-acquisition balance		15		15
Less: Unrealised Gain on inventories (10 ÷ 125 x 25)		-		(2)
Post-acquisition balance for CFS		**15**		**13**
Total balance on the acquisition date ie. 30.9.20X1 (A+B)		**125**		**115**

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2. Calculation of Effective Interest of P Ltd. in SS Ltd.

Acquisition by P Ltd. In S Ltd.	= 80%
Acquisition by S Ltd. In SS Ltd.	= 75%
Acquisition by Group in SS Ltd. (80% x 75%)	= 60%
Non-controlling Interest	= 40%

3. Calculation of Goodwill / Capital Reserve on the acquisition

	S Ltd.	SS Ltd.
Investment or consideration	340	(280 x 80%) 224
Add: NCI at Fair value		
(400 x 20%)	80	
(320 x 40%)	-	128
	420	352
Less: Identifiable net assets (Share Capital + Increase in the Reserves and Surplus till acquisition date)	(400+125) (525)	(320+115) (435)
Capital Reserve	105	83
Total Capital Reserve (105 + 83)	**188**	

4. Calculation of Non-controlling Interest

	S Ltd.	SS Ltd.
At Fair Value (See Note 3)	80	128
Add: Post Acquisition Reserves (See Note 1)	(10 x 20%) 2	(10 x 40%) 4
Add: Post Acquisition Retained Earnings (See Note 1)	(15 x 20%) 3	(13 x 40%) 5.2
Less: NCI share of investment in SS Ltd.	(280 x 20%) (56)*	-
	29	137.2
Total (29 + 137.2)	166.2	

***Note:** The non-controlling interest in S Ltd. will take its proportion in SS Ltd. So, they have to bear their proportion in the investment by S Ltd. (in SS Ltd.) also.

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5. Calculation of Consolidated Other Equity

	Reserves	Retained Earnings
P Ltd.	180	160
Add: Share in S Ltd.	(10 x 80%) 8	(15 x 80%) 12
Add: Share in SS Ltd.	(10 x 60%) 6	(13 x 60%) 7.8
	194	**179.8**

Note: It is assumed date the sale of goods by SS Ltd. is done after acquisition of shares by S Ltd. Alternatively, it may be assumed that the sale has either been done before acquisition of shares by S Ltd. in SS Ltd. or sale has been throughout the year. Accordingly, the treatment for unrealized gain may vary.

*****

4.3 LOSS OF CONTROL

A parent can lose control over a subsidiary in a number of ways. These include:

- Loss of control due to outright sale – where the entire stake is sold off,
- Loss of control due to partial sale – where the parent retains interest as an associate, jointly controlled entity or a financial asset,
- Deemed loss of control where no consideration is received but the parent's interest is diluted in some other manner such as:
  - voting rights issued to a new investor,
  - control on relevant activities,
  - consolidation of voting rights of other shareholders;
  - an investor acquiring substantial stake from the stock exchange.

In this section we will discuss following two things:

- Accounting treatment of loss of control of a subsidiary
- Loss of control of a subsidiary in two or more arrangements (transactions)

4.3.1 Accounting treatment on loss of control of a subsidiary

If a parent loses control of a subsidiary, it shall follow the accounting treatment mentioned below:

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If a parent loses control of a subsidiary, it shall			
Derecognise: • the assets (including any goodwill) and liabilities of the subsidiary • the carrying amount of any non-controlling interests in the former subsidiary	**Recognise:** • the fair value of the consideration received • if loss of control involves a distribution of shares of the subsidiary to owners, then that distribution; and • any investment retained in the former subsidiary at its fair value at the date when control is lost (refer **note 1** below)	**Reclassify:** • to profit or loss, or transfer directly to retained earnings if required by other Ind ASs, the amounts recognised in other comprehensive income in relation to the subsidiary (refer **note 2** below)	**Recognises gain / loss:** • recognise any resulting difference as a gain or loss in profit or loss attributable to the parent

Note 1: The fair value at which the retained interest is recognized shall be regarded as the fair value on initial recognition of a financial asset in accordance with Ind AS 109 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.

Example 7

A Ltd. was holding 60% stake in B Ltd. Now A Ltd. has sold 50% stake to a third party and balance 10% stake is retained. The fair value of that 10% stake on the date of loss of control is ₹ 1,00,000. So, A Ltd. will record the 10% stake at ₹ 1,00,000 on the date of loss of control. This fair value will be treated as fair value on initial recognition as per Ind AS 109. In case, after the loss of control, A Ltd. still has significant influence over B Ltd. (e.g. through board representation) then this fair value of ₹ 1,00,000 will be treated as cost on initial recognition of investment in associate B Ltd.

Note 2: If a parent loses control of a subsidiary, the parent shall account for all amounts previously recognized in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.

Example 8

X Ltd. has previously recognized in other comprehensive income in relation to a subsidiary Y Ltd. i) cumulative exchange differences relating to a foreign operation and ii) revaluation surplus. Now X Ltd. has sold its entire holding in Y Ltd. and hence has lost control over it. Hence, on loss of control, X Ltd. should reclassify the cumulative exchange differences relating to the foreign operation (that would have been reclassified to profit or loss if the parent had directly disposed that foreign operation) to profit or loss as reclassification adjustment. The revaluation surplus (that would have been transferred directly to retained earnings if the parent had directly disposed the asset) shall be transferred directly to retained earnings.

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Illustration 30: Subsidiary issues shares to a third party and parent loses control

In March 20X1 a group had a 60% interest in subsidiary with share capital of 50,000 ordinary shares. The carrying amount of goodwill is ₹ 20,000 at March 20X1 calculated using the partial goodwill method. On 31 March 20X1, an option held by the minority shareholders exercised the option to subscribe for a further 25,000 ordinary shares in the subsidiary at ₹ 12 per share, raising ₹ 3,00,000. The net assets of the subsidiary in the consolidated balance sheet prior to the option's exercise were ₹ 4,50,000, excluding goodwill.

Calculate gain or loss on loss of interest in subsidiary due to option exercised by minority shareholder.

Solution:

Shareholdings

	Before		After	
	No	**%**	**No**	**%**
Group	30,000	60	30,000	40
Other party	20,000	40	45,000	60
	50,000	100	75,000	100
Net assets	**₹' 000**	**%**	**₹' 000**	**%**
Group's share	270	60	300	40
Other party's share	180	40	450	60
	450	100	750	100

Calculation of group gain on deemed disposal	**₹' 000**
Fair value of 40% interest retained (₹ 12 x 30,000)**	360
Less: Net assets derecognized	(450)
Non-controlling interest derecognized	180
Goodwill	(20)
Gain on deemed disposal	70

** **Note**: For simplicity, it has been assumed the fair value per share is equal to the subscription price.

As control of the subsidiary is lost, the retained interest is recognized at its fair value at the date control is lost. The resulting remeasurement gain is recognized in profit and loss.

*****

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Illustration 31: Calculation of gain on outright sale of subsidiary

A parent purchased 80% interest in a subsidiary for ₹ 1,60,000 on 1 April 20X1 when the fair value of the subsidiary's net assets was ₹ 1,75,000. Goodwill of ₹ 20,000 arose on consolidation under the partial goodwill method. An impairment of goodwill of ₹ 8,000 was charged in the consolidated financial statements for year ended 31 March 20X3. No other impairment charges have been recorded. The parent sold its investment in the subsidiary on 31 March 20X4 for ₹ 2,00,000. The book value of the subsidiary's net assets in the consolidated financial statements on the date of the sale was ₹ 2,25,000 (not including goodwill of ₹ 12,000). When the subsidiary met the criteria to be classified as held for sale under Ind AS 105, no write off was required because the expected fair value less cost to sell (of 100% of the subsidiary) was greater than the carrying value.

The parent carried the investment in the subsidiary in its separate financial statements at cost, as permitted by Ind AS 27.

Calculate gain or loss on disposal of subsidiary in parent's separate and consolidated financial statements as at 31st March 20X4.

Solution:

The parent's separate statement of profit and loss for 20X3-20X4 would show a gain on the sale of investment of ₹ 40,000 calculated as follow:

	₹' 000
Sales proceeds	200
Less: Cost of investment in subsidiary	(160)
Gain on sale in parent's account	40

However, the group's statement of profit & loss for 20X3-20X4 would show a gain on the sale of subsidiary of ₹ 8,000 calculated as follows:

		₹' 000
Sales proceeds		200
Less: Share of net assets at date of disposal (₹ 2,25,000 X 80%)	(180)	
Goodwill on consolidation at date of sale (W.N.)	(12)	(192)
Gain on sale in group's account		8

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Working note

The goodwill on consolidation (assuming partial goodwill method) is calculated as follows:

		₹' 000
Fair value of consideration at the date of acquisition		160
Non-controlling interest measured at proportionate share of the acquiree's identifiable net assets (1,75,000 X 20%)	35	
Less: Fair value of net assets of subsidiary at date of acquisition	(175)	(140)
Goodwill arising on consolidation		20
Impairment at 31 March 20X3		(8)
Goodwill at 31 March 20X4		12

*****

Illustration 32: Partial disposal when subsidiary becomes an associate

AT Ltd. purchased a 100% subsidiary for ₹ 50,00,000 on 31st March 20X1 when the fair value of the net assets of BT Ltd. was ₹ 40,00,000. Therefore, goodwill is ₹ 10,00,000. AT Ltd. sold 60% of its investment in BT Ltd. on 31st March 20X3 for ₹ 67,50,000, leaving the AT Ltd. with 40% and significant influence. At the date of disposal, the carrying value of net assets of BT Ltd. excluding goodwill is ₹ 80,00,000. Assume the fair value of the investment in associate BT Ltd. retained is proportionate to the fair value of the 60% sold, that is ₹ 45,00 000.

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as at 31st March 20X3. Provide Journal Entries.

Solution:

AT Ltd.'s standalone statement for profit or loss of 20X2-20X3 would show a gain on the sale of investment of a ₹ 37,50,000 calculated as follows:

	₹' lakh
Sales proceeds	67.5
Less: Cost of investment in subsidiary (₹ 50,00,000 * 60%)	(30.0)
Gain on sale in parent's account	37.5

In the consolidated financial statements, the group will calculate the gain or loss on disposal differently. The carrying amount of all of the assets including goodwill is derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

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The gain on the disposal will, therefore, be calculated as follows:

	₹' lakh
Sales proceeds	67.5
Fair value of 40%interest retained	45.0
	112.5
Less: Net assets disposed, including goodwill (80,00,000+ 10,00,000)	(90.0)
Gain on sale in the group's financial statements	22.5

The gain on loss of control would be recorded in consolidated statement of profit and loss. The gain or loss includes the gain of ₹ 13,50,000 [₹ 67,50,000 – (₹ 90,00,000 x 60%)] on the portion sold. However, it also includes a gain on remeasurement of the 40% retained interest of ₹ 9,00,000 (₹ 36,00,000* to ₹ 45,00,000). The entity will need to disclose the portion of the gain that is attributable to remeasuring any remaining interest to fair value, that is, ₹ 9,00,000.

* 90,00,000 x 40%= 36,00,000

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Illustration 33: Partial disposal when 10% investment in former subsidiary is retained

The facts of this illustration are same per the above Illustration, except the group AT Ltd. Disposes of a 90% interest for ₹ 85,50,000 leaving the AT Ltd. with a 10% investment. The fair value of the remaining interest is ₹ 9,50,000 (assumed for simplicity to be pro rata to the fair value of the 90% sold)

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as at 31st March 20X3.

Solution:

The parent's AT Ltd. income statement in its separate financial statements for 20X2-20X3 would show a gain on the sale of the investment of ₹ 40,50,000 calculated as follows:

	₹' lakh
Sales proceeds	85.5
Less: Cost of investment in subsidiary (₹ 50,00,000 * 90%)	(45.0)
Gain on sale in parent's account	40.5

In the consolidated financial statements, all of the assets, including goodwill are derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

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	₹' lakh
Sales proceeds	85.5
Fair value of 10%interest retained	9.5
	95.0
Less: Net assets disposed, including goodwill (80,00,000 + 10,00,000)	(90.0)
Gain on sale in the group's financial statements	5.0

The gain on loss of control would be recorded in profit or loss. The gain or loss includes the gain of ₹ 4,50,000 related to the 90% portion sold [₹ 85,50,000 – (₹ 90,00,000 x 90%)] as well as ₹ 50,000 related to the remeasurement of fair value of 10% retained interest (₹ 9,00,000 to ₹ 9,50,000).

*****

4.3.2 Loss of control of a subsidiary in two or more arrangements (transactions)

A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be **accounted for as a single transaction**.

The above requirement is relevant because Ind AS 110 requires an entity to record gain / loss on disposal of investment in subsidiary in profit or loss only when the control is lost. This can give opportunity to an entity to arrange the disposal in such a way that it can reduce the amount to be recognized in profit or loss.

Example 9

MN Ltd. was holding 80% stake in UV Ltd. Now, MN Ltd. wants to dispose its entire holding in UV Ltd. It can do it in following ways:

- Option 1: Sale entire 80% stake in single transaction. In this case, the entire gain / loss on sale of 80% stake would be recognised in profit or loss.
- Option 2: Sale 25% stake in one transaction and sale the remaining 55% stake in another transaction. In this case, the gain / loss on sale of 25% stake would be recognised directly in equity since it will be sale of stake without loss of control. When the remaining 55% stake is sold then the gain / loss pertaining to that stake will be recognised in profit or loss.

In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:

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They are entered into at the **same time or in contemplation of each other**.

They form a single transaction designed to **achieve an overall commercial effect**

The occurrence of one arrangement is **dependent** on the occurrence of at least one other arrangement.

One arrangement considered on its own is **not economically justified, unless it is considered together** with other arrangements. (e.g. when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market)

Illustration 34: Loss control of a subsidiary in two transactions

MN Ltd. was holding 80% stake in UV Ltd. Now, MN Ltd. has disposed of the entire stake in UV Ltd. in two different transactions as follows:

- *Transaction 1: Sale of 25% stake for a cash consideration of ₹ 2,50,000*
- *Transaction 2: Sale of 55% stake for a cash consideration of ₹ 5,50,000*

Both the transactions have happened within a period of one month. In accordance with the guidance given in Ind AS 110, both the transactions have to be accounted as a single transaction.

The net assets of UV Ltd. and non-controlling interest on the date of both the transactions was ₹ 9,00,000 and ₹ 1,80,000 respectively (assuming there were no earnings between the period of two transactions).

How MN Ltd. should account the transaction?

Solution:

MN Ltd. will account for the transaction as follows:

		₹
Recognise:		
Fair value of consideration (2,50,000 + 5,50,000)		8,00,000
Derecognise:		
Net assets of UV Ltd.	(9,00,000)	
Non-controlling interest	1,80,000	(7,20,000)
Gain to be recorded in profit or loss		**80,000**

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If MN Ltd. loses control over UV Ltd. on the date of transaction 1, then the above gain is recorded on the date of transaction 1 and MN Ltd. will stop consolidating UV Ltd. from that date. The consideration of ₹ 5,50,000 receivable in transaction 2 will be shown as consideration receivable.

If MN Ltd. loses control over UV Ltd. on the date of transaction 2, then the above gain is recorded on the date of transaction 2 and MN Ltd. will stop consolidating UV Ltd. from that date. The consideration of ₹ 2,50,000 received in transaction 1 will be shown as advance consideration received.

*****

4.4 ACCOUNTING FOR A CHANGE IN INVESTMENT ENTITY STATUS

A parent that either ceases to be an investment entity or becomes an investment entity shall account for the change in its status **prospectively** from the date at which the change in status occurred.

4.4.1 Accounting when an entity ceases to be an investment entity

When an entity ceases to be an investment entity, it shall apply Ind AS 103 to any subsidiary that was previously measured at fair value through profit or loss. The date of the change of status shall be the deemed acquisition date. The fair value of the subsidiary at the deemed acquisition date shall represent the transferred deemed consideration when measuring any goodwill or gain from a bargain purchase that arises from the deemed acquisition. All subsidiaries shall be consolidated in accordance with the consolidation principles discussed above in this unit.

Illustration 35: An entity ceases to be an investment entity

A Limited ceased to be in investment entity from 1st April 20X1 on which date it was holding 80% of B Limited. The carrying value of such investment in B Limited (which was measured at fair value through profit or loss) was ₹ 4,00,000. The fair value of non-controlling interest on the date of change in status was ₹ 1,00,000. The value of subsidiary's identifiable net assets as per Ind AS 103 was ₹ 4,50,000 on the date of change in status. Determine the value of goodwill and pass the journal entry on the date of change in status of investment entity. (Assume that non-controlling interest is measured at fair value method)

Solution:

Goodwill calculation:	₹
Deemed consideration (i.e. fair value of subsidiary on the date of change in status)	4,00,000
Fair value of non-controlling interest	1,00,000
	5,00,000

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Value of subsidiary's identifiable net assets as per Ind AS 103			(4,50,000)
Goodwill			**50,000**
Journal Entry		₹	
		Dr.	Cr.
Net identifiable assets	Dr.	4,50,000	
Goodwill	Dr.	50,000	
To Investment in B Limited (on date of change in status)			4,00,000
To Non-controlling interest			1,00,000

*****

4.4.2 Accounting when an entity becomes an investment entity

When an entity becomes an investment entity, it shall cease to consolidate its subsidiaries at the date of the change in status (except for any subsidiary that itself is not an investment entity but provide services related to the investment entity's investment activities. Such subsidiaries shall be continued to be consolidated). The investment entity shall apply the requirements of loss of control explained earlier in this unit to those subsidiaries that it ceases to consolidate as if the investment entity had lost control of those subsidiaries at that date.

Illustration 36: An entity becomes an investment entity

CD Ltd. purchased a 100% subsidiary for ₹ 20,00,000 on 31st March 20X1 when the fair value of the net assets of KL Ltd. was ₹ 16,00,000. Therefore, goodwill was ₹ 4,00,000. CD Ltd. becomes an investment entity on 31st March 20X3 when the carrying value of its investment in KL Ltd. (measured at fair value through profit or loss) was ₹ 25,00,000. At the date of change in status, the carrying value of net assets of KL Ltd. excluding goodwill was ₹ 19,00,000.

Calculate gain or loss with respect to investment in KL Ltd. on the date of change in investment entity status of CD Ltd.

Solution:

The gain on the disposal will be calculated as follows:

	₹
Fair value of retained interest (100%)	25,00,000
Less: Net assets disposed, including goodwill (19,00,000 + 4,00,000)	(23,00,000)
Gain on the date of change in investment entity status of CD Ltd.	2,00,000

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4.5 SIGNIFICANT DIFFERENCES BETWEEN IND AS 110 AND AS 21

S. No.	Topic	Ind AS 110	AS 21
1.	Preparation of Consolidated Financial Statements	Ind AS 110 makes the preparation of consolidated financial statements mandatory for a parent (subject to limited exceptions).	AS 21 does not mandate the preparation of consolidated financial statements by a parent. However, if a parent presents consolidated financial statements, it is required to apply AS 21 in preparing and presenting such financial statements.
2.	Control	The definition of control in Ind AS 110 is principle based - an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.	As per AS 21, control is the ownership of more than one-half of the voting power of an enterprise or control of the composition of the board of directors or other similar governing body of another enterprise so as to obtain economic benefits from its activities. Thus, AS 21 lays down quantitative parameters for determining whether an entity controls another entity.
3.		As per the definition of 'control' under Ind AS 110, control of an entity can be with one entity only.	There can occasionally be situations where application of the definition of 'control' as per AS 21 results in there being two parents of an entity. In such a case, both the parents are required to consolidate the entity in their respective consolidated financial statements.

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4.	Exclusion of a subsidiary from consolidation	Ind AS 110 does not permit exclusion of a subsidiary from consolidation on either of these grounds.	As per AS 21, a subsidiary is excluded from consolidation when control is intended to be temporary or when it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.
5.	Difference between the date of the subsidiary's financial statements and that of the consolidated financial statements	Under Ind AS 110 difference between the date of the subsidiary's financial statements and that of the consolidated financial statements cannot exceed three months.	As per AS 21, difference between the date of the subsidiary's financial statements and that of the consolidated financial statements cannot exceed six months.
6.	Changes in a parent's ownership interest in a subsidiary not resulting in losing control	Ind AS 110 specifically lays down accounting requirements applicable to changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary.	In AS 21, no such guidance has been given.
7.	Uniform accounting policies	Ind AS 110, require the use of uniform accounting policies. No such exemption is given in Ind AS 110.	AS 21 allows the use of non-uniform accounting policies if it is not practicable to use uniform accounting policies disclosure is, however, required of, that fact together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

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8.	Potential equity shares and its voting rights	As per Ind AS 110, potential voting rights that are substantive are also considered when assessing whether an entity has control over another entity.	For considering share ownership, potential equity shares of the investee held by investor are not taken into account as per AS 21.
9.	Recognition of deferred taxes	Ind AS 110, read with Ind AS 12, requires recognition of deferred taxes in respect of temporary differences that arise from such elimination in consolidated financial statements.	According to AS 21, the tax expense (comprising current tax and deferred tax) to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries. This means that under AS 21, deferred taxes are not recognised in consolidated financial statements in respect of timing differences that arise from the elimination of profits and losses resulting from intragroup transactions in consolidated financial statements.

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UNIT 5:
IND AS 111: JOINT ARRANGEMENTS

5.1 OBJECTIVE OF IND AS 111

Joint arrangement is an arrangement of which two or more parties have joint control. Joint arrangements are established for a variety of purposes (e.g. as a way for parties to share costs and risks, or as a way to provide the parties with access to new technology or new markets) and can be established using different structures and legal forms.

The objective of Ind AS 111 is to establish principles for financial reporting by entities that have an interest in a joint arrangement.

This Ind AS defines various terms related to joint arrangements. It requires an entity that is a party to a joint arrangement to determine the type of joint arrangement in which it is involved i.e. whether it is a joint operation or a joint venture by assessing its rights and obligations. Based on the type of the arrangement, the accounting treatment for that arrangement will be decided.

5.2 SCOPE OF IND AS 111

Ind AS 111 shall be applied by all entities that are a **party to a joint arrangement**.

5.3 ASSESSMENT OF JOINT ARRANGEMENT

As mentioned above, a joint arrangement is an arrangement of which two or more parties have joint control.

A joint arrangement has the following characteristics:

The parties are bound by a **contractual arrangement**	AND	The contractual arrangement gives two or more of those parties **joint control** of the arrangement

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5.3.1 Contractual arrangement

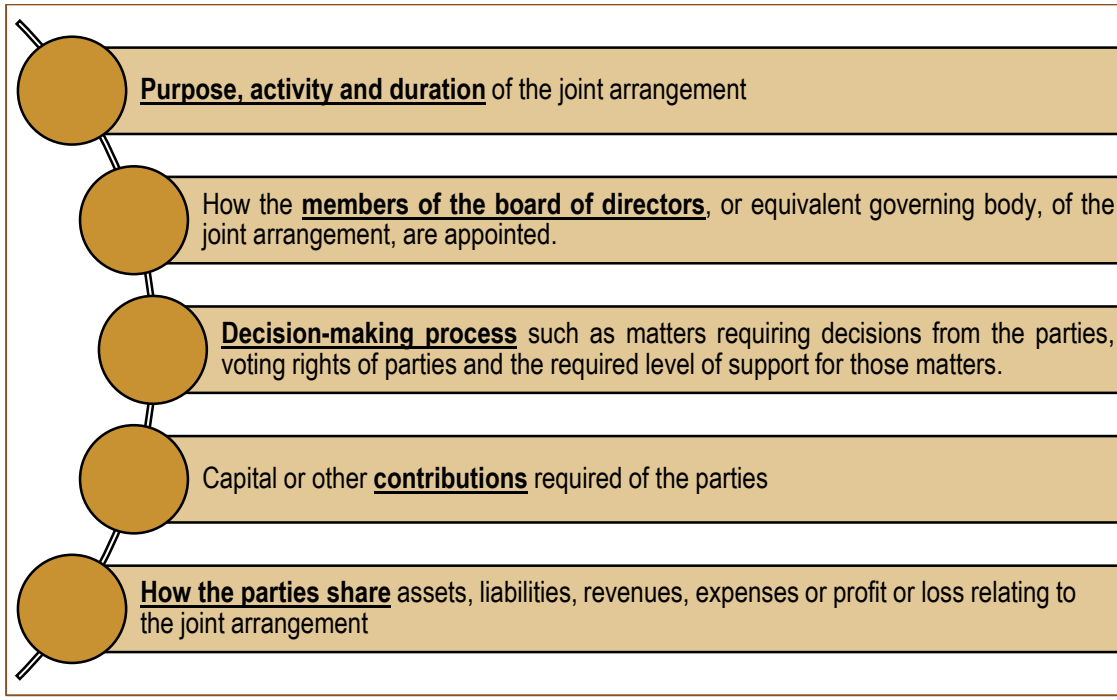
One of the essential elements of a joint arrangement is that there has to be a contractual arrangement between the parties to the arrangement. A contractual arrangement is usually in writing, however, it can be evidenced in several other ways as well.

A joint arrangement can be structured through a separate vehicle. In most of such case, the contractual arrangement is incorporated in the articles, charter or by-laws of the separate vehicle.

Example 1

A Ltd. and B Ltd. incorporated a new entity AB Ltd. The articles of association of AB Ltd. defines the terms of contractual arrangements between A Ltd. and B Ltd.

The contractual arrangement describes the terms of arrangement between the two or more parties that are involved in the activity that is subject of the arrangement. The contractual arrangement generally deals with such matters as:



5.3.2 Joint control

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when **decisions about the relevant activities** require the **unanimous consent** of the parties sharing control.

Hence, in a joint arrangement, all the parties to an arrangement must act collectively in order to take decisions about the relevant activities of the arrangement and there is no single party who

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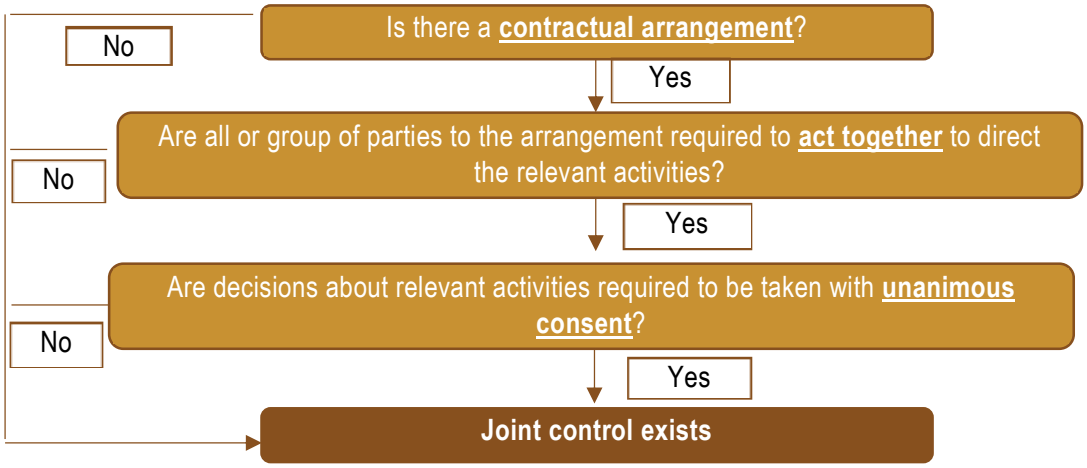
can control the arrangement individually. In a joint arrangement, any party sharing the control can prevent the other party / parties from controlling the arrangement.

In order to assess the joint control, an entity that is a party to an arrangement should **first assess** that whether the contractual arrangement gives all the parties or a group of the parties **control over the arrangement**. Control assessment will be done based on the guidance given in Ind AS 110 (which is discussed in Unit 3). Accordingly, all the principles of control assessment, some of which are summarised below, would be relevant while doing the assessment of joint control by the parties:

- Power over the relevant activities of the investee
  - Power with and without voting rights
  - Potential voting rights
  - Rights to appoint Key Managerial Personnel
  - De-facto control
  - Purpose and design of the investee
  - Contractual arrangements
  - Special relationship with investor and investee
- Exposure to returns
- Ability to use the power to affect the returns of the investee

Hence, if all the parties or a group of parties to a contractual arrangement (**considered collectively**) have power, exposure to returns and ability to use that power to affect the returns of the arrangement then the parties have control over the arrangement collectively.

The flowchart below can be used as a visual aid to remember the aforementioned concepts in brief:



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Please remember: In a joint arrangement, no single party controls the arrangement on its own. That is because, by definition, a party with joint control can prevent other parties from controlling the arrangement.

Following are some of the illustrations for doing assessment of joint control.

(One should keep in mind that the illustrations on control assessment discussed in Unit 3 would also be equally relevant for doing assessment of joint control).

Illustration 1: Joint control

ABC Ltd. and DEF Ltd. have entered into a contractual arrangement to manufacture a product and sell that in retail market. As per the terms of the arrangement, decisions about the relevant activities require consent of both the parties. The parties share the returns of the arrangement equally amongst them. Whether the arrangement can be treated as joint arrangement?

Solution:

The arrangement is a joint arrangement since both the parties are bound by the contractual arrangement and the decisions about relevant activities require unanimous consent of both the parties.

*****

Sometimes the decision-making process that is agreed upon by the parties in their contractual arrangement **implicitly leads to joint control**. This is explained in below illustrations:

Illustration 2: Implicit joint control

PQR Ltd. and XYZ Ltd. established an arrangement in which each has 50% of the voting rights and the contractual arrangement between them specifies that at least 51% of the voting rights are required to make decisions about the relevant activities. Whether the arrangement can be treated as joint arrangement?

Solution:

In this case, the parties have implicitly agreed that they have joint control of the arrangement because decisions about the relevant activities cannot be made without both parties agreeing.

*****

Illustration 3: Implicit joint control

A Ltd., B Ltd. and C Ltd. established an arrangement whereby A Ltd. has 50% of the voting rights in the arrangement, B Ltd. has 30% and C has 20%. The contractual arrangement between A Ltd., B Ltd. and C Ltd. specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement. Whether the arrangement can be treated as joint arrangement?

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Solution:

In this case, even though A can block any decision, it does not control the arrangement because it needs the agreement of B. The terms of their contractual arrangement requiring at least 75% of the voting rights to make decisions about the relevant activities imply that A Ltd. and B Ltd. have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A Ltd. and B Ltd. agreeing.

*****

Apart from the above-mentioned situations of implicit joint control, there can be other circumstances where the contractual arrangement requires a minimum proportion of the voting rights to make decisions about the relevant activities. When that minimum required proportion of the voting rights can be achieved by more than one combination of the parties agreeing together, that arrangement is not a joint arrangement unless the **contractual arrangement specifies** which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement. This is explained in below illustrations:

Illustration 4: Explicit joint control

An arrangement has three parties: X Ltd. has 50% of the voting rights in the arrangement and Y Ltd. and Z Ltd. each have 25%. The contractual arrangement between them specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement. Whether the arrangement can be treated as joint arrangement?

Solution:

In this case, even though X Ltd. can block any decision, it does not control the arrangement because it needs the agreement of either Y Ltd. or Z Ltd. In this question, X Ltd., Y Ltd. and Z Ltd. collectively control the arrangement. However, there is more than one combination of parties that can agree to reach 75% of the voting rights (i.e. either X Ltd. and Y Ltd. or X Ltd. and Z Ltd.). In such a situation, to be a joint arrangement the contractual arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to decisions about the relevant activities of the arrangement.

*****

Illustration 5: Explicit joint control

An arrangement has A Ltd. and B Ltd. each having 35% of the voting rights in the arrangement with the remaining 30% being widely dispersed. Decisions about the relevant activities require approval by a majority of the voting rights. Whether the arrangement can be treated as joint arrangement?

Solution:

A Ltd. and B Ltd. have joint control of the arrangement only if the contractual arrangement specifies that decisions about the relevant activities of the arrangement require both A Ltd. and

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B Ltd. agreeing. However, in the given case, decisions about the relevant activities require approval by a majority of the voting rights. Hence, there is no joint arrangement.

*****

The above illustrations also highlight that it is **not necessary** that all the parties in an arrangement should have joint control to form a joint arrangement. Some party or parties may be participating in the joint arrangement but may not be having joint control of that joint arrangement. That is the reason the word "or" has been used between the words "all" and "group of parties" in the flowchart given earlier.

Following are some further illustrations on assessment of whether a joint arrangement exists or not:

Illustration 6: Joint control through board representation

Electronics Ltd. is established by two investors R Ltd. and S Ltd. The investors are holding 60% and 40% of the voting power of the investee respectively.

As per the articles of association of Electronics Ltd., both the investors have right to appoint 2 directors each on the board of Electronics Ltd. The directors appointed by each investor will act in accordance with the directions of the investor who has appointed such director. Further, articles of association provides that the decision about relevant activities of the entity will be taken by board of directors through simple majority.

Determine whether Electronics Ltd. is controlled by a single investor or is jointly controlled by both the investors.

Solution:

The decisions about relevant activities are required to be taken by majority of board of directors. Hence, out of the 4 directors, at least 3 directors need to agree to pass any decision. Accordingly, the directors appointed by any one investor cannot take the decisions independently without the consent of at least one director appointed by other investor. Hence, Electronics Ltd. is jointly controlled by both the investors. R Ltd. holding majority of the voting rights is not relevant in this case since the voting rights do not given power over the relevant activities of the investee.

*****

Illustration 7: Chairman with casting vote

MN Software Ltd. is established by two investors M Ltd. and N Ltd. Both the investors are holding 50% of the voting power each of the investee.

As per the articles of association of MN Software Ltd., both the investors have right to appoint 2 directors each on the board of the company. The directors appointed by each investor will act in accordance with the directions of the investor who has appointed such director. The decision about relevant activities of the entity will be taken by board of directors through simple majority.

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Articles of association also provides that M Ltd. has right to appoint the chairman of the board who will have right of a casting vote in case of a deadlock situation.

Determine whether MN Software Ltd. is jointly controlled by both the investors.

Solution:

The decisions about relevant activities are required to be taken by majority of board of directors. Hence, out of the 4 directors, at least 3 directors need to agree to pass any decision. Accordingly, the directors appointed by any one investor cannot take the decisions independently without the consent of at least one director appointed by other investor. However, the chairman of the board has right for a casting vote in case of a deadlock in the board. Hence, M Ltd. has the ability to take decisions related to relevant activities through 2 votes by directors and 1 casting vote by chairman of the board. Therefore, M Ltd. individually has power over MN Software Ltd. and there is no joint control.

*****

Illustration 8: Equal voting rights but no joint control

ABC Ltd. is established by two investors AB Ltd. and BC Ltd. Each investor is holding 50% of the voting power of the investee.

As per the articles of association of ABC Ltd., AB Ltd. and BC Ltd. have right to appoint 3 directors and 2 directors respectively on the board of ABC Ltd. The directors appointed by each investor will act in accordance with the directions of the investor who has appointed such director. Further, articles of association provides that the decision about relevant activities of the entity will be taken by board of directors through simple majority.

Determine whether ABC Ltd. is jointly controlled by both the investors.

Solution:

The decisions about relevant activities are required to be taken by majority of board of directors. Hence, out of the 5 directors, at least 3 directors need to agree to pass any decision. Accordingly, the directors appointed by AB Ltd. can take the decisions independently without the consent of any of the directors appointed by BC Ltd. Hence, ABC Ltd. is not jointly controlled by both the investors. Equal voting rights held by both the investors is not relevant in this case since the voting rights do not given power over the relevant activities of the investee.

*****

Illustration 9: Joint control over specific asset

X Ltd. and Y Ltd. entered into a contractual arrangement to buy a piece of land to construct residential units on the said land and sell to customers.

As per the arrangement, the land will be further divided into three equal parts. Out of the three parts, both the parties will be responsible to construct residential units on one part each by taking

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decision about relevant activities independently and they will be entitled to the returns generated from their own part of land. The third part of the land will be jointing managed by both the parties requiring unanimous consent of both the parties for all the decision making.

Determine whether the arrangement is a joint arrangement or not.

Solution:

The two parts of the land which are required to be managed by both the parties independently on their own would not fall within the definition of a joint arrangement. However, the third part of the land which is required to be managed by both the parties with unanimous decision making would meet the definition of a joint arrangement.

*****

Illustration 10: Multiple relevant activities directed by different investors

Entity R and entity S established a new entity RS Ltd. to construct a national highway and operate the same for a period of 30 years as per the contract given by government authorities.

As per the articles of association of RS Ltd, the construction of the highway will be done by entity R and all the decisions related to construction will be taken by entity R independently. After the construction is over, entity S will operate the highway for the period of 30 years and all the decisions related to operating of highway will be taken by entity S independently. However, decisions related to funding and capital structure of RS Ltd. will be taken by both the parties with unanimous consent.

Determine whether RS Ltd. is a joint arrangement between entity R and entity S?

Solution:

In this case, the investors should evaluate which of the decisions about relevant activities can most significantly affect the returns of RS Ltd. In the given case, construction of the national highway and operation of the same are both significant activities with control over the same being held unilaterally by R Ltd. and S Ltd. However, the decisions related to funding and capital structure of RS Ltd. are taken with unanimous consent.

The above structure is tabulated below:

Activity	Decision-making	Remarks
Construction of the highway	R Ltd., independently	All activities are significant for RS Ltd., but since funding and capital structure are essential without which construction and operation cannot commence, the same is highly significant.
Operation of the highway	S Ltd., independently	
Funding and Capital Structure	Joint decision-making by R Ltd. and S Ltd., both	

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In view of the above, since the decision relating to Funding and Capital Structure are taken jointly by R Ltd. and S Ltd. both, we can conclude that RS Ltd. is a joint arrangement.

*****

Illustration 11: Informal agreement for sharing of control

An entity has four investors A, B, C and D holding 10%, 20%, 30% and 40% voting power respectively. The articles of association require decisions about relevant activities to be taken by majority voting rights. However, investor A, B and C have informally agreed to vote together. This informal agreement has been effective in recent meetings of the investors to take decisions about relevant activities. Whether A, B and C have joint control over the entity?

Solution:

In this case, three investors have informally agreed to make unanimous decisions. These three investors together also have majority voting rights in the entity. Hence, investor A, B and C have joint control over the entity. The agreement between investor A, B and C need not be formally documented as long as there is evidence of its existence in recent meetings of the investors.

*****

It should be noted that if the requirement for unanimous consent relates only to decisions that give a party **protective rights** and not to decisions about the relevant activities of an arrangement, that party is not a party with joint control of the arrangement. This is explained in below illustration:

Illustration 12: Party with protective rights

D Ltd., E Ltd. and F Ltd. have established a new entity DEF Ltd. As per the arrangement, unanimous consent of all three parties is required only with respect to decisions related to change of name of the entity, amendment to constitutional documents of the entity to enter into a new business, change in the registered office of the entity, etc. Decisions about other relevant activities require consent of only D Ltd. and E Ltd. Whether F Ltd. is a party with joint control of the arrangement?

Solution:

Consent of F Ltd. is required only with respect to the fundamental changes in DEF Ltd. Hence these are protective rights. The decisions about relevant activities are taken by D Ltd. and E Ltd. Hence, F Ltd. is not a party with joint control of the arrangement.

*****

A contractual arrangement might include clauses on the **resolution of disputes**, such as arbitration. These provisions may allow for decisions to be made **without unanimous consent** among the parties that have joint control. The existence of such provisions does not prevent the arrangement from being jointly controlled and, consequently, from being a joint arrangement. This is explained in below illustration:

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Illustration 13: Resolution of disputes without unanimous consent

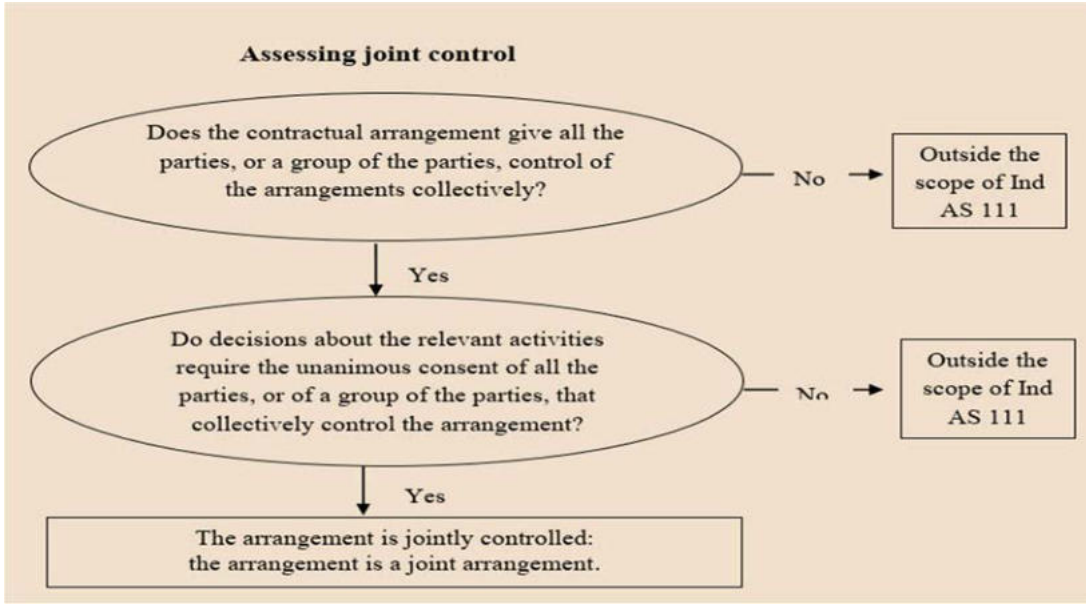
Entity A and Entity B established a contractual arrangement whereby the decision related to relevant activities are required to be taken by unanimous consent of both the parties. However, in case of any dispute with any vendor or customer of the arrangement, entity A has right to take necessary decisions for the resolution of disputes including decisions of going for the arbitration or filing a suit in court of law. Whether the arrangement is a joint arrangement?

Solution:

The arrangement is a joint arrangement since the contractual arrangement requires decisions about relevant activities to be taken by unanimous consent of both the parties. The right available with entity A to take decisions for resolution of disputes will not prevent the arrangement from being a joint arrangement.

*****

The following flow chart summarises the requirements of assessing joint control:



When an arrangement is outside the scope of Ind AS 111, an entity accounts for its interest in the arrangement in accordance with relevant Ind AS, such as Ind AS 110, Ind AS 28 or Ind AS 109.

If facts and circumstances change, an entity shall reassess whether it still has joint control of the arrangement.

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5.4 TYPES OF JOINT ARRANGEMENT

Once it is determined that an arrangement is a joint arrangement, the entity needs to determine whether the joint arrangement is a joint operation or a joint venture depending upon the rights and obligations of the parties to the arrangement. This determination is relevant because of the way the joint arrangement is accounted for i.e. whether it is a consolidation of assets, liabilities, income and expenses or use of equity method specified under Ind AS 28.

Joint operation and joint venture are defined below:

A **joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have **rights to the assets, and obligations for the liabilities**, relating to the arrangement. Those parties are called joint operators.

A **joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have **rights to the net assets** of the arrangement. Those parties are called joint venturers.

As mentioned above, for classification of a joint arrangement between joint operation and joint venture, the parties shall assess their rights and obligations arising from the arrangement. When making that assessment, an entity shall consider the **structure of the joint arrangement**. Further, if the joint arrangement is **structured through a separate** vehicle then the entity shall consider the following.

- The legal form of the separate vehicle
- The terms of the contractual arrangement
- When relevant, other facts and circumstances

Each of the above factors are discussed below in detail. If facts and circumstances change, an entity shall reassess whether its earlier conclusion on the type of joint arrangement has changed.

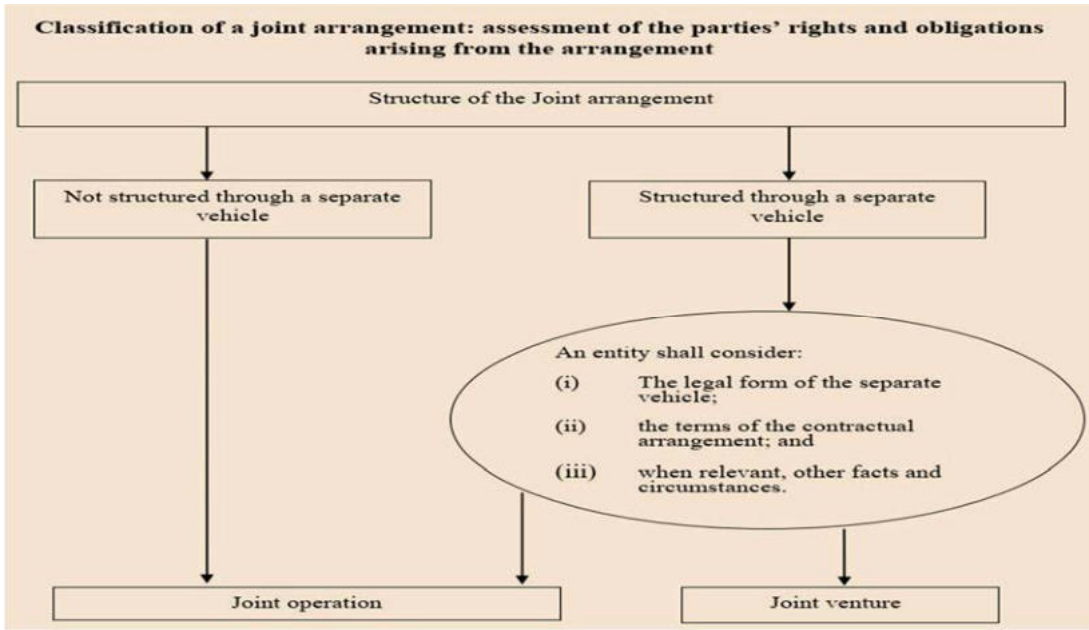
5.4.1 Assessment of whether a joint arrangement is a joint operation or a joint venture

When assessing whether a joint arrangement is a joint operation or a joint venture, an entity should first determine whether the joint arrangement is structured through a separate vehicle or not. Some joint arrangements are not structured through a separate vehicle and some joint arrangements are structured through a separate vehicle.

A separate vehicle is defined in Ind AS 111 as a **separately identifiable financial structure**, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality. **Examples** of a separate vehicle include partnership, company, trust, association of persons, government authority, etc.

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Below chart summarise the classification of a joint arrangement based on the structure of the arrangement.



5.4.1.1 Joint arrangements not structured through a separate vehicle

A joint arrangement that is not structured through a separate vehicle is a **joint operation**.

In such case, the contractual arrangement often describes the nature of the activities that are the subject of the arrangement and how the parties intend to undertake those activities together. The contractual arrangement also establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement. The contractual arrangement could also specify how the revenues and expenses that are common to the parties are to be shared among them.

This is explained in below illustration:

Illustration 14: Joint operation

P Ltd. and Q Ltd. are two construction entities and they have entered into a contractual arrangement to jointly construct a metro rail project.

The construction of metro rail project involves various activities such as construction of infrastructure (like metro station, control room, pillars at the centre of the road, etc.) for the metro, laying of the tracks, acquiring of the coaches of the metro, etc. The total length of the metro line to be constructed is 50 kms. As per the arrangement, both the parties are responsible to construct 25 kms each. Each party is required to incur its own cost, use its own assets, incur the liability and has right to the revenue from their own part of the work.

Determine whether the arrangement is a joint operation or not?

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Solution:

The arrangement is a joint operation since the arrangement is not structured through a separate vehicle and each party has rights to the assets, and obligations for the liabilities relating to their own part of work in the joint arrangement.

*****

In some cases, the parties to a joint arrangement might agree, for example, to share and operate an asset together. However, such arrangements are still a joint operation since they are not structured through a separate vehicle.

In such a case, the contractual arrangement establishes the parties' rights to the asset that is operated jointly, and how output or revenue from the asset and operating costs are shared among the parties. This is explained in below illustration:

Illustration 15: Joint operation by sharing an asset

RS Ltd. and MN Ltd. entered into a contractual arrangement to run a business of providing cars of hire. The cars will be owned by both the parties jointly. The expenses to run the car (like driver salary, petrol, maintenance, insurance, etc.) and revenues from the business will be shared between both the parties as agreed in the contractual arrangement. Determine whether the arrangement is a joint operation or not?

Solution:

The arrangement is a joint operation since the arrangement is not structured through a separate vehicle.

*****

5.4.1.2 Joint arrangements structured through a separate vehicle

A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle can be either **a joint venture or a joint operation**.

As mentioned earlier, when the joint arrangement is structured through a separate vehicle, an entity should consider i) legal form of the separate vehicle, ii) the terms of the contractual arrangement and, when relevant, iii) any other facts and circumstances to assess whether the arrangement is a joint venture or a joint operation. Each of these factors are further explained below.

5.4.1.2.1 The legal form of the separate vehicle

The legal form of the separate vehicle is relevant when assessing the type of joint arrangement.

For example, there may be a situation where the legal form of a separate vehicle causes the separate vehicle to be **considered in its own right** (i.e. the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and

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liabilities of the parties). In such case, the legal form of the separate vehicle indicates that the arrangement is a joint venture.

If the legal form of the separate vehicle indicates that the arrangement is a joint venture then the entity should further evaluate the terms of contractual arrangements and any other relevant facts and circumstance to see whether those factors indicate that the arrangement is a joint operation or not. However, if the legal form indicates that the arrangement is a joint operation (i.e. in a situation where the legal form does not confer separation between the parties and the separate vehicle) then there is no need to evaluate any other factor and the arrangement is concluded to be a joint operation.

Illustration 16: Legal form indicates the arrangement to be a joint venture

Entity X and Entity Y are engaged in the business of Engineering, Procurement and Construction (EPC) for its customers. Both the parties have jointly won a contract from a customer for executing an EPC contract and for that the parties have established a new entity XY Ltd. The contract will be executed through XY Ltd.

All the assets required for the execution of the contract will be acquired and liabilities relating to the execution will be incurred by XY Ltd. in its own name. Entity X and entity Y will have share in the net profits of XY Ltd. in the ratio of their shareholding i.e. 50% each. Assuming that the arrangement meets the definition of a joint arrangement, determine whether the joint arrangement is a joint operation or a joint venture?

Solution:

The legal form of the separate vehicle is a company. The legal form of the separate vehicle causes the separate vehicle to be considered in its own right. Hence, it indicates that the arrangement is a joint venture. In this case, the parties should further evaluate the terms of contractual arrangements and other relevant facts and circumstance to conclude whether the arrangement is a joint venture or a joint operation.

*****

Illustration 17: Legal form indicates the arrangement to be a joint operation

Two entities have established a Limited Liability Partnership (LLP) with each party having 50% share in the net profits of the firm. If the arrangement meets the definition of a joint arrangement, determine whether the joint arrangement is a joint operation or a joint venture? Would your answer change if a partnership firm was established instead of an LLP.

Solution:

A limited liability partnership is recognized as a body corporate with an existence distinct from that of its partners. Accordingly, the partners to the LLP would have a right to the net assets of the LLP as against a right to the assets and obligations to the liabilities of the same. Accordingly, such an arrangement would be a joint venture.

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In case the entity formed is a partnership firm, the Indian Partnership Act, 1932 does not distinguish the partners from the partnership firm, and therefore all the partners would be liable to the liabilities of the firm, as well as have interest in the assets of the firm (and not the net assets). accordingly, there would be no separation between the partners and the partnership firm. Hence, in such a case, the joint arrangement would be regarded as a joint operation.

*****

5.4.1.2.2 Assessing the terms of the contractual arrangement

Generally, the rights and obligations conferred through contractual arrangement are consistent with the rights and obligations conferred by the legal form of the separate vehicle. However, in some case the contractual arrangement alters the rights and obligations conferred by the legal form of the separate vehicle.

If the contractual arrangement indicates that the arrangement is a joint operation then there is no need to evaluate any other facts and circumstances and the arrangement is concluded to be a joint operation.

Illustration 18: Assessing the terms of the contractual arrangement

Continuing with the illustration 16 above, assume that Entity X and Entity Y have entered into a separate agreement whereby they have agreed that each party has an interest in the assets of the XY Ltd. and each party is liable for the liabilities of XY Ltd. in a specified proportion. Determine whether the joint arrangement is a joint operation or a joint venture?

Solution:

In this case, the terms of the separate agreement may cause the arrangement to be a joint operation.

*****

The following table provides some examples (not an exhaustive list) of some common terms present in contractual arrangements of parties to a joint operation and a joint venture:

Assessing the terms of the contractual arrangement		
	Joint operation	**Joint venture**
The terms of the contractual arrangement	The terms provide the parties with rights to the assets, and obligations for the liabilities, relating to the arrangement.	The terms provide the parties with rights to the net assets of the arrangement.
Rights to assets	The parties share all interests (e.g. rights, title or ownership) in the	The assets brought into the arrangement or subsequently acquired by the joint

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	assets relating to the arrangement in a specified proportion.	arrangement are the arrangement's assets. The parties have no interests (i.e. no rights, title or ownership) in the assets of the arrangement.
Obligations for liabilities	The parties to the joint arrangement share all liabilities, obligations, costs and expenses in a specified proportion. The parties to the joint arrangement are liable for claims raised by third parties.	The joint arrangement is liable for the debts and obligations of the arrangement. The parties are liable to the arrangement only to the extent of their respective investments in the arrangement or to their respective obligations to contribute any unpaid or additional capital to the arrangement. Creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.
Revenues, expenses, profit or loss	Revenues and expenses are allocated on the basis of the relative performance of each party to the joint arrangement. However, the parties might have agreed to share the profit or loss relating to the arrangement on the basis of a specified proportion such as the parties' ownership interest in the arrangement. This would not prevent the arrangement from being a joint operation if the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.	Each party has share in the profit or loss relating to the activities of the arrangement.

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Guarantees	The parties to joint arrangements might provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees does not, by itself, determine that the joint arrangement is a joint operation. The feature that determines whether the classification of joint arrangement is whether the parties have obligations for the liabilities relating to the arrangement (whether they are guaranteed by the parties or not is irrelevant).

5.4.1.2.3 Assessing other facts and circumstances

When the legal form of the separate vehicle and the terms of the contractual arrangement indicate that the arrangement is a joint venture, the parties should evaluate other relevant facts and circumstance to assess whether the arrangement is a joint operation or not. If the other relevant facts and circumstances also do not have evidence of the arrangement being a joint operation then the arrangement is concluded to be a joint venture.

The other relevant facts and circumstances that should be evaluated which might indicate that the arrangement is a joint operation are as follows. If both the following conditions are satisfied then the arrangement is a joint operation.

- The arrangement's activities primarily aim to **provide the parties with an output** (i.e. the parties have rights to substantially all the economic benefits of the assets held in the separate vehicle); and
- 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.

Illustration 19: Assessing other facts and circumstances

Two parties structure a joint arrangement in an incorporated entity i.e. Entity A in which each party has a 50% ownership interest. The purpose of the arrangement is to manufacture materials required by the parties for their own, individual manufacturing processes. The arrangement ensures that the parties operate the facility that produces the materials to the quantity and quality specifications of the parties. The legal form of Entity A (an incorporated entity) through which the activities are conducted initially indicates that the assets and liabilities held in Entity A are the assets and liabilities of Entity A. The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of Entity A. There are following other relevant facts and circumstances applicable in this case:

- *The parties agreed to purchase all the output produced by Entity A in a ratio of 50:50. Entity A cannot sell any of the output to third parties, unless this is approved by the two parties to the arrangement. Because the purpose of the arrangement is to provide the parties with*

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output they require, such sales to third parties are expected to be uncommon and not material.

- *The price of the output sold to the parties is set by both parties at a level that is designed to cover the costs of production and administrative expenses incurred by Entity A. On the basis of this operating model, the arrangement is intended to operate at a break-even level.*

Based on the above fact pattern, determine whether the arrangement is a joint operation or a joint venture?

Solution:

The legal form of Entity A and the terms of the contractual arrangement indicate that the arrangement is a joint venture. However, the other relevant facts and circumstances mentioned above indicates that:

- the obligation of the parties to purchase all the output produced by Entity A reflects the exclusive dependence of Entity A upon the parties for the generation of cash flows and, thus, the parties have an obligation to fund the settlement of the liabilities of Entity A.
- the fact that the parties have rights to all the output produced by Entity A means that the parties are consuming, and therefore have rights to, all the economic benefits of the assets of Entity A.

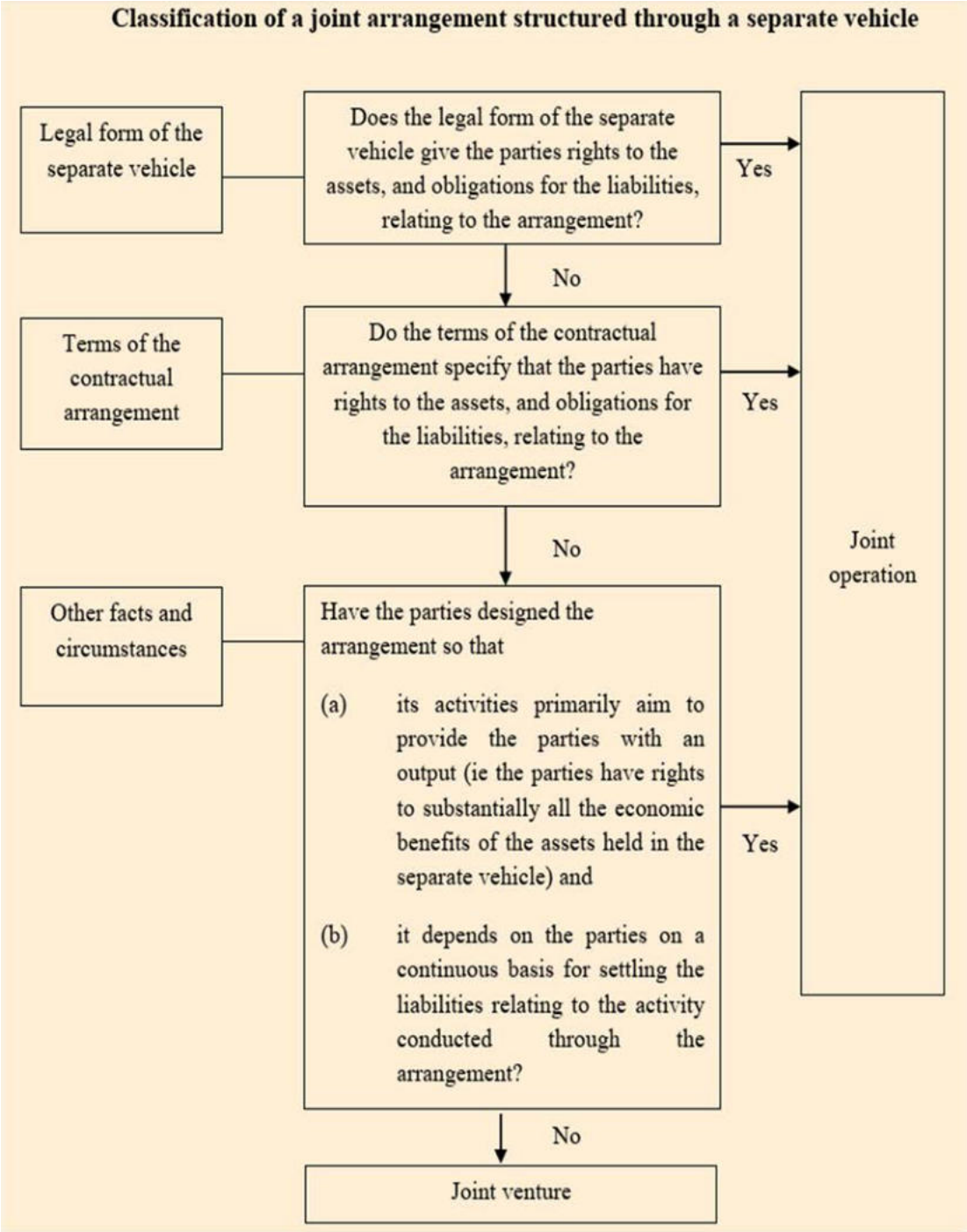
These facts and circumstances indicate that the arrangement is a joint operation. The conclusion about the classification of the joint arrangement in these circumstances would not change if, instead of the parties using their share of the output themselves in a subsequent manufacturing process, the parties sold their share of the output to third parties.

If the parties changed the terms of the contractual arrangement so that the arrangement was able to sell output to third parties, this would result in Entity A assuming demand, inventory and credit risks. In that scenario, such a change in the facts and circumstances would require reassessment of the classification of the joint arrangement. Such facts and circumstances would indicate that the arrangement is a joint venture.

*****

The following flow chart summarises the above principles an entity should follow to classify an arrangement when the joint arrangement is **structured through a separate vehicle**:

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5.4.2 Multiple joint arrangements under single framework agreement

Sometimes the parties may be bound by a framework agreement that sets up the general

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contractual terms for undertaking one or more activities. Under a single framework agreement, the parties might establish different joint arrangements for different activities to be performed under the framework agreement. Even though all such joint arrangements are related to the same framework agreement, their type might be different i.e. one joint arrangement can be a joint operation and another joint arrangement can be a joint venture. This is explained in below illustration:

Illustration 20: 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 ACD Ltd. are the assets and liabilities of ABC 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.

*****

5.5 ACCOUNTING OF JOINT OPERATIONS

In this section, we will discuss following concepts related to accounting of joint operations:

- Accounting of interest in joint operations in separate and consolidated financial statement of joint operator

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- Accounting for sales or contributions of assets to a joint operation in separate and consolidated financial statement of joint operator
- Accounting for purchases of assets from a joint operation in separate and consolidated financial statement of joint operator
- Accounting by an entity that is a party to the joint operation but does not have joint control

5.5.1 Accounting of interest in joint operations in separate and consolidated financial statement of joint operator

A joint operator shall recognise in its **separate and consolidated financial statements** in relation to its interest in a joint operation:

a) its assets, including its share of any assets held jointly;

b) its liabilities, including its share of any liabilities incurred jointly;

c) its revenue from the sale of its share of the output arising from the joint operation;

d) its share of the revenue from the sale of the output by the joint operation; and

e) its expenses, including its share of any expenses incurred jointly.

A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the Ind ASs applicable to the particular assets, liabilities, revenues and expenses.

Illustration 21: Accounting of interest in joint operation

P and Q form a joint arrangement PQ using a separate vehicle. P and Q each own 50% of the capital of PQ. However, the contractual terms of the joint arrangement states that P has the rights to all of Machinery and the obligation to pay Bank Loan in PQ. P and Q have rights to all other assets in PQ and obligations for all other liabilities in PQ in proportion to their share of capital (i.e. 50% each).

PQ's balance sheet is as follows:

Balance Sheet

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

How should P record in its financial statements its rights and obligations in PQ?

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Solution:

Under Ind AS 111, P should record the following in its financial statements, to account for its rights in the assets of PQ and its obligations for the liabilities of PQ.

Machinery	2,50,000
Cash	25,000
Capital	75,000
Bank Loan	75,000
Other Loan	37,500

*****

Illustration 22: Accounting of interest in joint operation

AB Ltd. and BC Ltd. have established a joint arrangement through a separate vehicle PQR. The legal form of the separate vehicle does not confer separation between the parties and the separate vehicle itself. Thus, both the parties have rights to the assets and obligations for the liabilities of PQR. As neither the contractual terms nor the other facts and circumstances indicate otherwise, it is concluded that the arrangement is a joint operation and not a joint venture.

Both the parties own 50% each of the equity interest in PQR. However, the contractual terms of the joint arrangement state that AB Ltd. has the rights to all of Building No. 1 owned by PQR and the obligation to pay all of the debt owned by PQR to a lender XYZ. AB Ltd. and BC Ltd. have rights to all other assets of PQR and obligations for all other liabilities of PQR in proportion of their equity interests (i.e. 50% each)

PQR's balance sheet is as follows:

Balance Sheet

Liabilities	₹	Assets	₹
Debt owed to XYZ	240	Cash	40
Employee benefit plan obligation	100	Building 1	240
Equity	140	Building 2	200
	480		480

How should AB Ltd. record in its financial statements its rights and obligations in PQR?

Solution:

Under Ind AS 111, AB Ltd. should record the following in its financial statements, to account for its rights in the assets of PQR and its obligations for the liabilities of PQR.

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	₹
Assets	
Cash	20
Building 1 *	240
Building 2	100
Liabilities	
Debt (third party) ^	240
Employee benefit plan obligation	50
Equity	70

* Since AB Ltd. has the rights to all of Building No. 1, it records the amount in its entirety.

^ AB Ltd. has obligation for the debt owed by PQR to XYZ in its entirety

*****

5.5.2 Accounting for sales or contributions of assets to a joint operation in separate and consolidated financial statement of joint operator

When a joint operator sells or contributes any asset to the joint operation, it is in effect transacting with the other parties to the joint operation and hence the joint operator shall **recognise gains and losses** resulting from such transactions **only to the extent of the other parties' interest** in the joint operation.

Illustration 23: Accounting for sales or contributions of assets to a joint operation

A Ltd. is one of the parties to a joint operation holding 60% interest in a joint operation and the balance 40% interest is held by another joint operator. A Ltd. has contributed an asset held by it to the joint operation for the activities to be conducted in joint operation. The carrying value of the asset sold was ₹ 100 and the asset was actually sold for ₹ 80 i.e. at a loss of ₹ 20.

How should A Ltd. account for the sale of asset to joint operation in its books?

Solution:

A Ltd. should record the loss on the transaction only to the extent of other party's interest in the joint operation.

The total loss on the transaction is ₹ 20. Hence, A Ltd. shall record loss on sale of asset to the extent of ₹ 8 (₹ 20 x 40%) which is the loss pertaining to the interest of other party to the joint operation. The loss of ₹ 12 (₹ 20 - ₹ 8) shall not be recognised as that is unrealised loss.

Further, while accounting its interest in the joint operation, A Ltd. shall record its share in that asset at value of ₹ 60 [A Ltd. share of asset ₹ 48 (₹ 80 x 60%) plus unrealised loss of ₹ 12].

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The journal entry for the transaction would be as follows:

Bank	Dr.	₹ 32	
Loss on sale	Dr.	₹ 8	
To Asset			₹ 40

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When above transactions provide evidence of a **reduction in the net realisable value** of the assets to be sold or contributed to the joint operation, or of an **impairment loss** of those assets, those losses shall be **recognised fully** by the joint operator.

5.5.3 Accounting for purchases of assets from a joint operation in separate and consolidated financial statement of joint operator

When a joint operator purchases any asset from the joint operation, it **shall not recognise its share** of the gains and losses until it resells those assets to a third party.

Illustration 24: Accounting for purchases of assets from a joint operation

A Ltd. is one of the parties to a joint operation holding 60% interest in the joint operation and the balance 40% interest is held by another joint operator. A Ltd. has purchased an asset from the joint operation. The carrying value of the asset in the books of joint operation was ₹ 100 and the asset was actually purchased for ₹ 80 i.e. at a loss of ₹ 20. How should A Ltd. account for the purchase of asset from joint operation in its books?

Solution:

A Ltd. should not record its share of the loss until the asset is resold to a third party.

The joint operation has sold the asset at ₹ 80 by incurring a loss of ₹ 20. Hence, A Ltd. shall record the asset at ₹ 92 [Purchase price ₹ 80 + A Ltd.'s share in loss ₹ 12 (₹ 20 x 60%)].

Further, while accounting its interest in the joint operation, A Ltd. shall not record any share in the loss incurred in sale transaction by the joint operation.

The journal entry for the transaction would be as follows:

Asset	Dr.	₹ 32	
To Bank			₹ 32

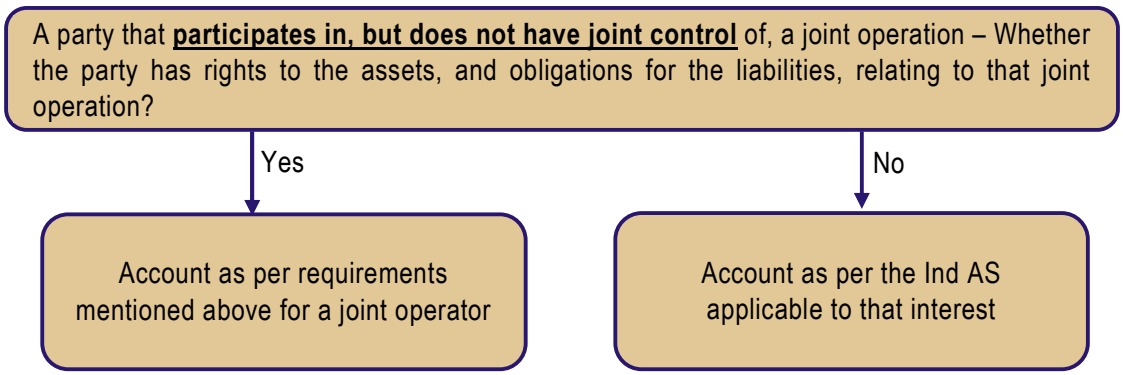
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When above transactions provide evidence of a **reduction in the net realisable value** of the assets to be purchased or of an **impairment loss** of those assets, a joint operator shall **recognise its share of those losses**.

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5.5.4 Accounting by an entity that is a party to the joint operation but does not have joint control

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



5.6 ACCOUNTING OF JOINT VENTURES

5.6.1 Accounting in the consolidated financial statements

A joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the **equity method** in accordance with **Ind AS 28**, unless the entity is exempted from applying the equity method as specified in that standard. These requirements are discussed in detail in unit 6.

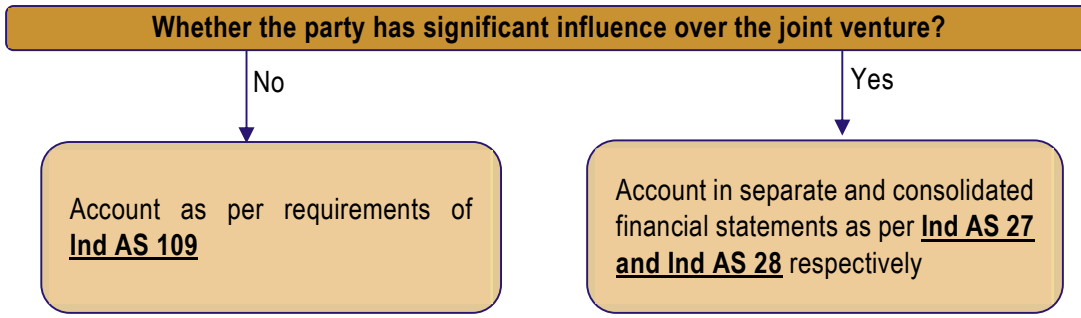
5.6.2 Accounting in the separate financial statements

In its separate financial statements, a joint venturer shall account for its interest in a joint venture in accordance **Ind AS 27**. These requirements are discussed in detail in unit 7.

5.6.3 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:

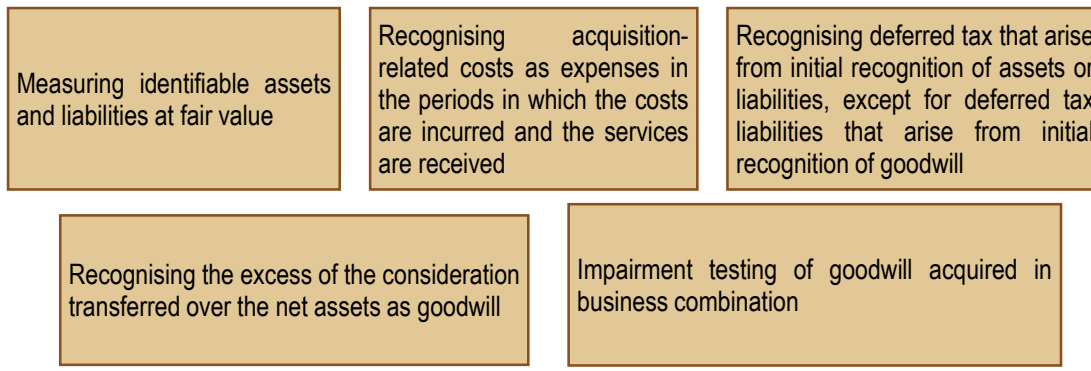
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5.7 ACCOUNTING FOR ACQUISITIONS OF INTERESTS IN JOINT OPERATIONS IN SEPARATE AND CONSOLIDATED FINANCIAL STATEMENT OF JOINT OPERATOR

When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes **a business, as defined in Ind AS 103**, it shall apply, to the extent of its share in the joint operation, all the requirements of business combinations accounting as per Ind AS 103, and other Ind ASs, that do not conflict with the guidance in Ind AS 111. Necessary disclosure shall also be made as required by those Ind ASs in relation to business combinations.

The principles on business combinations accounting that do not conflict with the guidance in Ind AS 111 include but are not limited to following:



The above requirements also apply to the **formation of a joint operation** if, and only **if, an existing business**, as defined in Ind AS 103, is contributed to the joint operation on its formation by one of the parties that participate in the joint operation. However, these requirements **do not apply** to the formation of a joint operation if all of the parties that participate in the joint operation **only contribute assets or groups of assets that do not constitute businesses** to the joint operation.

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A joint operator might **increase its interest in a joint operation** in which the activity of the joint operation constitutes a business, as defined in Ind AS 103, by acquiring an additional interest in the joint operation. In such cases, **previously held interests in the joint operation are not remeasured** if the joint operator retains joint control.

A party that participates in, but does not have joint control of, a joint operation might obtain joint control of the joint operation in which the activity of the joint operation constitutes a business as defined in Ind AS 103. In such cases, previously held interests in the joint operation are not remeasured.

If the transaction of acquisition of interest in the joint operation is a **common control transaction** as defined in Ind AS 103 then an entity should not apply the requirements mentioned above. In such case, the entity shall apply the accounting specified in **Appendix C of Ind AS 103**.

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5.8 SIGNIFICANT DIFFERENCES BETWEEN IND AS 111 AND AS 27

S. No.	Topic	Ind AS 111	AS 27
1.	Joint arrangement	Ind AS 111 defines the term 'joint arrangement' as "an arrangement of which two or more parties have joint control." Essentially, Ind AS 111 substitutes the term 'joint arrangement' for the term 'joint venture' used in AS 27 without any substantive change in the underlying concept. Ind AS 111 uses the term 'joint venture' in a restrictive sense to refer to one type of joint arrangement (the other type being a joint operation).	AS 27 defines the term 'joint venture' as "a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control".
2.	Classification	Under Ind AS 111, a joint arrangement is either a joint operation or a joint venture. Arrangements that are classified as jointly controlled operations or jointly controlled assets under AS 27 would be classified as 'joint	AS 27 classifies joint venture into three categories, namely, jointly controlled operations, jointly controlled assets and jointly controlled entities.

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		operations' under Ind AS 111. An arrangement that is classified as a jointly controlled entity under AS 27 would be classified as either a joint operation or a joint venture under Ind AS 111. The classification of joint arrangement depends on whether the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement (a joint operation) or whether those parties have rights to the net assets of the arrangement (a joint venture).	
3.	Accounting for interest in a jointly controlled entity	Ind AS 111 requires interest in a jointly controlled entity to be accounted for in the venturer's consolidated financial statements in accordance with Ind AS 28, i.e., using equity method of accounting (which is also used to account for interests in associates under Ind AS 28).	AS 27 requires a venturer to account for its interest in a jointly controlled entity in its (i.e., venturer's) consolidated financial statements using proportionate consolidation method.
4.	Circumstances in which proportionate consolidation method or equity method is not, or may not be, applied	Ind AS 111 (or Ind AS 28) does not provide a similar exemption from application of equity method to an interest in a joint venture, unless such an interest meets the criteria laid down in Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations to be classified as held for sale (in which case Ind AS 105 rather than equity method is applied to the interest).	Under AS 27 a venturer does not apply proportionate consolidation method to an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future.

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UNIT 6:
IND AS 28: INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

6.1 OBJECTIVE OF IND AS 28

Ind AS 28 prescribes following:

- guidance on accounting of investments in associates and
- the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

6.2 SCOPE OF IND AS 28

Ind AS 28 shall be applied by all entities that are

- investors with **joint control** of an investee (i.e. the investee is a joint venture of the investor), or
- **significant influence** over an investee (i.e. the investee is an associate of the investor).

6.3 SIGNIFICANT INFLUENCE

An associate is an entity over which the investor has significant influence. Hence, to assess whether an investee is an associate or not, an entity needs to understand the term 'significant influence'.

Significant influence is the power to **participate in the financial and operating policy decisions** of the investee but is not control or joint control of those policies.

In this section, we will discuss following concepts related to assessment of significant influence:

- Presumption of significant influence
- Judgement required in assessment of significant influence
- Consideration of potential voting rights when assessing significant influence
- Loss of significant influence

Each of the above concepts are discussed in detail below.

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6.3.1 Presumption of significant influence

Presumption of significant influence:

- If an entity holds (directly or indirectly through a subsidiary) **20% or more of the voting rights** of an investee then it is **presumed that the entity has significant influence**, unless it can be clearly demonstrated that it is not the case.
- Conversely, if the entity holds, (directly or indirectly through a subsidiary), less **than 20% of the voting power** of the investee, it is **presumed that the entity does not have significant influence**, unless such influence can be clearly demonstrated.

It should be noted that a substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

Illustration 1: Significant influence

E Ltd. holds 25% of the voting power of an investee. The balance 75% of the voting power is held by three other investors each holding 25%.

The decisions about the financing and operating policies of the investee are taken by investors holding majority of the voting power. Since, the other three investors together hold majority voting power, they generally take the decisions without taking the consent of E Ltd. Even if E Ltd. proposes any changes to the financing and operating policies of the investee, the other three investors do not vote in favour of those changes. So, in effect the suggestions of E Ltd. are not considered while taking decisions related to financing and operating policies.

Determine whether E Ltd. has significant influence over the investee?

Solution:

Since E Ltd. is holding more than 20% of the voting power of the investee, it indicates that E Ltd. might have significant over the investee. However, the other investors in the investee prevent E Ltd. from participating in the financing and operating policy decisions of the investee. Hence, in this case, E Ltd. is not in a position to have significant influence over the investee.

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6.3.2 Judgement required in assessment of significant influence

The assessment of whether the investor has significant influence over the investee requires application of judgement. In making such judgement, the investor shall consider following factors which generally demonstrate the existence of significant influence:

a) representation on the board of directors or equivalent governing body of the investee

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Illustration 2: Representation on board

Kuku Ltd. holds 12% of the voting shares in Boho Ltd. Boho Ltd.'s board comprise of eight members and two of these members are appointed by Kuku Ltd. Each board member has one vote at meeting. is Boho Ltd an associate of Kuku Ltd?

Solution:

Boho Ltd is an associate of Kuku Ltd as significant influence is demonstrated by the presence of directors on the board and the relative voting rights at meetings.

It is presumed that entity has significant influence where it holds 20% or more of the voting power of the investee, but it is not necessary to have 20% representation on the board to demonstrate significant influence, as this will depend on all the facts and circumstances. One board member may represent significant influence even if that board member has less than 20% of the voting power. But for significant influence to exist it would be necessary to show based on specific facts and circumstances that this is the case, as significant influence would not be presumed.

*****

b) participation in policy-making processes, including participation in decisions about dividends or other distributions

Illustration 3: Participation in policy-making processes

M Ltd. holds 10% of the voting power an investee. The balance 90% voting power is held by nine other investors each holding 10%.

The decisions about the relevant activities (except decision about taking borrowings) of the investee are taken by the members holding majority of the voting power. The decisions about taking borrowings are required to be taken by unanimous consent of all the investors. Further, decisions about taking borrowing are not the decisions that most significantly affect the returns of the investee.

Determine whether M Ltd. has significant influence over the investee?

Solution:

In this case, though M Ltd. is holding less than 20% of the voting power of the investee, M Ltd.'s consent is required to take decisions about taking borrowings which is one of the relevant activities. Further, since the decisions about taking borrowing are not the decisions that most significantly affect the returns of the investee, it cannot be said that all the investors have joint control over the investee.

Hence, it can be said that M Ltd. has significant influence over the investee.

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c) material transactions between the entity and its investee

Illustration 4: Material transactions between the entity and its investee

RS Ltd. is an entity engaged in the business of pharmaceuticals. It has invested in the share capital of an investee XY Ltd. and is holding 15% of XY Ltd.'s total voting power.

XY Ltd. is engaged in the business of producing packing materials for pharmaceutical entities. One of the incentives for RS Ltd. to invest in XY Ltd. was the fact that XY Ltd. is engaged in the business of producing packing materials which is also useful for RS Ltd. Since last many years, XY Ltd.'s almost 90% of the output is procured by RS Ltd.

Determine whether RS Ltd. has significant influence over XY Ltd.?

Solution:

Since 90% of the output of XY Ltd. is procured by RS Ltd., XY Ltd. would be dependent on RS Ltd. for the continuation of its business. Hence, even though RS Ltd. is holding only 15% of the voting power of XY Ltd. it has significant influence over XY Ltd.

*****

d) interchange of managerial personnel

Illustration 5: Interchange of managerial personnel

Entity X and entity Y operate in the same industry, but in different geographical regions. Entity X acquires a 10% shareholding in entity Y as a part of a strategic agreement. A new production process is key to serve a fundamental change in the strategic direction of entity Y. The terms of agreement provide for entity Y to start a new production process under the supervision of two managers from entity X. The managers seconded from entity X, one of whom is on entity X's board, will oversee the selection and recruitment of new staff, the purchase of new equipment, the training of the workforce and the negotiation of new purchase contracts for raw materials. The two managers will report directly to entity Y's board and as well as to entity X. Analyse.

Solution:

The secondment of the board member and a senior manager from entity X to entity Y gives entity X a range of power over a new production process and may evidence that entity X has significant influence over entity Y. This assessment takes into the account what are the key financial and operating policies of entity Y and the influence this gives entity X over those policies.

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e) provision of essential technical information

Illustration 6: Provision of essential technical information

R Ltd. is a tyre manufacturing entity. The entity has entered into a technology transfer agreement with another entity Y Ltd. which is also involved in the business of tyre manufacturing. R Ltd. is an established entity in this business whereas Y Ltd. is a relatively new entity.

As per the agreement, R Ltd. has granted to Y Ltd. a license to use its technical information and know-how which are related to the processes for the manufacture of tyres. Y Ltd. is dependent on the technical information and know-how supplied by R Ltd. because of its lack of expertise and experience in this business. Further, R Ltd. has also invested in 10% of the equity share capital of Y Ltd.

Determine whether R Ltd. has significant influence over Y Ltd.?

Solution:

Y Ltd. obtains essential technical information for the running of its business from R Ltd. Hence R Ltd. has significant influence over Y Ltd. despite of holding only 10% of the equity share capital of Y Ltd.

*****

6.3.3 Consideration of potential voting rights when assessing significant influence

An entity may own potential voting rights such as share warrants, share call options, convertible instruments, or other similar instruments that can give the entity additional voting power or reduce another party's voting power over the investee.

Potential voting rights that are **currently exercisable are considered** when assessing whether an entity has significant influence. Potential voting rights that are currently not exercisable are not considered for the assessment. This can be the case when the rights cannot be exercised until a future date or until the occurrence of a future event.

In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances except (a) the intentions of management and (b) the financial ability to exercise those potential rights.

Illustration 7: Potential voting rights

An entity which is currently holding 10% of the voting power of an entity has an option of purchase additional 15% voting power of the investee from other investors. However, the entity currently does not have financial ability to purchase additional 15% voting power of the investee. Determine whether the entity has significant influence over the investee?

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Solution:

Considering the potential voting rights, the entity can have more than 20% of the voting power of the investee and hence it is presumed that the entity has significant influence over the investee. The fact that the entity does not have financial ability to purchase such additional voting power is not considered in such assessment (It should be noted that under Ind AS 110, potential voting rights which an entity cannot exercise because of its financial ability are not considered as substantive and hence not factored in the assessment. However, under Ind AS 28, there is no such requirement given. Hence the potential voting rights, even if they are not substantive as per Ind AS 110, are included in the assessment of significant influence.)

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6.3.4 Loss of significant influence

An entity loses significant influence over an investee **when it loses the power to participate in the financial and operating policy decisions** of that investee.

The loss of significant influence can occur with or without a change in ownership levels. For example, loss of significant influence can occur when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual arrangement.

6.4 EQUITY METHOD

The **equity method** is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income. In this section, we will discuss following principles related to equity method of accounting:

- Application of the equity method
- Exemptions from applying the equity method
- Equity method procedure

The above principles are explained below.

6.4.1 Application of the equity method

An investor is required to account its investments in associates and joint ventures as per equity method.

It should be noted that equity method is **not applied** for accounting of investments in associates

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and joint ventures **in the separate financial statements** of the investor. In separate financial statements, an investor shall apply the guidance given in Ind AS 27 which is discussed in detail in unit 7.

Under the equity method of accounting, an investor shall pass following entries at various stages of investment:

1) Initial entry to record investment done in associate or joint venture at cost
2) Recording of investor's share in the profit / loss of the associate or joint venture after the date of acquisition
3) Recording of investor's share in the other comprehensive income of the associate or joint venture after the date of acquisition
4) Distributions received from an investee

Above entries are explained by way of an illustration below:

Illustration 8: Accounting entries related investment in associate / joint venture

On the first day of a financial year, A Ltd. invested in the equity share capital of B Ltd. at a cost of ₹ 1,00,000 to acquire 25% share in the voting power of B Ltd. A Ltd. has concluded that B Ltd. is an associate of A Ltd. At the end of the year, B Ltd. earned profit of ₹ 10,000 and other comprehensive income of ₹ 2,000. In that year, B Ltd. also declared dividend to the extent of ₹ 4,000. Pass necessary entries in the books of A Ltd. to account for the investment in associate.

Solution:

Following entries would be passed in the books of A Ltd.:

1) Initial entry to record investment done in associate

Investment in B Ltd. A/c	Dr.	1,00,000	
To Bank A/c			1,00,000

2) Recording of share in the profit of the associate

Investment in B Ltd. A/c	Dr.	2,500	
To Share in profit of investee (P&L)			2,500

[A Ltd. share in profit would be ₹ 2,500 (₹ 10,000 x 25%)]

3) Recording of share in the other comprehensive income (OCI) of the associate

Investment in B Ltd. A/c	Dr.	500	
To Share in OCI of investee (OCI)			500

[A Ltd. share in OCI would be ₹ 500 (₹ 2,000 x 25%)]

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4) Recording of dividend distributed by associate

Dividend Receivable A/c	Dr.	1,000	
To Investment in B Ltd. A/c			1,000

[A Ltd. share in dividend would be ₹ 1,000 (₹ 4,000 x 25%)]

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It should be noted that Ind AS 28 not only requires to record the income distributed by the associate or joint venture but it also requires an investor to record its share in the profit / loss of the associate or joint venture (which may not be yet distributed). This provides more informative reporting of the investor's net assets and profit or loss.

Potential voting rights

Generally, an entity accounts for its interest in an associate or joint venture on the basis of existing ownership interests and the possible effect of exercise or conversion of any **potential voting rights are not considered for applying equity method**. Instruments with such potential voting rights are accounted for as per Ind AS 109.

For example, if potential voting rights are contained in Compulsorily Convertible Preference Shares (CCPS) of the investee and such CCPS do not give present access to returns associated with ownership interests (refer below), then such CCPS shall be accounted for as per Ind AS 109 (refer chapter 12) i.e. either at fair value through profit or loss or at fair value through other comprehensive income.

However, there can be some cases where the potential voting rights in substance currently give access to the returns associated with an ownership interest in an associate or a joint venture. In such cases, the investor shall account for instruments with such potential voting rights as per equity method and not as per Ind AS 109. This can be the situation where, **for example**, an investor has a purchase option to acquire additional voting power in an investee and the terms of the contract provides that the investor will also get the share in the profit / loss of the investee even for the period prior to the date of actual exercise of the option.

6.4.2 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:

Exemption 1

As per paragraph 17 of Ind AS 28, an entity need not apply equity method if the entity is a parent that is **exempt from preparing consolidated financial statements** by the scope exception in paragraph 4(a) of Ind AS 110 **or if all the following** apply:

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Owners of the entity	
The entity is a wholly owned or partly owned subsidiary of another entity and all the owners of the entity are informed and they do not object to the entity not applying the equity method.	The entity's ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind ASs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110.
Public trading of instruments of the entity	
The debt or equity instruments of the entity are not traded in a public market (whether domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).	The entity has not filed nor is it in the process of filing its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

The above conditions are similar to the conditions given in paragraph 4(a) of Ind AS 110. To see illustration of above conditions, refer to the scope exemption illustrations give in unit 3 on Ind AS 110.

Exemption 2

When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a **venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds**, the entity may elect to measure investments in those associates and joint ventures at **fair value through profit or loss** in accordance with Ind AS 109. Such election shall be made separately for each associate or joint venture at time of its initial recognition.

Example 1

A mutual fund has invested in the equity share capital of certain companies in excess of 20% of the total equity share of those entities. Hence, those investees are presumed to be an associate of the mutual fund. In this case, the mutual fund can decide not to apply equity method to account for those investments and instead measure them at fair value through profit or loss as per Ind AS 109.

Exemption 3

When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with Ind AS 109.

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This is regardless of whether the venture capital organisation has significant influence over that portion of the investment.

If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organisation.

This exemption is explained in below illustration:

Illustration 9: Exemption from applying equity method

MNO Ltd. holds 15% of the voting power of DEF Ltd. PQR Mutual Fund (which is a subsidiary of MNO Ltd.) also holds 10% voting power of DEF Ltd. Hence, MNO Ltd. holds total 25% voting power of DEF Ltd. (15% held by own and 10% held by subsidiary) and accordingly has significant influence over DEF Ltd. How should MNO Ltd. account for investment in DEF Ltd. in its consolidated financial statements?

Solution:

The 15% interest which is held directly by MNO Ltd. should be measured as per equity method of accounting. However, with respect to the 10% interest which is held through a mutual fund, MNO Ltd. can avail the exemption from applying the equity method to that 10% interest and instead measure that investment at fair value through profit or loss. To summarise, the total interest of 25% in DEF Ltd. should be measured as follows:

- 15% interest held directly by MNO Ltd.: Measure as per equity method of accounting
- 10% interest held indirectly through a mutual fund: Measure as per equity method of accounting or at fair value thorough profit or loss as per Ind AS 109

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6.4.3 Equity method procedure

Many of the concepts used in applying the equity method of accounting are similar to the concepts used for consolidation procedure for subsidiaries. Following is the summary of various concepts used in applying the equity method of accounting:

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Calculation of goodwill / capital reserve on acquisition of investment in associate or joint venture and calculation of share in profit / loss of associate or joint venture

Determination group's share in an associate or a joint venture

Accounting of upstream and downstream transactions between the entity and its associate or joint venture

Accounting of contribution of non-monetary asset by an entity to its associate or joint venture

How to deal with different reporting periods of the entity and its associate or joint venture?

Requirement to have uniform accounting policies

What are the long-term interests in associate or joint venture apart from equity investment?

How to account for share in losses of loss making associate or joint venture in excess of value interest in the associate or joint venture?

Each of the above concepts are explained below.

6.4.3.1 Calculation of goodwill / capital reserve and calculation of share in profit / loss of associate or joint venture

An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture.

On acquisition of the investment, an entity shall identify the goodwill or capital reserve.

Goodwill

Any excess of the cost of the investment over the entity's share of the net fair value of the investee's identifiable assets and liabilities is treated as goodwill. Goodwill is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.

Capital reserve

Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is treated as capital reserve. It is recorded directly in equity.

While recording the entity's share in the profit / loss of the investee, the entity needs to make certain adjustment to that share of profit / loss. For example, adjustment shall be made for:

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- depreciation of the depreciable assets based on their fair values at the acquisition date.
- impairment losses such as for goodwill or property, plant and equipment.

Illustration 10: Acquisition of interest in an associate

Blue Ltd. acquired 25% of the equity share capital of Green Ltd. on the first day of the financial year for ₹ 1,25,000. As of that date, the carrying value of the net assets of Green Ltd. was ₹ 3,00,000 and the fair value was ₹ 4,00,000. The excess of fair value over the carrying value was attributable to one of the buildings owned by Green Ltd. having a remaining useful life of 20 years. Green Ltd. earned profit of ₹ 40,000 and other comprehensive income of ₹ 10,000 during the year. Calculate the goodwill / capital reserve on the date of acquisition, Blue Ltd.'s share in the profit and other comprehensive income for the year and closing balance of investment at the end of the year.

Solution:

(1) Goodwill / capital reserve on the date of acquisition

The cost of the investment is higher than the net fair value of the investee's identifiable assets and liabilities. Hence there is goodwill. Amount of goodwill is calculated as follows

	₹
Cost of acquisition of investment	1,25,000
Blue Ltd.'s share in fair value of net assets of Green Ltd. on the date of acquisition (4,00,000 x 25%)	(1,00,000)
Goodwill	**25,000**

Above goodwill will be recorded as part of carrying amount of the investment.

(2) Share in profit and other comprehensive income of Green Ltd.

	₹
Share in profit of Green Ltd. (40,000 x 25%)	10,000
Adjustment for depreciation based on fair value (1,00,000 ÷ 20) x 25%	(1,250)
Share in profit after adjustment	**8,750**
Share in other comprehensive income (10,000 x 25%)	**2,500**

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(3) Closing balance of investment at the end of the year

	₹
Cost of acquisition of investment (including goodwill of ₹ 25,000)	1,25,000
Share in profit after adjustments	8,750
Share in other comprehensive income	2,500
Closing balance of investment	**1,36,250**

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Illustration 11: Cumulative preference shares issued by associate or joint venture

KL Ltd. has invested in 50% voting power of a joint venture MN Ltd. MN Ltd. has also issued 10% cumulative preference shares, classified as equity, to other investors worth ₹ 10,00,000. During the year, MN Ltd. earned profit of ₹ 4,00,000. Also, MN Ltd. has not declared any dividend on the preference shares for current year. Calculate KL Ltd.'s share in the net profit of MN Ltd. for the year.

Solution:

If an associate or a joint venture has outstanding cumulative preference shares that are held by parties other than the entity and are classified as equity, the entity should compute its share of profit or loss after adjusting for dividend on such shares, whether or not the dividends have been declared.

In current case, KL Ltd.'s share in net profit of MN Ltd. would be as follows.

	₹
Profit of MN Ltd. for the year	4,00,000
Dividend on cumulative preference shares (10,00,000 x 10%)	(1,00,000)
Net profit attributable to the holders of equity share	3,00,000
KL Ltd.'s 50% share in net profit of MN Ltd.	1,50,000

*****

6.4.3.2 Group's share in an associate or a joint venture

For applying the equity method, an entity shall consider the share held by it **directly or indirectly (through a subsidiary)** in an associate or a joint venture. The holding by the entity's associate or joint venture in another associate or joint venture of the entity is ignored for this purpose.

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Example 2

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.

When an **associate or a joint venture has subsidiaries, associates or joint ventures**, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's **financial statements which include** the associate's or joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures.

Example 3

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.

Illustration 12: Share in the consolidated financial statements of associate

Entity A holds a 20% equity interest in Entity B (as associate) that in turn has a 100% equity interest in Entity C. Entity B recognised net assets relating to Entity C of ₹ 1,000 in its consolidated financial statements. Entity B sells 20% of its interest in Entity C to a third party (a non-controlling shareholder) for ₹ 300 and recognises this transaction as an equity transaction in accordance with paragraph 23 of Ind AS 110, resulting in a credit in Entity B's equity of ₹ 100.

The financial statements of Entity A and Entity B are summarised as follows before and after the transaction:

Before

A's consolidated financial statements

Assets	₹	Liabilities	₹
Investment in B	200	Equity	200
Total	200	Total	200

B's consolidated financial statements

Assets	₹	Liabilities	₹
Assets (from C)	1,000	Equity	1,000
Total	1,000	Total	1,000

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The financial statements of B after the transaction are summarised below:

After

B's consolidated financial statements

Assets	₹	Liabilities		₹
Assets (from C)	1,000	Equity	1,000	
Cash	300	Equity transaction with non-controlling interest	100	
		Equity attributable to owners		1,100
		Non-controlling interest		200
Total	1,300	Total		1,300

Although Entity A did not participate in the transaction, Entity A's share of net assets in Entity B increased as a result of the sale of B's 20% interest in C. Effectively, A's share in B's net assets is now ₹ 220 (20% of ₹ 1,100) i.e. ₹ 20 in addition to its previous share.

How is an equity transaction that is recognised in the financial statements of Entity B reflected in the consolidated financial statements of Entity A that uses the equity method to account for its investment in Entity B?

Solution:

The change of interest in the net assets / equity of the associate as a result of the investee's equity transaction is reflected in the investor's financial statements as 'share of other changes in equity of investee' (in the statement of changes in equity) instead of gain in Statement of profit and loss, since it reflects the post-acquisition change in the net assets of the investee and also faithfully reflects the investor's share of the associate's transaction as presented in the associate's consolidated financial statements.

Thus, in the given case, Entity A recognises ₹ 20 as change in other equity instead of in statement of profit and loss and maintains the same classification as of its associate, Entity B, i.e., a direct credit to equity as in its consolidated financial statements.

*****

6.4.3.3 Upstream and downstream transactions between the entity and its associate or joint venture

An entity (or a subsidiary of the entity) may enter into upstream or downstream transactions with its associate or joint venture.

- 'Upstream' transactions are, for example, sales of assets from an associate or a joint venture to the investor.

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- 'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture.

There may be some gain / loss resulting from such transactions. The entity shall record such gain / loss in its financial statements only to the extent of the unrelated investors' interests in the associate or joint venture.

Illustration 13: Upstream and downstream transaction between an entity and its associate

Scenario A

M Ltd. has invested in 40% share capital of N Ltd. and hence N Ltd. is an associate of M Ltd. During the year, N Ltd. sold inventory to M Ltd. for a value of ₹ 10,00,000. This included profit of 10% on the transaction price i.e. profit of ₹ 1,00,000. Out the above inventory, M Ltd. sold inventory of ₹ 6,00,000 to outside customers. Hence, the inventory of ₹ 4,00,000 purchased from N Ltd. is still lying with M Ltd. Determine the unrealised profit to be eliminated on above transaction.

Scenario B

Assume the same facts as per Scenario A except that the inventory is sold by M Ltd. to N Ltd. instead of N Ltd. selling to M Ltd. Determine the unrealised profit to be eliminated on above transaction.

Solution:

Scenario A

Firstly, as part of its equity method accounting for investment in N Ltd., M Ltd. will pass this journal entry:

Investment in N Ltd.	Dr.	40,000	
To Share in profit of N Ltd.			40,000

Out of the inventory of ₹ 10,00,000, M Ltd. has sold inventory worth ₹ 6,00,000 to outside customers. Hence, the profit of ₹ 60,000 (6,00,000 x 10% profit margin) on such inventory is realised. However, the inventory worth ₹ 4,00,000 is still held by M Ltd. which consists profit of ₹ 40,000 (4,00,000 x 10%). Hence, M Ltd.'s share in such profit i.e. ₹ 16,000 (40,000 x 40%) is considered as unrealised.

Accordingly, after recording of share in total profit of N Ltd., M Ltd. should pass following adjustment entry to reverse the unrealised profit margin:

Share in profit of N Ltd.	Dr.	16,000	
To Inventory / Investment in N Ltd.			16,000

In subsequent period, when this inventory of ₹ 4,00,000 is sold by N Ltd. to an outside customer then the above profit margin of ₹ 16,000 will be treated as realised and hence the above entry will be reversed in that period.

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[**Note**: in the separate financial statements of M Ltd., inventory is carried at ₹ 4,00,000 whereas in its consolidated financial statements, inventory is carried at ₹ 3,84,000 (due to elimination entry above in respect of unrealized profit). In the subsequent period, when the inventory is sold, Inventory Account is credited by ₹ 4,00,000 whereas for the purpose of consolidated financial statements, it should have been credited by only ₹ 3,84,000. The difference is adjusted by debiting back ₹ 16,000 to the Inventory Account and a corresponding recognition of share in profit of associate.]

Scenario B

Out of the inventory of ₹ 10,00,000, N Ltd. has sold inventory worth ₹ 6,00,000 to outside customers. Hence, the profit of ₹ 60,000 (6,00,000 x 10% profit margin) on such inventory is realised. However, the inventory worth ₹ 4,00,000 is still held by N Ltd. which consists profit of ₹ 40,000 (4,00,000 x 10%). Out of this profit of ₹ 40,000, profit to the extent of other investor's interest in the investee is treated as realised profit i.e. ₹ 24,000 (40,000 x 60%) is treated as realised profit. Balance profit of ₹ 16,000 (40,000 x 40%) is considered as unrealised. Hence, M Ltd. should pass following adjustment entry to reverse the unrealised profit:

Sales	Dr.	160,000	
To Cost of material consumed			144,000
To Investment in N Ltd.			16,000

In subsequent period, when this inventory of ₹ 4,00,000 is sold by N Ltd. to an outside customer then the above profit margin of ₹ 16,000 will be treated as realised and hence the above entry will be reversed in that period.

*****

When downstream transactions provide evidence of a **reduction in the net realisable value** of the assets to be sold or contributed, or of an **impairment loss** of those assets, those losses shall be **recognised in full** by the investor.

When upstream transactions provide evidence of a reduction in the **net realisable value** of the assets to be purchased or of an **impairment loss** of those assets, the investor shall **recognise its share** in those losses.

Illustration 14: Impairment loss on downstream and upstream transaction between an entity and its joint venture

Scenario A

X Ltd. has invested in a joint venture Y Ltd. by holding 50% of its equity share capital. During the year, X Ltd. sold an asset to Y Ltd. at its market value of ₹ 8,00,000. The asset's carrying value in X Ltd.'s books was ₹ 10,00,000. Determine how should X Ltd. account for the sale transaction in its books.

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Scenario B

Assume the same facts as per Scenario A except that the asset is sold by Y Ltd. to X Ltd. instead of X Ltd. selling to Y Ltd. Determine how should X Ltd. account for the above transaction in its books.

Solution:

Scenario A

X Ltd. should record full loss of ₹ 2,00,000 (10,00,000 – 8,00,000) in its books as that would represent the impairment loss because the market value has actually declined. This loss would have been recorded even if X Ltd. had first impaired the asset and then sold to Y Ltd. at zero profit / loss. Following entry should be passed in the books of X Ltd.

Bank A/c	Dr.	8,00,000	
Loss on sale of asset	Dr.	2,00,000	
To Asset			10,00,000

Scenario B

X Ltd. should record loss to the extent of its share in Y Ltd. Hence, X Ltd.'s share in loss i.e. ₹ 1,00,000 [(10,00,000 – 8,00,000) x 50%] should be recorded by X Ltd. in its books. The loss should be recorded since the market value of the asset has actually declined and this would represent impairment. This loss would have been recorded even if Y Ltd. would have first recorded an impairment loss of ₹ 2,00,000 and then sold to X Ltd. at zero profit / loss. Following entry should be passed in the books of X Ltd.

Asset	Dr.	8,00,000	
Share in loss of Y Ltd.	Dr.	1,00,000	
To Bank			8,00,000
To Investment in Y Ltd.			1,00,000

*****

6.4.3.4 Contribution of non-monetary asset by an entity to its associate or joint venture

An entity might contribute a non-monetary asset to an associate or a joint venture in exchange of an equity interest in that associate or joint venture. Such contribution of asset shall be accounted in accordance with the **guidance for downstream transactions** discussed above.

However, if such contribution of cnon-monetary asset **lacks commercial substance**, then the gain / loss involved in such transaction is treated as unrealised and such **gain / loss is eliminated against the investment value**. In other words, the carrying amount of the investment in associate

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or joint venture in such a situation will be equal to the carrying amount of non-monetary asset contributed in exchange. The term 'commercial substance' has the same meaning as defined in Ind AS 16 *'Property, Plant and Equipment'* and discussed in unit 2 of chapter 7.

If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity **recognises in full** in profit or loss the portion of the **gain or loss** on the non-monetary contribution **relating to the monetary or non-monetary assets received**.

6.4.3.5 Different reporting periods of the entity and its associate or joint venture

To apply equity method of accounting, an entity shall use the **most recent** available financial statements of the associate or joint venture.

When the end date of the reporting period of the entity and that of the associate or joint venture is different (e.g. entity's financial year ends on 31 March 20X1 but the associate's financial year ends on 31 December 20X0) then associate or joint venture shall prepare financial statements as of the period end date of the entity **for the purpose of doing equity method accounting** by the entity.

In above situation, if it is impracticable for the associate or joint venture to prepare financial statements as of the period end date of the entity then the entity can use the financial statements of associate or joint venture ending on different date subject to **giving effect of significant transactions or events** occurring between the end date of the associate's or joint venture's financial statements and end date of the entity's financial statements.

In no case, the difference between the end date of the reporting period of associate or joint venture and end date of reporting period of the entity **can exceed 3 months**.

The length of the reporting periods and any difference between the ends of the reporting periods shall be the same from period to period. This means that if the financial statements of an associate or a joint venture used for equity accounting in previous periods were ending on different dates than that of the entity whereas the financial statements used for current period end on the same date as that of the entity then the comparatives for previous period should be restated to have comparison of equivalent periods.

6.4.3.6 Uniform accounting policies

When using the financial statements of an associate or joint venture for doing equity method accounting, the **accounting policies** (for like transaction and events in similar circumstances) as used by associate or joint venture in preparing their financial statements **should be same as the policies used by the entity** in preparing its financial statements.

If the accounting policies are not same then **adjustments should be made to align** the accounting policies of associate or joint venture to those of the entity.

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Example 4

A Ltd. (a company incorporated and registered in India) holds 25% voting power of B Inc. (a company incorporated and registered in United States). B Inc. is an associate for A Ltd. A Ltd. Follows Ind AS for the preparation of its financial statements. However, B Inc. follows generally accepted accounting principles in United States (US GAAP). Hence, while using B Inc.'s financial statements for the purpose of doing equity method accounting, A Ltd. Shall do necessary adjustment to covert US GAAP financial statements to Ind AS financial statements and then do equity method accounting.

There are two exceptions to above rule:

Exception 1

In case of an **associate**, the adjustment for uniformity of accounting policies with those of the entity will not be done **if it is impracticable to do so**.

It is to be noted that this exemption is available in case of an associate only and not available for joint venture. This is because for an investor with just significant influence over an investee, it may be difficult to obtain necessary information to do adjustment for aligning accounting policies. However, in case of a joint venture, it would be relatively easy to obtain such information as the investor has joint control over the joint venture.

Exception 2

An entity may have interest in **an associate or a joint venture that is an investment entity**. Such an associate or a joint venture may also have interest in one or more subsidiaries. When this is the case, such associate or joint venture, being an investment entity, would **account for its interest in subsidiaries at fair value**. Hence, in such case, the **entity can elect to retain** the fair value measurement used by the associate or joint venture.

Such election can be made by the entity **separately for each associate or joint venture** at the later of the date on which:

a) the associate or joint venture is initially recognised

b) the associate or joint venture becomes an investment entity

c) the associate or joint venture first becomes a parent

6.4.3.7 Long-term interests in associate or joint venture apart from equity investment

An entity might hold financial instruments in an associate or joint venture other than the investments accounted for using the equity method. These includes long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture.

For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture.

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- Such items may include
  - preference shares and
  - long-term receivables or loans,
- but do not include
  - trade receivables,
  - trade payables or
  - any long-term receivables for which adequate collateral exists, such as secured loans.

An entity shall account such long-term interest in accordance with Ind AS 109. It is to be noted that certain requirements of Ind AS 28 also apply to such long-term interests (like allocating share in loss of associate or joint venture to such interests and testing for impairment and recording of impairment loss on the net investment in associate or joint venture – these are explained in subsequent paragraphs). However, an entity should first apply Ind AS 109 to those interests and then apply Ind AS 28 to the balance remaining after applying Ind AS 109.

6.4.3.8 Loss making associate or joint venture

In case of a loss making associate or joint venture, an entity's share of losses of such associate or joint venture may equal or exceed its **interest in the associate or joint venture**. In such case, the entity discontinues recognized its share of further losses.

It should be noted that the interest in the associate or joint venture not only includes the carrying amount of the investment in the associate or joint venture determined using the equity method but also includes any **long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture**. The examples of such long-term interests are discussed in 6.4.2.8 above. It should be noted that an entity should **first apply Ind AS 109** to such long-term interests and then apply the above requirement of allocating to such long-term interest any share in loss of associate or joint venture. Further, while applying Ind AS 109, an entity shall not take account of any adjustments to the carrying value of long-term interests that arise from applying Ind AS 28.

Losses recognized using the equity method in excess of the entity's investment in ordinary shares are applied to the other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (i.e. priority in liquidation).

After the entity's interest is reduced to zero, additional losses are provided for, and a liability is recognized, only to the extent that the entity has incurred **legal or constructive obligations or made payments** on behalf of the associate or joint venture.

If the associate or joint venture **subsequently reports profits**, the entity resumes recognized its share of those profits **only after** its share of the profits equals the share of losses not recognized.

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Illustration 15: Loss making associate and long-term interests

An entity has following three type interests in an associate:

- *Equity shares: 25% of the equity shares to which equity method of accounting is applied*
- *Preference shares: Non-cumulative preference shares that form part of net investment in the associate. Such preference shares are measured at fair value as per Ind AS 109.*
- *Long-term loan: The loan carrying interest of 10% p.a. The interest income is received at the end of each year. The long-term loan is accounted as per amortised cost as per Ind AS 109. This loan also forms part of net investment in the associate.*

At the start of year 1, the carrying value of each of the above interests is as follows:

- *Equity shares – ₹ 10,00,000*
- *Preference shares – ₹ 5,00,000*
- *Long-term loan – ₹ 3,00,000*

Following table summarises the changes in the fair value of preference shares as per Ind AS 109, impairment loss on long-term loan as per Ind AS 109 and entity's share in profit / loss of associate for year 1-5.

₹

End of Year	Increase / (Decrease) in fair value of preference shares as per Ind AS 109	Impairment loss / (reversal) on long-term loan as per Ind AS 109	Entity's share in profit / (loss) of associate
1	(50,000)	(50,000)	(16,00,000)
2	(50,000)	-	(2,00,000)
3	1,00,000	50,000	-
4	50,000	-	10,00,000
5	30,000	-	10,00,000

Throughout year 1 to 5, there has been no objective evidence of impairment in the net investment in the associate. The entity does not have any legal or constructive obligation to share the losses of the associate beyond its interest in the associate.

Based on above, determine the closing balance of each of the above interests at the end of each year.

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Solution:

Year 1

Below table summarises the closing balance of each of the interest at the end of year 1: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	10,00,000	NA	10,00,000	(10,00,000)	-
Preference shares	5,00,000	(50,000)	4,50,000	(4,50,000)	-
Long-term loan	3,00,000	(50,000)	2,50,000	(1,50,000)	1,00,000
Total	**18,00,000**	**(1,00,000)**	**17,00,000**	**(16,00,000)**	**1,00,000**

The entire loss of ₹ 16,00,000 is recognised. Hence, there is no unrecognised loss at the end of year 1.

Year 2

Below table summarises the closing balance of each of the interest at the end of year 2: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	-	NA	-	-	-
Preference shares	-	(50,000)	(50,000)	50,000 *	-
Long-term loan	1,00,000	-	1,00,000	(1,00,000)	-
Total	**1,00,000**	**(50,000)**	**50,000**	**(50,000)**	**-**

* Recognition of changes in fair value as per Ind AS 109 has resulted in the carrying amount of Preference shares being negative ₹ 50,000. Consequently, the entity shall reverse a portion of the associate's losses previously allocated to Preference shares.

Out of the total loss of ₹ 2,00,000 for the year, loss of only ₹ 50,000 is recognized. Hence, there is unrecognized loss to the extent of ₹ 1,50,000 at the end of year 2.

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Year 3

Below table summarises the closing balance of each of the interest at the end of year 3: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	-	NA	-	-	-
Preference shares	-	1,00,000	1,00,000	(1,00,000)	-
Long-term loan	-	50,000	50,000	(50,000)	-
Total	**-**	**1,50,000**	**1,50,000**	**(1,50,000)**	**-**

The share in profit / loss for the year is nil. However, there was previously unrecognised loss of ₹ 1,50,000 which is allocated in current year. After recognising the above loss, there is no unrecognised loss at the end of year 3.

Year 4

Below table summarises the closing balance of each of the interest at the end of year 4: ₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	-	NA	-	2,00,000	2,00,000
Preference shares	-	50,000	50,000	5,00,000	5,50,000
Long-term loan	-	-	-	3,00,000	3,00,000
Total	**-**	**50,000**	**50,000**	**10,00,000**	**10,50,000**

The entity's share in profit of associate for the year is ₹ 10,00,000. The entity shall allocate such profit to each of the instruments in order of their seniority in liquidation. The entity should limit the amount of profit to be allocated to preference shares and long-term loan to the extent of losses previously allocated to them. Hence, the entity has allocated ₹ 5,00,000 to preference shares and ₹ 3,00,000 to long-term debt.

There is no unrecognised loss at the end of year 4.

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Year 5

Below table summarises the closing balance of each of the interest at the end of year 5:

₹

Type of interest	Opening balance at the start of the year	Adjustment as per Ind AS 109	Balance after applying Ind AS 109	Share in profit / (loss) of associate	Closing balance at the end of the year
	(A)	(B)	I = (A+B)	(D)	I = (C+D)
Equity shares	2,00,000	NA	2,00,000	10,00,000	12,00,000
Preference shares	5,50,000	30,000	5,80,000	-	5,80,000
Long-term loan	3,00,000	-	3,00,000	-	3,00,000
Total	**10,50,000**	**30,000**	**10,80,000**	**10,00,000**	**20,80,000**

The entity's share in profit of associate for the year is ₹ 10,00,000. The entire profit is allocated to equity shares since there is no loss previously allocated to either preference shares or long-term loan.

There is no recognized loss at the end of year 5.

Year 1 to 5

The interest accrual on long-term loan would be done in each year at 10% p.a. This will be done without taking into account any adjustment done in the carrying value of long-term loan as per Ind AS 28. Hence, the entity will accrue interest of ₹ 30,000 (3,00,000 x 10%) in each year.

*****

6.5 IMPAIRMENT LOSSES

After doing accounting as per equity method explained above, an entity shall determine whether there is **an objective evidence** that the entity's net investment in an associate or a joint venture is impaired.

The objective evidence of impairment can arise as a result of:

- one or more events that occurred after the initial recognition of the net investment (a **'loss event'**) and
- that loss event (or events) has an **impact on the estimated future cash flows** from the net investment that can be reliably estimated.

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It is not necessary to identify a single event that caused impairment. Rather, impairment can be a combined effect of several individual events.

Losses expected as a result of future events, no matter how likely, are not recognized.

Objective evidence that the net investment is impaired includes **observable data** about the following loss events:

- Significant **financial difficulty** of the associate or joint venture
- **Breach of contract**, such as a default in payments by the associate or joint venture
- The entity **granting a concession** to associate or joint venture (because of its financial difficulties)
- It becoming probable that the associate or joint venture will enter **bankruptcy or other financial reorganisation**
- **Disappearance of an active market** for the net investment because of financial difficulties of the associate or joint venture
- **Adverse effect** in the environment (technological, market, economic or legal) in which associate or joint venture operates
- **Significant or prolonged decline in the fair value** of an investment in an equity instrument below its cost

It should be noted that the disappearance of an active market because the associate's or joint venture's equity or financial instruments are **no longer publicly traded is not evidence of impairment**.

A downgrade of an associate's or joint venture's credit rating or a decline in the fair value of the associate or joint venture, is not of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.

Impairment of goodwill included in carrying value of associate or joint venture

As discussed earlier in this unit, the goodwill on acquisition of associate or joint venture is recognized as part of the carrying amount of the net investment in associate or joint venture. Such goodwill is **not tested separately** for impairment, rather the entire carrying amount of the investment is **tested for impairment as a single asset** when there is objective evidence of impairment as mentioned above.

Any impairment loss recognized is **not allocated** to any asset, including goodwill, that forms part of the carrying amount of the net investment in the associate or joint venture.

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Reversal of impairment loss

Any reversal of impairment loss is recognized in accordance with Ind AS 36 *'Impairment of Assets'* to the extent that the recoverable amount of the net investment subsequently increases.

Determining value in use

Impairment loss is provided by comparing the recoverable amount (higher of value in use and fair value less ***costs of disposal***) with the carrying amount of the investment.

For above purpose, an entity can determine the value in use in **either** of the following ways:

a) Method 1: Values in use shall include entity's share in the present value of estimated future cash flows expected to be generated by the associate or joint venture, including:

   i. cash flows from the operations of the associate or joint venture and

   ii. proceeds from the ultimate disposal of the investment

b) Method 2: Value in use shall include the present value of estimated future cash flows expected to arise from:

   i. dividends to be received and

   ii. proceeds from the ultimate disposal of the investment.

If appropriate assumptions are used then both the above methods will give the same results.

The recoverable amount of an investment in an associate or a joint venture shall be assessed for each associate or joint venture separately, unless the associate or joint venture does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

6.6 DISCONTINUING THE USE OF THE 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

The accounting consequences when an investment ceases to be an associate or a joint venture are explained below.

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. Ind AS 103 requires revaluation of the previously held interest in the equity accounted investment at its acquisition date fair value, with recognition of any gain or loss in profit or loss.

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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. The entity shall recognise in profit or loss any difference between:

- the fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and
- the carrying amount of the investment at the date the equity method was discontinued.

Following illustration explains how an entity shall record in profit or loss any gain / loss on discontinuation of equity method in such case.

Illustration 16: Recording in profit or loss of the gain / loss on discontinuation of equity method

CD Ltd. held 50% of the voting power of RS Ltd. which is a joint venture of CD Ltd. The carrying value of the investment in RS Ltd. is ₹ 1,00,000. Now out of the 50% stake, CD Ltd. has sold 20% stake in RS Ltd. to a third party for a consideration of ₹ 80,000. The fair value of the retained 30% interest is ₹ 1,20,000. Determine how much gain / loss should be recorded in profit or loss of CD Ltd.

Solution:

CD Ltd. Shall record in profit or loss difference between below:

- the fair value of any retained interest (i.e. ₹ 1,20,000) and any proceeds from disposing of a part interest in the joint venture (i.e. ₹ 80,000); and
- the carrying amount of the investment at the date the equity method was discontinued (i.e. ₹ 1,00,000).

Hence, CD Ltd. Shall record gain of ₹ 1,00,000 in profit or loss.

*****

Reclassification of items recorded in other comprehensive income

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 on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.

Example 5

An investor has recognised in past in its other comprehensive income its share of ₹ 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 ₹ 10,000 recorded in its other comprehensive income to profit or loss.

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The above principle also applies in case there is a reduction in the ownership interest in an associate or joint venture but the investee still continues to be an associate or joint venture. In that case, the reclassification should be done in proportion to the reduction in the ownership interest.

It may be noted that while it is not explicitly stated in Ind AS 28, it can be inferred that in case there is a reduction in the ownership interest in an associate or joint venture but the investee still continues to be an associate or joint venture, the entity should recognize gain or loss. This accounting treatment is different from the accounting for changes in ownership interest interests in a subsidiary, without losing control.

An associate becomes a joint venture and vice versa

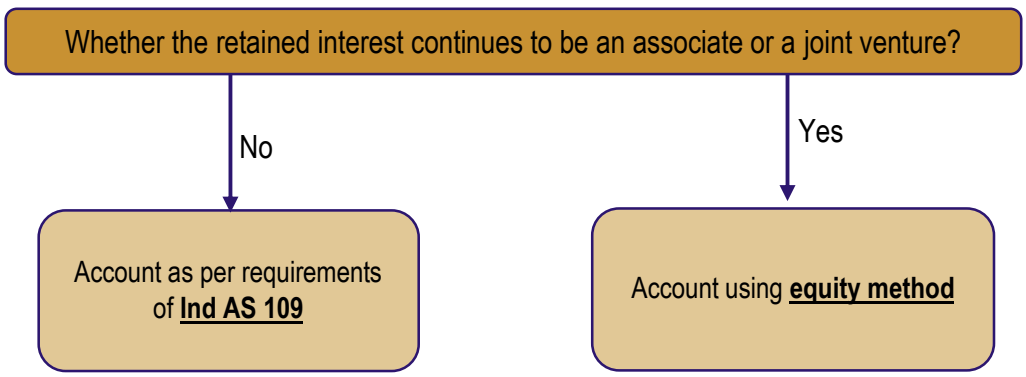
If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.

6.7 CLASSIFICATION OF INVESTMENT IN ASSOCIATE OR JOINT VENTURE 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:



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The above requirements are explained in below illustration:

Illustration 17: Investment in joint venture held for sale

Ram Ltd. holds 50% of the equity share capital of Shyam Ltd. The balance 50% equity share capital is held by another investor. Ram Ltd. has joint control over Shyam Ltd. and it is a joint venture of Ram Ltd., accounted using equity method. Now Ram Ltd. is planning to sell 10% of the equity share capital of Shyam Ltd. to a third party. Such 10% investment meets the criteria of an asset held for sale and has been measured and disclosed accordingly. Now determine how should Ram Ltd. account 40% interest retained in Shyam Ltd.

Solution:

Till the time 10% stake is sold, Ram Ltd. shall account for the retained interest of 40% as per equity method. After the sale of 10% investment, if Ram Ltd. still has joint control over Shyam Ltd. (e.g. through contractual arrangement) then it shall continue to measure that investment using equity method. However, if Ram Ltd. is not going to have joint control over Shyam Ltd. post the disposal of 10% investment then retained investment of 40% shall be accounted as per Ind AS 109.

*****

When an investment, or a portion of investment, in associate or a joint venture previously classified as held for sale **no longer meets the criteria** to be so classified, it shall be accounted for using the **equity method retrospectively** as from the date of its classification as held for sale. Financial statements for the prior periods shall be amended accordingly.

6.8 SIGNIFICANT CHANGES IN IND AS 28 FROM IAS 28 RESULTING INTO CARVE OUT

As per IFRS

IAS 28 (paragraph 35) requires that for the purpose of applying equity method of accounting in the preparation of investor's financial statements, uniform accounting policies should be used. In other words, if the associate's accounting policies are different from those of the investor, the investor should change the financial statements of the associate by using same accounting policies.

Carve out

In Ind AS 28 (paragraph 35), the phrase, 'unless impracticable to do so' has been added in the relevant requirements.

Reason

Certain associates, e.g., regional rural banks (RRBs), being associates of nationalized banks,

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may not be in a position to use the Ind AS as these may be too advanced for the RRBs. Accordingly, the above-stated words have been included to exempt such associates.

6.9 SIGNIFICANT DIFFERENCES BETWEEN IND AS 28 AND AS 23

S. No.	Topic	Ind AS 28	AS 23
1.	Significant Influence	In Ind AS 28, 'Significant Influence' has been defined as 'power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies'. Ind AS 28 defines joint control also.	In AS 23, 'Significant Influence' has been defined as 'power to participate in the financial and/or operating policy decisions of the investee but is not control over those policies'.
2.	Consideration for significant influence	As per Ind AS 28, existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether an entity has significant influence or not.	For considering share ownership for the purpose of significant influence, potential equity shares of the investee held by investor are not taken into account as per AS 23.
3.	Application of equity method	No exemption for applying equity method is provided in Ind AS 28.	One of the exemptions from applying equity method in AS 23 is where the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investee.
4.	Measurement of the investment in the associate at fair value through profit or loss as per Ind AS 109	Ind AS 28 permits an entity that has an investment in an associate, a portion of which is held indirectly through venture capital organisations, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, to elect to measure that portion of the investment in the associate at fair	AS 23 does not provide for the same.

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		value through profit or loss in accordance with Ind AS 109 regardless of whether these entities have significant influence over that portion of the investment.	
5.	Held for sale	Ind AS 28 requires a portion of an investment in an associate or a joint venture to be classified as held for sale if the disposal of that portion of the interest would fulfil the criteria to be classified as held for sale in accordance with Ind AS 105.	AS 23 does not specifically deal with this aspect.
6.	Accounting of investment in an associate in separate financial statements	As per Ind AS 28, in separate financial statements, investment in an associate is to be accounted for at cost or in accordance with Ind AS 109, Financial Instruments.	As per AS 23, in separate financial statements, investment in an associate is not accounted for as per the equity method, the same is accounted for in accordance with AS 13, Accounting for Investments.
7.	Difference in reporting dates	There is no limit on the length of difference in the reporting dates of the investor and the associate. As per Ind AS 28, length of difference in the reporting dates of the associate or joint venture should not be more than three months.	AS 23 permits the use of financial statements of the associate drawn upto a date different from the date of financial statements of the investor when it is impracticable to draw the financial statements of the associate upto the date of the financial statements of the investor.
8.	Accounting Policies	Both AS 23 and Ind AS 28 require that similar accounting policies should be used for preparation of investor's financial statements and in case an associate uses different accounting policies for like transactions, appropriate	AS 23 provide exemption to this that if it is not possible to make adjustments to the accounting policies of the associate, the fact shall be disclosed along with a brief description of the differences

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		adjustments shall be made to the accounting policies of the associate. Ind AS 28 provides that the entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances unless, in case of an associate, it is impracticable to do so.	between the accounting policies.
9.	Share of losses in the associate	As per Ind AS 28, carrying amount of investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture shall be considered for recognising entity's share of losses in the associate or joint venture.	As per AS 23, investor's share of losses in the associate is recognised to the extent of carrying amount of investment in the associate.
10.	Recognition of impairment loss on investment	Ind AS 28 requires that after application of equity method, including recognising the associate's or joint venture's losses, the requirements of Ind AS 109 shall be applied to determine whether it is necessary to recognise any additional impairment loss.	With regard to impairment, AS 23 requires that the carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment.
11.	When investment ceases to be an associate	Ind AS 28 provides that use of equity method will be discontinued from the date when investment ceases to be an associate and in case such associates become the subsidiary, it will be accounted in accordance with Business Combination (Ind AS 103) and if the retained interest becomes a financial asset, it will measure the retained interest at fair value.	AS 23 does not deal with the situation as to associate becoming a subsidiary. However, in other case (there is some retained interest), the investment will be accounted for in accordance with AS 13-Investments and retained interest will not be fair valued under AS 23.

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UNIT 7:
IND AS 27: SEPARATE FINANCIAL STATEMENTS

7.1 OBJECTIVE OF IND AS 27

The objective of Ind AS 27 is to prescribe the accounting and disclosure requirements for **investments in subsidiaries, joint ventures and associates** when an entity prepares separate financial statements.

7.2 SCOPE OF IND AS 27

Ind AS 27 shall be applied in accounting for investments in subsidiaries, joint ventures and associates when an entity

- elects, or
- is required by law,

to present separate financial statements.

It is to be noted that **Ind AS 27 does not mandate which entities produce separate financial statements**. It applies when an entity prepares separate financial statements that comply with Ind AS. However, it may be noted that as per the Companies Act, 2013, all companies covered under that Act are required to prepare financial statements.

7.3 WHAT ARE SEPARATE FINANCIAL STATEMENTS AND HOW THEY ARE PRESENTED?

What are separate financial statements?

Separate financial statements are those presented by:

- a parent (i.e. an investor with control of a subsidiary) or
- an investor with investment in an associate or a joint venture,

in which the investments are accounted for at **cost or in accordance with Ind AS 109** *'Financial Instruments'*.

How separate financial statements are presented?

Separate financial statements are presented:

- **in addition** to consolidated financial statements or

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- **in addition** to financial statements of an investor that does not have investments in subsidiaries but has investments in associates or joint ventures in which investments in associates or joint ventures are accounted for using the equity method.

There are two more scenarios in which separate financial statements are prepared:

Scenario 1

An entity that is exempted from:

- preparation of consolidated financial statements in accordance with paragraph 4(a) of Ind AS 110 (explained in detail in unit 3) or
- applying equity method as per paragraph 17 of Ind AS 28 (explained in detail in unit 6)

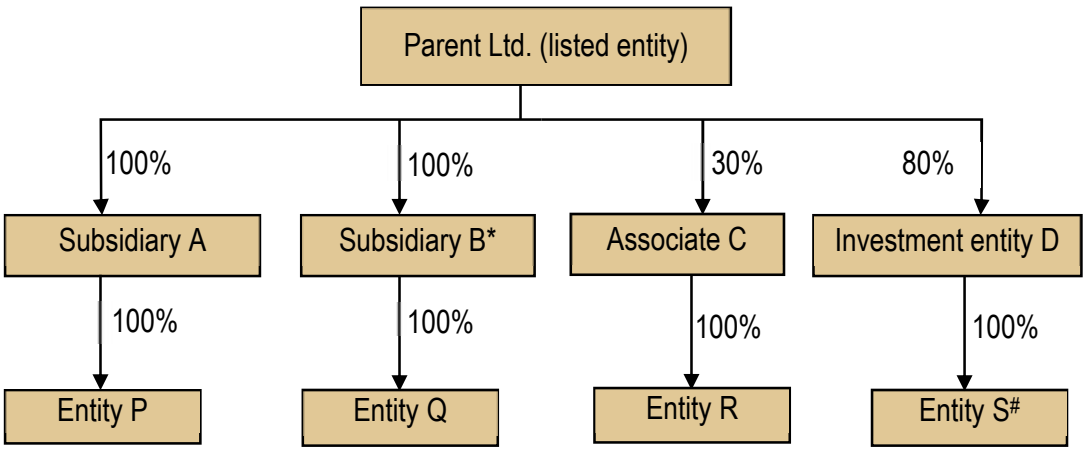
may present separate financial statements as its only financial statements.

Scenario 2

As per para 31 of Ind AS 110, an investment entity that has one or more subsidiaries and the purpose and activities of all those subsidiaries is not to provide services that relate to the investment entity's investment activities then such investment entity shall not prepare consolidated financial statements. Instead, such investments in subsidiaries are to be accounted at fair value through profit or loss as per Ind AS 109.

In such case, investment entity presents separate financial statements as its only financial statements.

Example: Following chart represents the group structure of Parent Ltd. and table below it explains the above requirements related to separate financial statements



* Subsidiary B has availed the exemption from preparation of consolidated financial statements as per paragraph 4(a) of Ind AS 110

Entity S does not provide services that relate to the Investment entity D's investment activities

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All the above entities are incorporated under the Companies Act, 2013.

Name of the entity	Whether entity prepares consolidated financial statements?	Status for separate financial statements
Parent Ltd.	Yes	Will be prepared as it is required by Companies Act, 2013
Subsidiary A	Yes	Will be prepared as it is required by Companies Act, 2013
Subsidiary B	No	Will be prepared as it is required by Companies Act, 2013 (in this case, entity will present separate financial statements as its only financial statements)
Associate C	Yes	Will be prepared as it is required by Companies Act, 2013
Investment entity D	No	Will be prepared as it is required by Companies Act, 2013. Entity will present separate financial statements as its only financial statements
Entity P	No	These entities will prepare their financial statements as required by Companies Act 2013, however, they will not be termed as separate financial statements since these entities do not have subsidiary, associate or joint venture.
Entity Q	No	
Entity R	No	
Entity S	No	

7.4 PREPARATION OF SEPARATE FINANCIAL STATEMENTS

In this section, we will discuss about following concepts relating to accounting in separate financial statements:

- Accounting of investments in subsidiaries, associates and joint ventures
- Accounting when a parent ceases to be an investment entity or becomes an investment entity
- Accounting of dividend from subsidiary, associate or joint venture
- Reorganisation of the group structure

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7.4.1 Accounting of investments in subsidiaries, associates and joint ventures

An entity shall prepare its separate financial statements in accordance with all the applicable Ind ASs except that it shall account for investments in subsidiaries, associates and joint ventures **in one of the following ways**:

- At cost, or
- In accordance with Ind AS 109 (i.e. either at fair value through profit or loss or at fair value through other comprehensive income)

The entity shall apply the same accounting for each category of investments.

Investments accounted for at cost shall be accounted for in accordance with Ind AS 105 *'Non-current Assets Held for Sale and Discontinued Operations'* when they are classified as held for sale. The measurement of investments accounted for in accordance with Ind AS 109 is not changed in such circumstances.

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.

Investments held by investment entities and similar entities

Ind AS 110 requires an investment entity to measure its investment in subsidiaries at fair value through profit or loss as per Ind AS 109. Then the investment entity shall account for those investments **in the same i.e. at fair value through profit or loss** in the separate financial statements.

Further, Ind AS 28 provides that an when an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital reorganization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with Ind AS 109. Hence, if an entity makes such election, then it shall also account for those investments **in the same way i.e. at fair value through profit or loss** in its separate financial statements.

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7.4.2 Accounting when a parent ceases to be an investment entity or becomes an investment entity

When a parent ceases to be an investment entity, or becomes an investment entity, it shall account for the change **from the date when the change in status occurred**, as follows:

When an entity ceases to be an investment entity

In such case, the entity shall account for an **investment in a subsidiary** in either of the following ways:

Account at cost. The fair value of the subsidiary at the date of the change of status shall be used as the **deemed cost** at that date

OR

Continue to account in accordance with **Ind AS 109**

Example 2

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

When an entity becomes an investment entity

In such case, the entity shall account for an investment in a subsidiary at fair value through profit or loss in accordance with Ind AS 109.

In that case, the difference between the previous carrying amount of the subsidiary and its fair value at the date of the change of status of the investor shall be recognized as a gain or loss in profit or loss. The cumulative amount of any fair value adjustment previously recognized in other comprehensive income in respect of those subsidiaries shall be reclassified to profit or loss as if the investment entity had disposed of those subsidiaries at the date of change in status.

Example 3

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 – 50,000) in the profit of loss.

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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.

7.4.3 Accounting of dividend from subsidiary, associate or joint venture

An entity shall recognise a dividend from a subsidiary, an associate or a joint venture in profit or loss in its separate financial statements when its right to receive the dividend is established.

Generally, the right to receive the dividend is established when the dividend is approved by the shareholders in their general meeting.

7.4.4 Reorganisation of the group structure

A parent reorganisation the structure of its group by establishing a new entity as its parent.

Ind AS 27 provides guidance on how to calculate the cost of investment when a parent reorganisation the structure of its group by establishing a new entity as its parent in a manner that satisfies the following criteria:

a) the new parent obtains control of the original parent by **issuing equity instruments** in exchange for existing equity instruments of the original parent;

b) the **assets and liabilities** of the new group and the original group are the **same** immediately before and after the reorganisation; and

c) the owners of the original parent before the reorganisation have the **same absolute and relative interests** in the net assets of the original group and the new group immediately before and after the reorganisation,

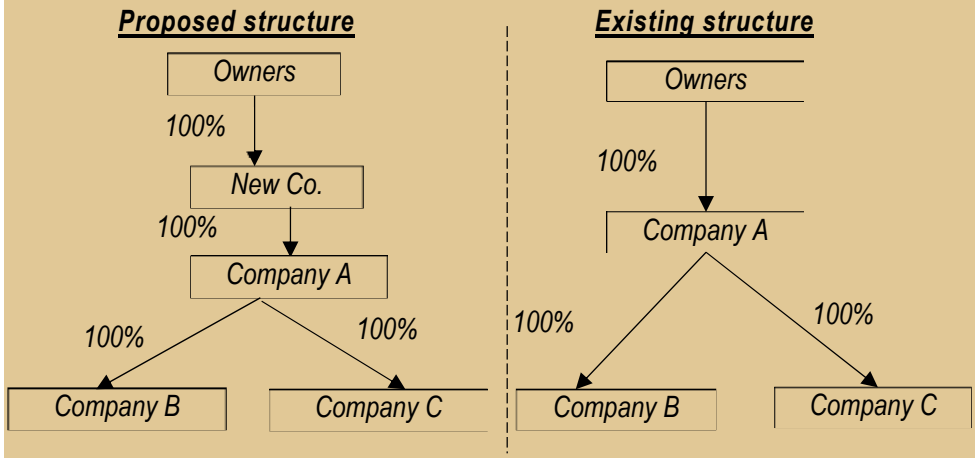
If above conditions are fulfilled and the new parent elects to account for its investment in the original parent at cost then the new parent shall measure cost at the **carrying amount of its share of the equity** items shown in the separate financial statements of the original parent at the date of the reorganisation.

This is explained in following illustration:

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Illustration 1: Reorganisation of the group structure

Following is the existing and proposed group structure of an original parent A Ltd.



As per the above structure, the Owners of Company A will transfer all their shareholding in Company A to New Co. in exchange of such shares, New Co. will issue its equity shares to the Owners. New Co. will issue the shares to the owners in the same ratio of their existing holding in Company A so that they have same absolute and relative interests in the net assets of the group immediately before and after the reorganisation. The assets and liabilities of the group immediately before and after the proposed restructuring will also be the same.

The cost of the investment in Company A in the books of the Owners is ₹ 10 lakh. Total equity of Company A (i.e. equity share capital and other equity attributable to the owners) as per its separate financial statements on the date of proposed restructuring is ₹ 15 lakh.

After the proposed restructuring, New Co. wants to record its investment in Company A at cost.

Determine how it should measure the cost of investment in Company A?

Solution:

In current case, New Co. should measure the cost of investment in Company A at the carrying amount of its share of the equity items shown in the separate financial statements of Company A at the date of the restructuring because:

a) New Co. obtains control of Company A by issuing equity instruments to the Owners in exchange for their existing equity instruments of Company A;

b) the assets and liabilities of the group immediately before and the proposed restructuring will be same; and

c) the Owners will have the same absolute and relative interests in the net assets of the group immediately before and after the proposed restructuring.

Hence, New Co. will measure the cost of investment in Company A at ₹ 15 lakh.

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A entity that is not a parent establishes a new entity as its parent

The requirements of measuring cost of investment by a new parent as discussed above will equally apply in case where an entity that is not a parent (i.e. it does not have a subsidiary) establishes a new parent between itself and its owners.

Hence, in illustration 1 above, the same accounting treatment will have to be followed by New Co. even if Company A does not have any subsidiary.

7.5 MAJOR CHANGES IN IND AS 27 FROM IAS 27 NOT RESULTING INTO CARVE OUT

Ind AS 27, like other Ind AS, has been converged from the global standards, i.e., IFRS, which has been made applicable to the Indian entities (based on the net worth criteria) in a phased manner via Ministry of Corporate Affairs Roadmap. While converging from IAS 27, following are the carve outs given under Appendix 1 to Ind AS 27, keeping in mind, the requirements of other converged Ind AS and the economic environment in India.

IAS 27 allows the entities to use the equity method to account for investment in subsidiaries, joint ventures and associates in their Separate Financial Statements (SFS). Such option is not given in Ind AS 27, as the equity method is not a measurement basis like cost and fair value but is a manner of consolidation and therefore would lead to inconsistent accounting conceptually.

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UNIT 8: DISCLOSURES

8.0 INTRODUCTION

This Unit is divided in two parts as follows:

- Part A: Disclosure of interest in other entities as per Ind AS 112
- Part B: Disclosure in separate financial statements as per Ind AS 27

Note: Only those disclosures which are significant from students' perspective have been covered here.

PART A: DISCLOSURE OF INTERESTS IN OTHER ENTITIES AS PER IND AS 112

8.1 OBJECTIVE OF IND AS 112

Ind AS 112 require an entity to disclose information (related to its interests in other entities) that enables users of its financial statements to evaluate:

the nature of, and risks associated with, its **interests in other entities** (defined below)	AND	the **effects of those interests** on its financial position, financial performance and cash flows.

Interests in other entities

Definition: For the purpose of Ind AS 112, an interest in another entity refers to **contractual and non-contractual involvement that exposes an entity to variability of returns** from the performance of the other entity. Consideration of the purpose and design of the other entity may help the reporting entity when assessing whether it has an interest in that entity and, therefore, whether it is required to provide the disclosures in Ind AS 112. That assessment shall include consideration of the risks that the other entity was designed to create and the risks the other entity was designed to pass on to the reporting entity and other parties.

- An interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees.

- It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship.

A reporting entity is typically exposed to variability of returns from the performance of another entity by holding instruments (such as equity or debt instruments issued by the other entity) or having another involvement that absorbs variability.

Example 4

Assume a structured entity holds a loan portfolio. The structured entity obtains a credit default swap from another entity (the reporting entity) to protect itself from the default of interest and principal payments on the loans. The reporting entity has involvement that exposes it to variability of returns from the performance of the structured entity because the credit default swap absorbs variability of returns of the structured entity.

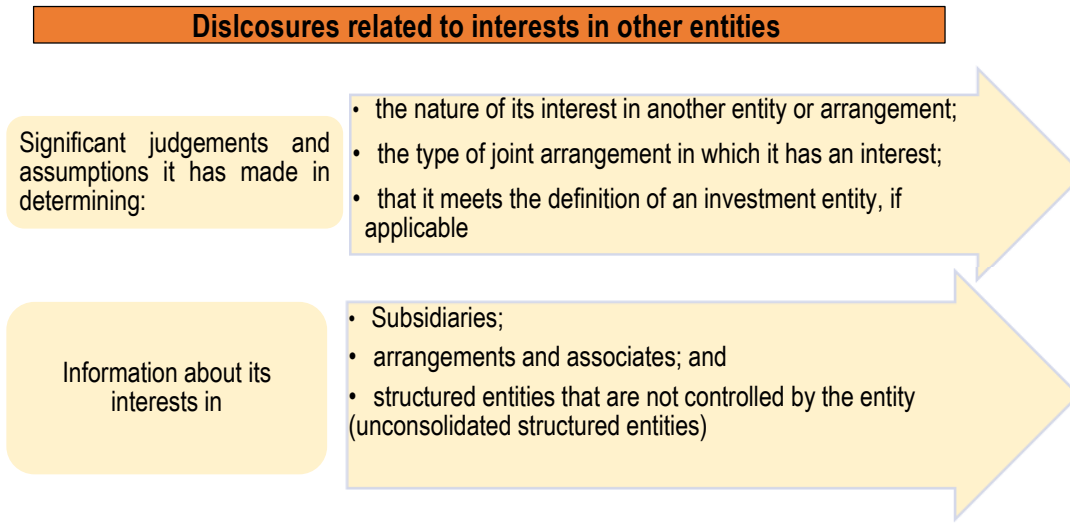
Some instruments are designed to transfer risk from a reporting entity to another entity. Such instruments create variability of returns for the other entity but do not typically expose the reporting entity to variability of returns from the performance of the other entity.

Example 5

Assume a structured entity is established to provide investment opportunities for investors who wish to have exposure to entity Z's credit risk (entity Z is unrelated to any party involved in the arrangement). The structured entity obtains funding by issuing to those investors notes that are linked to entity Z's credit risk (credit-linked notes) and uses the proceeds to invest in a portfolio of risk-free financial assets. The structured entity obtains exposure to entity Z's credit risk by entering into a credit default swap (CDS) with a swap counterparty. The CDS passes entity Z's credit risk to the structured entity in return for a fee paid by the swap counterparty. The investors in the structured entity receive a higher return that reflects both the structured entity's return from its asset portfolio and the CDS fee. The swap counterparty does not have involvement with the structured entity that exposes it to variability of returns from the performance of the structured entity because the CDS transfers variability to the structured entity, rather than absorbing variability of returns of the structured entity.

Meeting the objective

To meet the above objective, an entity shall disclose following:



Each of the above disclosures are explained in detail subsequently in this unit.

If the disclosures required by Ind AS 112, together with disclosures required by other Ind AS, do not meet the objective mentioned above, then an entity shall disclose whatever additional information is necessary to meet that objective.

Aggregation

An entity shall decide, in the light of its circumstances, how much detail it provides to satisfy the information needs of users, how much emphasis it places on different aspects of the requirements and how it aggregates the information. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation.

An entity may aggregate the disclosures required by Ind AS 112 for interests in similar entities if aggregation is consistent with the disclosure objective and the requirement in next paragraph and does not obscure the information provided. An entity shall disclose how it has aggregated its interests in similar entities.

An entity **shall** present information **separately** for interests in:

a) subsidiaries;

b) joint ventures;

c) joint operations;

d) associates; and

e) unconsolidated structured entities (explained in this unit).

In determining whether to aggregate information, an entity shall consider quantitative and qualitative information about the different risk and return characteristics of each entity it is considering for aggregation and the significance of each such entity to the reporting entity. The entity shall present the disclosures in a manner that clearly explains to users of financial statements the nature and extent of its interests in those other entities.

Examples of aggregation levels **within the classes of entities mentioned above** that might be appropriate are:

(a) nature of activities (e.g. a research and development entity, a revolving credit card securitisation entity).

(b) industry classification.

(c) geography (e.g. country or region)

8.2 SCOPE OF IND AS 112

Scope inclusions

Disclosure requirements of Ind AS 112 **applies** to an entity that has an interest in any of the following:

Subsidiaries	Joint arrangements (i.e. joint operationss or joint ventures)	Associates	Unconsolidated structured entities

The disclosure requirements of Ind AS 112 also applies if an entity's interests listed as above are classified (or included in a disposal group that is classified) as held for sale or discontinued operations in accordance with Ind AS 105 *'Non-current Assets Held for Sale and Discontinued Operations'*.

Scope exclusions

Disclosure requirements of Ind AS 112 **does not apply** to the following:

Post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19 *'Employee Benefits'* applies.

- For example, Company A has set up an Employee Benefit Plan trust. So, Company A is not required to make diclosures as required by Ind AS 112 of its interest in such trust.

An entity's separate financial statements to which Ind AS 27 *'Separate Financial Statements'* applies. However,

- If and entity has interests in uncosolidated structured entities and prepares separate financial statements as its only financial statements then it shall apply the disclosure requirements of Ind AS 112
- An Investment entity that prepares financial statements in which all of its subsidiaries are measured at fair value through profit or loss in accordance with Ind AS 110 *'Consolidated Fiancial Statements'* shall present the disclosures relating to investment entities required by Ind AS 112

Interest held by an entity that participates in, but does not have joint control of, a joint arrangement unless that interest results in significant influence over the arrangement or is an interest in a structured entity.

Interest in another entity that is accounted for in accordance with Ind AS 109 *'Financial Instruments'*. However, an entity shall apply Ind AS 112:

- when that interest is an interest in an associate or a joint venture that, in accordance with Ind AS 28 '*Investments in Associates and Joint Ventures'* is measured at fair value through profit or loss; or
- when that interest is an interest in an unconsolidated structured entity

8.3 DISCLOSURES RELATED TO INTERESTS IN SUBSIDIARIES

An entity shall disclose information that enables users of its consolidated financial statements

to understand

- the composition of the group; and
- the **interest that non-controlling interests have** in the group's activities and cash flows; and

to evaluate

- the **nature and extent of significant restrictions** on its ability to access or use assets, and settle liabilities, of the group
- the **nature of, and changes in, the risks associated** with its interests in consolidated structured entities
- the **consequences of changes in its ownership interest** in a subsidiary that do not result in a loss of control; and
- the **consequences of losing control** of a subsidiary during the reporting period

When the financial statements of a subsidiary used in the preparation of consolidated financial statements are as of a date or for a period that is different from that of the consolidated financial statements, an entity shall disclose:

- the date of the end of the reporting period of the financial statements of that subsidiary; and
- the reason for using a different date or period.

8.3.1 The interest that non-controlling interests have in the group's activities and cash flows

An entity shall disclose for each of its subsidiaries that have non-controlling interests that are material to the reporting entity:

the name of the subsidiary.

the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary.

the proportion of ownership interests held by non-controlling interests.

the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held.

the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period.

accumulated non-controlling interests of the subsidiary at the end of the reporting period.

summarised financial information about the subsidiary (explained subsequently in this unit)

The nature and extent of significant restrictions

An entity shall disclose following:

Significant restrictions (eg statutory, contractual and regulatory restrictions) on its ability to access or use the assets and settle the liabilities of the group, such as:

- those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group.
- guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group.

The **nature and extent** to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group (such as when a parent is obliged to settle liabilities of a subsidiary before settling its own liabilities, or approval of non-controlling interests is required either to access the assets or to settle the liabilities of a subsidiary).

The **carrying amounts** in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

8.3.2 Nature of the risks associated with an entity's interests in consolidated structured entities

An entity shall disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g. liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support).

If during the reporting period a parent or any of its subsidiaries has, without having a contractual obligation to do so, **provided financial or other support to a consolidated structured entity** (e.g. purchasing assets of or instruments issued by the structured entity), the entity shall disclose:

a) the type and amount of support provided, including situations in which the parent or its subsidiaries assisted the structured entity in obtaining financial support; and

b) the reasons for providing the support.

If during the reporting period a parent or any of its subsidiaries has, without having a contractual obligation to do so, **provided financial or other support to a previously unconsolidated structured entity** and that provision of support resulted in the entity controlling the structured entity, the entity shall disclose an explanation of the relevant factors in reaching that decision.

An entity shall disclose any current intentions to provide financial or other support to a consolidated structured entity, including intentions to assist the structured entity in obtaining financial support.

8.3.3 Consequences of changes in a parent's ownership interest in a subsidiary that do not result in a loss of control

An entity shall present a schedule that shows the effects on the equity attributable to owners of the parent of any changes in its ownership interest in a subsidiary that do not result in a loss of control.

8.3.4 Consequences of losing control of a subsidiary during the reporting period

An entity shall disclose the gain or loss, if any, calculated in accordance with Ind AS 110, and:

(a) the portion of that gain or loss attributable to measuring any investment retained in the former subsidiary at its fair value at the date when control is lost; and

(b) the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).

8.4 DISCLOSURES RELATED TO INTERESTS IN JOINT ARRANGEMENTS AND ASSOCIATES

An entity shall disclose information that enables users of its financial statements to evaluate:

(a) the **nature, extent and financial effects** of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and

(b) the nature of, and changes in, the **risks associated with its interests** in joint ventures and associates

The above disclosure requirements are discussed in detail in this section below.

8.4.1 Nature, extent and financial effects of an entity's interests in joint arrangements and associates

An entity shall disclose:

For each **joint arrangement and associate** that is material to the reporting entity:

- the name of the joint arrangement or associate.
- the nature of the entity's relationship with the joint arrangement or associate (by, for example, describing the nature of the activities of the joint arrangement or associate and whether they are strategic to the entity's activities).
- the principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement or associate.
- the proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).

For each **joint venture and associate** that is material to the reporting entity:*

- whether the investment in the joint venture or associate is measured using the equity method or at fair value.
- summarised financial information about the joint venture or associate (explained subsequently in this unit)
- if the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, if there is a quoted market price for the investment.

Financial information (explained suequently in this unit) about the entity's investments in joint ventures and associates that are **not individually material**: *

- in aggregate for all individually immaterial joint ventures and, separately,
- in aggregate for all individually immaterial associates.

* This information is not required to be disclosed by an investment entity.

8.5 DISCLOSURES OF SUMMARISED FINANCIAL INFORMATION FOR SUBSIDIARIES, JOINT VENTURES AND ASSOCIATES

In this section, we will discuss disclosure requirements for following:

- Disclosures for subsidiary that has non-controlling interests that are material
- Disclosures for joint venture and associate

- Disclosure for subsidiary, associate or joint venture classified as held for sale

8.5.1 Disclosures for subsidiary that has non-controlling interests that are material

For each subsidiary that has non-controlling interests that are material to the reporting entity, an entity shall disclose:

a) dividends paid to non-controlling interests.

b) summarised financial information about the assets, liabilities, profit or loss and cash flows of the subsidiary that enables users to understand the interest that non-controlling interests have in the group's activities and cash flows. That information might include but is not limited to, for example, current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss and total comprehensive income. (This information shall be the amounts before inter-company eliminations).

8.5.2 Disclosures for joint venture and associate

For each **joint venture and associate that is material** to the reporting entity, an entity shall disclose:

Dividends received from the joint venture or associate.

Summarised financial information for the joint venture or associate including, but not necessarily limited to:

- current assets
- non-current assets
- current liabilities
- non-current liabilities
- revenue
- profit or loss from continuing operations
- post-tax profit or loss from discontinued operations
- other comprehensive income
- total comprehensive income

In addition to the summarised financial information mentioned above, an entity shall disclose for **each joint venture that is material** to the reporting entity the amount of:

Cash and cash equivalents
Current financial liabilities (excluding trade and other payables and provisions)
Non-current financial liabilities (excluding trade and other payables and provisions)
Depreciation and amortisation
Interest income
Interest expense
Income tax expense or income

The summarised financial information presented in accordance with above for joint venture and associate shall be the amounts included in the Ind AS financial statements of the joint venture or associate (and not the entity's share of those amounts). If the entity accounts for its interest in the joint venture or associate using the equity method:

a) the amounts included in the Ind AS financial statements of the joint venture or associate shall be adjusted to reflect adjustments made by the entity when using the equity method, such as fair value adjustments made at the time of acquisition and adjustments for differences in accounting policies.

b) the entity shall provide a reconciliation of the summarised financial information presented to the carrying amount of its interest in the joint venture or associate.

An entity may present the summarised financial information required for joint venture or associate on the basis of the joint venture's or associate's financial statements if:

a) the entity measures its interest in the joint venture or associate at fair value in accordance with Ind AS 28; and

b) the joint venture or associate does not prepare Ind AS financial statements and preparation on that basis would be impracticable or cause undue cost.

(In that case, the entity shall disclose the basis on which the summarised financial information has been prepared.)

An entity shall disclose, in aggregate, the **carrying amount of its interests in all individually immaterial joint ventures or associates** that are accounted for using the equity method. An

entity shall also disclose separately the aggregate amount of its share of those joint ventures' or associates':

(a) profit or loss from continuing operations.

(b) post-tax profit or loss from discontinued operations.

(c) other comprehensive income.

(d) total comprehensive income.

(An entity provides these disclosures separately for joint ventures and associates)

8.5.3 Disclosure for subsidiary, associate or joint venture classified as held for sale

When an entity's interest in a subsidiary, a joint venture or an associate (or a portion of its interest in a joint venture or an associate) is classified (or included in a disposal group that is classified) as **held for sale** in accordance with Ind AS 105, the entity is not required to disclose summarised financial information for that subsidiary, joint venture or associate as mentioned above.

PART B:
DISCLOSURE IN SEPARATE FINANCIAL STATEMENTS AS PER IND AS 27

An entity shall apply all applicable Ind AS when providing disclosures in its separate financial statements, including the requirements mentioned below.

When a parent, in accordance with paragraph 4(a) of Ind AS 110, **elects not to prepare consolidated financial statements** and instead prepares separate financial statements, it shall disclose in those separate financial statements:

Dislcosures in separate financial statements		
The fact that: • the financial statements are separate financial statements; • the exemption from consolidation has been used; • the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with Ind ASs have been produced for public use; and • the address where those consolidated financial statements are obtainable.	A list of significant investments in subsidiaries, joint ventures and associates, including: • the name of those investees. • the principal place of business (and country of incorporation, if different) of those investees. • its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.	A description of the method used to account for those investments.

When an investment entity that is a parent prepares separate financial statements as its only financial statements, it shall disclose that fact. The investment entity shall also present the disclosures relating to investment entities required by Ind AS 112.

When a parent (other than a parent covered by paragraphs mentioned above) or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, the parent or investor shall **identify the financial statements prepared in accordance with Ind AS 110, Ind AS 111 or Ind AS 28** to which they relate. The parent or investor shall also disclose in its separate financial statements:

a) the fact that the statements are separate financial statements

b) a list of significant investments in subsidiaries, joint ventures and associates, including:

   I. the name of those investees.

II. the principal place of business (and country of incorporation, if different) of those investees.

III. its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.

c) a description of the method used to account for those investments.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



IND AS 27



IND AS 28



IND AS 110



IND AS 111

TEST YOUR KNOWLEDGE

Questions

1. X Limited was holding 100% of the equity share capital of Y Limited and Y Limited was treated as a subsidiary by X Limited. Now, Y Limited issues convertible preference shares to Z Limited. As per the issue document of convertible preference shares, Z Limited also gets the rights to participate in the relevant activities of Y Limited whereby Z Limited's consent is also necessary to pass any decision by the equity shareholder of Y Limited (i.e. X Limited). Determine how should X Limited account for its investment in Y Limited in its consolidated financial statements after the issue of convertible preference shares by Y Limited to Z Limited?

2. M Limited holds 90% interest in subsidiary N Limited. N Limited holds 25% interest in an associate O Limited. As at 31 March 20X1, the net assets of O Limited was ₹ 300 lakhs including profit of ₹ 40 lakhs for the year ended 31 March 20X1. Calculate how the investment in O Limited will be accounted in the consolidated financial statements of M Limited?

3. AB Limited holds 30% interest in an associate which it has acquired for a cost of ₹ 300 lakhs. On the date of acquisition of that stake, the fair value of net assets of the associate was ₹ 900 lakh. The value of goodwill on acquisition was ₹ 30 lakhs. After the acquisition, AB Limited accounted for the investment in the associate as per equity method of accounting and now the carrying value of such investment in the consolidated financial statements of AB Limited is ₹ 360 lakhs. The associate has now issued equity shares to some investors other than AB Limited for a consideration of ₹ 800 lakhs. This has effectively reduced the holding of AB Limited to 20%. Determine how AB Limited should account for such reduction in interest in the associate?

4. DEF Ltd. acquired 100% ordinary shares of ₹ 100 each of XYZ Ltd. on 1st October 20X1. On March 31, 20X2 the summarised Balance Sheets of the two companies were as given below:

	DEF Ltd.	XYZ Ltd.
Assets		
Property Plant Equipment		
Land & Buildings	15,00,000	18,00,000
Plant & Machinery	24,00,000	13,50,000
Investment in XYZ Ltd.	34,00,000	-
Inventory	12,00,000	3,64,000

Financial Assets		
Trade Receivable	5,98,000	4,00,000
Cash	1,45,000	80,000
Total	**92,43,000**	**39,94,000**
Equity & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	50,00,000	20,00,000
Other Equity		
Other reserves	24,00,000	10,00,000
Retained Earnings	5,72,000	8,20,000
Financial Liabilities		
Bank Overdraft	8,00,000	-
Trade Payable	4,71,000	1,74,000
Total	**92,43,000**	**39,94,000**

The retained earnings of XYZ Ltd. showed a credit balance of ₹ 3,00,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; DEF Ltd. has recognised the dividend received to profit or loss account; Fair Value of P&M as on 1st October 20X1 was ₹ 20,00,000. The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with Book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	1,00,000	Land & Buildings	10,00,000
		Inventories	1,50,000

Notes:

I. It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.

II. Also assume that the Other Reserves of both the companies as on 31st March 20X2 are the same as was on 1st April 20X1.

III. All fair value adjustments have not yet started impacting consolidated post-acquisition profits.

Prepare consolidated Balance Sheet as at March 31, 20X2.

5. Ram Ltd. acquired 60% ordinary shares of ₹ 100 each of Krishan Ltd. on 1st October 20X1. On March 31, 20X2 the summarised Balance Sheets of the two companies were as given below:

	Ram Ltd.	Krishan Ltd.
Assets		
Property, Plant and Equipment		
Land & Buildings	3,00,000	3,60,000
Plant & Machinery	4,80,000	2,70,000
Investment in Krishan Ltd.	8,00,000	-
Inventory	2,40,000	72,800
Financial Assets		
Trade Receivables	1,19,600	80,000
Cash	29,000	16,000
Total	**19,68,600**	**7,98,800**
Equity & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	10,00,000	4,00,000
Other Equity		
Other Reserves	6,00,000	2,00,000
Retained earnings	1,14,400	1,64,000
Financial Liabilities		
Bank Overdraft	1,60,000	-
Trade Payable	94,200	34,800
Total	**19,68,600**	**7,98,800**

The Retained earnings of Krishan Ltd. showed a credit balance of ₹ 60,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; Ram Ltd. has credited the dividend received to its Retained earnings; Fair Value of P&M as on 1st October 20X1 was ₹ 4,00,000; The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	20,000	Land & Buildings	2,00,000
		Inventories	30,000

Notes:

I. It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.

II. Also assume that the Other Reserves as on 31st March 20X2 are the same as was on 1st April 20X1.

Prepare consolidated Balance Sheet as at March 31, 20X2.

6. On 31 March 20X2, Blue Heavens Ltd. acquired 100% ordinary shares carrying voting rights of Orange County Ltd. for ₹ 6,000 lakh in cash and it controlled Orange County Ltd. from that date. The acquisition-date statements of financial position of Blue Heavens Ltd. and Orange County Ltd. and the fair values of the assets and liabilities recognised on Orange County Ltd. balance sheet were:

	Blue Heavens Ltd.	Orange County Ltd.	
	Carrying Amount (₹ in lakh)	Carrying Amount (₹ in lakh)	Fair Value (₹ in lakh)
Assets			
Non-current assets			
Building and other PPE	7,000	3,000	3,300
Investment in Orange County Ltd.	6,000		
Current assets			
Inventories	700	500	600
Trade receivables	300	250	250
Cash	1,500	700	700
Total assets	**15,500**	**4,450**	
Equity and liabilities			
Equity			
Share capital	5,000	2,000	
Retained earnings	10,200	2,300	
Current liabilities			
Trade payables	300	150	150
Total liabilities and equity	**15,500**	**4,450**	

Prepare the Consolidated Balance Sheet as at March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.

7. The facts are the same as in Question 6 above. However, Blue Heavens Ltd. acquires only 75% of the ordinary shares, to which voting rights are attached of Orange County Ltd. Blue Heavens Ltd. pays ₹ 4,500 lakhs for the shares. Prepare the Consolidated Balance Sheet as at March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.

8. Facts are same as in Question 6 &7, Blue Heavens Ltd. acquires 75% of Orange County Ltd. Blue Heavens Ltd. pays ₹ 4,500 lakhs for the shares. At 31 March 20X3, i.e one year after Blue Heavens Ltd. acquired Orange County Ltd., the individual statements of financial position and statements of comprehensive income of Blue Heavens Ltd. and Orange County Ltd. are:

	Blue Heavens Ltd. Carrying Amount (₹ in lakh)	Orange County Ltd. Carrying Amount (₹ in lakh)
Assets		
Non-current assets		
PPE (Building and others)	6,500	2,750
Investment in Orange County Ltd.	4,500	
	11,000	2,750
Current assets		
Inventories	800	550
Financial Asset - Trade receivables	380	300
Cash	4,170	1,420
	5,350	2,270
Total assets	**16,350**	**5,020**
Equity and liabilities		
Equity		
Share capital	5,000	2,000
Retained earnings	11,000	2,850
	16,000	4,850

Current liabilities		
Financial Liabilities-Trade payables	350	170
	350	170
Total liabilities and equity	**16,350**	**5,020**

Statements of Profit and Loss for the year ended 31 March 20X3:

	Blue Heavens Ltd. Carrying Amount (₹ in lakh)	Orange County Ltd. Carrying Amount (₹ in lakh)
Revenue	3,000	1,900
Cost of sales	(1,800)	(1,000)
Administrative expenses	(400)	(350)
Profit for the year	**800**	**550**

Note: Blue Heavens Ltd. estimates that goodwill has impaired by 98. The fair value adjustment to buildings and other PPE is in respect of a building; all buildings have an estimated remaining useful life of 20 years from 31 March 20X2 and estimated residual values of zero. Blue Heavens Ltd. uses the straight-line method for depreciation of PPE. All the inventory held by Orange County Ltd. at 31 March 20X2 was sold during 20X3.

Prepare the Consolidated Balance Sheet as at March 31, 20X3 of group of entities Blue Heavens Ltd. and Orange County Ltd.

9. P Pvt. Ltd. has a number of wholly-owned subsidiaries including S Pvt. Ltd. at 31st March 20X2. P Pvt. Ltd.'s consolidated balance sheet and the group carrying amount of S Pvt. Ltd.'s assets and liabilities (ie the amount included in the consolidated balance sheet in respect of S Pvt. Ltd.'s assets and liabilities) at 31st March 20X2 are as follows:

Particulars	Consolidated (₹ in millions)	Group carrying amount of S Pvt. Ltd. asset and liabilities Ltd. (₹ in millions)
Assets		
Non-Current Assets		
Goodwill	380	180
Buildings	3,240	1,340
Current Assets		

Inventories	140	40
Trade Receivables	1,700	900
Cash	3,100	1000
Total Assets	**8,560**	**3,460**
Equities & Liabilities		
Equity		
Share Capital	1600	
Other Equity		
Retained Earnings	4,260	
Current liabilities		
Trade Payables	2,700	900
Total Equity & Liabilities	**8,560**	**900**

Prepare consolidated Balance Sheet after disposal as at 31st March, 20X2 when P Pvt. Ltd. group sold 100% shares of S Pvt. Ltd. to independent party for ₹ 3,000 millions.

10. Reliance Ltd. has a number of wholly-owned subsidiaries including Reliance Jio Infocomm Ltd. at 31st March 20X2.

Reliance Ltd.'s consolidated balance sheet and the group carrying amount of Reliance Jio Infocomm Ltd. assets and liabilities (ie the amount included in that consolidated balance sheet in respect of Reliance Jio Infocomm Ltd. assets and liabilities) at 31st March 20X2 are as follows:

Particulars	**Consolidated (₹ In '000)**	**Group carrying amount of Reliance Jio Infocomm Ltd. asset and liabilities Ltd. (₹ In '000)**
Assets		
Non-current Assets		
Goodwill	190	90
Buildings	1,620	670
Current Assets		
Inventories	70	20

Financial Assets		
Trade Receivables	850	450
Cash	1,550	500
Total Assets	**4,280**	**1,730**
Equity & Liabilities		
Equity		
Share Capital	800	
Other Equity		
Retained Earnings	2,130	
	2,930	
Current liabilities		
Financial liabilities		
Trade Payables	1,350	450
Total Equity & Liabilities	**4,280**	**450**

Prepare consolidated Balance Sheet after disposal as at 31st March, 20X2 when Reliance Ltd. group sold 90% shares of Reliance Jio Infocomm Ltd. to independent party for ₹ 1000 thousand.

11. Airtel Telecommunications Ltd. owns 100% share capital of Airtel Infrastructures Pvt. Ltd. On 1 April 20X1 Airtel Telecommunications Ltd. acquired a building from Airtel Infrastructures Pvt. Ltd., for ₹ 11,00,000 that the group plans to use it as its new headquarters office.

    Airtel Infrastructures Pvt. Ltd. had purchased the building from a third party on 1 April 20X0 for ₹ 10,25,000. At that time the building was assessed to have a useful life of 21 years and a residual value of ₹ 5,00,000. On 1 April 20X1 the carrying amount of the building was ₹ 10,00,000 in Airtel Infrastructures Pvt. Ltd.'s individual accounting records.

    The estimated remaining useful life of the building measured from 1 April 20X1 is 20 years and the residual value of the building is now estimated at ₹ 3,50,000. The method of depreciation is straight-line.

    Pass necessary accounting entries in individual and consolidation situations.

12. As at the beginning of its current financial year, AB Limited holds 90% equity interest in BC Limited. During the financial year, AB Limited sells 70% of its equity interest in BC Limited to PQR Limited for a total consideration of ₹ 56 crore and consequently loses

control of BC Limited. At the date of disposal, fair value of the 20% interest retained by AB Limited is ₹ 16 crore and the net assets of BC Limited are carry valued at ₹ 60 crore.

These net assets include the following:

(a) Debt investments classified as fair value through other comprehensive income (FVOCI) of ₹ 12 crore and related FVOCI reserve of ₹ 6 crore.

(b) Net defined benefit liability of ₹ 6 crore that has resulted in a reserve relating to net measurement losses of ₹ 3 crore.

(c) Equity investments (considered not held for trading) of ₹ 10 crore for which irrevocable option of recognising the changes in fair value in OCI has been availed and related FVOCI reserve of ₹ 4 crore.

(d) Net assets of a foreign operation of ₹ 20 crore and related foreign currency translation reserve of ₹ 8 crore.

In consolidated financial statements of AB Limited, 90% of the above reserves were included in equivalent equity reserve balances, with the 10% attributable to the non-controlling interest included as part of the carrying amount of the non-controlling interest.

What would be the accounting treatment on loss of control in the consolidated financial statements of AB Limited?

13. On 1st April 2019, Investor Ltd. acquires 35% interest in another entity, XYZ Ltd. Investor Ltd. determines that it is able to exercise significant influence over XYZ Ltd. Investor Ltd. has paid total consideration of ₹ 47,50,000 for acquisition of its interest in XYZ Ltd. At the date of acquisition, the book value of XYZ Ltd.'s net assets was ₹ 90,00,000 and their fair value was ₹ 1,10,00,000. Investor Ltd. has determined that the difference of ₹ 20,00,000 pertains to an item of property, plant and equipment (PPE) which has remaining useful life of 10 years.

During the year, XYZ Ltd. made a profit of ₹ 8,00,000. XYZ Ltd. paid a dividend of ₹ 12,00,000 on 31st March, 2020. XYZ Ltd. also holds a long-term investment in equity securities. Under Ind AS, investment is classified as at FVTOCI in accordance with Ind AS 109 and XYZ Ltd. recognized an increase in value of investment by ₹ 2,00,000 in OCI during the year. Ignore deferred tax implications, if any.

Calculate the closing balance of Investor Ltd.'s investment in XYZ Ltd. as at 31st March, 2020 as per the relevant Ind AS.

14. On 1st April 20X1 Alpha Ltd. commenced joint construction of a property with Gama Ltd. For this purpose, an agreement has been entered into that provides for joint operation and ownership of the property. All the ongoing expenditure, comprising maintenance plus borrowing costs, is to be shared equally. The construction was completed on 30th September

20X1 and utilisation of the property started on 1st January 20X2 at which time the estimated useful life of the same was estimated to be 20 years.

Total cost of the construction of the property was ₹ 40 crores. Besides internal accruals, the cost was partly funded by way of loan of ₹ 10 crores taken on 1st January 20X1. The loan carries interest at an annual rate of 10% with interest payable at the end of year on 31st December each year. The company has spent ₹ 4,00,000 on the maintenance of such property.

The company has recorded the entire amount paid as investment in Joint Venture in the books of accounts. Suggest the suitable accounting treatment of the above transaction as per applicable Ind AS.

15. Gamma Limited, a parent company, is engaged in manufacturing and retail activities. The group holds investments in different entities as follows:

- Gamma Limited holds 100% Investment in G Limited and D Limited;
- G Limited and D Limited hold 60% and 40% in GD Limited respectively;
- Delta Limited is a 100% subsidiary of GD Limited

Firstly, Gamma Limited wants you to suggest whether GD Limited can avail the exemption from the preparation and presentation of consolidated financial statements as per applicable Ind AS?

Secondly, if all other facts remain the same as above except that G Limited and D Limited are both owned by an Individual (say, Mr. X) instead of Gamma Limited, then explain whether GD Limited can avail the exemption from the preparation and presentation of consolidated financial statements.

Answers

1. As per the issue document of convertible preference shares, unanimous consent of both X Limited and Z Limited are required to pass any decision about the relevant activities of Y Limited. Hence, Y Limited is jointly controlled by X Limited and Z Limited and thereby, Y Limited becomes a joint arrangement between X Limited and Z Limited.

Y Limited is structured through a separate vehicle. The legal form of Y Limited, terms of the contractual arrangement or other facts and circumstances do not give X Limited and Z Limited rights to the assets, and obligations for the liabilities, relating to Y Limited. Hence, Y Limited is a joint venture between X Limited and Z Limited.

When the convertible preference shares are issued to Z Limited, X Limited losses control over Y Limited. Hence X Limited should derecognise the assets and liabilities of Y Limited from its consolidated financial statements. 100% equity shares in Y Limited is still held by X Limited. Hence such investment would be accounted at fair value on the date of loss of

control by X Limited. The difference between the fair value of 100% equity shares retained in Y Limited and the carrying value of assets and liabilities of Y Limited derecognised is recognised in profit or loss of X Limited. After the loss of control, the investment in Y Limited is accounted as per equity method of accounting by X Limited whereby the investment value in Y Limited will be adjusted for the change in the X Limited's share of the net assets Y Limited post the date of loss of control. Also, the difference between the fair value of investment in Y Limited and fair value of net identifiable assets of Y Limited shall be goodwill or capital reserve.

2. Since N Limited is a subsidiary of M Limited, the consolidated financial statements of M Limited will include 100% amounts of the consolidated financial statements of N Limited (including investment in O Limited accounted for using equity method). Accordingly, the investment in O Limited will be accounted as follows in the consolidated financial statements of M Limited:

		₹' lakh
Investment in O Limited (300 x 25%)		75
Share in profit of O Limited		
Attributable to M Limited (40 x 25% x 90%)	9	
Attributable to Non-controlling interest of N Limited (50 x 25% x 10%)	1	10

3. Because of the issue of shares by associate to other investors, AB Limited has effectively sold 10% (30 – 20) of its interest in the associate. The gain / loss on reduction in interest in associate in calculated as follows:

	₹' lakhs
AB Limited's share in the consideration received by the associate for issue of shares (800 x 20%) (1)	160
Less: Carrying value of interest sold (360 x 1/3)(2)	(120)
Gain on reduction in interest in associate(3)	**40**

Notes:

(1) The share in the consideration received by associate on issue of shares (i.e. ₹ 160 lakhs) would be recorded as part of investment in associate.

(2) The carrying amount of interest sold (i.e. ₹ 120 lakhs) will be derecognised, including proportionate goodwill of ₹ 10 lakhs (30 x 1/3).

(3) Gain of ₹ 40 lakhs will be recorded in the profit or loss.

4. Consolidated Balance Sheet of DEF Ltd. and its subsidiary, XYZ Ltd. as at 31st March, 20X2

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	86,00,000
(2) Current Assets		
(i) Inventories	2	17,14,000
(ii) Financial Assets		
(a) Trade Receivables	3	9,98,000
(b) Cash & Cash equivalents	4	2,25,000
Total Assets		**1,15,37,000**
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	5	50,00,000
(ii) Other Equity	6	49,92,000
(2) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	7	7,45,000
(b) Short term borrowings	8	8,00,000
Total Equity & Liabilities		**1,15,37,000**

Notes to Accounts

			₹
1.	**Property Plant & Equipment**		
	Land & Building	43,00,000	
	Plant & Machinery	43,00,000	86,00,000
2.	**Inventories**		
	DEF Ltd.	12,00,000	
	XYZ Ltd.	5,14,000	17,14,000

3.	**Trade Receivables**		
	DEF Ltd.	5,98,000	
	XYZ Ltd.	4,00,000	9,98,000
4.	**Cash & Cash equivalents**		
	DEF Ltd.	1,45,000	
	XYZ Ltd.	80,000	2,25,000
7.	**Trade payable**		
	DEF Ltd.	4,71,000	
	XYZ Ltd.	2,74,000	7,45,000
8.	**Shorter-term borrowings**		
	Bank overdraft		8,00,000

Statement of Changes in Equity:

5. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
50,00,000	0	50,00,000

6. Other Equity

	Share application money pending allotment	Equity component of compound financial instrument	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning				0	24,00,000	24,00,000
Total comprehensive income for the year			0	5,72,000		5,72,000
Dividends			0	(2,00,000)		(2,00,000)
Total						

comprehensive income attributable to parent			0	3,35,000		3,35,000
Gain on Bargain purchase			18,85,000			18,85,000
Balance at the end of reporting period			18,85,000	7,07,000	24,00,000	49,92,000

It is assumed that there exists no clear evidence for classifying the acquisition of the subsidiary as a bargain purchase and, hence, the bargain purchase gain has been recognized directly in capital reserve. If, however, there exists such a clear evidence, the bargain purchase gain would be recognized in other comprehensive income and then accumulated in capital reserve. In both the cases, closing balance of capital reserve will be ₹ 18,85,000.

Working Notes:

1. Adjustments of Fair Value

The Plant & Machinery of XYZ Ltd. would stand in the books at ₹ 14,25,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 15,00,000 total depreciation being ₹ 1,50,000. The value put on the assets being ₹ 20,00,000 there is an appreciation to the extent of ₹ 5,75,000.

2. Acquisition date profits of XYZ Ltd. ₹

Reserves on 1.4. 20X1	10,00,000
Profit & Loss Account Balance on 1.4. 20X1 Profit for 20X2: Total ₹ 8,20,000 less ₹ 1,00,000 (3,00,000 – 2,00,000) i.e. ₹ 7,20,000; for 6 months i.e. up to 1.10.20X1	3,00,000
Total Appreciation including machinery appreciation (10,00,000 1,50,000 + 5,75,000 – 1,00,000)	3,60,000
Share of DEF Ltd.	16,25,000
	32,85,000

3. Post-acquisition profits of XYZ Ltd. ₹

Profit after 1.10. 20X1 [8,20,000-1,00,000]x 6/12	3,60,000
Less: 10% depreciation on ₹ 20,00,000 for 6 months less depreciation already charged for 2nd half of 20X1-20X2 on ₹ 15,00,000 (1,00,000-75,000)	(25,000)
Share of DEF Ltd.	3,35,000

4. Consolidated total comprehensive income ₹

DEF Ltd.	
Retained earnings on 31.3.20X2	5,72,000
Less: Retained earnings as on 1.4.20X1	(0)
Profits for the year 20X1-20X2	5,72,000
Less: Elimination of intra-group dividend	(2,00,000)
Adjusted profit for the year	3,72,000
XYZ Ltd.	
Adjusted profit attributable to DEF Ltd. (W.N.3)	3,35,000
Consolidated profit or loss for the year	7,07,000

5. No Non-controlling Interest as 100% shares of XYZ Ltd. are held by DEF Ltd.

6. Gain on Bargain Purchase ₹

Amount paid for 20,000 shares		34,00,000
Par value of shares	20,00,000	
DEF Ltd.'s share in acquisition date profits of XYZ Ltd.	32,85,000	(52,85,000)
Gain on Bargain Purchase		18,85,000

7. Value of Plant & Machinery ₹

DEF Ltd.		24,00,000
XYZ Ltd.	13,50,000	
Add: Appreciation on 1.10. 20X1	5,75,000	
	19,25,000	
Add: Depreciation for 2nd half charged on pre-revalued value	75,000	
Less: Depreciation on ₹ 20,00,000 for 6 months	(1,00,000)	19,00,000
		43,00,000

8. Consolidated retained earnings ₹

	DEF Ltd.	XYZ Ltd.	Total
As given	5,72,000	8,20,000	13,92,000
Consolidation Adjustments:			
(i) Elimination of pre-acquisition element [3,00,000 + 3,60,000]	0	(6,60,000)	(6,60,000)
(ii) Elimination of intra-group dividend	(2,00,000)	2,00,000	0
(iii) Impact of fair value adjustments	0	(25,000)	(25,000)
Adjusted retained earnings consolidated	3,72,000	3,35,000	7,07,000

Assumptions:

1. Investment in XYZ Ltd is carried at cost in the separate financial statements of DEF Ltd.
2. Appreciation of ₹10 lakhs in land & buildings is entirely attributable to land element only.
3. Depreciation on plant and machinery is on WDV method.
4. Acquisition-date fair value adjustment to inventories of XYZ Ltd. existing at the balance sheet date does not result in need for any write-down.

5. Consolidated Balance Sheet of Ram Ltd. and its subsidiary, Krishan Ltd. as at 31st March, 20X2

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property, Plant & Equipment	1	17,20,000
(ii) Goodwill	2	1,65,800
(2) Current Assets		
(i) Inventories	3	3,42,800
(ii) Financial Assets		
(a) Trade Receivables	4	1,99,600
(b) Cash & Cash equivalents	5	45,000
Total Assets		**24,73,200**

II.	**Equity and Liabilities**		
	(1) Equity	6	10,00,000
	(i) Equity Share Capital	7	7,30,600
	(ii) Other Equity		4,33,600
	(2) Non-controlling Interest (WN 4)		
	(3) Current Liabilities		
	(i) Financial Liabilities	8	1,49,000
	(a) Trade Payables	9	1,60,000
	(b) Short term borrowings		**24,73,200**
Total Equity & Liabilities			

Notes to accounts

			₹
1.	**Property Plant & Equipment**		
	Land & Building	8,60,000	
	Plant & Machinery	8,60,000	17,20,000
2.	Goodwill		1,65,800
3.	**Inventories**		
	Ram Ltd.	2,40,000	
	Krishan Ltd.	1,02,800	3,42,800
4.	**Trade Receivables**		
	Ram Ltd.	1,19,600	
	Krishan Ltd.	80,000	1,99,600
5.	**Cash & Cash equivalents**		
	Ram Ltd.	29,000	
	Krishan Ltd.	16,000	45,000
8.	**Trade Payables**		
	Ram Ltd.	94,200	
	Krishan Ltd.	54,800	1,49,000
9.	**Short-term borrowings**		
	Bank overdraft		1,60,000

Statement of Changes in Equity:

6. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
10,00,000	0	10,00,000

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning of the reporting period				0	6,00,000	6,00,000
Total comprehensive income for the year			0	1,14,400		1,14,400
Dividends			0	(24,000)		(24,000)
Total comprehensive income attributable to parent			0	40,200		40,200
Gain on Bargain purchase				0		0
Balance at the end of reporting period				1,30,600	6,00,000	7,30,600

Working Notes:

1. Adjustments of Fair Value

The Plant & Machinery of Krishan Ltd. would stand in the books at ₹ 2,85,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 3,00,000 total depreciation being ₹ 30,000. The value put on the assets being ₹ 4,00,000 there is an appreciation to the extent of ₹ 1,15,000.

2. Acquisition date profits of Krishan Ltd.

Reserves on 1.4. 20X1		2,00,000
Profit & Loss Account Balance on 1.4. 20X1		60,000
Profit for 20X1-20X2: Total (₹ 1,64,000 less ₹ 20,000) x 6/12 i.e. ₹ 72,000; upto 1.10. 20X1		72,000
Total Appreciation		3,25,000
		6,57,000
Holding Co. Share (60%)		3,94,200

3. Post-acquisition profits of Krishan Ltd.

Profit after 1.10. 20X1 [1,64,000-20,000]x 6/12	72,000
Less: 10% depreciation on ₹ 4,00,000 for 6 months less depreciation already charged for 2nd half of 20X1-20X2 on ₹ 3,00,000 (20,000-15,000)	(5,000)
Total	67,000
Share of holding Co. (60%)	40,200

4. Non-controlling Interest

Par value of 1600 shares	160,000
Add: 2/5 Acquisition date profits (6,57,000 – 40,000)	2,46,800
Add: 2/5 Post-acquisition profits [WN 3]	26,800
	4,33,600

5. Goodwill:

Amount paid for 2,400 shares		8,00,000
Par value of shares	2,40,000	
Acquisition date profits share of Ram Ltd.	3,94,200	(6,34,200)
Goodwill		1,65,800

6. Value of Plant & Machinery:

Ram Ltd.		4,80,000
Krishan Ltd.	2,70,000	
Add: appreciation on 1.10. 20X1	1,15,000	
	3,85,000	
Add: Depreciation for 2nd half charged on pre-revalued value	15,000	
Less: Depreciation on ₹ 4,00,000 for 6 months	(20,000)	3,80,000
		8,60,000

7. Profit & Loss account consolidated

Ram Ltd. (as given)	1,14,400	
Less: Dividend	(24,000)	90,400
Share of Ram Ltd. in post-acquisition profits		40,200
		1,30,600

6. Blue Heavens Ltd. consolidated balance sheet at 31 March 20X2 will be calculated as follows: **(in lakhs)**

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			1,300 (WN 1)	1,300
Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	6,000		(6,000)	
Current assets				
Inventories	700	500	100	1,300
Financial Assets				
Trade receivables	300	250		550
Cash	1,500	700		2,200
Total assets	**15,500**	**4,450**		**15,650**

Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	10,200	2,300	(2,300)	10,200
Trade payable	300	150		450
Total liabilities and equity	**15,500**	**4,450**		**15,650**

Consolidation involves:

- Adding the balance sheet of the parent and its subsidiary together line by line.
- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased) and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary.

1. Working for goodwill:	(₹ in lakhs)
Consideration paid	6,000
Less: Acquisition date fair value of Orange County Ltd. net assets	(4,700)
Goodwill	1,300

2. Working for the acquisition date fair value of Orange County Ltd. net assets: Acquisition date fair value of acquiree (Orange County Ltd.) assets

Buildings and other PPE	3,300
Inventories	600
Trade receivables	250
Cash	700
Less: fair value of trade payables	(150)
Fair value of net assets acquired	4,700

7. Non-controlling interest

= 25 % × Orange County Ltd. identifiable net assets at fair value of ₹ 4,700

= ₹ 1,175.

Blue Heavens Ltd.'s consolidated balance sheet at 31 March 20X2 will be calculated as follows: **(in lakhs)**

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			975 (WN 1)	975
Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	4,500		(4,500)	
Current assets				
Inventories	700	500	100	1,300
Financial Assets				
Trade receivables	300	250		550
Cash	3,000	700		3,700
Total assets	**15,500**	**4,450**		**16,825**
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	10,200	2,300	(2,300)	10,200
			1,175	1,175
Non-controlling interest				
Current liabilities				
Financial Liabilities				
Trade payables	300	150		450
Total liabilities and equity	**15,500**	**4,450**		**16,825**

Note: In this question, Blue Heavens Ltd.'s (and consequently the group's) cash balance is ₹ 1,500 lakh higher than in Question above because, here Blue Heavens Ltd. paid ₹ 1,500 less to acquire Orange County Ltd. (i.e. ₹ 6,000 less ₹ 4,500).

1. **Working for goodwill:** (₹ in lakhs)

Consideration paid	4,500
Non- controlling interest	1,175
Less: Acquisition date fair value of Orange County Ltd. net assets (cal. as above)	4,700
Goodwill	975

(Goodwill recognized in the consolidated balance sheet relates solely to the acquirer's proportion of the subsidiary; it does not include the non-controlling interest's share).

8. Alternative I for calculation of Non-controlling Interest:

The Non-controlling Interest proportion of Orange County Ltd. is 25%.

At 31 March 20X3, the NCI in the consolidated balance sheet would be calculated as:

₹ (lakh)

NCI at date of acquisition (31 March 20X2) (see solution to Question 7)	1,175
NCI's share of profit for the year ended 31 March 20X3, being 25% Of ₹ 435 lakh (being ₹ 550 profit of Orange County Ltd. as per Orange County Ltd. financial statements less ₹ 100 group inventory Fair value adjustment less ₹ 15 group depreciation on building fair value adjustment)*	109
NCI as at 31 March 20X3	1,284

*In calculating the NCI's share of profit for the year ended 31 March 20X3, no deduction is made for goodwill amortization because, as explained above, the goodwill arising on consolidation relates solely to the acquirer's proportion of the subsidiary and does not include the non-controlling interest's share.

Alternative II for calculation of Non-controlling Interest:

As an alternative to the above three-step approach, at 31 March 20X3 the NCI in the consolidated balance sheet is calculated as 25% (the NCI's proportion) of ₹ 5,135, which is ₹ 1,284. ₹ 5,135 is Orange County Ltd. net assets at 31 March 20X3 as shown in Orange County Ltd. balance sheet (₹ 4,850, being ₹ 5,020 assets less ₹ 170 liabilities) plus the fair value adjustment to those assets as made in preparing the group balance sheet (₹ 285, being the fair value adjustment in respect of Orange County Ltd. building, ₹ 300, less one year's depreciation of that adjustment, ₹ 15).

Blue Heavens Ltd. consolidated statement of comprehensive income for the year ended 31 March 20X3 will be computed as follows:

	Blue Heavens Ltd.	Orange County Ltd.	Consolidate adjustments	Consolidated
Revenue	3,000	1,900		4,900
Cost of sales	(1,800)	(1,000)	(100) (WN 1)	(2,900)
Profit for the year	1,200	900		2,000
Administrative expenses	(400)	(350)	(113) (WN 2)	(863)
Total comprehensive income for the year	800	550		1,137

Total comprehensive income attributable to:

Owners of the parent (75%)	1,028
Non-controlling interest (25%)	109
	1,137

Consolidation involves:

- Adding the statement of comprehensive income of the parent and its subsidiary together line by line
- Recognising the fair value adjustments and/ or amortisation thereof together with amortisation of the goodwill asset that arose on acquisition of the subsidiary.

Blue Heavens Ltd. consolidated balance sheet at 31 March 20X3 will be computed as follows: **(₹ in lakh)**

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			975-98 (WN 3)	877

Buildings and other PPE	6,500	2,750	285 (WN 4)	9,535
Financial Assets				
Investment in Entity B	4,500		(4,500)	
Current assets				
Inventories	800	550		1,350
Financial Assets				
Trade receivables	380	300		680
Cash	4,170	1420		5,590
Total assets	**16,350**	**5,020**		**18,032**
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	11,000	2,850	(2,622) (WN 5)	11,228
Non-controlling interest			1,284	1,284
Current liabilities				
Financial Liabilities				
Trade payables	350	170		520
Total liabilities and equity	**16,350**	**5,020**		**18,032**

Consolidation involves:

- Adding the balance sheet of the parent and its subsidiary together line by line.
- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased), and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary as adjusted to reflect the first year post-acquisition
- Recognising the non-controlling interest in the net assets of Entity B.

Working Notes:

(1) Cost of sales adjustment:

₹ 100 = fair value adjustment in respect of inventories at 31 March 20X2.

(2) Administrative expenses adjustment:

₹ 113 = Impairment of goodwill ₹ 98 (WN 3) + additional depreciation on building ₹ 15 (WN 4).

For simplicity it is assumed that all the goodwill impairment and the additional depreciation on buildings (on account of fair value adjustment) is adjusted against administrative expenses.

(3) Working for goodwill:

Goodwill at the acquisition date, ₹ 975, less accumulated impairment, ₹ 98 = ₹ 877.

(4) Working for building consolidation adjustment:

The fair value adjustment at 31 March 20X2 in respect of Orange County Ltd. building was ₹ 300, that is, the carrying amount at 31 March 20X2 was ₹ 300 lower than was recognized in the group's consolidated balance sheet. The building is being depreciated over 20 years from 31 March 20X2. Thus, at 31 March 20X3 the adjustment required on consolidation to the balance sheet will be ₹ 285, being ₹ 300 × 19/20 years' estimated useful life remaining. The additional depreciation recognized in the consolidated statement of comprehensive income is ₹ 15 (being ₹ 300 x 1/20).

(5) Reserves adjustment:

₹ 2,300 adjustment at the acquisition date (Question 7)

plus ₹ 98 (WN 3) impairment of goodwill

plus ₹ 15 (WN 4) additional depreciation on building

plus ₹ 100 (WN 1) fair value adjustment in respect of inventories

plus ₹ 109 NCI's share of Orange County Ltd. profit for the year (as included in the consolidated statement of comprehensive income)

= ₹ 2,622.

8. When 100% shares sold to independent party Consolidated Balance Sheet of P Pvt. Ltd. and its remaining subsidiaries as at 31st March, 20X2

Particulars	Note No.	(₹ in millions)
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	1,900
(ii) Goodwill	2	200
(2) Current Assets		
(i) Inventories	3	100

(ii) Financial Assets		
(a) Trade Receivables	4	800
(b) Cash & Cash equivalents	5	5,100
Total Assets		**8,100**
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	6	1,600
(ii) Other Equity	7	4,700
(2) Non-controlling Interest		
(3) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	8	1,800
Total Equity & Liabilities		**8,100**

Notes to accounts:

			(₹ in millions)
1.	**Property Plant & Equipment**		
	Land & Building	3,240	
	Less: S Pvt. Ltd.	(1,340)	1,900
2.	**Goodwill**	380	
	Less: S Pvt. Ltd.	(180)	200
3.	**Inventories**		
	Group	140	
	Less: S Pvt. Ltd.	(40)	100
4.	**Trade Receivables**		
	Group	1,700	
	Less: S Pvt. Ltd.	(900)	800
5.	**Cash & Cash equivalents**		
	Group (WN 2)	5,100	5,100
6.	**Trade Payables**		
	Group	2,700	
	Less: S Pvt. Ltd.	900	1,800

Statement of changes in Equity:

6. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
1600	0	1600

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				4,260		4,260
Total comprehensive income for the year			0			
Dividends			0			
Total comprehensive income attributable to parent			0			
Gain on disposal of S Pvt. Ltd.				440		440
Balance at the end of reporting period			0	4,700		4,700

Working Notes:

1. When sold, the carrying amount of all assets and liabilities attributable to S Pvt. Ltd. were eliminated from the consolidated balance sheet.

2. Cash on hand (in millions):

Cash before disposal of S Pvt. Ltd.	3,100
Less: S Pvt. Ltd. Cash	(1,000)
Add: Cash realized from disposal	3,000
Cash on Hand	5,100

3. Gain/ Loss on disposal of entity (in millions):

Proceeds from disposal	3,000
Less: Net assets of S Pvt. Ltd.	(2,560)
Gain on disposal	440

4. Retained Earnings (in millions):

Retained Earnings before disposal	4,260
Add: Gain on disposal	440
Retained earnings after disposal	4,700

10. When 90% shares sold to independent party Consolidated Balance Sheet of Reliance Ltd. and its remaining subsidiaries as at 31st March, 20X2

Particulars	**Note No.**	**(₹ In '000)**
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	950
(ii) Goodwill	2	100
(iii) Financial Assets		
(a) Investments	3	128
(2) Current Assets		
(i) Inventories	4	50
(ii) Financial Assets		
(b) Trade Receivables	5	400
(c) Cash & Cash equivalents	6	2,050
Total Assets		**3,678**
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	7	800
(ii) Other Equity	8	1,978
(2) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	9	900
Total Equity & Liabilities		**3,678**

Notes to accounts:

			(₹ In '000)
1.	**Property Plant & Equipment**		
	Land & Building	1620	
	Less: Reliance Jio Infocomm Ltd.	(670)	950

2.	Goodwill	190	
	Less: Reliance Jio Infocomm Ltd.	(90)	100
3.	**Investments**		
	Investment in Reliance Jio Infocomm Ltd. (WN 2)	128	128
4.	**Inventories**		
	Group	70	
	Less: Reliance Jio Infocomm Ltd.	(20)	50
5.	**Trade Receivables**		
	Group	850	
	Less: Reliance Jio Infocomm Ltd.	(450)	400
6.	**Cash & Cash equivalents**		
	Group (WN 3)	2,050	2,050
9.	**Trade Payables**		
	Group	1,350	
	Less: Reliance Jio Infocomm Ltd.	450	900

Statement of changes in Equity:

7. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
800	0	800

8. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				2,130		2,130
Total comprehensive income for the year			0			
Dividends			0			
Total			0			

comprehensive Income attributable to parent						
Loss on disposal of Reliance Jio Infocomm Ltd.				(152)		(152)
Balance at the end of reporting period			0	1,978		1,978

Working Notes:

1. When 90% being sold, the carrying amount of all assets and liabilities attributable to Reliance Jio Infocomm Ltd. were eliminated from the consolidated balance sheet and further financial asset is recognized for remaining 10%.

2. Carrying value of remaining investment (in '000):

Net Assets of Reliance Ltd.	1,280
Less: 90% disposal	(1152)
Financial Asset	128

3. Cash on hand (in '000):

Cash before disposal of Reliance Jio Infocomm Ltd.	1,550
Less: Reliance Jio Infocomm Ltd. Cash	(500)
Add: Cash realized from disposal	1,000
Cash on Hand	2,050

4. Gain/ Loss on disposal of entity (in '000):

Proceeds from disposal	1,000
Less: Proportionate (90%) Net assets of Reliance Jio Infocomm Ltd. (90% of 1,280)	(1,152)
Loss on disposal	(152)

5. Retained Earnings (in '000):

Retained Earnings before disposal	2,130
Less: Loss on disposal	(152)
Retained earnings after disposal	1,978

11. Journal Entries in Airtel Infrastructures Pvt. Ltd.

1.	Assets (Building) A/c	Dr.	10,25,000	
	To Cash			10,25,000
2.	Depreciation (P/L) A/c	Dr.	25,000	
	To Asset (Building)			25,000
3.	Cash A/c	Dr.	11,00,000	
	To Asset (Building)			10,00,000
	To Gain on sale of asset (P/L)			1,00,000

Journal Entries in Airtel Telecommunications Ltd.

1.	Asset (Building) A/c	Dr.		11,00,000
	To Cash			11,00,000
2.	Depreciation (P/L) A/c	Dr.	37,500	
	To Assets (Building)			37,500

Journal entry for consolidation:

1.	Gain on sale of asset (P/L)	Dr.	1,00,000	
	To Asset (Building) A/c			1,00,000
2.	Asset (Building) A/c	Dr.		5,000 (WN 1)
	To Consolidated P&L			5,000

Working Note:

To be depreciated on original value	(10,00,000-3,50,000)/20	32,500
Depreciation charged	(11,00,000-3,50,000)/20	37,500
Reversal of depreciation		**5,000**

Particulars	Consolidated financial statements	Individual Financial statements	
		Airtel Telecommunications Ltd.	Airtel Infrastructures Pvt. Ltd.
31st March 20X1	10,00,000	0	10,00,000
1st April 20X1 purchase sale	0	11,00,000	(10,00,000)
Depreciation	(32,500)	(37,500)	0
31st March 20X2	9,67,500	10,62,500	0

12. Paragraph 25 of Ind AS 110 states that if a parent loses control of a subsidiary, the parent:

(a) derecognises the assets and liabilities of the former subsidiary from the consolidated balance sheet.

(b) recognises any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant Ind ASs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with Ind AS 109 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.

(c) recognises the gain or loss associated with the loss of control attributable to the former controlling interest."

Paragraph B98(c) of Ind AS 110 states that on loss of control over a subsidiary, a parent shall reclassify to profit or loss, or transfer directly to retained earnings if required by other Ind AS, the amounts recognized in other comprehensive income in relation to the subsidiary on the basis specified in paragraph B99.

As per paragraph B99, if a parent loses control of a subsidiary, the parent shall account for all amounts previously recognized in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.

Therefore, if a gain or loss previously recognized in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. If a revaluation surplus previously recognized in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

In view of the basis in its consolidated financial statements, AB Limited shall:

(a) re-classify the FVOCI reserve in respect of the debt investments of ₹ 5.4 crore (90% of ₹ 6 crore) attributable to the owners of the parent to the statement of profit or loss in accordance with paragraph B5.7.1A of Ind AS 109, Financial Instruments which requires that the cumulative gains or losses previously recognised in OCI shall be recycled to profit and loss upon derecognition of the related financial asset. This is reflected in the gain on disposal. Remaining 10% (i.e., ₹ 0.6 crore) relating to non-controlling interest (NCI) is included as part of the carrying amount of the non-controlling interest that is derecognised in calculating the gain or loss on loss of control of the subsidiary;

(b) transfer the reserve relating to the net measurement losses on the defined benefit liability of ₹ 2.7 crore (90% of ₹ 3 crore) attributable to the owners of the parent within

equity to retained earnings. It is not reclassified to profit or loss. The remaining 10% (i.e., ₹ 0.3 crore) attributable to the NCI is included as part of the carrying amount of NCI that is derecognised in calculating the gain or loss on loss of control over the subsidiary. No amount is reclassified to profit or loss, nor is it transferred within equity, in respect of the 10% attributable to the non-controlling interest.

(c) reclassify the cumulative gain on fair valuation of equity investment of ₹ 3.6 crore (90% of ₹ 4 crore) attributable to the owners of the parent from OCI to retained earnings under equity as per paragraph B5.7.1 of Ind AS 109, Financial Instruments, which provides that in case an entity has made an irrevocable election to recognise the changes in the fair value of an investment in an equity instrument not held for trading in OCI, it may subsequently transfer the cumulative amount of gains or loss within equity. Remaining 10% (i.e., ₹ 0.4 crore) related to the NCI are derecognised along with the balance of NCI and not reclassified to profit and loss.

(d) reclassify the foreign currency translation reserve of ₹ 7.2 crore (90% × ₹ 8 crore) attributable to the owners of the parent to statement of profit or loss as per paragraph 48 of Ind AS 21, The Effects of Changes in Foreign Exchange Rates, which specifies that the cumulative amount of exchange differences relating to the foreign operation, recognised in OCI, shall be reclassified from equity to profit or loss on the disposal of foreign operation. This is reflected in the gain on disposal. Remaining 10% (i.e., ₹ 0.8 crore) relating to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss on the loss of control of subsidiary, but is not reclassified to profit or loss in pursuance of paragraph 48B of Ind AS 21, which provides that the cumulative exchange differences relating to that foreign operation attributed to NCI shall be derecognised on disposal of the foreign operation, but shall not be reclassified to profit or loss.

The impact of loss of control over BC Limited on the consolidated financial statements of AB Limited is summarized below:

(₹ in crore)

Particular		Amount (Dr)	Amount (Cr)	PL Impact	RE Impact
Gain/Loss on Disposal on Investments					
Bank	Dr.	56			
Non-controlling interest (Derecognised)	Dr.	6			
Investment at FV (20% Retained)	Dr.	16			
To Gain on Disposal (PL) - ***balancing figure***			18	18	
To De-recognition of total net assets of subsidiary			60		

Reclassification of FVTOCI reserve on debt instruments to profit or loss					
FVTOCI reserve on debt instruments (6 cr. x 90%)	Dr.	5.4			
To Profit and loss			5.4	5.4	
Reclassification of net measurement loss reserve to profit or loss					
Retained Earnings	Dr.	2.7			-2.7
To Net measurement loss reserve (FVTOCI) [(3 cr. x 90%)]			2.7		
Reclassification of FVTOCI reserve on equity instruments to retained earnings					
FVTOCI reserve on equity instruments (4 cr.x 90%)	Dr.	3.6			
To Retained earnings			3.6		3.6
Foreign currency translation reserve reclassified to profit or loss					
Foreign currency translation reserve (FVOCI) [8 cr. x 90%]	Dr.	7.2			
To Profit and loss			7.2	7.2	
Total				30.6	0.9

13. Calculation of Investor Ltd.'s investment in XYZ Ltd. under equity method:

	₹	₹
Acquisition of investment in XYZ Ltd.		
Share in book value of XYZ Ltd.'s net assets (35% of ₹ 90,00,000)	31,50,000	
Share in fair valuation of XYZ Ltd.'s net assets [35% of (₹ 1,10,00,000 – ₹ 90,00,000)]	7,00,000	
Goodwill on investment in XYZ Ltd. (balancing figure)	9,00,000	
Cost of investment		**47,50,000**
Profit during the year		
Share in the profit reported by XYZ Ltd. (35% of ₹ 8,00,000)	2,80,000	

Adjustment to reflect effect of fair valuation [35% of (₹ 20,00,000/10 years)]	(70,000)	
Share of profit in XYZ Ltd. recognised in income by Investor Ltd.		**2,10,000**
Long term equity investment		
FVTOCI gain recognised in OCI (35% of ₹ 2,00,000)		70,000
Dividend received by Investor Ltd. during the year [35% of ₹ 12,00,000]		(4,20,000)
Closing balance of Investor Ltd.'s investment in XYZ Ltd.		**46,10,000**

14. As provided in Ind- AS 111 - Joint Arrangements - this is a joint arrangement because two or more parties have joint control of the property under a contractual arrangement. The arrangement will be regarded as a joint operation because Alpha Ltd. and Gama Ltd. have rights to the assets and obligations for the liabilities of this joint arrangement. This means that the company and the other investor will each recognise 50% of the cost of constructing the asset in property, plant and equipment.

The borrowing cost incurred on constructing the property should under the principles of Ind AS 23 'Borrowing Costs', be included as part of the cost of the asset for the period of construction.

In this case, the relevant borrowing cost to be included is ₹ 50,00,000 (₹ 10,00,00,000 x 10% x 6/12).

The total cost of the asset is ₹ 40,50,00,000 (₹ 40,00,00,000 + ₹ 50,00,000) ₹ 20,25,00,000 crores is included in the property, plant and equipment of Alpha Ltd. and the same amount in the property, plant and equipment of Gama Ltd.

The depreciation charge for the year ended 31 March 20X2 will therefore be ₹ 1,01,25,000 (₹ 40,50,00,000 x 1/20 x 6/12) ₹ 50,62,500 will be charged in the statement of profit or loss of the company and the same amount in the statement of profit or loss of Gama Ltd.

The other costs relating to the arrangement in the current year totalling ₹ 54,00,000 (finance cost for the second half year of ₹ 50,00,000 plus maintenance costs of ₹ 4,00,000) will be charged to the statement of profit or loss of Alpha Ltd. and Gama Ltd. in equal proportions- ₹ 27,00,000 each.

15. As per paragraph 4(a) of Ind AS 110, an entity that is a parent shall present consolidated financial statements. This Ind AS applies to all entities, except as follows:

A parent need not present consolidated financial statements if it meets all the following conditions:

(i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(iv) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind ASs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this Ind AS.

In accordance with the above, it may be noted that as per paragraph 4(a)(i) above, a parent need not present consolidated financial statements if it is a:

— wholly-owned subsidiary; or

— is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.

Although GD Limited is a partly-owned subsidiary of G Limited, it is the wholly-owned subsidiary of Gamma Limited (and therefore satisfies the condition 4(a)(i) of Ind AS 110 without regard to the relationship with its immediate owners, i.e. G Limited and D Limited). Thus, GD Limited being the wholly owned subsidiary fulfils the conditions as mentioned under paragraph 4(a)(i) and is not required to inform its other owner D Limited of its intention not to prepare the consolidated financial statements.

Thus, in accordance with the above, GD Limited may take the exemption given under paragraph 4(a) of Ind AS 110 from presentation of consolidated financial statements.

In Alternative Scenario, where both G Limited and D Limited are owned by an individual Mr. X, then GD Limited is ultimately wholly in control of Mr. X (i.e., an individual) and hence it cannot be considered as a wholly owned subsidiary of an entity.

This is because Ind AS 110 makes use of the term ‘entity’ and the word 'entity’ includes a company as well as any other form of entity. Since, Mr. X is an ‘individual’ and not an ‘entity’, therefore, GD Limited cannot be considered as wholly owned subsidiary of an entity.

Therefore, in the given case, GD Limited is a partially-owned subsidiary of another entity. Accordingly, in order to avail the exemption under paragraph 4(a), its other owner, D Limited should be informed about and do not object to GD Limited not presenting consolidated financial statements. Further, for the purpose of consolidation of G Limited and D Limited, GD Limited will be required to provide relevant financial information as per Ind AS.

NOTES

NOTES

CHAPTER 14

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



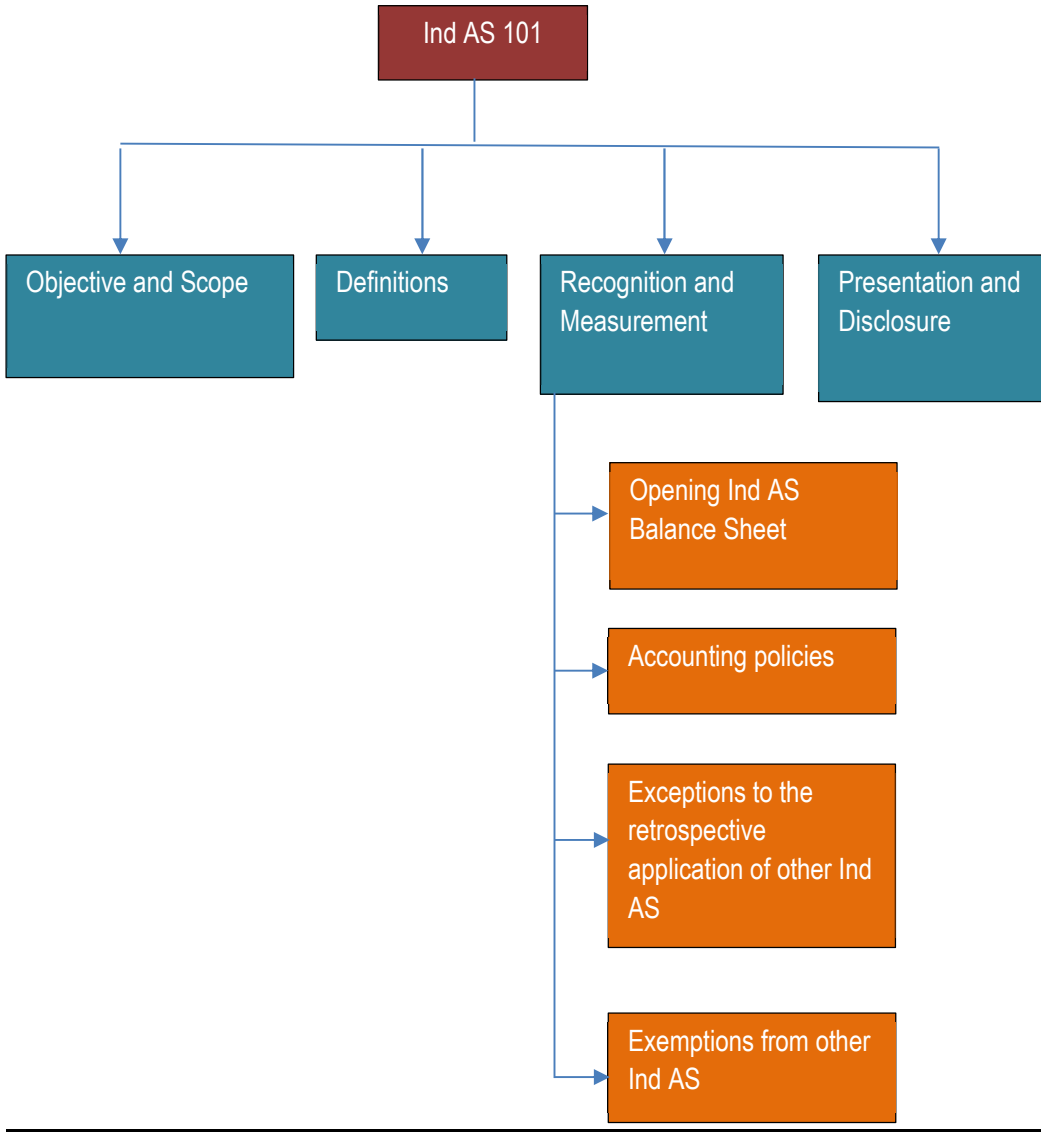
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the objective for issuing this standard
- Appreciate the applicability and non-applicability of this standard
- Define the relevant terms like 'First Ind AS Financial Statements', 'First –time adopter', 'Opening Ind AS Balance sheet', 'Date of Transition to Ind AS', 'First Ind AS reporting period', 'Deemed cost' and 'Previous GAAP'
- Apply the recognition and measurement principles in the preparation of opening Ind AS Balance Sheets
- Evaluate the mandatory exceptions in which Ind AS prohibits retrospective application of Ind AS
- Examine when Ind AS 101 grants voluntary exemptions from some specific requirements of other Ind AS
- Know the carve outs in Ind AS 101 from IFRS 1

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CHAPTER OVERVIEW



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1. INTRODUCTION

Ind AS 101 prescribes the accounting principles for first - time adoption of Ind AS. It lays down various 'transition' requirements when a company adopts Ind AS for the first time, i.e., a move from Accounting Standards (Indian GAAP) to Ind AS.

Conceptually, the accounting under Ind AS should be applied retrospectively at the time of transition to Ind AS. However, 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. 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.

Ind AS 101 also prescribes presentation and disclosure requirements to explain the transition to the users of financial statements including explaining how the transition from Indian GAAP to Ind AS affected the company's financial position, financial performance and cash flows.

Ind AS 101 does not provide any exemption from the disclosure requirements in other Ind AS.

2. OBJECTIVE

The objective of this Ind AS is to ensure that an entity's first Ind-AS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that:

- is transparent for users and comparable;
- provides a suitable starting point; and
- at a cost that does not exceed the benefits.

3. DEFINITIONS

1. First Ind AS Financial Statements

- The first annual financial statements in which an entity adopts Ind AS, by an explicit and unreserved statement of compliance with Ind AS.
- This means compliance with ALL Ind-AS, partial compliance is not enough to make entity Ind AS compliant.

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2. First –time adopter

An entity that presents its first Ind AS financial statements, that entity is known as first time adopter

3. Opening Ind AS Balance sheet

An entity's balance sheet at the date of transition to Ind AS

4. Date of Transition to Ind AS

The beginning of the earliest period for which an entity presents full comparative information under Ind ASs in first Ind AS Financial statements.

Illustration 1

X Ltd. is required to adopt Ind AS from April 1, 20X1, with comparatives for one year, i.e., for 20X0-20X1.

What will be its date of transition?

Solution

The date of transition for X Ltd. will be April 1, 20X0 being the beginning of the earliest comparative period presented. To explain it further, X Ltd. is required to adopt an Ind AS from April 1, 20X1 (i.e. year 20X1-20X2), and it will give comparatives as per Ind AS for 20X0-20X1. Accordingly, the beginning of the comparative period will be April 1, 20X0 which will be considered as date of transition.

*****

5. First Ind AS reporting period

- The latest reporting period covered by an entity's first Ind AS financial statements

Example 1

XYZ Ltd. is a BSE listed company having net worth of ₹ 100 cr. XYZ Ltd. has to prepare financial statements as per Ind AS from 1st April 20X1.

The first Ind AS Financial Statements would be for period ending as on 31.3.20X2

First–time adopter - "XYZ Ltd" with effect from 1.4.20X1

Opening Ind AS Balance sheet – 1.4.20X0

Date of Transition to Ind AS – 1.4.20X0

First Ind AS reporting period – 1.4.20X1 to 31.3.20X2

The financial statements for the period 1.4.20X0 to 31.3.20X1 shall be the comparative period for the first Ind AS reporting period.

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6. Deemed cost

An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost. This definition will be used in measurement, at the date of transition to Ind AS, of

(i) investments in subsidiaries, joint ventures and associates

(ii) property, plant and equipment, an investment property, an intangible asset or a right-of-use asset

(iii) assets acquired and liabilities assumed in a business combination when the exemption under Ind AS 101 is availed.

7. Previous GAAP

The basis of accounting that a first-time adopter used for its statutory reporting requirements in India immediately before adopting Ind AS. For instance, companies required to prepare their financial statements in accordance with Section 133 of the Companies Act, 2013, shall consider those financial statements as previous GAAP financial statements. Those previous GAAP financial statements were prepared as per the Companies (Accounting Standards) Rules, 2006 and hence such accounting standards are the "Previous GAAP" for those companies in India.

Illustration 2

Company B is a foreign subsidiary of Company A and has adopted IFRS as issued by IASB as its primary GAAP for its local financial reporting purposes. Company B prepares its financial statements as per Accounting Standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 for the purpose of consolidation with Company A.

On transition of Company A to Ind-AS, what would be the previous GAAP of the foreign subsidiary Company B for its financial statements prepared for consolidation with Company A?

Solution

Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its statutory reporting requirements in India (***emphasis added***) immediately before adopting Ind AS. For instance, companies preparing their financial statements in accordance with the Accounting Standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 shall consider those financial statements as previous GAAP financial statements.

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Accordingly, the previous GAAP of the foreign subsidiary for the purpose of consolidation under Ind-AS with the parent company would be accounting standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 and not the IFRS as issued by the IASB since the first time adoption has to be considered in the context of India only.

*****

4. SCOPE

Ind AS 101 applies to:

- First Ind AS financial statements
- Each interim financial report for part of the period covered by its first Ind AS financial statements. For example, if the period covered by the first Ind AS financial statements is year ended 31 March 20X2 and the company prepares quarterly financial results (i.e. interim financial report) for each quarter of that year, Ind AS 101 shall be applied in preparation of those financial results.

However, it does not apply to:

- Changes in accounting policies made by an entity that already applied Ind AS.

Illustration 3

E Ltd. is required to first time adopt Indian Accounting Standards (Ind AS) from 1 April 20X1. The management of E Ltd. has prepared its financial statements in accordance with Ind AS and an explicit and unreserved statement of compliance with Ind AS has been given by the management. However, there is a disagreement on application of one Ind AS between the management and the auditor.

Can such financial statements of E Ltd. be treated as first Ind AS financial statements?

Solution

Ind AS 101 defines first Ind AS financial statements as "The first annual financial statements in which an entity adopts Indian Accounting Standards (Ind AS), by an explicit and unreserved statement of compliance with Ind AS." In accordance with the above definition, if an explicit and unreserved statement of compliance with Ind AS has been given in the financial statements, even if the auditor's report contains a qualification because of disagreement on application of Indian Accounting Standard(s), it would be considered that E Ltd. has done the first time adoption of Ind AS. In such a case, exemptions given under Ind AS 101 cannot be availed again. If, however, the unreserved statement of compliance with Ind AS is not given in the

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financial statements, such financial statements would not be considered to be first Ind AS financial statements.

*****

5. RECOGNITION AND MEASUREMENT

5.1 Opening Ind AS Balance Sheet

An entity shall prepare and present an opening Ind AS balance sheet at the date of transition to Ind AS. This is the starting point for its accounting in accordance with Ind AS.

5.2 Accounting policies

Entity uses the same accounting policies in its opening Ind AS Balance Sheet and through all periods presented in its first Ind AS financial statements. Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, subject to:

- Mandatory exceptions and
- Optional exemptions

Example 2: Consistent application of latest version of Ind AS

The end of entity A's first Ind AS reporting period is 31 March 20X2. Entity A decides to present comparative information in those financial statements for one year only. Therefore, its date of transition to Ind AS is the beginning of business on 1 April 20X0 (or, equivalently, close of business on 31 March 20X0).

Entity A presented financial statements in accordance with its previous GAAP annually to 31 March each year up to, and including, 31 March 20X1.

Application of requirements:

Entity A is required to apply the Ind AS effective for periods ending on 31 March 20X2 in:

a) preparing and presenting its opening Ind AS balance sheet at 1 April 20X0; and

b) preparing and presenting its balance sheet for 31 March 20X2 (including comparative amounts for the year ended 31 March 20X1), statement of profit and loss, statement of changes in equity and statement of cash flows for the year to 31 March 20X2 (including comparative amounts for the year ended 31 March 20X1) and disclosures (including comparative information for the year ended 31 March 20X1).

If a new Ind AS is not yet mandatory but permits early application, entity A is permitted, but not required, to apply that Ind AS in its first Ind AS financial statements.

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The general principle of Ind AS 101

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.

So lets talk of the general principle first - an entity shall, in its opening Ind AS Balance sheet:

- Recognise all assets and liabilities whose recognition is required by Ind AS. For example, recognition of derivative assets and liabilities for which a different guidance was followed under Indian GAAP or intangible assets arising in a business combination, which were not carried in the books of the acquiree entity under Indian GAAP;
- Not recognise items as assets or liabilities if Ind AS do not permit such recognition. For example, Ind AS 115, Revenue from Contracts with Customers, has different thresholds for revenue recognition as compared to AS 9 under Indian GAAP and hence an item that is recognized as a trade receivable in Indian GAAP, may not be so recognized under Ind AS;
- Reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS. For example, Ind AS requires classification of assets given on operating lease as investment property whereas the same are presented as property, plant and equipment under Indian GAAP; and
- Apply Ind AS in measuring all recognised assets and liabilities. For example, Ind AS has well-defined measurement principles for financial assets and liabilities, like certain investments are measured at fair value under Ind AS, whereas the same are measured at lower of cost and fair value under Indian GAAP.

6. EXCEPTIONS/ EXEMPTIONS

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

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6.1 Mandatory exceptions to the retrospective application of other Ind AS

1. Estimates

An entity's estimates in accordance with Ind AS at the date of transition to Ind AS shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

Step 1 Estimates required by previous GAAP? If yes, then go to Step 2 otherwise Step 3.

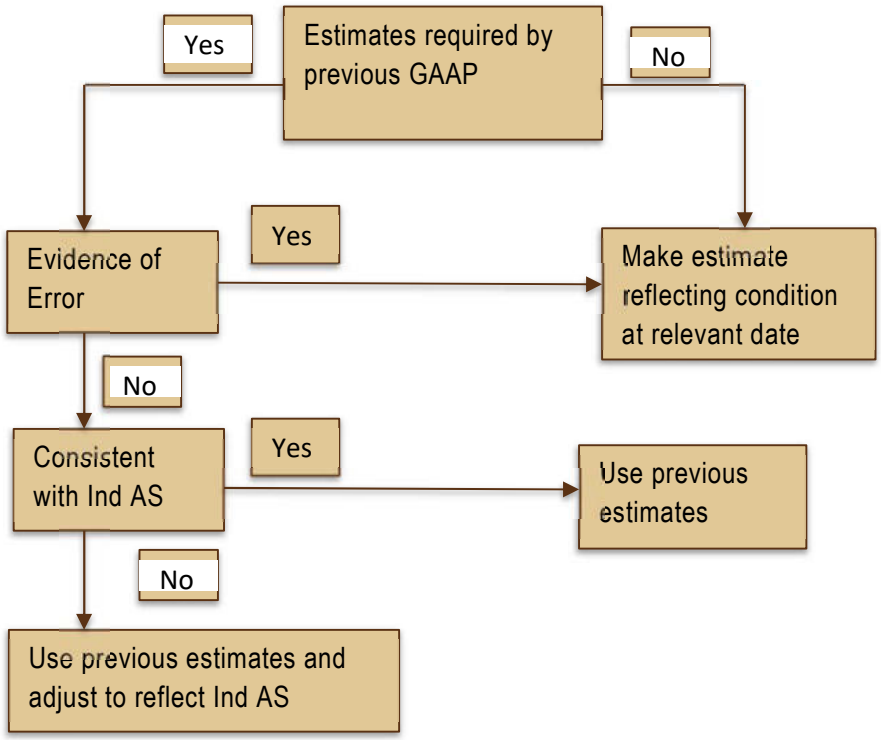
Step 2 Evidence of Error? If yes then go to Step 3 otherwise Step 4.

Step 3 Make estimate reflecting condition at relevant date i.e. the date to which the estimate relates.

Step 4 Consistent with Ind AS? If yes then go to step 5 otherwise Step 6

Step 5 Use previous estimates

Step 6 Use previous estimates and adjust to reflect Ind AS.



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2. Derecognition of financial assets and liabilities

A first-time adopter shall apply the derecognition requirements in Ind AS 109 **prospectively** for transactions occurring on or after the date of transition to Ind AS.

Example 3

If a first time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to Ind AS, it shall not recognise those assets and liabilities in accordance with Ind AS (unless they qualify for recognition as a result of a later transaction or event). A practical example of such financial assets could be securitization of a loan portfolio by a NBFC to a Trust before the date of transition resulting in derecognition of the same from books under Indian GAAP, whereas under Ind AS, the derecognition criteria may not have been met.

An entity may apply the derecognition requirements in Ind AS 109 **retrospectively** from a date of the entity's choosing, provided that the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

3. Hedge accounting

At the date of transition to Ind AS an entity shall:

(a) measure all derivatives at fair value; and

(b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

An entity shall not reflect in its opening Ind AS Balance Sheet a hedging relationship of a type that does not qualify for hedge accounting in accordance with Ind AS 109 (for example, many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk). In other words, if the hedge relationship:

(A) is of a type that qualifies for hedge accounting (i.e. hedge relationship consists of eligible hedging instruments and eligible hedged items as per Ind AS 109), and

(B) is designated under Indian GAAP

then:

(1) the hedge relationship is required to be reflected in the opening Ind AS Balance Sheet, irrespective of whether other conditions for applying hedge accounting (i.e. documentation and effectiveness) are met; and

(2) if those conditions are not met, requirements of Ind AS 109 with respect to discontinuance of hedge accounting are applied subsequently.

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As a corollary to this principle, if either of (A) or (B) above are not met, barring a specific exception (dealt with in subsequent paragraph), the hedge relationship is required to be removed from the opening Ind AS Balance Sheet.

If an entity designated a net position as a hedged item in accordance with previous GAAP, which is not a qualifying hedged item otherwise under Ind AS 109, it may designate as a hedged item in accordance with Ind AS an individual item within that net position, or a net position if that meets the requirements in Ind AS 109, provided that it does so no later than the date of transition to Ind AS.

Hedge accounting is followed only from the date the qualifying criteria are met, irrespective of the conditions stated at (A) and (B) above. Transactions entered into before the date of transition to Ind AS shall not be retrospectively designated as hedges.

4. Non-controlling interests

A first-time adopter shall apply the following requirements of Ind AS 110 prospectively from the date of transition to Ind AS:

a) Total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

b) Accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

c) Accounting for a loss of control over a subsidiary, and the related requirements of Ind AS 105, Non-current Assets Held for Sale and Discontinued operations i.e. classification of all the assets and liabilities of that subsidiary as held for sale.

However, if a first-time adopter elects to apply Ind AS 103 retrospectively to past business combinations, it shall also apply Ind AS 110 from that date.

Illustration 4

Ind AS requires allocation of losses to the non-controlling interest, which may ultimately lead to a debit balance in non-controlling interests, even if there is no contract with the non-controlling interest holders to contribute assets to the Company to fund the losses.

Whether this adjustment is required or permitted to be made retrospectively?

Solution

In case an entity elects not to restate past business combinations, Ind AS 101 requires the measurement of non-controlling interests (NCI) to follow from the measurement of other assets and liabilities on transition to Ind AS. However, Ind AS 101 contains a mandatory exception that prohibits retrospective allocation of accumulated profits between the owners of the parent and the NCI. In case an entity elects not to restate past business

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combinations, the previous GAAP carrying value of NCI is not changed other than for adjustments made (remeasurement of the assets and liabilities subsequent to the business combination) as part of the transition to Ind AS. As such, the carrying value of NCI in the opening Ind AS balance sheet cannot have a deficit balance on account of recognition of the losses attributable to the non-controlling interest, which was not recognised under the previous GAAP as part of NCI in the absence of contract to contribute assets to fund such a deficit.

However, the NCI could have a deficit balance due to remeasurement of the assets and liabilities subsequent to the business combination as part of the transition to Ind AS.

In case an entity restates past business combination, Ind AS 101 requires that the balance in NCI as at the date of transition shall be determined retrospectively in accordance with Ind AS, taking into account the impact of other elections made as part of the adoption of Ind AS.

As such, the NCI could have a deficit balance on account of losses attributable to the NCI, even if there is no obligation on the holders of NCI to contribute assets to fund such a deficit.

*****

5. Classification and measurement of financial instruments

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

An entity shall disclose the carrying amount of such financial assets until those financial assets are derecognized.

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

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gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to Ind AS.

6. Impairment of financial assets

An entity shall apply the impairment requirements of Ind AS 109 retrospectively subject to 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.

7. Embedded derivatives

A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of (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. 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 4

Government of India provides loans to MSMEs at a below-market rate of interest to fund the set-up of a new manufacturing facility.

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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 = Amount / 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.

During the next 4 years, the interest expense charged to statement of profit and loss shall be:

Year ended	Opening amortised cost (₹)	Interest expense for the year (₹) @ 5.74% p.a. approx.	Closing amortised cost (₹)
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	6,41,430	1,18,21,770
31 March 20X9	1,18,21,770	6,78,230	1,25,00,000

Calculations have been done on full scale calculator. However, in case calculations are done taking EIR as exact 5.74%, then there will be difference of a few ₹ due to rounding off.

An entity may apply the requirements in Ind AS 109 and Ind AS 20 retrospectively to any government loan originated before the date of transition to Ind AS, provided that the information needed to do so had been obtained at the time of initially accounting for that loan.

6.2 Optional exemptions from retrospective application of other Ind AS

1. Business combination

Ind AS 103 need not be applied to business combinations before date of transition. But, if one business combination is restated to comply with Ind AS 103, all subsequent business combinations are restated.

When the exemption is used:

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- There won't be any change in classification from previous GAAP.

For **example,** 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.

❖ **Recognition exemptions:**

The table below summarises the provisions of paragraph C4(b) and (c) of Ind AS 101:

Case	Asset / liability recognised in previous GAAP	Asset / liability qualifies for recognition in Ind AS	Is the change an intangible asset?	Result: whether asset or liability recognised in opening Ind AS Balance Sheet?	How is the resulting change accounted for?
1	No	No	Not Applicable		
2	No	Yes	No	Yes*	Retained Earnings
3	No	Yes	Yes	Yes	Goodwill
4	Yes	No	Yes	No	Goodwill**
5	Yes	No	No	No	Retained Earnings

* Unless a financial asset or financial liability was derecognised in previous GAAP (refer mandatory exception below)

** Including any resulting changes to deferred tax and non-controlling interests

❖ **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.

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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 5

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.

As discussed in the chapter on consolidation, Ind AS 110 requires an entity to be consolidated based on assessment of "control". This assessment may sometimes result in consolidation of entities which were not consolidated in the previous GAAP financial statements.

Let's understand the implications of this in the context of first Ind AS financial statements through an illustration.

Illustration 5

A Ltd. had made certain investments in B Ltd.'s convertible debt instruments. The conversion rights are substantive rights and would provide A Ltd. with a control over B Ltd. A Ltd. has evaluated that B Ltd. would be treated as its subsidiary under Ind AS and, hence, would require consolidation in its Ind AS consolidated financial statements. B Ltd. was not considered as a subsidiary, associate or a joint venture under previous GAAP.

How should B Ltd. be consolidated on transition to Ind AS assuming that A Ltd. has opted to avail the exemption from retrospective restatement of past business combinations?

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Solution

Ind AS 101 prescribes an optional exemption from retrospective restatement in relation to past business combinations. Ind AS 101 prescribes that when the past business combinations are not restated and a parent entity had not consolidated an entity as a subsidiary in accordance with its previous GAAP (either because it was not regarded as a subsidiary or no consolidated financial statements were required under previous GAAP), then the subsidiary's assets and liabilities would be included in the parent's opening consolidated financial statements at such values as would appear in the subsidiary's separate financial statements if the subsidiary were to adopt the Ind AS as at the parent's date of transition. For this purpose, the subsidiary's separate financial statements would be prepared as if it was a first-time adopter of Ind AS i.e. after applying the relevant first-time adoption mandatory exceptions and voluntary exemptions. In other words, the parent will adjust the carrying amount of the subsidiary's assets and liabilities to the amounts that Ind AS would require in the subsidiary's balance sheet.

The deemed cost of goodwill equals the difference at the date of transition between:

(a) the parent's interest in those adjusted carrying amounts; and

(b) the cost in the parent's separate financial statements of its investment in the subsidiary.

The measurement of non-controlling interest and deferred tax follows from the measurement of other assets and liabilities.

It may be noted here that the above exemption is available only under those circumstances where the parent, in accordance with the previous GAAP, has not presented consolidated financial statements for the previous year; or where the consolidated financial statements were prepared in accordance with the previous GAAP but the entity was not treated as a subsidiary, associate or joint venture under the previous GAAP.

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Illustration 6

A Ltd. has a subsidiary B Ltd. On first time adoption of Ind AS by B Ltd., it availed the optional exemption of not restating its past business combinations. However, A Ltd. in its consolidated financial statements has decided to restate all its past business combinations.

Whether the amounts recorded by subsidiary need to be adjusted while preparing the consolidated financial statements of A Ltd. considering that A Ltd. does not avail the business combination exemption? Will the answer be different if A Ltd. adopts Ind AS after B Ltd?

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Solution

As per Ind AS 101: "A first-time adopter may elect not to apply Ind AS 103 retrospectively to past business combinations (business combinations that occurred before the date of transition to Ind AS). However, if a first-time adopter restates any business combination to comply with Ind AS 103, it shall restate all later business combinations and shall also apply Ind AS 110 from that same date.

For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X0, it shall restate all business combinations that occurred between 30 June 20X0 and the date of transition to Ind AS, and it shall also apply Ind AS 110 from 30 June 20X0." Based on the above, if A Ltd. restates past business combinations, it would have to be applied to all business combinations of the group including those by subsidiary B Ltd. for the purpose of Consolidated Financial Statements. Ind AS 101 states, "However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary." Thus, in case where the parent adopts Ind AS later than the subsidiary (for example, if the parent is a non-banking financial company and the subsidiary is a trading or manufacturing company) then it does not change the amounts already recognised by the subsidiary.

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2. Insurance contracts

Ind AS 104 will apply for annual periods beginning on or after date of transition to Ind AS.

If an insurer changes its accounting policies for insurance liabilities, it is permitted to reclassify some or all of its financial assets as FVTPL (fair value through profit or loss).

3. Share based payment transactions

A first-time adopter is encouraged, but not required, to apply Ind AS 102, Share-based Payment, to equity instruments that vested before date of transition to Ind AS.

However, a first-time adopter may apply Ind AS 102 to equity instruments, if it has disclosed publicly the fair value of those equity instruments, determined at the measurement date.

It is encouraged to apply Ind AS 102 to liabilities arising from share-based payment transactions that were settled before the date of transition to Ind AS.

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Illustration 7

X Ltd. is a first-time adopter of Ind AS. The date of transition is April 1, 20X1. It has given 200 stock options to its employees. Out of these, 75 options have vested on November 30, 20X0 and the remaining 125 will vest on November 30, 20X1.

What are the options available to X Ltd. at the date of transition?

Solution

Ind AS 101 provides that a first-time adopter is encouraged, but not required, to apply Ind AS 102 on 'Share-based Payment' to equity instruments that vested before the date of transition to Ind AS. However, if a first-time adopter elects to apply Ind AS 102 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.

Having regard to the above, X Ltd. has the following options:

- For 75 options that vested before the date of transition:

  (a) To apply Ind AS 102 and account for the same accordingly, provided it has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.

  (b) Not to apply Ind AS 102.

  However, for all grants of equity instruments to which Ind AS 102 has not been applied, i.e., equity instruments vested but not settled before date of transition to Ind AS, X Ltd. would still need to disclose the information.

- For 125 options that will vest after the date of transition: X Ltd. will need to account for the same as per Ind AS 102.

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4. Deemed cost for PPE, intangible assets and right of use assets

An entity has the following options with respect to measurement of its property, plant and equipment (Ind AS 16), intangible assets (Ind AS 38) and right of use assets (Ind AS 116) in the opening Ind AS balance sheet:

- Measurement basis as per the respective standards applied retrospectively. This measurement option can be applied on an item-by-item basis. For example, Plant A can be measured applying Ind AS 16 retrospectively and Plant B can be measured applying the "fair value" or "revaluation" options mentioned below.
- Fair value at the date of transition to Ind AS. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.

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- Previous GAAP revaluation, if such revaluation was, at the date of revaluation, broadly comparable to (a) fair value or (b) cost or depreciated cost in accordance with other Ind AS adjusted to reflect changes in general or specific price index. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.
- Previous GAAP carrying amounts (provided there is no change in functional currency). This measurement option can be applied only if applied to "all" of the assets classes and items therein. In addition, this measurement option can be applied to investment property (Ind AS 40) as well.

For Investment Property

Ind AS 40, Investment Property permits only the cost model. Therefore, option of availing fair value as deemed cost for investment property is not available for first time adopters of Ind AS for its financial statements.

Illustration 8

X Ltd. is the holding company of Y Ltd. X Ltd. is required to adopt Ind AS from April 1, 20X1. X Ltd. wants to avail the optional exemption of using the previous GAAP carrying values in respect of its property, plant and equipment whereas Y Ltd. wants to use fair value of its property, plant and equipment as its deemed cost on the date of transition.

Examine whether X Ltd. can do so for its consolidated financial statements. Also, examine whether different entities in a group can use different basis for arriving at deemed cost for property, plant and equipment in their respective standalone financial statements

Solution

Where there is no change in its functional currency on the date of transition to Ind AS, a first-time adopter to Ind AS may elect to continue with the carrying value of all of its property, plant and equipment as at the date of transition measured as per the previous GAAP and use that as its deemed cost at the date of transition after making necessary adjustments. If a first-time adopter chooses this option then the option of applying this on selective basis to some of the items of property, plant and equipment and using fair value for others is not available. Nothing prevents different entities within a group to choose different basis for arriving at deemed cost for the standalone financial statements. However, in Consolidated Financial Statements, the entire group should be treated as one reporting entity. Accordingly, it will not be permissible to use different basis for arriving at the deemed cost of property, plant and equipment on the date of transition by different entities of the group for the purpose of preparing Consolidated Financial Statements.

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Illustration 9

For the purpose of deemed cost on the date of transition, an entity has the option of using the carrying value as the deemed cost.

In this context, suggest which carrying value is to be considered as deemed cost: original cost or net book value? Also examine whether this would have any impact on future depreciation charge?

Solution

For the purpose of deemed cost on the date of transition, if an entity uses the carrying value as the deemed cost, then it should consider the net book value on the date of transition as the deemed cost and not the original cost because carrying value here means net book value. The future depreciation charge will be based on the net book value and the remaining useful life on the date of transition. Further, as per the requirements of Ind AS 16, the depreciation method, residual value and useful life need to be reviewed atleast annually. As a result of this, the depreciation charge may or may not be the same as the depreciation charge under the previous GAAP.

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Illustration 10

Is it possible for an entity to allocate cost as per the previous GAAP to a component based on its fair value on the date of transition even when it does not have the component-wise historical cost?

Solution

Yes, an entity can allocate cost to a component based on its fair value on the date of transition. This is permissible even when the entity does not have component-wise historical cost.

*****

Illustration 11

Revaluation under previous GAAP can be considered as deemed cost if the revaluation was, at the date of the revaluation, broadly comparable to fair value or cost or depreciated cost of assets in accordance with Ind AS, adjusted to reflect, e.g., changes in a general or specific price index.

What is the acceptable time gap of such revaluation from the date of transition? Can adjustments be made to take effects of events subsequent to revaluation?

Solution

There are no specific guidelines in Ind AS 101 to indicate the acceptable time gap of such revaluation from the date of transition. The management of an entity needs to exercise judgement in this regard. However, generally, a period of 2–3 years may be treated as an acceptable time gap of such revaluation from the date of transition. In any case,

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adjustments should be made to reflect the effect of material events subsequent to revaluation.

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5. Cumulative translation difference

No need to:

- Recognise some translation differences in other comprehensive income.
- Reclassify cumulative translation differences for foreign operation from entity to profit or loss as part of gain or loss on its disposal

If first time adopter uses this exemption:

- Cumulative translation differences set to zero for all foreign operations.
- Gain / loss on subsequent disposal of a foreign operation shall exclude these differences that arose before transition

6. Long-term foreign currency monetary items

Paragraph 46A of AS 11 notified under the Companies (Accounting Standards) Rules, 2006 permitted companies to recognise foreign currency exchange gain / loss arising on long-term foreign currency monetary items in either of the following ways:

- In profit or loss
- If such monetary item was entered into to acquire property, plant and equipment or intangible asset - in the cost thereof
- If such monetary item was entered into for any other purpose – accumulated in foreign currency monetary item translation difference account (FCMITDA)

A first time adopter may continue the accounting policy adopted for accounting for exchange differences arising from 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 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.

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Illustration 12

Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X1. On the date of transition, there is a long- term foreign currency monetary liability of ₹ 60 crores (US $ 10 million converted at an exchange rate of US $ 1 = ₹ 21 60). The accumulated exchange difference on the date of transition is nil since Y Ltd. was following AS 11 notified under the Companies (Accounting Standards) Rules, 2006 and has not exercised the option provided in paragraph 46/46A of AS 11. The Company wants to avail the option under paragraph 46A of AS 11 prospectively or retrospectively on the date of transition to Ind AS.

How should it account for the translation differences in respect of this item under Ind AS 101?

Solution

Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

If the Company wants to avail the option prospectively

The Company cannot avail the exemption given in Ind AS 101 and cannot exercise option under paragraph 46/46A of AS 11, prospectively, on the date of transition to Ind AS in respect of Long term foreign currency monetary liability existing on the date of transition as the company has not availed the option under paragraph 46/46A earlier. Therefore, the Company need to recognise the exchange differences in accordance with the requirements of Ind AS 21, The Effects of Changes in Foreign Exchange Rates which requires all foreign exchange differences to be recognised in profit or loss, except such foreign exchange differences which are accounted for as an adjustment to borrowing costs in accordance with Ind AS 23.

If the Company wants to avail the option retrospectively

The Company cannot avail the exemption given in Ind AS 101 and cannot exercise the option under paragraph 46/46A of AS 11 retrospectively on the date of transition to Ind AS in respect of long-term foreign currency monetary liability that existed on the date of transition since the option is available only if it is in continuation of the accounting policy followed in accordance with the previous GAAP. Y Ltd. has not been using the option provided in Para 46/ 46A of AS 11, hence, it will not be permitted to use the option given in Ind AS 101 retrospectively.

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Illustration 13

Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X5. On April 1, 20X1, it obtained a 7 year US$ 1,00,000 loan. It has been exercising the option provided in Paragraph 46/46A of AS 11 and has been amortising the exchange differences in respect of this loan over the balance period of such loan. On the date of transition, the company wants to continue the same accounting policy with regard to amortising exchange differences.

Whether the Company is permitted to do so?

Solution

Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. In view of the above, the Company can continue to follow the existing accounting policy of amortising the exchange differences in respect of this loan over the balance period of such long-term liability.

*****

7. Investment in subsidiaries, joint ventures and associates

Ind AS 27 requires measurement of investments in subsidiaries, joint ventures and associates either at (a) cost or (b) in accordance with Ind AS 109 (i.e. at fair value, either through other comprehensive income or through profit or loss).

Ind AS 101 permits a first-time adopter to measure such investments at:

- Cost determined in accordance with Ind AS 27 (as above) or
- Deemed cost:
  - Fair value at the date of transition; or
  - Previous GAAP carrying amount at the date of transition.

Illustration 14

A Ltd. acquired B Ltd. in a business combination transaction. A Ltd. agreed to pay certain contingent consideration (liability classified) to B Ltd. As part of its investment in its separate financial statements, A Ltd. did not recognise the said contingent consideration (since it was not considered probable). A Ltd. considered the previous GAAP carrying amounts of investment as its deemed cost on first-time adoption.

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In that case, does the carrying amount of investment required to be adjusted for this transaction?

Solution

In accordance with Ind AS 101, an entity has an option to treat the previous GAAP carrying values, as at the date of transition, of investments in subsidiaries, associates and joint ventures as its deemed cost on transition to Ind AS. If such an exemption is adopted, then the carrying values of such investments are not adjusted. Accordingly, any adjustments in relation to recognition of contingent consideration on first time adoption shall be made in the statement of profit and loss.

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8. Compound financial instruments

A first time adopter need not split the compound financial instruments into separate liability and equity component, if liability component is not outstanding as at transition date.

Illustration 15

On April 1, 20X1, Sigma Ltd. issued 30,000 6% convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31 March 20X5 or these may be converted into ordinary shares at the option of the holder. The interest rate for equivalent debentures without conversion rights would have been 10%. The date of transition to Ind AS is 1 April 20X3.

Suggest how should Sigma Ltd. account for this compound financial instrument on the date of transition. The present value of ₹ 1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:

End of year	6%	10%
1	0.94	0.91
2	0.89	0.83
3	0.84	0.75
4	0.79	0.68

Solution

The carrying amount of the debenture on the date of transition under previous GAAP, assuming that all interest accrued other than premium on redemption have been paid, will be ₹ 31,50,000 [(30,000 x 100) + (30,000 x 100 x 10/100 x 2/4)]. The premium payable on redemption is being recognised as borrowing costs as per para 4(b) of AS 16 ie under previous GAAP on straight-line basis.

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As per para D18 of Ind AS 101, Ind AS 32, Financial Instruments: Presentation, requires an entity to split a compound financial instrument at inception into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of Ind AS 32 would involve separating two portions of equity. The first portion is recognised in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, in accordance with this Ind AS, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to Ind AS.

In the present case, since the liability is outstanding on the date of transition, Sigma Ltd. will need to split the convertible debentures into debt and equity portion on the date of transition. Accordingly, we will first measure the liability component by discounting the contractually determined stream of future cash flows (interest and principal) to present value by using the discount rate of 10% p.a. (being the market interest rate for similar debentures with no conversion option).

	(₹)
Interest payments p.a. on each debenture	6
Present Value (PV) of interest payment for years 1 to 4 (6 × 3.17) (Note 1)	19.02
PV of principal repayment (including premium) 110 × 0.68 (Note 2)	74.80
Total liability component per debenture	93.82
Equity component per debenture (Balancing figure)	6.18
Face value of debentures	100.00
Total equity component for 30,000 debentures	1,85,400
Total debt amount (30,000 x 93.82)	28,14,600

Thus, on the date of initial recognition, the amount of ₹ 30,00,000 being the amount of debentures will be split as under:

Debt	₹ 28,14,600
Equity	₹ 1,85,400

However, on the date of transition, unwinding of ₹ 28,14,600 will be done for two years as follows:

Year	Opening balance	Finance cost @ 10%	Interest paid	Closing balance
1	28,14,600	2,81,460	1,80,000	29,16,060
2	29,16,060	2,91,606	1,80,000	30,27,666

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Therefore, on transition date, Sigma Ltd. shall –

a. recognise the carrying amount of convertible debentures at ₹ 30,27,666;

b. recognise equity component of compound financial instrument of ₹ 1,85,400;

c. debit ₹ 63,066 to retained earnings being the difference between the previous GAAP amount of ₹ 31,50,000 and ₹ 30,27,666 and the equity component of compound financial instrument of ₹ 1,85,400; and

d. derecognise the debenture liability in previous GAAP of ₹ 31,50,000.

Notes:

1. 3.17 is present value of annuity factor of ₹ 1 at a discount rate of 10% for 4 years.

2. On maturity, ₹ 110 will be paid (₹ 100 as principal payment + ₹ 10 as premium)

*****

9. 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.

10. Decommissioning liabilities included in Property, Plant and Equipment

Appendix 'A' to Ind AS 16 "Changes in Existing Decommissioning, Restoration and Similar Liabilities" requires specified changes in a decommissioning, restoration or similar liability to be added to or deducted from the cost of the asset to which it relates; the adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life.

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,
- If the liability is in the scope of Appendix A to Ind AS 16, roll-back that liability to the

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date that liability first arose using best estimate of historical risk-adjusted discount rate and include it in the cost of the asset, and

- Calculate accumulated depreciation on the transition date on the basis of estimated useful life as at that date.

11. 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

12. 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.

13. Severe Hyperinflation

In hyperinflationary economy, when an entity's date of transition to Ind AS, is on, or after, the functional currency normalization date, then all assets and liabilities held before the functional currency normalization date may be measured at fair value on the date of transition.

This fair value may be used as deemed cost of those assets and liabilities in the opening Ind AS statement of financial position.

When the functional currency normalisation date falls within a 12- month comparative period, the comparative period may be less than 12 months, provided that a complete set of financial statements (as required by paragraph 10 of Ind AS 1) is provided for that shorter period.

14. 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.

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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.

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.

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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. Designation of contracts to buy or sell a non-financial item

Ind AS 109 permits some contracts to buy or sell a non-financial item to be designated **at inception** as measured at fair value through profit or loss (see paragraph 2.5 of Ind AS 109). Despite this requirement an entity is permitted to designate, a**t the date of transition to Ind AS**, contracts that already exist on that date as measured at fair value through profit or loss but only if they meet the requirements of paragraph 2.5 of Ind AS 109 at that date and the entity designates all similar contracts.

17. 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 component of the ore body with which the predecessor stripping asset can be associated.

18. 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

19. 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.

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20. 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.

21. 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 the entity had previously proportionately consolidated including goodwill arising on acquisition.
- To test the investment for impairment, regardless of whether there are indicators of such impairment. Any resulting impairment shall be recognised as an adjustment to retained earnings at the date of transition to Ind AS.
- If aggregate of all previously recognized assets/liabilities results in negative asset and if having legal or constructive obligation, then 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 of net assets (including goodwill) 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

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- Provide reconciliation between amount derecognized, recognized and adjustment to retained earnings.

7. PRESENTATION AND DISCLOSURE

I. Comparative Information

- Ind AS does not require historical summaries to comply with the recognition and measurement requirement of Ind AS.
- In any financial statements containing historical summaries or comparative information in accordance with previous GAAP, an entity shall:
  - Label the previous GAAP information prominently as not being prepared in accordance with Ind AS; and
  - Disclose the nature of the main adjustments that would make it comply with Ind AS. An entity need not quantify those adjustments.

II. Explanation of transition to Ind AS

- Reconciliation of

  (a) Equity from previous GAAP to Ind AS at transition and last year end;

  (b) Last year's total comprehensive income under previous GAAP to Ind AS.

- Sufficient detail to understand adjustments to each line item.
- Reconciliation to distinguish correction of errors identified during transition from change in accounting policy.
- Fair value as deemed cost and the amount of the adjustment.
- Ind AS 36 disclosures for impairment during transition.
- If adopted first time exemption option, to disclose the fact and accounting policy until such time those PPE, Intangible Assets, investment properties or intangible assets significantly depreciated/impaired/derecognized.
- Interim financial reports to include reconciliation with equity and profit or loss under previous GAAP.
- Further information to comply with Ind AS 34.

Illustration 16

H Ltd. has the following assets and liabilities as at March 31, 20X1, prepared in accordance with previous GAAP:

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Particulars	Notes	Amount (₹)
Property, Plant & Equipment	1	1,34,50,000
Investments in S. Ltd.	2	48,00,000
Trade Receivables		2,00,000
Advances for purchase of inventory		50,00,000
Inventory		8,00,000
Cash		49,000
Total assets		2,42,99,000
VAT deferral loan	3	60,00,000
Creditors		30,00,000
Short term borrowing		8,00,000
Provisions		12,00,000
Total liabilities		1,10,00,000
Share capital		1,30,00,000
Reserves:		2,99,000
Cumulative translation difference	4	1,00,000
ESOP reserve	4	20,000
Retained earnings		1,79,000
Total equity		1,32,99,000
Total equity and liabilities		2,42,99,000

The following GAAP differences were identified by the Company on first-time adoption of Ind AS with effect from April 1, 20X1:

1. *In relation to property, plant and equipment, the following adjustments were identified:*
   - *Property, plant and equipment comprise land held for capital appreciation purposes costing ₹ 4,50,000 and was classified as investment property as per Ind AS 40.*
   - *Exchange differences of ₹ 1,00,000 were capitalised to depreciable property, plant and equipment on which accumulated depreciation of ₹ 40,000 was recognised.*
   - *There were no asset retirement obligations.*
   - *The management intends to adopt deemed cost exemption for using the previous GAAP carrying values as deemed cost as at the date of transition for PPE and investment property.*
2. *The Company had made an investment in S Ltd. (subsidiary of H Ltd.) for ₹ 48,00,000 that carried a fair value of ₹ 68,00,000 as at the transition date. The Company intends to recognise the investment at its fair value as at the date of transition.*

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3. *Financial instruments:*

- ***VAT deferral loan ₹ 60,00,000 :***

  The VAT deferral loan of ₹ 60,00,000 was obtained on March 31, 20X1, for setting up a business in a backward region with a condition to create certain defined targets for employment of local population of that region. The loan does not carry any interest and is repayable in full at the end of 5 years. In accordance with Ind AS 109, the discount factor on the loan is to be taken as 10%, being the incremental borrowing rate. Accordingly, the fair value of the loan as at March 31, 20X1, is ₹ 37,25,528. The entity chooses to exercise the option given in paragraph B11 of Ind AS 101, i.e., the entity chooses to apply the requirements of Ind AS 109, Financial Instruments and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, retrospectively as required information had been obtained at the time of initially accounting for VAT deferral loan

4. *The retained earnings of the Company contained the following:*

- ***ESOP reserve of ₹ 20,000:***

  The Company had granted 1,000 options to employees out of which 800 have already vested. The Company followed an intrinsic value method for recognition of ESOP charge and recognised ₹ 12,000 towards the vested options and ₹ 8,000 over a period of time as ESOP charge and a corresponding reserve. If fair value method had been followed in accordance with Ind AS 102, the corresponding charge would have been ₹ 15,000 and ₹ 9,000 for the vested and unvested shares respectively. The Company intends to avail Ind AS 101 exemption for share-based payments for not restating the ESOP charge as per previous GAAP for vested options.

- ***Cumulative translation difference :***

  The Company had a non-integral foreign branch in accordance with AS 11 and had recognised a balance of ₹ 1,00,000 as part of reserves. On first-time adoption of Ind AS, the Company intends to avail Ind AS 101 exemption of resetting the cumulative translation difference to zero.

Prepare transition date Ind AS balance sheet of Company H showing adjustments to the values of assets and liabilities.

Solution

Adjustments for opening balance sheet as per Ind AS 101

1. **Property, Plant & Equipment:** As the land held for capital appreciation purposes qualifies as investment property, such investment property should be reclassified from property, plant and equipment (PPE) to investment property and presented separately. As the Company has adopted the previous GAAP carrying values as deemed cost, all items of PPE and investment property should be carried at its previous GAAP carrying values. As such, the past capitalised exchange differences require no adjustment in this case.

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2. **Investment in subsidiary:** On first time adoption of Ind AS, a parent company has an option to carry its investment in subsidiary at fair value as at the date of transition in its separate financial statements. As such, the company can recognise such investment at a value of ₹ 68,00,000.

3. **Financial instruments:** As the VAT deferral loan is a financial liability under Ind AS 109, that liability should be recognised at its present value discounted at an appropriate discounting factor. Consequently, the VAT deferral loan should be recognised at ₹ 37,25,528 and the remaining ₹ 22,74,472 would be recognised as deferred government grant.

4. **ESOPs:** Ind AS 101 provides an exemption of not restating the accounting as per the previous GAAP in accordance with Ind AS 102 for all options that have vested by the transition date. Accordingly, out of 1000 ESOPs granted, the first-time adoption exemption is available on 800 options that have already vested. As such, its accounting need not be restated. However, the 200 options that are not vested as at the transition date, need to be restated in accordance with Ind AS 102. As such, the additional impact of ₹ 1,000 (i.e., 9,000 less 8,000) would be recognised in the opening Ind AS balance sheet.

5. **Cumulative translation difference :** As per paragraph D12 of Ind AS 101, the first-time adopter can avail an exemption regarding requirements of Ind AS 21 in context of cumulative translation differences. If a first-time adopter uses this exemption the cumulative translation differences for all foreign operation are deemed to be zero as at the transition date. In that case, the balance is transferred to retained earnings. As such, the balance of ₹ 1,00,000 should be transferred to retained earnings

6. **Retained earnings:**

	₹
Increase in fair value of investment in subsidiary (note 2)	20,00,000
Additional ESOP charge on unvested options (note 4)	(1,000)
Transfer of cumulative translation difference balance to retained earnings (note 5)	1,00,000
Increase in Retained Earnings	20,99,000

The transition date Ind AS Balance Sheet after the above adjustments in the carrying values of assets and liabilities is as under:

Transition date Ind AS Balance Sheet of H Ltd. as at 1st April, 20X1

Particular	Notes	Previous GAAP	Adjustments	Ind AS GAAP
Non-Current Assets				
Property, Plant & Equipment	1	1,34,50,000	(4,50,000)	1,30,00,000
Investment property	1	0	4,50,000	4,50,000

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Current Assets				
Inventory		8,00,000		8,00,000
Financial assets:				
Investment in S Ltd.	2	48,00,000	20,00,000	68,00,000
Trade Receivables		2,00,000		2,00,000
Cash		49,000		49,000
Other current asset – (Advances for purchase of inventory)		50,00,000		50,00,000
Total assets		2,42,99,000	20,00,000	2,62,99,000
Share capital		1,30,00,000		1,30,00,000
Other Equity:				
Cumulative translation difference	5	1,00,000	(1,00,000)	0
ESOP reserve	4	20,000	1,000	21,000
Retained earnings	6	1,79,000	20,99,000	22,78,000
Total equity		1,32,99,000	20,00,000	1,52,99,000
Non-current Liabilities				
Financial liability:				
VAT deferral loan	3	60,00,000	(22,74,472)	37,25,528
Deferred government grant	3	0	22,74,472	22,74,472
Current Liabilities				
Financial Liabilities				
Trade payables		30,00,000		30,00,000
Short term borrowings		8,00,000		8,00,000
Provisions		12,00,000		12,00,000
Total liabilities		1,10,00,000		1,10,00,000
Total equity and liabilities		2,42,99,000	20,00,000	2,62,99,000

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Illustration 17

Shaurya Limited is the company having its registered and corporate office at New Delhi. 60% of Shaurya Limited's shares are held by the Government of India and rest by other investors.

This is the first time that Shaurya limited would be applying Ind AS for the preparation of its financials for the current financial year 2019-2020. Following balance sheet is prepared as per earlier GAAP as at the beginning of the preceding period along with the additional information:

Balance Sheet as at 31 March 2018

(All figures are in '000, unless otherwise specified)

Particulars	Amount
EQUITY AND LIABILITIES	
(1) Shareholders' Funds	
(a) Share Capital	10,00,000
(b) Reserves & Surplus	25,00,000
(2) Non-Current Liabilities	
(a) Long Term Borrowings	4,50,000
(b) Long Term Provisions	3,50,000
(c) Deferred tax liabilities	3,50,000
(3) Current Liabilities	
(a) Trade Payables	22,00,000
(b) Other Current Liabilities	4,50,000
(c) Short Term Provisions	12,00,000
TOTAL	85,00,000
ASSETS	
(1) Non-Current Assets	
(a) Property, Plant & Equipment (net)	20,00,000
(b) Intangible assets	2,00,000
(c) Goodwill	1,00,000
(d) Non-current Investments	5,00,000
(e) Long Term Loans and Advances	1,50,000
(f) Other Non-Current Assets	2,00,000
(2) Current Assets	
(a) Current Investments	18,00,000
(b) Inventories	12,50,000

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(c) Trade Receivables	9,00,000
(d) Cash and Bank Balances	10,00,000
(e) Other Current Assets	4,00,000
TOTAL	85,00,000

Additional Information (All figures are in '000) :

1. Other current liabilities include ₹ 3,90,000 liabilities to be paid in cash such as expense payable, salary payable etc. and ₹ 60,000 are statutory government dues.
2. Long term loans and advances include ₹ 40,000 loan and the remaining amount consists Advance to staff of ₹ 1,10,000.
3. Other non-current assets of ₹ 2,00,000 consists Capital advances to suppliers.
4. Other current assets include ₹ 3,50,000 current assets receivable in cash and Prepaid expenses of ₹ 50,000.
5. Short term provisions include Dividend payable of ₹ 2,00,000. The dividend payable had been as a result of board meeting wherein the declaration of dividend for financial year 2017-2018 was made. However, it is subject to approval of shareholders in the annual general meeting.

Chief financial officer of Shaurya Limited has also presented the following information against corresponding relevant items in the balance sheet:

a) Property, Plant & Equipment consists a class of assets as office buildings whose carrying amount is ₹ 10,00,000. However, the fair value of said office building as on the date of transition is estimated to be ₹ 15,00,000. Company wants to follow revaluation model as its accounting policy in respect of its property, plant and equipment for the first annual Ind AS financial statements.

b) The fair value of Intangible assets as on the date of transition is estimated to be ₹ 2,50,000. However, the management is reluctant to incorporate the fair value changes in books of account.

c) Shaurya Ltd. had acquired 80% shares in a company, Excel private limited few years ago thereby acquiring the control upon it at that time. Shaurya Ltd. recognised goodwill as per erstwhile accounting standards by accounting the excess of consideration paid over the net assets acquired at the date of acquisition. Fair value exercise was not done at the time of acquisition.

d) Trade receivables include an amount of ₹ 20,000 as provision for doubtful debts measured in accordance with previous GAAP. Now as per latest estimates using hindsights, the provision needs to be revised to ₹ 25,000.

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e) *Company had given a loan of ₹ 1,00,000 to an entity for the term of 10 years six years ago. Transaction costs were incurred separately for this loan. The loan carries an interest rate of 7%. The principal amount is to be repaid in equal installments over the period of ten years at the year end. Interest is also payable at each year end. The fair value of loan as on the date of transition is ₹ 50,000 as against the carrying amount of loan which at present amounts to ₹ 40,000. However, Ind AS 109 mandates to recognise the interest income as per effective interest method after the adjustment of transaction costs. Management says it is tedious task in the given case to apply the effective interest rate changes with retrospective effect and hence is reluctant to apply the same retrospectively in its first-time adoption.*

f) *In the long-term borrowings, ₹ 4,50,000 of component is due towards the State Government. Interest is payable on the government loan at 4%, however the prevailing rate in the market at present is 8%. The fair market value of loan stands at ₹ 4,20,000 as on the relevant date.*

g) *Under Previous GAAP, the mutual funds were measured at cost or market value, whichever is lower. Under Ind AS, the Company has designated these investments at fair value through profit or loss. The value of mutual funds as per previous GAAP is ₹ 2,00,000 as included in 'current investment'. However, the fair value of mutual funds as on the date of transition is ₹ 2,30,000.*

h) *Ignore separate calculation of deferred tax on above adjustments. Assume the net deferred tax income to be ₹ 50,000 on account of Ind AS transition adjustments.*

Requirements:

- *Prepare transition date balance sheet of Shaurya Limited as per Indian Accounting Standards*
- *Show necessary explanation for each of the items presented by chief financial officer in the form of notes, which may or may not require the adjustment as on the date of transition.*

Solution

Transition date (opening) IND-AS Balance Sheet of Shaurya Limited
As at 1 April 2018
(All figures are in '000, unless otherwise specified)

Particulars	Previous GAAP	Transitional Ind AS adjustments	Opening Ind AS Balance Sheet
ASSETS			
Non-current assets			
Property, plant and equipment (Note 1)	20,00,000	5,00,000	25,00,000

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Goodwill (Note 2)	1,00,000	-	1,00,000
Other Intangible assets (Note 3)	2,00,000	-	2,00,000
Financial assets:			
Investment	5,00,000	-	5,00,000
Loans (Note 4)	40,000	10,000	50,000
Other financial assets	1,10,000	-	1,10,000
Other non-current assets	2,00,000	-	2,00,000
Current assets			
Inventories	12,50,000	-	12,50,000
Financial assets			
Investment (Note 5)	18,00,000	30,000	18,30,000
Trade receivables (Note 6)	9,00,000	-	9,00,000
Cash and cash equivalents/Bank	10,00,000	-	10,00,000
Other financial assets	3,50,000	-	3,50,000
Other current assets	50,000	-	50,000
TOTAL ASSETS	85,00,000	5,40,000	90,40,000
EQUITY AND LIABILITIES			
Equity			
Equity share capital	10,00,000	-	10,00,000
Other equity	25,00,000	7,90,000	32,90,000
Non-current liabilities			
Financial liabilities			
Borrowings (Note-7)	4,50,000	-	4,50,000
Provisions	3,50,000	-	3,50,000
Deferred tax liabilities (Net)	3,50,000	(50,000)	3,00,000
Current liabilities			
Financial liabilities			
Trade payables	22,00,000	-	22,00,000
Other financial liabilities	3,90,000	-	3,90,000
Other current liabilities	60,000	-	60,000
Provisions (Note-8)	12,00,000	(2,00,000)	10,00,000
TOTAL EQUITY AND LIABILITIES	85,00,000	5,40,000	90,40,000

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OTHER EQUITY

	Retained Earnings (₹)	Fair value reserve	Total
As at 31 March, 2018	27,90,000 (W.N.1)	5,00,000	32,90,000

Working Note 1:

Retained earnings balance:	
Balance as per Earlier GAAP	25,00,000
Transitional adjustment due to loan's fair value	10,000
Transitional adjustment due to increase in mutual fund's fair value	30,000
Transitional adjustment due to decrease in deferred tax liability	50,000
Transitional adjustment due to decrease in provisions (dividend)	2,00,000
Total	27,90,000

Disclosure forming part of financial statements:

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

Note 1: Property, plant & Equipment:

As per para D5 of Ind AS 101, an entity may elect to measure an item of property, plant and equipment at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date.

Para D7AA has to be applied for all items of property, plant and equipment. So, if D5 exemption is taken for buildings, Ind AS will have to be applied retrospectively for other assets as well. Since, an entity elect to measure an item of property, plant and equipment at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date, it is assumed that the carrying amount of other assets based on retrospective application of Ind AS is equal to their fair value of ₹ 10 lakhs.

Note 2: Goodwill:

Ind AS 103 mandatorily requires measuring the assets and liabilities of the acquiree at its fair value as on the date of acquisition. However, a first time adopter may elect to not apply the provisions of Ind AS 103 with retrospective effect that occurred prior to the date of transition to Ind AS.

Hence company can continue to carry the goodwill in its books of account as per the previous GAAP.

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Note 3: Intangible assets:

Para D7 read with D6 of Ind AS 101 states that a first-time adopter may elect to use a previous GAAP revaluation at, or before, the date of transition to Ind AS as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to:

(a) Fair value; or

(b) Cost or depreciated cost in accordance with Ind AS, adjusted to reflect, for example, changes in a general or specific price index.

However, there is a requirement that Intangible assets must meet the definition and recognition criteria as per Ind AS 38.

Hence, company can avail the exemption given in Ind AS 101 as on the date of transition to use the carrying value as per previous GAAP.

Note 4: Loan:

Para B8C of Ind AS 101 states that if it is impracticable (as defined in Ind AS 8) for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind ASs shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to Ind AS.

Accordingly, ₹ 50,000 would be the gross carrying amount of loan and difference of ₹ 10,000 (₹ 50,000 – ₹ 40,000) would be adjusted to retained earnings.

Note 5: Mutual Funds:

Para 29 of Ind AS 101 states that an entity is permitted to designate a previously recognised financial asset as a financial asset measured at fair value through profit or loss in accordance with paragraph D19A. The entity shall disclose the fair value of financial assets so designated at the date of designation and their classification and carrying amount in the previous financial statements.

D19A states that an entity may designate a financial asset as measured at fair value through profit or loss in accordance with Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind AS.

Note 6: Trade receivables:

Para 14 of Ind AS 101 states that an entity's estimates in accordance with Ind 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.

Para 15 of Ind AS 101 further states that an entity may receive information after the date of transition to Ind AS about estimates that it had made under previous GAAP. In accordance with

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paragraph 14, an entity shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with Ind AS 10, Events after the Reporting Period.

The entity shall not reflect that new information in its opening Ind AS Balance Sheet (unless the estimates need adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the entity shall reflect that new information in profit or loss (or, if appropriate, other comprehensive income) for the year ended 31 March 2019.

Note 7: Government Grant:

Para 10A of Ind AS 20 states that the benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with Ind AS 109, Financial Instruments. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109, and the proceeds received. The benefit is accounted for in accordance with this Standard.

However, Para B10 of Ind AS 101 states, a first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with Ind AS 32, Financial Instruments: Presentation. Except as permitted by paragraph B11, a first-time adopter shall apply the requirements in Ind AS 109, Financial Instruments, and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance*, prospectively* to government loans existing at the date of transition to Ind ASs and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant. Consequently, if a first-time adopter did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with Ind AS requirements, it shall use its previous GAAP carrying amount of the loan at the date of transition to Ind AS as the carrying amount of the loan in the opening Ind AS Balance Sheet. An entity shall apply Ind AS 109 to the measurement of such loans after the date of transition to Ind AS.

Note 8: Dividend

Dividend should be deducted from retained earnings during the year when it has been declared and approved. Accordingly, the provision declared for preceding year should be reversed (to rectify the wrong entry). Retained earnings would increase proportionately due to such adjustment.

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8. CARVE OUTS IN IND AS 101 FROM IFRS 1

(i) Definition of previous GAAP under Ind AS 101

As per IFRS

IFRS 1 defines previous GAAP as the basis of accounting that a first - time adopter used immediately before adopting IFRS.

Carve out

Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its reporting requirement in India immediately before adopting Ind AS. The change made it mandatory for Indian entities to consider the financial statements prepared in accordance with notified Accounting Standards as was applicable to them as previous GAAP when it transitions to Ind AS.

Reason

The change makes it mandatory for Indian companies to consider the financial statements prepared in accordance with Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 as previous GAAP when it transitions to Ind AS as the law prevailing in India recognises only the financial statements prepared in accordance with the Companies Act, 2013.

(ii) Allowing the use of carrying cost of Property, Plant and Equipment (PPE) on the date of transition of Ind AS 101

As per IFRS

IFRS 1 *First time Adoption of International Accounting Standards* provides that on the date of transition, either the items of Property, Plant and Equipment shall be determined by applying IAS 16 *Property, Plant and Equipment* retrospectively or the same should be recorded at fair value or a previous GAAP revaluation, subject to certain requirements.

Carve out

Paragraph D7AA of Ind AS 101 provides an additional option to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

Reason

In case of old companies, retrospective application of Ind AS 16 or fair values at the date of transition to determine deemed cost may not be possible for old assets. Accordingly, Ind AS 101 provides relief to an entity to use carrying values of all items of property, plant

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and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

(iii) Long Term Foreign Currency Monetary Items

As per IFRS

No provision in IFRS 1.

Carve out

Paragraph D13AA of Appendix D to Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Consequently, Ind AS 21 also provides that it does not apply to long-term foreign currency monetary items for which an entity has opted for the exemption given in paragraph D13AA of Appendix D to Ind AS 101. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items.

Reason

Para 46A of AS 11 provides an option to recognise long term foreign currency monetary items as a part of the cost of property, plant and equipment or to defer its recognition in the statement of profit and loss over the period of loan in case the loan is not related to acquisition of fixed assets. To provide transitional relief, such entities have been given an option to continue the capitalisation or deferment of exchange differences, as the case may be, on foreign currency borrowings obtained before the beginning of first Ind AS reporting period.

(iv) 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

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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.

(v) 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.

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FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. Company A intends to restate its past business combinations with effect from 30 June 20X0 (being a date prior to the transition date).

   If business combinations are restated, whether certain other exemptions, such as the deemed cost exemption for property, plant and equipment (PPE), can be adopted?

2. X Ltd. was using cost model for its property, plant and equipment till March 31, 20X2 under previous GAAP. The Ind AS become applicable to the company for financial year beginning April 1, 20X2. On April 1, 20X1, i.e., the date of its transition to Ind AS, it used fair value as the deemed cost in respect of its property, plant and equipment. X Ltd. wants to follow revaluation model as its accounting policy in respect of its property, plant and equipment for the first annual Ind AS financial statements.

   Whether use of fair values as deemed cost on the date of transition and use of revaluation model in the first annual Ind AS financial statements would amount to a change in accounting policy?

3. Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X5. On April 1, 20X0, it obtained a 7 year US $ 1,00,000 loan. It has been exercising the option provided in Paragraph 46/46A of AS 11 and has been amortising the exchange differences in respect of this loan over the balance period of such loan. On the date of transition to Ind AS, Y Ltd. wants to discontinue the accounting policy as per the previous GAAP and follow the requirements of Ind AS 21 with respect to recognition of foreign exchange differences.

   Whether the Company is permitted to do so?

4. A company has chosen to elect the deemed cost exemption in accordance with Ind AS 101. However, it does not wish to continue with its existing policy of capitalising exchange

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fluctuation on long term foreign currency monetary items to property, plant and equipment i.e. it does not want to elect the exemption available as per Ind AS 101.

In such a case, how would the company be required to adjust the foreign exchange fluctuation already capitalised to the cost of property, plant and equipment under previous GAAP?

5. XYZ Pvt. Ltd. is a company registered under the Companies Act, 2013 following Accounting Standards notified under Companies (Accounting Standards) Rules, 2006. The Company has decided to voluntarily adopt Ind AS w.e.f 1st April, 20X2 with a transition date of 1st April, 20X1.

The Company has one Wholly Owned Subsidiary and one Joint Venture which are into manufacturing of automobile spare parts.

The consolidated financial statements of the Company under Indian GAAP are as under:

Consolidated Financial Statements

(₹ in Lakhs)

Particulars	31.03.20X2	31.03.20X1
Shareholder's Funds		
Share Capital	7,953	7,953
Reserves & Surplus	16,547	16,597
Non-Current Liabilities		
Long Term Borrowings	1,000	1,000
Long Term Provisions	1,101	691
Other Long-Term Liabilities	5,202	5,904
Current Liabilities		
Trade Payables	9,905	8,455
Short Term Provisions	500	475
Total	**42,208**	**41,075**
Non-Current Assets		
Property Plant & Equipment	21,488	22,288
Goodwill on Consolidation of subsidiary and JV	1,507	1,507
Investment Property	5,245	5,245
Long Term Loans & Advances	6,350	6,350
Current Assets		
Trade Receivables	4,801	1,818

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Investments ·	1,263	3,763
Other Current Assets	1,554	104
Total	**42,208**	**41,075**

Additional Information:

The Company has entered into a joint arrangement by acquiring 50% of the equity shares of ABC Pvt. Ltd. Presently, the same has been accounted as per the proportionate consolidated method. The proportionate share of assets and liabilities of ABC Pvt. Ltd. included in the consolidated financial statement of XYZ Pvt. Ltd. is as under:

Particulars	₹ in Lakhs
Property, Plant & Equipment	1,200
Long Term Loans & Advances	405
Trade Receivables	280
Other Current Assets	50
Trade Payables	75
Short Term Provisions	35

The Investment is in the nature of Joint Venture as per Ind AS 111.

Suggest the accounting adjustments which are required to be made in the opening Balance Sheet as on 1st April, 20X1.

6. Mathur India Private Limited has to present its first financials under Ind AS for the year ended 31st March, 20X3. The transition date is 1st April, 20X1.

The following adjustments were made upon transition to Ind AS:

(a) The Company opted to fair value its land as on the date on transition.

The fair value of the land as on 1st April, 20X1 was ₹ 10 crores. The carrying amount as on 1st April, 20X1 under the existing GAAP was ₹ 4.5 crores.

(b) The Company has recognised a provision for proposed dividend of ₹ 60 lacs and related dividend distribution tax of ₹ 18 lacs during the year ended 31st March, 20X1. It was written back as on opening balance sheet date.

(c) The Company fair values its investments in equity shares on the date of transition. The increase on account of fair valuation of shares is ₹ 75 lacs.

(d) The Company has an Equity Share Capital of ₹ 80 crores and Redeemable Preference Share Capital of ₹ 25 crores.

(e) The reserves and surplus as on 1st April, 20X1 before transition to Ind AS was ₹ 95 crores representing ₹ 40 crores of general reserve and ₹ 5 crores of capital

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reserve acquired out of business combination and balance is surplus in the Retained Earnings.

(f) The company identified that the preference shares were in nature of financial liabilities.

What is the balance of total equity (Equity and other equity) as on 1st April, 20X1 after transition to Ind AS? Show reconciliation between total equity as per AS (Accounting Standards) and as per Ind AS to be presented in the opening balance sheet as on 1st April, 20X1.

Ignore deferred tax impact.

7. ABC Ltd is a government company and is a first-time adopter of Ind AS. As per the previous GAAP, the contributions received by ABC Ltd. from the government (which holds 100% shareholding in ABC Ltd.) which is in the nature of promoters' contribution have been recognised in capital reserve and treated as part of shareholders' funds in accordance with the provisions of AS 12, Accounting for Government Grants.

State whether the accounting treatment of the grants in the nature of promoters' contribution as per AS 12 is also permitted under Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance. If not, then what will be the accounting treatment of such grants recognised in capital reserve as per previous GAAP on the date of transition to Ind AS.

Answers

1. Ind-AS 101 prescribes that an entity may elect to use one or more of the exemptions of the Standard. As such, an entity may choose to adopt a combination of optional exemptions in relation to the underlying account balances.

When the past business combinations after a particular date (30 June 20X0 in the given case) are restated, it requires retrospective adjustments to the carrying amounts of acquiree's assets and liabilities on account of initial acquisition accounting of the acquiree's net assets, the effects of subsequent measurement of those net assets (including amortisation of non-current assets that were recognised at its fair value), goodwill on consolidation and the consolidation adjustments. Therefore, the goodwill and equity (including non-controlling interest (NCI)) cannot be computed by considering the deemed cost exemption for PPE. However, the entity may adopt the deemed cost exemption for its property, plant and equipment other than those acquired through business combinations.

2. In the instant case, X Ltd. is using revaluation model for property, plant and equipment for the first annual Ind AS financial statements and using fair value of property, plant and equipment on the date of the transition, as deemed cost. Since the entity is using fair value at the transition date as well as in the first Ind AS financial statements, there is no change in accounting policy and mere use of the term 'deemed cost' would not mean that there is a change in accounting policy.

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3. Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Ind AS 101 gives an option to continue the existing accounting policy. Hence, Y Ltd. may opt for discontinuation of accounting policy as per previous GAAP and follow the requirements of Ind AS 21. The cumulative amount lying in the Foreign Currency Monetary Item Translation Difference Account (FCMITDA) as per AS 11 should be derecognised by an adjustment against retained earnings on the date of transition.

4. Ind AS 101 permits to continue with the carrying value for all of its property, plant and equipment as per the previous GAAP and use that as deemed cost for the purposes of first time adoption of Ind AS. Accordingly, the carrying value of property, plant and equipment as per previous GAAP as at the date of transition need not be adjusted for the exchange fluctuations capitalized to property, plant and equipment. Separately, it allows a company to continue with its existing policy for accounting for exchange differences arising from translation of long term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Accordingly, given that Ind AS 101 provides these two choices independent of each other, it may be possible for an entity to choose the deemed cost exemption for all of its property, plant and equipment and not elect the exemption of continuing the previous GAAP policy of capitalising exchange fluctuation to property, plant and equipment. In such a case, in the given case, a harmonious interpretation of the two exemptions would require the company to recognise the property, plant and equipment at the transition date at the previous GAAP carrying value (without any adjustment for the exchanges differences capitalized under previous GAAP) but for the purposes of the first (and all subsequent) Ind AS financial statements, foreign exchange fluctuation on all long term foreign currency borrowings that arose after the transition date would be recognised in the statement of profit and loss.

5. As per paras D31AA and D31AB of Ind AS 101, when changing from proportionate consolidation to the equity method, an entity shall recognise its investment in the joint venture at transition date to Ind AS.

That initial investment shall be measured as the aggregate of the carrying amounts of the assets and liabilities that the entity had previously proportionately consolidated, including any goodwill arising from acquisition. If the goodwill previously belonged to a larger cash-generating unit, or to a group of cash-generating units, the entity shall allocate goodwill to the joint venture on the basis of the **relative** carrying amounts of the joint venture and the cash-generating unit or group of cash-generating units to which it belonged. The balance of the investment in joint venture at the date of transition to Ind AS, determined in accordance with paragraph D31AA above is regarded as the deemed cost of the investment at initial recognition.

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Accordingly, the deemed cost of the investment will be

Property, Plant & Equipment	1,200
Goodwill (Refer Note below)	119
Long Term Loans & Advances	405
Trade Receivables	280
Other Current Assets	50
Total Assets	2,054
Less: Trade Payables	75
Short Term Provisions	35
Deemed cost of the investment in JV	1,944

Calculation of proportionate goodwill share of Joint Venture ie ABC Pvt. Ltd.

Property, Plant & Equipment	22,288
Goodwill	1,507
Long Term Loans & Advances	6,350
Trade Receivables	1,818
Other Current Assets	104
Total Assets	32,067
Less: Trade Payables	8,455
Short Term Provisions	475
	23,137

Note: Only those assets and liabilities have been taken into account for calculation of 'proportionate goodwill share of Joint Venture', which were given in the question as 'proportionate share of assts and liabilities of ABC Ltd. added to XYZ Ltd.'

Proportionate Goodwill of Joint Venture

= [(Goodwill on consolidation of subsidiary and JV/Total relative net asset) x Net asset of JV]

= (1507 / 23,137) x 1825 = 119 (approx.)

Accordingly, the proportional share of assets and liabilities of Joint Venture will be removed from the respective values assets and liabilities appearing in the balance sheet on 31.3.20X1 and Investment in JV will appear under non-current asset in the transition date balance sheet as on 1.4.20X1.

Adjustments made in previous GAAP balance sheet to arrive at Transition date Ind AS Balance Sheet

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Transition Date Ind AS Balance Sheet of XYZ Pvt. Ltd. as at 1st April, 20X1

Particulars	Previous GAAP	Ind AS Adjustment	Ind AS GAAP
Non-Current Assets			
Property, Plant & Equipment	22,288	(1,200)	21,088
Investment Property	5,245	-	5,245
Intangible assets - Goodwill on Consolidation	1,507	(119)	1,388
Financial Assets			
Long Term Loans & Advances	6,350	(405)	5,945
Non- current investment in JV	-	1,944	1,944
Current Assets	-		
Financial Assets			
Investments ·	3,763	-	3,763
Trade Receivables	1,818	(280)	1,538
Other Current Assets	104	(50)	54
Total	**41,075**	**(110)**	**40,965**
Equity and liabilities			
Equity			
Share Capital	7,953	-	7,953
Other equity	16,597	-	16,597
Non-Current Liabilities			
Financial Liabilities			
Borrowings	1,000		1,000
Long Term Provisions	691		691
Other Long-Term Liabilities	5,904		5,904
Current Liabilities			
Financial Liabilities			
Trade Payables	8,455	(75)	8,380
Short Term Provisions	475	(35)	440
Total	**41,075**	**(110)**	**40,965**

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6. Computation of balance total equity as on 1st April, 20X1 after transition to Ind AS

			₹ in crore
Share capital- Equity share Capital			80
Other Equity			
General Reserve		40	
Capital Reserve		5	
Retained Earnings (95-5-40)	50		
Add: Increase in value of land (10-4.5)	5.5		
Add: De recognition of proposed dividend (0.6 + 0.18)	0.78		
Add: Increase in value of Investment	0.75	57.03	102.03
Balance total equity as on 1st April, 20X1 after transition to Ind AS			182.03

Reconciliation between Total Equity as per AS and Ind AS to be presented in the opening balance sheet as on 1st April, 20X1

		₹ in crore
Equity share capital		80
Redeemable Preference share capital		25
		105
Reserves and Surplus		95
Total Equity as per AS		200
Adjustment due to reclassification		
Preference share capital classified as financial liability		(25)
Adjustment due to derecognition		
Proposed Dividend not considered as liability as on 1st April 20X1		0.78
Adjustment due to remeasurement		
Increase in the value of Land due to remeasurement at fair value	5.5	
Increase in the value of investment due to remeasurement at fair value	0.75	6.25
Equity as on 1st April, 20X1 after transition to Ind AS		182.03

7. Paragraph 2 of Ind AS 20, "Accounting for Government Grants and Disclosure of Government Assistance" inter alia states that the Standard does not deal with government participation in the ownership of the entity.

Since ABC Ltd. is a Government company, it implies that government has 100% shareholding in the entity. Accordingly, the entity needs to determine whether the payment

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is provided as a shareholder contribution or as a government. Equity contributions will be recorded in equity while grants will be shown in the Statement of Profit and Loss.

Where it is concluded that the contributions are in the nature of government grant, the entity shall apply the principles of Ind AS 20 retrospectively as specified in Ind AS 101 'First Time Adoption of Ind AS'. Ind AS 20 requires all grants to be recognised as income on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. Unlike AS 12, Ind AS 20 requires the grant to be classified as either a capital or an income grant and does not permit recognition of government grants in the nature of promoter's contribution directly to shareholders' funds.

Where it is concluded that the contributions are in the nature of shareholder contributions and are recognised in capital reserve under previous GAAP, the provisions of paragraph 10 of Ind AS 101 would be applied which states that except in certain cases, an entity shall in its opening Ind AS Balance Sheet:

(a) recognise all assets and liabilities whose recognition is required by Ind AS;

(b) not recognise items as assets or liabilities if Ind AS do not permit such recognition;

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS; and

(d) apply Ind AS in measuring all recognised assets and liabilities.

Accordingly, as per the above requirements of paragraph 10(c) in the given case, contributions recognised in the Capital Reserve should be transferred to appropriate category under 'Other Equity' at the date of transition to Ind AS.

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NOTES

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CHAPTER 15

ANALYSIS OF FINANCIAL STATEMENTS



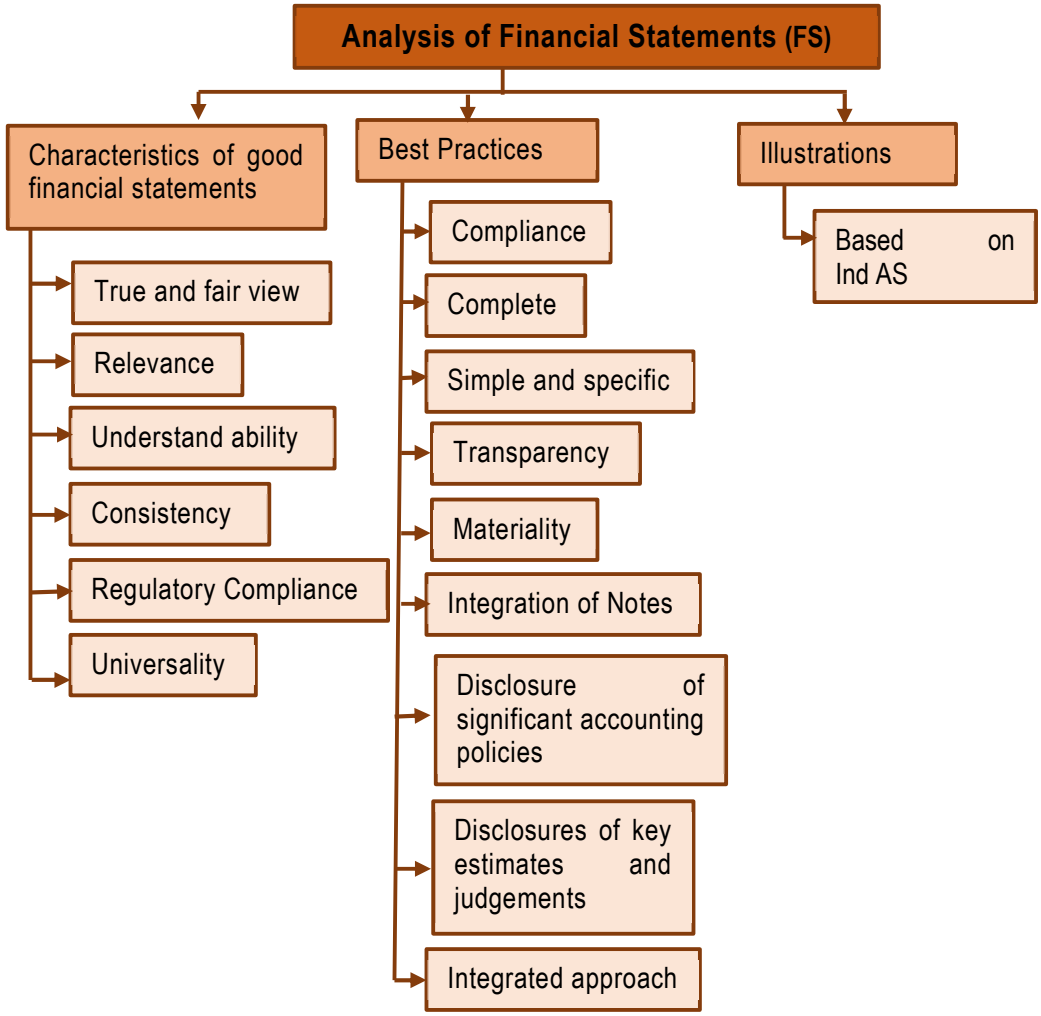
LEARNING OUTCOMES

After studying this chapter, you would be able to:

- Examine the key features of the financial statements and its relevancy for better reporting.
- Examine the key factors to be kept in mind in the preparation of financial statements.
- Follow the best practices in the preparation of financial statements.
- Analyse the common mistakes incurred by the preparers of the financial statements in the presentation of financial statements with respect to Schedule III.
- Rectify the mistakes found in the financial statements by addressing the issues and prescribing the correct presentation and disclosures.

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CHAPTER OVERVIEW



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1. INTRODUCTION

Business is important organ of society that helps in its overall development. A typical business has a variety of stakeholder that include its employees, owners, banks, trade associations, government, general public and so on. These stakeholders, particularly investors are keenly interested in knowing about the financial well-being of business organisations.

Financial reporting is an important means of communication for entities to disseminate information of its operations to various stakeholders. With the increased focus on governance the significance of financial reporting has exponentially increased. The importance of robust financial reporting cannot be emphasized enough. As India and Indian enterprises move ahead in the growth path at much faster pace and exposure of Indian entities to global environment expands, ever increasing complexities of transactions throws up newer challenges in financial reporting and related guidance. Presentation and disclosures, in this context, are assuming greater significance as enterprises aim to achieve excellence in financial reporting. Today, there are a number of requirements mandated by the regulators. It has now become imperative for entities to keep pace with the fast evolving requirements in the area of financial reporting.

The financial statements are a source of critical communication between an entity and the investors and other stakeholders. They act as the barometer to assess the performance, both past and future, for any enterprise. Decades back when enterprises were mostly proprietary owned, the financial statements were simpler in content and were presented annually just to provide the historical data. However, with globalization and increased dependence on technology, where companies are expanding both horizontally and vertically, many even spanning across geographies; the number of stakeholders – be it be investors, suppliers, employees, or even tax authorities, have increased manifold.

The financial statements are supplemented with the disclosures which are the key source of information and help the users in interpreting the financial statements in a better manner in taking appropriate decisions. Therefore, one can say that disclosures are added for good reasons. Disclosures are not the only requirement which will make a financial statement to be a good financial statement. The presentation and the compliance of formats are also the important factors which are taken into consideration in the evaluation of a financial statement.

This chapter enumerates some of the practices currently being followed in financial reporting and sets out suggested 'best practice' to enhance the quality of financial reporting to enable preparers of financial statements in benchmarking their financial statements. It intends to bring to the notice of the preparers and reviewers of the financial statements some common errors or omissions which they shall avoid while preparing the financial statements.

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2. FINANCIAL STATEMENTS OF CORPORATE ENTITIES

The format and content of the financial statements for companies is required to be in accordance with Schedule III to the Companies Act, 2013. Further, there are several additional disclosure requirements both with respect to the balance sheet and statement of profit and loss.

Certain industries have formats specified by their industry regulators, which need to be followed by them. This fact has also been recognised in the Companies Act, 2013 in the proviso to Section 129(1) which implies that the format set out in Schedule III will not be applicable to insurance companies and banking companies. The formats for these companies are prescribed by specific regulators.

In terms of format, Schedule III only prescribes the vertical format of balance sheet and does not provide the alternative of using the horizontal format. Further, Schedule III sets out the minimum requirements for disclosure on the face of the balance sheet and the statement of profit and loss. It allows line items, sub-line items and sub-totals to be presented as an addition or substitution on the face of the financial statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Standards. Schedule III now requires all disclosures to be made as a part of the notes.

Apart from granting an overriding status to the Standards, cognizance has also been given to the requirements of Standards in the format of the balance sheet and accordingly elements such as deferred tax assets and intangible assets have been included in the balance sheet. Also, it has been clearly stated that the disclosure requirements specified in Part I and Part II or Part III of the Schedule III are in addition to and not in substitution of the disclosure requirements specified in the respective notified Standards. The terms used in Schedule III are to be considered as per the respective notified Standards.

One of the pertinent aspects which needs to be considered in the preparation of financial statements with regard to Schedule III is that it does not prescribe the accounting treatment to be adopted by the entity; it only prescribes the format and content. Consequently, the fact that a particular item has been included in the format of the balance sheet in Schedule III does not imply that the particular item can be recognized in the balance sheet. Schedule III prescribes only presentation and not treatment which is a subject matter of Standards, which has also been specifically acknowledged in Schedule III.

3. CHARACTERISTICS OF GOOD FINANCIAL STATEMENTS

In the Indian scenario, the ICAI has been the recognized accounting body issuing generally accepted accounting policies and has made the standards mandatory for enterprises operating within India. Besides Accounting Standards, ICAI has also issued the converged set of Ind AS

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that is adopted and notified by MCA, and many large entities have already implemented it or are in the transition phase for adoption (depending on the net worth or other specified criteria).

The key features to any set of financial statements are:

1. **True and fair view of the affairs of the enterprise:** This is the most important feature of any set of financial statements. The user of the financial statements depends fully on the same and hence the reliability factor is supreme.

2. **Relevance:** The financial statements should provide the relevant information for the period it is presented. There is no point in presenting historical data of past several years that are redundant as of date. The key here is that the user of the financial statements should be in a position to take independent decision after reading the financial statements. This decision can be different for different users – for an investor the decision whether to hold the shares of the enterprise will stem from the set of statements, for a senior employee of the company it can be the future growth prospects of the company etc. But what is important is that the users should be empowered to make decisions through the financial statements

3. **Understandability:** For the user to make sense, the financial statements should be readable and content lucid to digest. Even a layman should be able to read the same, and understand the basic information, if not the accounting policies and procedures.

4. **Consistency:** The users of the financial statements will be benefitted only if the statements are released in periodic intervals and in standard formats. Else, the entire purpose of furnishing financials will be defeated. That is the reason that laws are prescribed for presentation formats and periodicity.

5. **Regulatory Compliance:** Needless to say, the tax authorities, market regulators etc. rely hugely on financial statements to understand and gauge the compliances met by the enterprise.

6. **Universality:** Last but not the least; the financial statements should be comparable both within the industry and outside. So financial statements by two different companies should look in similar lines if both are engaged in, say, manufacturing steel. Likewise, the financials of a company manufacturing steel in India should be comparable to the set of financial statements of a company based out of US engaged in the similar line of business.

The need to have the above key characteristics have brought the accounting bodies world over to come together to have a set of common standards for better integration and harmonization of accounting principles and practices.

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4. BEST PRACTICES - APPLICABLE TO ALL COMPANIES

Following are some of the practices, if followed by the preparers of the financial statements, it would lead to better presentation and disclosure and will also serve the meaningful purpose for various stakeholders in understanding the functioning, financial position and financial performance of the entity and in appropriate decision making:

1. Compliance

Financial reporting is a regulated activity and compliance with the requirements is a must. Comply with the standards and regulations but also ensure your financial statements are an effective part of your wider communication with your stakeholders. It should be simple and understandable without any change in the interpretation.

2. Complete

The information disclosed in the financial statements should be complete and should not lead to any further cross questioning in the mind of the users. Ensure consistency of disclosures across the financial statements.

Example :

Where the accounting policy states that "Balances of debtors, creditors and loans and advances are subject to reconciliations and confirmations". This indicates that these

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balances may or may not be appropriately stated as well as raising questions regarding the appropriateness of the audit process.

3. Simple and specific

- Draft your notes, accounting policies, commentary on more complex areas in simple and plain English. Ensuring that there are no vague or ambiguous notes.

Example :

The definition of a derivative and a hedged item and how the company uses such items:

"A derivative is a type of financial instrument the company uses to manage risk. It is something that derives its value based on an underlying asset. It's generally in the form of a contract between two parties entered into for a fixed period. Underlying variables, such as exchange rates, will cause its value to change over time. A hedge is where the company uses a derivative to manage its underlying exposure. The company's main exposure is to fluctuation in foreign exchange risk. We manage this risk by hedging forex movements, in effecting the boundaries of exchange rate changes to manageable, affordable amounts."

- Make your policies clear and specific.
- Ensure that there should not be any vague or ambiguous notes, with no further information or explanation which may lead to misinterpretation of information.
- Reduce generic disclosures and focus on company specific disclosures that explain how the company applies the policies.

Example :

A note stated "Land not registered in the name of the company has been given for the use of group companies". However, there are no disclosures regarding such lease elsewhere in the financial statements. This leads to ambiguity regarding whether the land has been capitalized in the books of account or not.

A better disclosure would be to include this note in the note relating to 'Property, plant and Equipment' with an asterix against land and a note which states "Land includes area measuring XX acres, towards which the registration process is still in progress. This land has been given on lease to group companies."

4. Transparency

In preparation of financial statements many a times certain assumptions, or other bases are taken. Disclose those assumptions and bases transparently, so that they users are not misled. Rather such transparency shall provide useful additional information and substantiate your decision/judgement.

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5. Materiality

- The lack of clarity in how to apply the concept of materiality is perceived to be one of the main drivers for overloaded financial statements. Make effective use of materiality to enhance the clarity and conciseness of your financial statements.
- Information should only be disclosed if it is material. It is material if it could influence users' decisions which are based on the financial statements.
- Your materiality assessment is the 'filter' in deciding what information to disclose and what to omit.
- Once you have determined which specific line items require disclosure, you should assess what to disclose about these items, including how much detail to provide and how best to organise the information.

Example: Capital Commitments

A company has committed to purchase several items of property, plant and equipment. Individually each purchase is immaterial. However, the total amounts to a material commitment for the company and therefore some disclosure should be made regarding this commitment.

Example : New Revenue Stream

A company in the software sector has communicated to its stakeholders a strategic intention to focus its new development efforts in cloud-based solutions. In a particular financial year cloud-based revenues are less than 5% of the total but have grown rapidly. The company therefore decides to provide separate disclosure about this revenue stream in accordance with Ind AS 108 'Operating Segments' even though other revenue streams of similar size are typically combined into 'other revenue.'

6. Integration of Notes

- Notes cover the largest portion of the financial statements. They are an effective tool of communication and have the greatest impact on the effectiveness of your financial statements.
- Group notes into categories, place the most critical information more prominently or a combination of both.
- Integrate your main note of a line item with its accounting policy and any relevant key estimates and judgements.

Example: Inventories

1. Accounting Policy

Inventories are stated at the lower of cost and net realisable value. Cost includes all expenses directly attributable to the manufacturing process as well as suitable portions

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of related production overheads, based on normal operating capacity. Costs of ordinarily interchangeable items are assigned using the first in, first out cost formula. Net realisable value is the estimated selling price in the ordinary course of business less any applicable selling expenses.

2. Significant Estimation of Uncertainty

Management estimates the net realisable values of inventories, taking into account the most reliable evidence available at each reporting date. The future realisation of these inventories may be affected by future technology or other market-driven changes that may reduce future selling prices.

3. Inventories consist of the following: **(₹ in crores)**

	31st March, 20X2	31st March, 20X1
Raw materials and consumables	7,000	6,000
Merchandise	11,000	9,000
	18,000	15,000

- Ensuring that the accounting policies are disclosed in one place and not scattered across various notes.

  For example, in one case it was observed that the policy of recognizing 100% depreciation on assets costing less than ₹ 5,000 was specified in the note on fixed assets, rather than in the accounting policy for fixed assets.

7. Disclosure of Material Accounting Policies

- The financial statements should disclose your material accounting policies. Disclose only your material accounting policies – remove your non-material disclosures that do not add any value.
- Your disclosures should be relevant, specific to your company and explain how you apply your policies.
- The aim of accounting policy disclosures is to help your investors and other stakeholders to properly understand your financial statements.
- Use judgement to determine whether your accounting policies are material, considering not only the materiality of the balances or transactions affected by the policy but also other factors including the nature of the company's operations.

Example:

Taxable temporary differences arise on certain brands and licenses that were acquired in past business combinations. Management considers that these assets have an indefinite

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life and are expected to be consumed by use in the business. For these assets deferred tax is recognised using the capital gains tax applicable on sale.

8. Disclosures of Key Estimates and Judgements

- Effective disclosures about the most important estimates and judgements enable investors to understand your financial statements.
- Focus on the most difficult, subjective and complex estimates.
- Include details of how the estimate was derived, key assumptions involved, the process for reviewing and an analysis of its sensitiveness.
- Provide sufficient background information on the judgement, explain how the judgement was made and the conclusion reached.

9. Integrated Approach

- Financial statements are just one part of your communication with the stakeholders. An annual report typically includes financial statements, a management commentary and information about governance, strategy and business developments, CSR Reporting, Business Responsibility Reporting etc. There is also a growing trend towards integrated reporting.
- To ensure overall effective communication consider the annual report as a whole and deliver a consistent and coherent message throughout.
- Ind AS 1 also acknowledges that one may present, outside the financial statements, a financial review that describes and explains the main features of the company's financial performance and financial position, and the principal uncertainties it faces.
- Many companies also present, outside the financial statements, reports and statements such as environmental reports and value added statements, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group.
- Even though the reports and statements presented outside financial statements are outside the scope of AS / Ind AS, they are not out of the scope of regulation.

Example :

CSR disclosures, as required by the Companies Act, 2013. in section 134 and Schedule VII.

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5. CASE STUDIES BASED ON IND AS

Case Study 1

On 1 April 20X1, Star Limited has advanced a housing loan of ₹ 15 lakhs to one of its employees at an interest rate of 6% per annum which is repayable in 5 equal annual installments along with interest at each year end. Employee is not required to give any specific performance against this benefit. The market rate of similar loan for housing finance by banks is 10% per annum.

The accountant of the company has recognized the staff loan in the balance sheet equivalent to the amount of housing loan disbursed i.e. ₹ 15 lakhs. The interest income for the year is recognized at the contracted rate in the Statement of Profit and Loss by the company i.e. ₹ 90,000 (6% of ₹ 15 lakhs).

Analyze whether the above accounting treatment made by the accountant is in compliance with the relevant Ind AS. If not, advise the correct treatment of housing loan, interest and other expenses in the financial statements of Star Limited for the year 20X1-20X2 along with workings and applicable Ind AS.

You are required to explain how the housing loan should be reflected in the Ind AS compliant Balance Sheet of Star Limited on 31 March 20X2.

Solution

The accounting treatment made by the accountant is not in compliance with Ind AS 109 'Financial Instruments'. As per Ind AS 109, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value. The fair value of a financial instrument at initial recognition is normally the transaction price i.e. the fair value of the consideration given or received.

After initial recognition, an entity shall measure a financial asset either at amortised cost or at fair value through profit and loss or fair value through other comprehensive income.

Here, the loan given to employee is not at market rate. Hence, the fair value of the loan will not be equal to its initial loan proceeds. As per Ind AS 109, a financial instrument is initially measured and recorded in the books at its fair value. Further, interest income to be recognised in the Statement of Profit and Loss will be the finance income recognised at effective rate of interest i.e. @ 10% and not the rate of interest charged by the company i.e. @ 6%.

The correct accounting treatment as per Ind AS 109 will be as under:

For measuring the fair value or present value of the loan at initial recognition, market rate of interest of similar loan is considered (level 1 observable input) ie @ 10%, to discount the cash outflows.

The fair value of the loan shall be as follows:

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Date	Outstanding loan	Principal	Interest income @ 6%	Total inflow	Discount factor @ 10%	PV
31 March 20X2	15,00,000	3,00,000	90,000	3,90,000	0.909	3,54,510
31 March 20X3	12,00,000	3,00,000	72,000	3,72,000	0.826	3,07,272
31 March 20X4	9,00,000	3,00,000	54,000	3,54,000	0.751	2,65,854
31 March 20X5	6,00,000	3,00,000	36,000	3,36,000	0.683	2,29,488
31 March 20X6	3,00,000	3,00,000	18,000	3,18,000	0.621	1,97,478
Fair value of the loan						13,54,602

As per Ind AS 19, employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for termination of employment. Difference of loan proceeds and present value of the loan (fair value) will be treated as prepaid employee cost irrespective of the fact that employee is not required to give any specific performance against this benefit. This is because employee is required to be in service of the company to continue availing the benefits of concessional rate of interest on housing loan. Practically, once the employee leaves the organisation, they have to repay the outstanding loan because the company provides the loan at concessional rate of interest only to its employees.

Hence, it is an employee benefit given by the company to its employees. This deemed employee cost of ₹ 1,45,398 (15,00,000 – 13,54,602) will be deferred and amortised over the period of loan on straight line basis.

Calculation of amortised cost of loan to employees

Financial year ending on 31 March	Amortised cost (opening balance)	Interest to be recognised @ 10%	Repayment (including interest)	Amortised cost (closing balance)
20X2	13,54,602	1,35,460	3,90,000	11,00,062
20X3	11,00,062	1,10,006	3,72,000	8,38,068
20X4	8,38,068	83,807	3,54,000	5,67,875
20X5	5,67,875	56,788	3,36,000	2,88,663
20X6	2,88,663	29,337*	3,18,000	-

* 2,88,663 x 10% = ₹ 28,866. Difference of ₹ 471 (29,337 – 28,866) is due to approximation in computation.

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Journal Entries to be recorded at every period end:

1. On 1 April 20X1

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan to employee A/c	Dr.	13,54,602	
Prepaid employee cost A/c	Dr.	1,45,398	
To Bank A/c			15,00,000
(Being loan asset recorded at initial fair value)			

2. On 31 March 20X2

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	3,90,000	
To Finance income A/c (profit and loss) @10%			1,35,460
To Loan to employee A/c			2,54,540
(Being first instalment of repayment of loan accounted for using the amortised cost and effective interest rate @ 10%)			
Employee benefit cost (profit and loss) A/c	Dr.	29,080	
To Prepaid employee cost A/c (1,45,398/5)			29,080
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)			

The Following housing loan balances should appear in the financial statements:

Extracts of Balance sheet of Star Ltd. as at 31 March 20X2

Non-current asset	
Financial asset	
Loan to employee (11,00,062 – 3,72,000 + 1,10,006)	8,38,068
Other non-current asset	
Prepaid employee cost	87,238
Current asset	
Financial asset	
Loan to employee (3,72,000-1,10,006)	2,61,994
Other current asset	
Prepaid employee cost	29,080

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Deferred tax on temporary differences arising on the above-mentioned account balances (appearing in the balance sheet) should be recognised. However, in the absence of any tax rate in the question no deferred tax has been recognised.

Case Study 2

Pluto Ltd. has purchased a manufacturing plant for ₹ 6 lakhs on 1st April, 20X1. The useful life of the plant is 10 years. On 30th September, 20X3, Pluto temporarily stops using the manufacturing plant because demand has declined. However, the plant is maintained in a workable condition and it will be used in future when demand picks up.

The accountant of Pluto ltd. decided to treat the plant as held for sale until the demands picks up and accordingly measures the plant at lower of carrying amount and fair value less cost to sell.

Also, the accountant has also stopped charging the depreciation for the rest of period considering the plant as held for sale. The fair value less cost to sell on 30th September, 20X3 and 31st March, 20X4 was ₹ 4 lakhs and ₹ 3.5 lakhs respectively.

The accountant has performed the following working: ₹

Carrying amount on initial classification as held for sale		
Purchase Price of Plant	*6,00,000*	
Less: Accumulated dep (6,00,000/ 10 Years) x 2.5 years	*(1,50,000)*	*4,50,000*
Fair Value less cost to sell as on 30th September, 20X3		*4,00,000*
The value will be lower of the above two		*4,00,000*

Balance Sheet extracts as on 31st March, 20X4

Assets	
Current Assets	
Other Current Assets	
Assets classified as held for sale	*3,50,000*

Analyse whether the above accounting treatment made by the accountant is in compliance with the Ind AS. If not, advise the correct treatment alongwith the necessary workings.

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Solution:

The above treatment needs to be examined in the light of the provisions given in Ind AS 16 '*Property, Plant and Equipment*' and Ind AS 105 '*Non-current Assets Held for Sale and Discontinued Operations'*.

Para 6 of Ind AS 105 *'Non-current Assets Held for Sale and Discontinued Operations'* states that:

"An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use".

Paragraph 7 of Ind AS 105 states that:

"For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable. Thus, an asset (or disposal group) cannot be classified as a non-current asset (or disposal group) held for sale, if the entity intends to sell it in a distant future".

Further, paragraph 8 of Ind AS 105 states that:

"For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn."

Paragraph 13 of Ind AS 105 states that:

"An entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned. This is because its carrying amount will be recovered principally through continuing use."

Paragraph 14 of Ind AS 105 states that:

"An entity shall not account for a non-current asset that has been temporarily taken out of use as if it had been abandoned."

Paragraph 55 of Ind AS 16 states that:

"Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated."

Going by the guidance given above,

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The Accountant of Pluto Ltd. has treated the plant as held for sale and measured it at the fair value less cost to sell. Also, the depreciation has not been charged thereon since the date of classification as held for sale which is not correct and not in accordance with Ind AS 105 and Ind AS 16.

Accordingly, the manufacturing plant should neither be treated as abandoned asset nor as held for sale because its carrying amount will be principally recovered through continuous use. Pluto Ltd. shall not stop charging depreciation or treat the plant as held for sale because its carrying amount will be recovered principally through continuing use to the end of their economic life.

The working of the same for presenting in the balance sheet is given as below:

Calculation of carrying amount as on 31st March, 20X4	
Purchase Price of Plant	6,00,000
Less: Accumulated depreciation (6,00,000/ 10 Years) x 3 Years	(1,80,000)
	4,20,000
Less: Impairment loss	(70,000)
	3,50,000

Balance Sheet extracts as on 31st March, 20X4

Assets	
Non-Current Assets	
Property, Plant and Equipment	3,50,000

Working Note:

Fair value less cost to sell of the Plant = ₹ 3,50,000

Value in Use (not given) or = Nil (since plant has temporarily not been used for manufacturing due to decline in demand)

Recoverable amount = higher of above i.e. ₹ 3,50,000

Impairment loss = Carrying amount – Recoverable amount

Impairment loss = ₹ 4,20,000 - ₹ 3, 50,000 = ₹ 70,000.

Case Study 3

On 5th April, 20X2, fire damaged a consignment of inventory at one of the Jupiter's Ltd.'s warehouse. This inventory had been manufactured prior to 31st March, 20X2 costing ₹ 8 lakhs. The net realisable value of the inventory prior to the damage was estimated at ₹ 9.60 lakhs. Because of the damage caused to the consignment of inventory, the company was required to

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spend an additional amount of ₹ 2 lakhs on repairing and re-packaging of the inventory. The inventory was sold on 15th May, 20X2 for proceeds of ₹ 9 lakhs.

The accountant of Jupiter Ltd treats this event as an adjusting event and adjusted this event of causing the damage to the inventory in its financial statement and accordingly re-measures the inventories as follows: *₹ lakhs*

Cost	*8.00*
Net realisable value (9.6 -2)	*7.60*
Inventories (lower of cost and net realisable value)	*7.60*

Analyse whether the above accounting treatment made by the accountant in regard to financial year ending on 31.0.20X2 is in compliance of the Ind AS. If not, advise the correct treatment alongwith working for the same.

Solution:

The above treatment needs to be examined in the light of the provisions given in Ind AS 10 *'Events after the Reporting Period'* and *Ind AS 2 'Inventories'*.

Para 3 of Ind AS 10 *'Events after the Reporting Period'* defines *"Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue. Two types of events can be identified:*

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

Further, paragraph 10 of Ind AS 10 states that:

"An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period".

Further, paragraph 6 of Ind AS 2 defines:

"Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale".

Further, paragraph 9 of Ind AS 2 states that:

"Inventories shall be measured at the lower of cost and net realisable value".

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Accountant of Jupiter Ltd. has re-measured the inventories after adjusting the event in its financial statement which is not correct and nor in accordance with provision of Ind AS 2 and Ind AS 10.

Accordingly, the event causing the damage to the inventory occurred after the reporting date and as per the principles laid down under Ind AS 10 '*Events After the Reporting Date'* is a non-adjusting event as it does not affect conditions at the reporting date. Non-adjusting events are not recognised in the financial statements, but are disclosed where their effect is material.

Therefore, as per the provisions of Ind AS 2 and Ind AS 10, the consignment of inventories shall be recorded in the Balance Sheet at a value of ₹ 8 Lakhs calculated below: *₹' lakhs*

Cost	8.00
Net realisable value	9.60
Inventories (lower of cost and net realisable value)	8.00

Case Study 4

On 1st April, 20X1, Sun Ltd. has acquired 100% shares of Earth Ltd. for ₹ 30 lakhs. Sun Ltd. has 3 cash-generating units A, B and C with fair value of ₹ 12 lakhs, ₹ 8 lakhs and ₹ 4 lakhs respectively. The company recognizes goodwill of Rs 6 lakhs that relates to CGU 'C' only.

During the financial year 20X2-20X3, the CFO of the company has a view that there is no requirement of any impairment testing for any CGU since their recoverable amount is comparatively higher than the carrying amount and believes there is no indicator of impairment.

Analyse whether the view adopted by the CFO of Sun Ltd is in compliance of the Ind AS. If not, advise the correct treatment in accordance with relevant Ind AS

Solution

The above treatment needs to be examined in the light of the provisions given in Ind AS 36: Impairment of Assets.

Para 9 of Ind AS 36 *'Impairment of Assets'* states that *"An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset."*

Further, paragraph 10(b) of Ind AS 36 states that:

"Irrespective of whether there is any indication of impairment, an entity shall also test goodwill acquired in a business combination for impairment annually."

Sun Ltd has not tested any CGU on account of not having any indication of impairment is partially correct i.e. in respect of CGU A and B but not for CGU C. Hence, the treatment made by the Company is not in accordance with Ind AS 36.

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Accordingly, impairment testing in respect of CGU A and B are not required since there are no indications of impairment. However, Sun Ltd shall test CGU C irrespective of any indication of impairment annually as the goodwill acquired on business combination is fully allocated to CGU 'C'.

Case Study 5

Deepak started a new company Softbharti Pvt. Ltd. with Iktara Ltd. wherein investment of 55% is done by Iktara Ltd. and rest by Deepak. Voting powers are to be given as per the proportionate share of capital contribution. The new company formed was the subsidiary of Iktara Ltd. with two directors, and Deepak eventually becomes one of the directors of company. A consultant was hired and he charged ₹ 30,000 for the incorporation of company and to do other necessary statuary registrations. ₹ 30,000 is to be charged as an expense in the books after incorporation of company. The company, Softbharti Pvt. Ltd. was incorporated on 1st April 20X1.

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

An accountant who was hired at the time of company's incorporation, has prepared the draft financials of Softbharti Pvt. Ltd. for the year ending 31st March, 20X2 as follows:

Statement of Profit and Loss

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

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Balance Sheet

Particulars	Amount (₹)
EQUITY AND LIABILITIES	
(1) Shareholders' Funds	
(a) Share Capital	1,00,000
(b) Reserves & Surplus	2,27,500
(2) Non-Current Liabilities	
(a) Long Term Provisions	25,000
(b) Deferred tax liabilities	6,000
(3) Current Liabilities	
(a) Trade Payables	11,000
(b) Other Current Liabilities	45,000
(c) Short Term Provisions	1,06,500
TOTAL	**5,21,000**
ASSETS	
(1) Non Current Assets	
(a) Property, plant and equipment (net)	1,00,000
(b) Long-term Loans and Advances	40,000
(c) Other Non Current Assets	50,000
(2) Current Assets	
(a) Current Investment	30,000
(b) Inventories	80,000
(c) Trade Receivables	55,000
(d) Cash and Bank Balances	1,15,000
(e) Other Current Assets	51,000
TOTAL	**5,21,000**

Additional information of Softbharti Pvt Ltd.:

i. Deferred tax liability of ₹ 6,000 is created due to following temporary difference:

Difference in depreciation amount as per Income tax and Accounting profit

ii. There is only one property, plant and equipment in the company, whose closing balance as at 31st March, 20X2 is as follows:

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

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iii. Pre incorporation expenses are deductible on straight line basis over the period of five years as per Income tax. However, the same are immediately expensed off in the books.

iv. Current tax is calculated at 30% on PBT - ₹ 3,55,000 without doing any adjustments related to Income tax. The correct current tax after doing necessary adjustments of allowances / disallowances related to Income tax comes to ₹ 1,25,700.

v. After the reporting period, the directors have recommended dividend of ₹ 15,000 for the year ending 31st March, 20X2 which has been deducted from reserves and surplus. Dividend payable of ₹ 15,000 has been grouped under 'other current liabilities' alongwith other financial liabilities.

vi. There are 'Government statuary dues' amounting to ₹ 15,000 which are grouped under 'other current liabilities'.

vii. The capital advances amounting to ₹ 50,000 are grouped under 'Other non-current assets'.

viii. Other current assets of ₹ 51,000 comprise Interest receivable from trade receivables.

ix. Current investment of ₹ 30,000 is in shares of a company which was done with the purpose of trading; current investment has been carried at cost in the financial statements. The fair value of current investment in this case is ₹ 50,000 as at 31st March, 20X2.

x. Actuarial gain on employee benefit measurements of ₹ 1,000 has been omitted in the financials of Softbharti private limited for the year ending 31st March, 20X2.

The financial statements for financial year 20X1-20X2 have not been yet approved.

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

Solution

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

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

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

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

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STATEMENT OF PROFIT AND LOSS
for the year ended 31st March, 20X2

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

BALANCE SHEET

as at 31st March, 20X2

Particulars	(₹)
ASSETS	
Non-current assets	
Property, plant and equipment	1,00,000
Financial assets	

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

STATEMENT OF CHANGES IN EQUITY

For the year ended 31st March, 20X2

A. EQUITY SHARE CAPITAL

	Balance (₹)
As at 31st March, 20X1	-
Changes in equity share capital during the year	1,00,000
As at 31st March, 20X2	1,00,000

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B. OTHER EQUITY

	Reserves & Surplus
	Retained Earnings (₹)
As at 31st March, 20X1	-
Profit for the year	2,44,500
Other comprehensive income for the year	700
Total comprehensive income for the year	2,45,200
Less: Dividend on equity shares (refer note – 4)	-
As at 31st March, 20X2	2,45,200

DISCLOSURE FORMING PART OF FINANCIAL STATEMENTS:

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

Notes:

1. Current investment are held for the purpose of trading. Hence, it is a financial asset classified as FVTPL. Any gain in its fair value will be recognised through profit or loss. Hence, ₹ 20,000 (₹ 50,000 – ₹ 30,000) increase in fair value of financial asset will be recognised in profit and loss. However, it will attract deferred tax liability on increased value (Refer W.N).
2. Assets for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
3. Liabilities for which there is no contractual obligation to deliver cash or other financial asset to another entity, are not financial liabilities.
4. As per Ind AS 10, 'Events after the Reporting Period', If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognized as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with Ind AS 1, Presentation of Financial Statements.
5. Other current financial liabilities:

	(₹)
Balance of other current liabilities as per financial statements	45,000
Less: Dividend declared for FY 20X1 – 20X2 (Note – 4)	(15,000)
Reclassification of government statuary dues payable to 'other current liabilities'	(15,000)
Closing balance	15,000

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Working Note:

Calculation of deferred tax on temporary differences as per Ind AS 12 for financial year 20X1 – 20X2

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

Case Study 6

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

(a) Owing to the proposed schedules of Indian Hockey League as well as Cricket Premier Tournament, Mumbai Challengers Ltd. needs a new stadium to host the sporting events. This stadium will form a part of the Property, Plant and Equipment of the company. Mumbai Challengers Ltd. began the construction of the stadium on 1 December, 20X1. The construction of the stadium was completed in 20X2-20X3. Costs directly related to the construction amounted to ₹ 140 crores in December 20X1. Thereafter, ₹ 350 crores have been incurred per month until the end of the financial year. The company has not taken any specific borrowings to finance the construction of the stadium, although it has incurred finance costs on its regular overdraft during the period, which were avoidable had the stadium not been constructed. Mumbai Challengers Ltd. has calculated that the weighted average cost of the borrowings for the period 1 December 20X1 to 31 March 20X2 amounted to 15% per annum on an annualized basis.

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

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

At the end of each season, which happens to also be the reporting period end for Mumbai Challengers Ltd., the club reviews its contracts with the players and makes decisions as to whether they wish to sell/transfer any players' registrations. The company actively markets

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these registrations by circulating with other clubs a list of players' registrations and their estimated selling price. Players' registrations are also sold during the season, often with performance conditions attached. In some cases, it becomes clear that a player will not play for the club again because of, for example, a player sustaining a career threatening injury or being permanently removed from the playing squad for any other reason. The playing registrations of certain players were sold after the year end, for total proceeds, net of associated costs, of ₹ 175 crores. These registrations had a net book value of ₹ 49 crores.

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

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

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

Solution:

(a) Borrowing Costs

As per Ind AS 23 *Borrowing Costs*, an entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset (i.e. an asset that necessarily takes a substantial period of time to get ready for its intended use or sale) as part of the cost of that asset. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period.

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

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Particulars	₹ in crores
Costs incurred in December 20X1: (₹ 140 crores x 15% x 4/12)	7.000
Costs incurred in January 20X2: (₹ 350 crores x 15% x 3/12)	13.125
Costs incurred in February 20X2: (₹ 350 crores x 15% x 2/12)	8.750
Costs incurred in March 20X2: (₹ 350 crores x 15% x 1/12)	4.375
Borrowing Costs to be capitalized in 20X1-X2	**33.250**

OR

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

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

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

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

(b) Players' Registrations

Acquisition

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

Sale of registrations

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

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those registrations are classified as held for sale where unconditional offers have been received prior to the reporting date.

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

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

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

Impairment review

Ind AS 36 *Impairment of Assets* requires companies to **annually test their assets for impairment**. An asset is said to be impaired if the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is higher of the asset's fair value less costs to sell and its value in use (which is the present value of future cash flows expected to arise from the use of the asset). In the given scenario, it is not easy to determine the value in use of any player in isolation as that player cannot generate cash flows on his/her own unless via a sale transaction or an insurance recovery. Whilst any individual player cannot really be separated from the single cash-generating unit (CGU), being a cricket team or a hockey team in the instant case, there may be certain instances where a player is taken out of the CGU when it becomes clear that he/she will not play for the club again. If such circumstances arise, the **carrying amount of the player should be assessed against the best estimate of the player's fair value less any costs to sell and an impairment charge should be recognized in the profit or loss**, which reflects any loss arising.

(c) Valuation of stadiums

In terms of Ind AS 113 *Fair Value Measurement*, stadiums would be valued at the **price which would be received to sell the asset in an orderly transaction between market participants** at the measurement date (i.e. exit price). The price would be the one which **maximizes the value of the asset** or the group of assets using the principle of the highest and best use. The price would essentially use Level 2 inputs which are inputs other than quoted market prices included within Level 1 which are observable for the asset or liability, either directly or indirectly. Property naming rights present complications when valuing property. The status of the property indicates its suitability for inviting sponsorship attached

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to its name. It has nothing to do with the property itself but this can be worth a significant amount. Therefore, Mumbai Challengers Ltd. could include the property naming rights in the valuation of the stadium and write it off over three years.

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

Case Study 7

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

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

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

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

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

Solution

(a) Joint Arrangement

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

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

Property, Plant and Equipment	Dr.	xxx	
To Provision for Dismantling, Removal and Restoration			xxx

Neelanchal Gas Refinery Ltd. should recognize 60% of the cost of decommissioning of the underground storage facility. However, in line Para 29 of Ind AS 37 where an entity is jointly

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and severally liable for an obligation, **the part of the obligation that is expected to be met by other parties is treated as a contingent liability**. Accordingly, Neelanchal Gas Refinery Ltd. should also disclose 40% of the cost of decommissioning of the underground facility as a contingent liability, should there arise future events that prevent Seemanchal Refineries Ltd. from fulfilling its obligations under the arrangement.

As per Ind AS 16, Property, Plant and Equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

Thus, Neelanchal Gas Refinery Ltd. should classify and account for its share of irrecoverable gas as property, plant and equipment, as the irrecoverable gas is necessary for the storage facility to perform its function. Therefore, the **irrecoverable gas, being a part of the storage facility, should be capitalized as a component of the storage facility asset**, and should be depreciated to its residual value over the life of the storage facility. However, if the gas is recoverable in full upon decommissioning of the storage facility, then depreciation against the irrecoverable gas component will be recorded only if the estimated residual value of the gas decreases below cost during the life of the facility. Upon decommissioning of the storage facility, when the cushion gas is extracted and sold, the sale of irrecoverable gas is accounted as a disposal of an item of property, plant and equipment in accordance with Ind AS 16 and the resulting gain or loss is recognized in the Statement of Profit and Loss. The natural gas in excess of the irrecoverable gas which is injected into the facility would be treated as inventory in accordance with Ind AS 2 *Inventories*.

(b) Contract with Uttaranchal Refineries Pvt. Ltd.

As per para 2.4 of Ind AS 109 *Financial Instruments,* this standard applies to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, **with the exception** of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (i.e. own use contracts). This contract will result in physical delivery of the commodity i.e. extra gas.

Para 2.5 of Ind AS 109 further provides that a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency

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(sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard.

There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

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

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

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

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TEST YOUR KNOWLEDGE

Questions

1. Venus Ltd. is a multinational entity that owns three properties. All three properties were purchased on 1st April, 20X1. The details of purchase price and market values of the properties are given as follows:

Particulars	Property 1	Property 2	Property 3
	Factory	Factory	Let-Out
Purchase price	15,000	10,000	12,000
Market value 31.03.20X2	16,000	11,000	13,500
Life	10 Years	10 Years	10 Years
Subsequent Measurement	Cost Model	Revaluation Model	Revaluation Model

Property 1 and 2 are used by Venus Ltd. as factory building whilst property 3 is let-out to a non-related party at a market rent. The management presents all three properties in balance sheet as 'property, plant and equipment'.

The Company does not depreciate any of the properties on the basis that the fair values are exceeding their carrying amount and recognise the difference between purchase price and fair value in Statement of Profit and Loss.

Required:

Analyse whether the accounting policies adopted by the Venus Ltd. in relation to these properties is in accordance with Ind AS. If not, advise the correct treatment alongwith working for the same.

2. On 1st January, 20X2, Sun Ltd. was notified that a customer was taking legal action against the company in respect of a financial losses incurred by the customer. Customer alleged that the financial losses were caused due to supply of faulty products on 30th September, 20X1 by the Company. Sun Ltd. defended the case but considered, based on the progress of the case up to 31st March, 20X2, that there was a 75% probability they would have to pay damages of ₹ 10 lakhs to the customer.

However, the accountant of Sun Ltd. has not recorded this transaction in its financial statement as the case is not yet finally settled. The case was ultimately settled against the company resulting in to payment of damages of ₹ 12 lakhs to the customer on 15th May, 20X2. The financials have been authorized by the Board of Directors in its meeting held on 18th May, 20X2.

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Analyse whether the above accounting treatment made by the accountant is in compliance of the Ind AS. If not, advise the correct treatment along with working for the same.

3. Mercury Ltd. is an entity engaged in plantation and farming on a large scale diversified across India. On 1st April, 20X1, the company has received a government grant for ₹ 10 lakhs subject to a condition that it will continue to engage in plantation of eucalyptus tree for a coming period of five years. Eucalyptus trees are not considered as bearer plant in this case.

   The management has a reasonable assurance that the entity will comply with condition of engaging in the plantation of eucalyptus tree for specified period of five years and accordingly it recognises proportionate grant for ₹ 2 lakhs in Statement of Profit and Loss as income following the principles laid down under *Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance*.

   Analyse whether the above accounting treatment made by the management is in compliance of the Ind AS. If not, advise the correct treatment alongwith working for the same.

4. Mercury Ltd. has sold goods to Mars Ltd. at a consideration of ₹ 10 lakhs, the receipt of which receivable in three equal installments of ₹ 3,33,333 over a two year period (receipts on 1st April, 20X1, 31st March, 20X2 and 31st March, 20X3).

   The company is offering a discount of 5 % (i.e. ₹ 50,000) if payment is made in full at the time of sale. The sale agreement reflects an implicit interest rate of 5.36% p.a.

   The total consideration to be received from such sale is at ₹ 10 Lakhs and hence, the management has recognised the revenue from sale of goods for ₹ 10 lakhs.

   Analyse whether the above accounting treatment made by the accountant is in compliance of the Ind AS. If not, advise the correct treatment along with working for the same.

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

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

Particulars	₹
ASSETS	
Non-current assets	
Property, plant and equipment	85,37,500
Financial assets	
Other financial assets (Security deposits)	4,62,500

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Other non-current assets (capital advances)	17,33,480
Deferred tax assets	2,54,150
Current assets	
Trade receivables	7,25,000
Inventories	5,98,050
Financial assets	
Investments	55,000
Other financial assets	2,17,370
Cash and cash equivalents	1,16,950
TOTAL ASSETS	**1,27,00,000**
EQUITY AND LIABILITIES	
Equity share capital	10,00,000
Non-current liabilities	
Other Equity	25,00,150
Deferred tax liability	4,74,850
Borrowings	64,00,000
Long term provisions	5,24,436
Current liabilities	
Financial liabilities	
Other financial liabilities	2,00,564
Trade payables	6,69,180
Current tax liabilities	9,30,820
TOTAL EQUITY AND LIABILITIES	**1,27,00,000**

Additional Information:

1. On 1st April 20X1, 8% convertible loan with a nominal value of ₹ 64,00,000 was issued by the entity. It is redeemable on 31st March 20X5 also at par. Alternatively, it may be converted into equity shares on the basis of 100 new shares for each ₹ 200 worth of loan.

   An equivalent loan without the conversion option would have carried interest at 10%. Interest of ₹ 5,12,000 has already been paid and included as a finance cost.

   Present Value (PV) rates are as follows:

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Year End	@ 8%	@ 10%
1	0.93	0.91
2	0.86	0.83
3	0.79	0.75
4	0.73	0.68

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

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

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

4. Property, Plant and Equipment consists following items:

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

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

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

6. Current Investments consist of securities held for trading which are carried at fair value through profit & loss. Investments were purchased on 1st January,20X2 at

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₹ 55,000 and accordingly are shown at cost as at 31st March 20X2. The fair value of said investments as on 31st March 20X2 is ₹ 60,000.

7. Trade payables and Trade receivables are due within 12 months.

8. There has been no changes in equity share capital during the year.

9. Entity has the intention to set off a deferred tax asset against a deferred tax liability as they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off taxes.

10. Other Equity consists retained earnings only. The opening balance of retained earnings was ₹ 21,25,975 as at 1st April 20X1.

11. No dividend has been actually paid by company during the year.

12. Assume that the deferred tax impact, if any on account of above adjustments is correctly calculated in financials.

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

6. HIM Limited having net worth of ₹ 250 crores is required to adopt Ind AS from 1st April, 20X2 in accordance with the Companies (Indian Accounting Standard) Rules 2015.

Rahul, the senior manager, of HIM Ltd. has identified following issues which need specific attention of CFO so that opening Ind AS balance sheet as on the date of transition can be prepared:

Issue 1 : As part of Property, Plant and Equipment, Company has elected to measure land at its fair value and want to use this fair value as deemed cost on the date of transition. The carrying value of land as on the date of transition was ₹ 5,00,000. The land was acquired for a consideration of ₹ 5,00,000. However, the fair value of land as on the date of transition was ₹ 8,00,000.

Issue 2 : Under Ind AS, the Company has designated mutual funds as investments at fair value through profit or loss. The value of mutual funds as per previous GAAP was ₹ 4,00,000 (at cost). However, the fair value of mutual funds as on the date of transition was ₹ 5,00,000.

Issue 3 : Company had taken a loan from another entity. The loan carries an interest rate of 7% and it had incurred certain transaction costs while obtaining the same. It was carried at cost on its initial recognition. The principal amount is to be repaid in equal instalments over the period of loan. Interest is also payable at each year end. The fair value of loan as

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on the date of transition is ₹ 1,80,000 as against the carrying amount of loan which at present equals ₹ 2,00,000.

Issue 4 : The company has declared dividend of ₹ 30,000 for last financial year. On the date of transition, the declared dividend has already been deducted by the accountant from the company's 'Reserves & Surplus' and the dividend payable has been grouped under 'Provisions'. The dividend was only declared by board of directors at that time and it was not approved in the annual general meeting of shareholders. However, subsequently when the meeting was held it was ratified by the shareholders.

Issue 5 : The company had acquired intangible assets as trademarks amounting to ₹ 2,50,000. The company assumes to have indefinite life of these assets. The fair value of the intangible assets as on the date of transition was ₹ 3,00,000. However, the company wants to carry the intangible assets at ₹ 2,50,000 only.

Issue 6 : After consideration of possible effects as per Ind AS, the deferred tax impact is computed as ₹ 25,000. This amount will further increase the portion of deferred tax liability. There is no requirement to carry out the separate calculation of deferred tax on account of Ind AS adjustments.

Management wants to know the impact of Ind AS in the financial statements of company for its general understanding.

Prepare Ind AS Impact Analysis Report (Extract) for HIM Limited for presentation to the management wherein you are required to discuss the corresponding differences between Earlier IGAAP (AS) and Ind AS against each identified issue for preparation of transition date balance sheet. Also pass journal entry for each issue.

Answers

1. The above issue needs to be examined in the umbrella of the provisions given in Ind AS 1 '*Presentation of Financial Statements'*, Ind AS 16 *'Property, Plant and Equipment'* in relation to property '1' and '2' and *Ind AS 40 'Investment Property'* in relation to property '3'.

Property '1' and '2'

Para 6 of Ind AS 16 '*Property, Plant and Equipment'* defines:

"Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period."

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Paragraph 29 of Ind AS 16 states that:

"An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment".

Further, paragraph 36 of Ind AS 16 states that:

"If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued".

Further, paragraph 39 of Ind AS 16 states that:

"If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss".

Further, paragraph 52 of Ind AS 16 states that:

"Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount".

Property '3'

Para 6 of Ind AS 40 '*Investment property*' defines:

"Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business".

Further, paragraph 30 of Ind AS 40 states that:

"An entity shall adopt as its accounting policy the cost model to all of its investment property".

Further, paragraph 79 (e) of Ind AS 40 requires that:

"An entity shall disclose the fair value of investment property".

Further, paragraph 54 (2) of Ind AS 1 '*Presentation of Financial Statements*' requires that:

"As a minimum, the balance sheet shall include line items that present the following amounts:

(a) property, plant and equipment;

(b) investment property;

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As per the facts given in the question, Venus Ltd. has

(a) presented all three properties in balance sheet as 'property, plant and equipment';

(b) applied different accounting policies to Property '1' and '2';

(c) revaluation is charged in statement of profit and loss as profit; and

(d) applied revaluation model to Property '3' being classified as Investment Property.

These accounting treatment is neither correct nor in accordance with provision of Ind AS 1, Ind AS 16 and Ind AS 40.

Accordingly, Venus Ltd. shall apply the same accounting policy (i.e. either revaluation or cost model) to entire class of property being property '1' and '2". It also required to depreciate these properties irrespective of that, their fair value exceeds the carrying amount. The revaluation gain shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.

There is no alternative of revaluation model in respect to property '3' being classified as Investment Property and only cost model is permitted for subsequent measurement. However, Venus ltd. is required to disclose the fair value of the property in the Notes to Accounts. Also the property '3' shall be presented as separate line item as Investment Property.

Therefore, as per the provisions of Ind AS 1, Ind AS 16 and Ind AS 40, the presentation of these three properties in the balance sheet is as follows:

Case 1: Venus Ltd. has applied the Cost Model to an entire class of property, plant and equipment.

Balance Sheet (extracts) as at 31st March, 20X2 ₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	13,500	
Property '2'	9,000	22,500
Investment Properties		
Property '3'		10,800

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Case 2: Venus Ltd. has applied the Revaluation Model to an entire class of property, plant and equipment.

Balance Sheet (extracts) as at 31st March, 20X2 ₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	16,000	
Property '2'	11,000	27,000
Investment Properties		
Property '3'		10,800
Equity and Liabilities		
Other Equity		
Revaluation Reserve		
Property '1' [16,000 – (15,000 – 1,500)]	2,500	
Property '2' [11,000 – (10,000 – 1,000)]	2,000	4,500

The revaluation reserve should be routed through Other Comprehensive Income (subsequently not reclassified to Profit and Loss) in Statement of Profit and Loss and shown in a separate column under Statement of Changes in Equity.

2. The above treatment needs to be examined in the light of the provisions given in Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets' and Ind AS 10 'Events After the Reporting Period'.

Para 10 of Ind AS 37 *'Provisions, Contingent Liabilities and Contingent Assets'* defines:

"Provision is a liability of uncertain timing or amount.

Liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits".

Further, paragraph 14 of Ind AS 37, states:

"A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

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(c) a reliable estimate can be made of the amount of the obligation".

Further, paragraph 36 of Ind AS 37, states:

"The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period".

Further, paragraph 3 of Ind AS 10 *'Events after the Reporting Period'* defines:

"Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue. Two types of events can be identified:

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

Further, paragraph 8 of Ind AS 10 states that:

"An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period."

The Accountant of Sun Ltd. has not recognised the provision and accordingly not adjusted the amounts recognised in its financial statements to reflect adjusting events after the reporting period is not correct and nor in accordance with provision of Ind AS 37 and Ind AS 10.

As per given facts, the potential payment of damages to the customer is an obligation arising out of a past event which can be reliably estimated. Therefore, following the provision of Ind AS 37 '*Provisions, Contingent Liabilities and Contingent Assets'* – a provision is required. The provision should be for the best estimate of the expenditure required to settle the obligation at 31st March, 20X2 which comes to ₹ 7.5 lakhs (₹ 10 lakhs x 75%).

Further, following the principles of Ind AS 10 '*Events After the Reporting Period'* evidence of the settlement amount is an adjusting event. Therefore, the amount of provision created shall be increased to ₹ 12 lakhs and accordingly be recognised as a current liability.

3. As per given facts, the company is engaged in plantation and farming. Hence Ind AS 41 Agriculture shall be applicable to this company.

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The above facts need to be examined in the light of the provisions given in *Ind AS 20* '*Accounting for Government Grants and Disclosure of Government Assistance'* and *Ind AS 41 'Agriculture'.*

Para 2(d) of Ind AS 20 *'Accounting for Government Grants and Disclosure of Government Assistance'* states:

"This Standard does not deal with government grants covered by Ind AS 41, Agriculture".

Further, paragraph 1 (c) of Ind AS 41 *'Agriculture'*, states:

"This Standard shall be applied to account for the government grants covered by paragraphs 34 and 35 when they relate to agricultural activity".

Further, paragraph 1 (c) of Ind AS 41 *'Agriculture'*, states:

"If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met".

Understanding of the given facts, The Company has recognised the proportionate grant for ₹ 2 lakhs in Statement of Profit and Loss before the conditions attaching to government grant are met which is not correct and nor in accordance with provision of Ind AS 41 *'Agriculture'*.

Accordingly, the accounting treatment of government grant received by the Mercury Ltd. is governed by the provision of Ind AS 41 *'Agriculture'* rather Ind AS 20 *'Accounting for Government Grants and Disclosure of Government Assistance'.*

Government grant for ₹ 10 lakhs shall be recognised in profit or loss when, and only when, the conditions attaching to the government grant are met i.e. after the expiry of specified period of five years of continuing engagement in the plantation of eucalyptus tree.

Balance Sheet extracts showing the presentation of Government Grant as on 31st March, 20X2 ₹

Liabilities	
Non-Current liabilities	
Other Non-Current Liabilities	
Government Grants	10,00,000

4. The revenue from sale of goods shall be recognised at the fair value of the consideration received or receivable. The fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest where the receipt is deferred beyond normal

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credit terms. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue.

The fair value of consideration (cash price equivalent) of the sale of goods is calculated as follows: ₹

Year	Consideration (Installment)	Present value factor	Present value of consideration
Time of sale	3,33,333	-	3,33,333
End of 1st year	3,33,333	0.949	3,16,333
End of 2nd year	3,33,334	0.901	3,00,334
	10,00,000		**9,50,000**

The Company that agrees for deferring the cash inflow from sale of goods will recognise the revenue from sale of goods and finance income as follows:

Initial recognition of sale of goods		₹	₹
Cash	Dr.	3,33,333	
Trade Receivable	Dr.	6,16,667	
To Sale			9,50,000
Recognition of interest expense and receipt of second installment			
Cash	Dr.	3,33,333	
To Interest Income			33,053
To Trade Receivable			3,00,280
Recognition of interest expense and payment of final installment			
Cash	Dr.	3,33,334	
To Interest Income (Balancing figure)			16,947
To Trade Receivable			3,16,387

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

₹

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

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

₹

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

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

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

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

Statement of changes in equity
For the year ended 31st March, 20X2

A. Equity Share Capital

	Balance (₹)
As at 31st March, 20X1	10,00,000
Changes in equity share capital during the year	-
As at 31st March, 20X2	10,00,000

B. Other Equity

	Retained Earnings (₹)	Equity component of Compound Financial Instrument (₹)	Total (₹)
As at 31st March, 20X1	21,25,975	-	21,25,975
Total comprehensive income for the year (25,00,150 + 5,000 - 85,504- 21,25,975)	2,93,671	-	2,93,671
Issue of compound financial instrument during the year	-	4,24,960	4,24,960
As at 31st March, 20X2	**24,19,646**	**4,24,960**	**28,44,606**

Disclosure forming part of Financial Statements:

Proposed dividend on equity shares is subject to the approval of the shareholders of the company at the annual general meeting and not recognized as liability as at the Balance Sheet date. (Note 9)

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Notes/ Workings: (for adjustments/ explanations)

1. Property, plant and equipment are tangible items that: (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one period. Therefore, the items of PPE are Buildings (₹ 37,50,250) and Vehicles (₹ 12,37,500), since those assets are held for administrative purposes.
2. Property, plant and equipment which are not ready for intended use as on the date of Balance Sheet are disclosed as "Capital work-in-progress". It would be classified from PPE to Capital work-in-progress.
3. Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

   (a) use in the production or supply of goods or services or for administrative purposes; or

   (b) sale in the ordinary course of business.

   Therefore, Land held for capital appreciation should be classified as Investment property rather than PPE.
4. Assets for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
5. Current investments here are held for the purpose of trading. Hence, it is a financial asset classified as FVTPL. Any gain in its fair value will be recognised through profit or loss. Hence, ₹ 5,000 (60,000 – 55,000) increase in fair value of financial asset will be recognised in profit and loss.
6. A contractual right to receive cash or another financial asset from another entity is a financial asset. Trade receivables is a financial asset in this case and hence should be reclassified.
7. Cash is a financial asset. Hence it should be reclassified.
8. Other current financial assets:

Particulars	Amount (₹)
Interest accrued on bank deposits	57,720
Royalty receivable from dealers	69,650
Total	1,27,370

Prepaid expenses does not result into receipt of any cash or financial asset. However, it results into future goods or services. Hence, it is not a financial asset.

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9. As per Ind AS 10, 'Events after the Reporting Period', If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognized as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with Ind AS 1, Presentation of Financial Statements.

10. 'Other Equity' cannot be shown under 'Non-current liabilities'. Accordingly, it is reclassified under 'Equity'.

11. There are both 'equity' and 'debt' features in the instrument. An obligation to pay cash i.e. interest at 8% per annum and a redemption amount will be treated as 'financial liability' while option to convert the loan into equity shares is the equity element in the instrument. Therefore, convertible loan is a compound financial instrument.

Calculation of debt and equity component and amount to be recognised in the books:

S. No	Year	Interest amount @ 8%	Discounting factor @ 10%	Amount
Year 1	20X2	5,12,000	0.91	4,65,920
Year 2	20X3	5,12,000	0.83	4,24,960
Year 3	20X4	5,12,000	0.75	3,84,000
Year 4	20X5	69,12,000	0.68	47,00,160
Amount to be recognised as a liability				59,75,040
Initial proceeds				(64,00,000)
Amount to be recognised as equity				4,24,960

* In year 4, the loan note will be redeemed; therefore, the cash outflow would be ₹ 69,12,000 (₹ 64,00,000 + ₹ 5,12,000).

Presentation in the Financial Statements:

In Statement of Profit and Loss for the year ended on 31 March 20X2

Finance cost to be recognised in the Statement of Profit and Loss (59,75,040 x 10%)	₹ 5,97,504
Less: Already charged to the Statement of Profit and Loss	(₹ 5,12,000)
Additional finance charge required to be recognised in the Statement of Profit and Loss	₹ 85,504

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In Balance Sheet as at 31 March 20X2

Equity and Liabilities	
Equity	
Other Equity (8% convertible loan)	4,24,960
Non-current liability	
Financial liability [8% convertible loan – [(59,75,040+ 5,97,504–5,12,000)]	60,60,544

12. Since entity has the intention to set off deferred tax asset against deferred tax liability and the entity has a legally enforceable right to set off taxes, hence their balance on net basis should be shown as:

Particulars	Amount (₹)
Deferred tax liability	4,74,850
Deferred tax asset	(2,54,150)
Deferred tax liability (net)	2,20,700

13. A liability that is a contractual obligation to deliver cash or another financial asset to another entity is a financial liability. Trade payables is a financial liability in this case.

14. 'Other current financial liabilities':

Particulars	Amount (₹)
Wages payable	21,890
Salary payable	61,845
Interest accrued on trade payables	35,564
Total	1,19,299

15. Liabilities for which there is no contractual obligation to deliver cash or other financial asset to another entity, are not financial liabilities. Hence, TDS payable should be reclassified from 'Other current financial liabilities' to 'Other current liabilities' since it is not a contractual obligation.

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6. Assessment of Preliminary Impact Assessment of Transition to Ind AS on Him Limited's Financial Statements

Issue 1: Fair value as deemed cost for property plant and equipment:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS 10, Property, Plant and Equipment is recognised at cost less depreciation.	Ind AS 101 allows entity to elect to measure Property, Plant and Equipment on the transition date at its fair value or previous GAAP carrying value (book value) as deemed cost.	The company has decided to adopt fair value as deemed cost in this case. Since fair value exceeds book value, so the book value should be brought up to fair value. The resulting impact of fair valuation of land ₹ 3,00,000 should be adjusted in other equity.

Journal Entry on the date of transition

Particulars		Debit (₹)	Credit (₹)
Property Plant and Equipment	Dr.	3,00,000	
To Revaluation Surplus (OCI- Other Equity)			3,00,000

Issue 2: Fair valuation of Financial Assets:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per Accounting Standard, investments are measured at lower of cost and fair value.	On transition, financial assets including investments are measured at fair values except for investments in subsidiaries, associates and JVs' which are recorded at cost.	All financial assets (other than Investment in subsidiaries, associates and JVs' which are recorded at cost) are initially recognized at fair value. The subsequent measurement of such assets are based on its categorization either Fair Value through Profit & Loss (FVTPL) or Fair Value through Other Comprehensive Income (FVTOCI) or at Amortised Cost based on business model assessment and contractual cash flow characteristics. Since investment in mutual fund are designated at FVTPL, increase of ₹ 1,00,000 in mutual funds fair value

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		would increase the value of investments with corresponding increase to Retained Earnings.

Journal Entry on the date of transition

Particulars		Debit (₹)	Credit (₹)
Investment in mutual funds	Dr.	1,00,000	
To Retained earnings			1,00,000

Issue 3: Borrowings - Processing fees/transaction cost:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, such expenditure is charged to Profit and loss account or capitalised as the case may be	As per Ind AS, such expenditure is amortised over the period of the loan. Ind AS 101 states that if it is impracticable for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind AS shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability.	Fair value as on the date of transition is ₹ 1,80,000 as against its book value of ₹ 2,00,000. Accordingly, the difference of ₹ 20,000 is adjusted through retained earnings.

Journal Entry on the date of transition

Particulars		Debit (₹)	Credit (₹)
Borrowings / Loan payable	Dr.	20,000	
To Retained earnings			20,000

Issue 4: Proposed dividend:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, provision for proposed divided is made in the year when it has been	As per Ind AS, liability for proposed dividend is recognised in the	Since dividend should be deducted from retained earnings during the year when it has been declared and approved. Therefore, the provision

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declared and approved.	year in which it has been declared and approved.	declared for preceding year should be reversed (to rectify the wrong entry). Retained earnings would increase proportionately due to such adjustment

Journal Entry on the date of transition

Particulars		Debit (₹)	Credit (₹)
Provisions	Dr.	30,000	
To Retained earnings			30,000

Issue 5 : Intangible assets:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
The useful life of an intangible asset cannot be indefinite under IGAAP principles. The Company amortised brand/trademark on a straight line basis over maximum of 10 years as per AS 26.	The useful life of an intangible asset like brand/trademark can be indefinite. Not required to be amortised and only tested for impairment. Company can avail the exemption given in Ind AS 101 as on the date of transition to use the carrying value as per previous GAAP.	Consequently, there would be no impact as on the date of transition since company intends to use the carrying amount instead of book value at the date of transition.

Issue 6: Deferred tax

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, deferred taxes are accounted as per income statement approach.	As per Ind AS, deferred taxes are accounted as per balance sheet approach.	On date of transition to Ind AS, deferred tax liability would be increased by ₹ 25,000.

Journal Entry on the date of transition

Particulars		Debit (₹)	Credit (₹)
Retained earnings	Dr.	25,000	
To Deferred tax liability			25,000

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NOTES

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CHAPTER 16

PROFESSIONAL AND ETHICAL DUTY OF A CHARTERED ACCOUNTANT



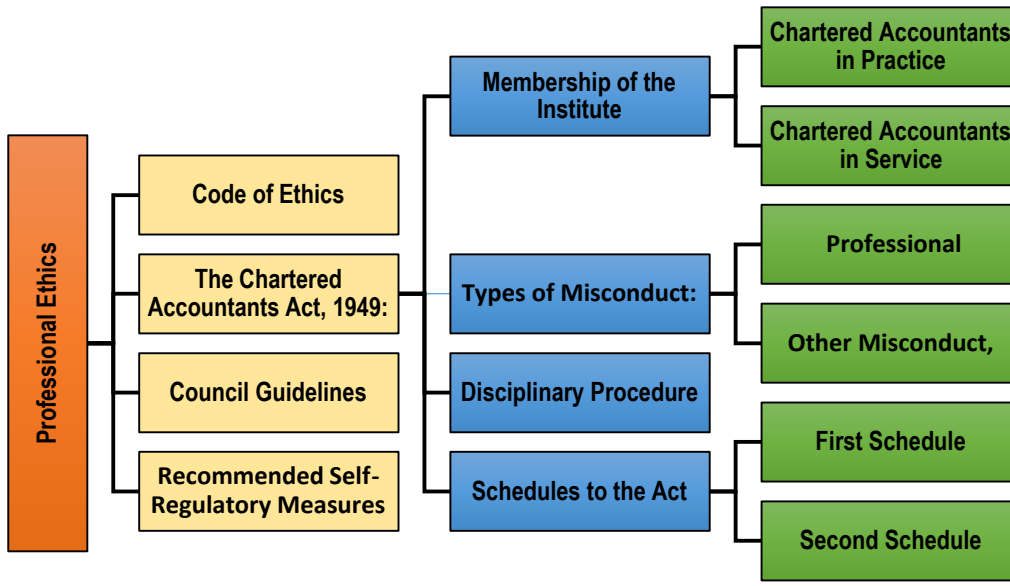
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Comply with the Code of Ethics, Fundamental Principles and Conceptual Framework (applicable to all Chartered Accountants); and
- Comply with the Code of Ethics relevant for the Chartered Accountants in Service and Practice.
- Realise the implications of various Schedules of Chartered Accountants Act relating to professional and other misconduct.

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CHAPTER OVERVIEW



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1. WHAT ARE ETHICS?

The Merriam-Webster dictionary defines ethic / ethics to be a set of moral principles: a theory or system of moral values, the principles of conduct governing an individual or the discipline dealing with what is good and bad and with moral duty and obligation.

2. ETHICAL PRINCIPLES IN FINANCIAL REPORTING

ICAI's Code of Ethics (2019), the "Code", which was developed on adopting the provisions of International Federation of Accountants (IFAC) Code of Ethics for the Chartered Accountants identifies the fundamental principles relevant to accountants. This Code of Ethics is applicable from 1st July, 2020.

This Code has been derived from the International Ethics Standards Board for Accountants (IESBA) Code of Ethics, 2018 issued by the International Federation of Accountants (IFAC).

A. The Code of Ethics ("the Code") sets out fundamental principles of ethics for Chartered Accountants (hereinafter also called as "accountants"), reflecting the recognition and responsibility of the profession 'chartered accountant' in public interest. These principles establish the standard of behaviour expected of a Chartered Accountant.

B. The Code provides a conceptual framework that Chartered Accountants are to apply in order to identify, evaluate and address threats to compliance with the fundamental principles. The Code sets out requirements and application material on various topics to help accountants apply the conceptual framework to those topics.

Note: The principles laid down in the Code of Ethics pertaining to the case of audits, reviews and other assurance engagements, including Independence Standards, established by the application of the conceptual framework to threats to independence in relation to these engagements are dealt with in detail in the 'Advanced Auditing, Assurance and Professional Ethics'.

3. THE CHARTERED ACCOUNTANTS ACT, 1949

A person qualifying as a Chartered Accountant becomes the member on registration with the Institute of the Chartered Accountants of India. Every member has to carry on their professional and other conduct as per the Chartered Accountants Act, 1949.

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A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any Professional or Other Misconduct.

4. WHAT IS PROFESSIONAL OR OTHER MISCONDUCT FOR A CHARTERED ACCOUNTANT?

According to section 22 of the Act, the expression "professional or other misconduct" shall be deemed to include any act or omission provided in any of the Schedules (of the Act).

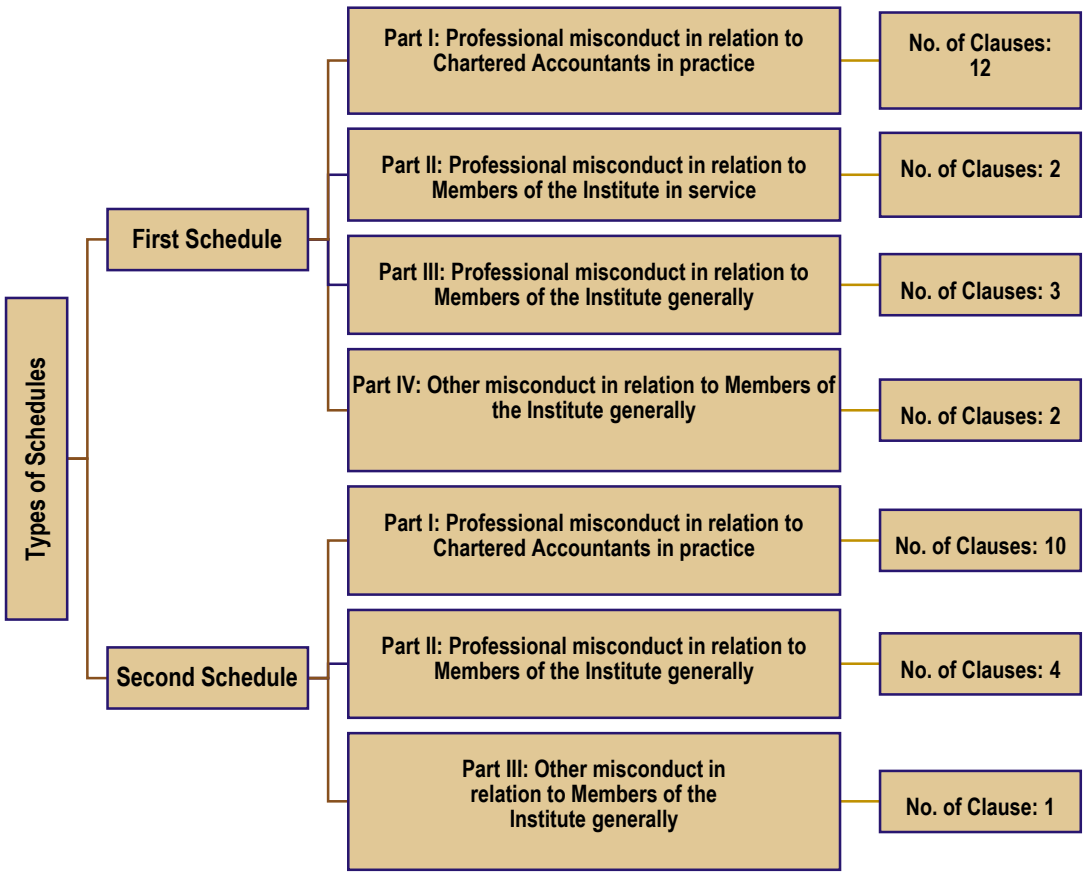
4.1 Professional Misconduct

Professional misconduct has been defined in Part I, II and III of the First Schedule; and Part I and II of the Second Schedule. A member who is engaged in the profession of accountancy whether in practice or in service should conduct/restrict his actions in accordance with the provisions contained in the respective parts of the schedules. If the member is found guilty of any of the acts or omissions stated in any of the respective parts of the Schedule, he/she shall be deemed to be guilty of professional misconduct.

4.2 Other Misconduct

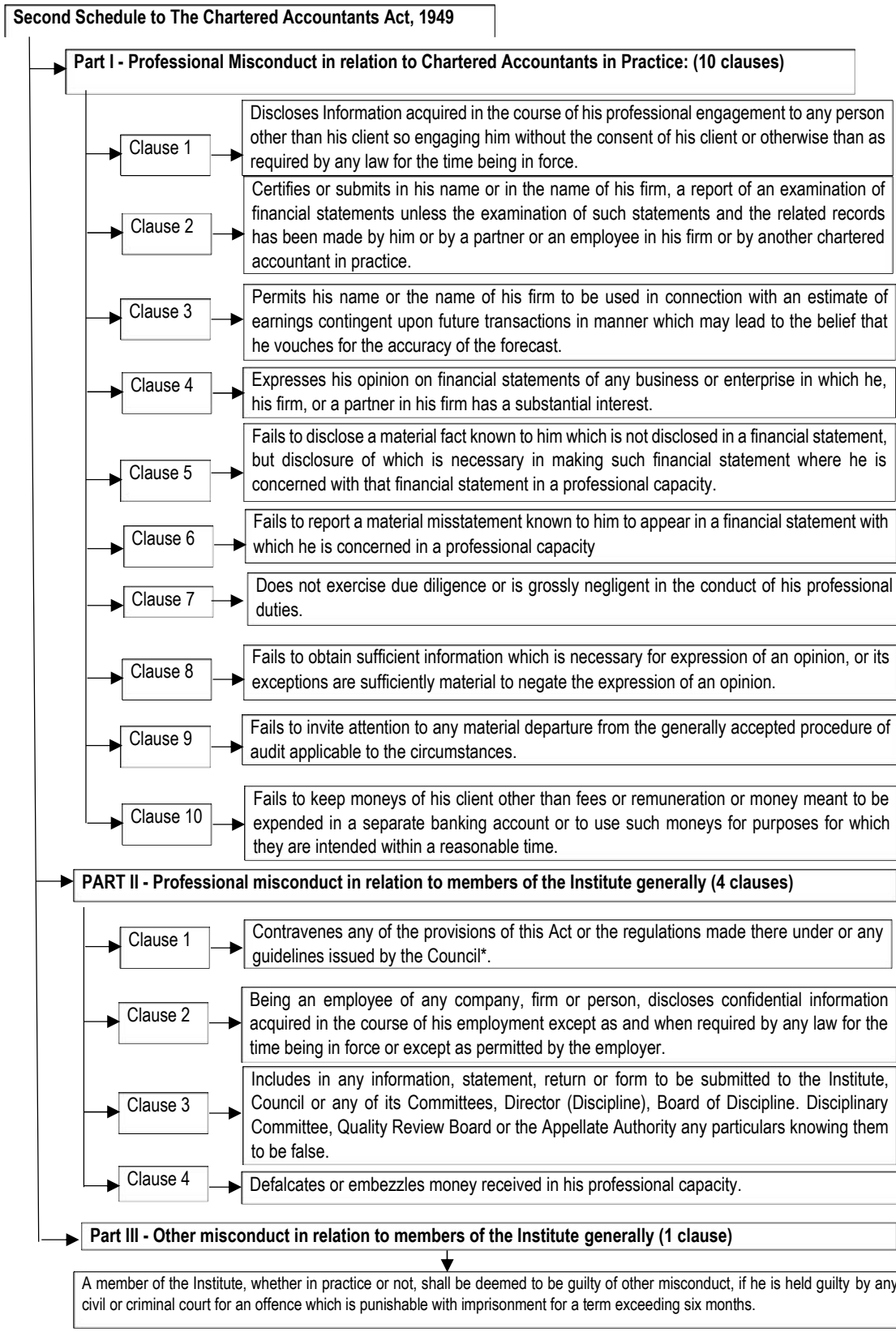
Other misconduct has been defined in part IV of the First Schedule and part III of the Second Schedule. These provisions empower the Council to inquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action.

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The clauses covered in Part I, II and III of Second Schedule have been shown in the form of flowchart below. However, for detail explanation, one must refer the Chapter on 'Professional Ethics' of Final Paper 3 'Advanced Auditing, Assurance and Professional Ethics'.

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***Note : Council Guidelines**

For conduct of a member being an employee, the Council Guidelines in its Appendix 34 of the Chartered Accountants Act, 1949, states that a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

The following part of the Code of Ethics shall be dealt with in Financial Reporting:

- Complying with the Code, Fundamental Principles and Conceptual Framework (applicable to all Chartered Accountants) (relevant part of this Section covered in detail in subsequent pages); and
- Chartered Accountants in Service (relevant part of this Section covered in detail in subsequent pages).

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PART 1: COMPLYING WITH THE CODE, FUNDAMENTAL PRINCIPLES AND CONCEPTUAL FRAMEWORK

1. COMPLYING WITH THE CODE

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A Chartered Accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable Chartered Accountants to meet their responsibility to act in the public interest.

A Chartered Accountant shall comply with the Code. There might be circumstances where laws or regulations preclude an accountant from complying with certain parts of the Code. In such circumstances, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code.

The principle of professional behaviour requires a Chartered Accountant to comply with relevant laws and regulations. Accountants need to be aware of differences in local regulations from the provisions as set out in the Code and comply with the more stringent provisions unless prohibited by law or regulation.

2. THE FUNDAMENTAL PRINCIPLES

There are five fundamental principles of ethics for Chartered Accountants:

(a) **Integrity** – to be straightforward and honest in all professional and business relationships.

(b) **Objectivity** – not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.

(c) **Professional Competence and Due Care** – to:

  (i) attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and

  (ii) act diligently and in accordance with applicable technical and professional standards.

(d) **Confidentiality** – to respect the confidentiality of information acquired as a result of professional and business relationships.

(e) **Professional Behaviour** – to comply with relevant laws and regulations and avoid any conduct that the Chartered Accountant knows or should know might discredit the profession.

A Chartered Accountant shall comply with each of the fundamental principles.

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A Chartered Accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, with:

- Others within the firm or employing organization.
- Those charged with governance.
- Institute
- Legal counsel.

However, such consultation does not relieve the accountant from the responsibility to exercise professional judgment to resolve the conflict or, if necessary, and unless prohibited by law or regulation, disassociate from the matter creating the conflict.

3. INTEGRITY

A Chartered Accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships.

A Chartered Accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information:

- Contains a materially false or misleading statement;
- Contains statements or information provided negligently; or
- Omits or obscures required information where such omission or obscurity would be misleading.

4. OBJECTIVITY

A Chartered Accountant shall comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of others.

Illustration 1:

Infostar Ltd. is a listed company engaged in the provision of IT services in India. The directors are paid a bonus based on the profits achieved by the company during the year as per the bonus table given below:

Range of Profit after tax	*Bonus to Directors*
Less than ₹ 1 crore	*NIL*
₹ 1 crore to < ₹ 5 crores	*2% of Net Profit after tax*
₹ 5 crores to < ₹ 10 crores	*4% of Net Profit after tax*

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₹ 10 crores to < ₹ 20 crores	*6% of Net Profit after tax*
₹ 20 crores to < ₹ 30 crores	*8% of Net Profit after tax*
₹ 30 crores and above	*10% of Net Profit after tax*

The draft Statement of Profit and Loss for the year ended 31 March 20X2 currently shows a profit of ₹ 2 crores.

Issue:

On 25 March 20X2, Infostar Ltd. sold land located adjacent to its head office to a third party Zest Ltd. for a consideration of ₹ 40 crores, with an option to purchase the land back on 25 May 20X2 for ₹ 40 crores plus a premium of 6%. The amount received from the transaction eliminated the bank overdraft of Infostar Ltd. as on 31 March 20X2. On instructions of the Chief Financial Officer of the company, who is a chartered accountant, the transaction was treated as a sale, including the profit arising on disposal in the Statement of Profit and Loss for the year ending 31 March 20X2.

Required:

Discuss the ethical and accounting implications of the above issues with respect to a chartered accountant in service, referring to the relevant Ind AS wherever appropriate.

Solution

Accounting Treatment

The sale of land meets the conditions specified in Ind AS 115, *Revenue from Contracts with Customers* for qualifying as a repurchase agreement as Infostar Ltd. has an option to buy back the land from Zest Ltd. and therefore, control is not transferred as Zest Ltd.'s ability to use and gain benefit from the land is limited. Infostar Ltd. must treat the transaction as a financing arrangement and record both the asset (land) and the financial liability (the amount received which is repayable to Zest Ltd.).

Infostar Ltd. should not have derecognized the land from the financial statements because the risks and rewards of ownership are not transferred. Thus, the substance of the transaction is a loan of ₹ 40 crores, with the 6% 'premium' on repurchase effectively reflecting interest payment.

Recording the aforesaid transaction as a sale is an attempt to manipulate the financial statements in order to show an improved profit figure and a more favourable cash position. The sale must be reversed and the land should be reinstated at its carrying amount prior to the transaction.

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Ethical Issues

Chartered Accountants are required to comply with the fundamental principles laid down in the Code of Ethics. This includes acting with integrity. It appears that the integrity of CFO is compromised in this situation as he had accounted the transaction as sale and not as a loan or financial arrangement. The effect of accounting it as sale just before the year end is merely to improve profits and eliminate the bank overdraft, thereby making the cash position seem better than it is. This effectively amounts to 'window dressing', which is not honest as it does not present the actual performance and position of Infostar Ltd.

Accountants must also act with objectivity, which means they must not allow bias, conflict or undue influence of others to override professional or business judgments. Therefore, the management must put the interests of the company and the shareholders before their own interests. The pressure to show profits and achieve a bonus is in the self-interest of the directors and seems to have been partly driven the transaction and the subsequent accounting, which is clearly a conflict of interest.

It is further necessary for the accountants to comply with the principles of professional behaviour, which require compliance with relevant laws and regulations. In the instant case, the accounting treatment is not in conformity with Ind AS. The given facts do not make it clear whether CFO is aware of this or not. If he is aware but still applied the incorrect treatment, he has not complied with the principle of professional behaviour. It may be that he was under undue pressure from the directors to record the transaction in this manner. If, however, he is not aware that the treatment is incorrect, then he has not complied with the principle of professional competence as his knowledge and skills are not updated.

In such a case, he is subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

*****

5. PROFESSIONAL COMPETENCE AND DUE CARE

Maintaining professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables a Chartered Accountant to develop and maintain the capabilities to perform competently within the professional environment.

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Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

In complying with the principle of professional competence and due care, a Chartered Accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountant's authority have appropriate training and supervision.

Illustration 2:

Rustom Ltd., a company engaged in oil extraction, has a present obligation to dismantle the oil rig installed by it at the end of the useful life of 10 years. Rustom Ltd. cannot cancel this obligation or transfer it. Rustom Ltd. intends to carry out the dismantling work itself and estimates the cost of the work to be ` 100 crores at the end of 10 years.

The directors of Rustom Ltd. are aware of the requirements of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', read with Ind AS 16 'Property, Plant and Equipment'. However, they propose to expense the costs of dismantling the oil rig as and when incurred, with no entries or disclosures in the latest financial statements. They argue that application of Ind AS involves judgment, and although prudence is mentioned in the Conceptual Framework, it is only one among the many ways of achieving faithful representation.

Required:

Discuss whether the directors are acting unethically in the above instance what should be the practising Chartered Accountant's course of action in this regard.

Solution

The treatment proposed by the director is in contravention of Ind AS 37. As per Ind AS 16 and Ind AS 37, an entity, at the time of initial recognition of the asset, capitalises the present value of the cost of dismantling to be occurred at the end of the life of the asset, to the cost of the asset by simultaneously creating a provision for the same. In the given case, it appears to be a deliberate intention to contravene Ind AS 16 and Ind AS 37, and not an unintentional mistake.

Though the directors can exercise strong or undue influence over the chartered accountant, the chartered accountant is bound to act with integrity and remain unbiased, recommending to the directors that Ind AS 16 and Ind AS 37 must be complied with, and ensure appropriate entries are passed in the financial statements. The matter may be raised before the non-executive directors, explaining the issue to them and ensure the financial statements are true and fair and comply with the relevant Ind AS.

It is essential for the chartered accountant to inform those in governance (directors) about the necessary corrective measures in this case. By doing so, he uphold the fundamental principle of professional behaviour and demonstrate compliance with relevant laws and regulations. By

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communicating the corrective measures to those responsible for governance, the chartered accountant can ensure that the contravention of Ind AS 16 and Ind AS 37 is addressed and rectified.

However, if he does not communicate the corrective measures to the directors, the fundamental principle of **professional behaviour** will be breached. Members should comply with relevant laws and regulations and avoid any action that discredits the profession. By knowingly allowing the directors not to apply the requirements of an Ind AS, the Chartered Accountant would not be acting diligently in accordance with applicable guidance and would not be demonstrating professional competence and due care. In such a situation, he will be subject to professional misconduct under Clauses 5, 6 and 7 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 5 states that a chartered accountant is guilty of professional misconduct when he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

Clause 6 states that a CA is guilty of professional misconduct when he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

Clause 7 states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

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6. CONFIDENTIALITY

A Chartered Accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. An accountant shall:

(a) Be alert to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member;

(b) Maintain confidentiality of information within the firm or employing organization;

(c) Maintain confidentiality of information disclosed by a prospective client or employing organization;

(d) Not disclose confidential information acquired as a result of professional and employment relationships outside the firm or employing organization without proper and specific authority, unless there is a legal or professional duty or right to disclose;

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(e) Not use confidential information acquired as a result of professional and employment relationships for the personal advantage of the accountant or for the advantage of a third party;

(f) Not use or disclose any confidential information, either acquired or received as a result of a professional or employment relationship, after that relationship has ended; and

(g) Take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, respect the accountant's duty of confidentiality.

For instance, confidentiality is a paramount ethical principle that should not be breached when providing payroll services to clients, unless required by law or authorized by the client. Chartered Accountants have a duty to uphold the confidentiality of payroll-related information and ensure the security and protection of sensitive data of the organisation.

Confidentiality serves the public interest because it facilitates the free flow of information from the Chartered Accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where Chartered Accountants are or might be required to disclose confidential information or when such disclosure might be appropriate:

(a) Disclosure is required by law, for example:

  (i) Production of documents or other provision of evidence in the course of legal proceedings; or

  (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light;

(b) Disclosure is permitted by law and is authorized by the client or the employing organization; and

(c) There is a professional duty or right to disclose, when not prohibited by law:

  (i) To comply with the requirements of peer review or quality review of the Institute

  (ii) To respond to an inquiry or investigation by a professional or regulatory body;

  (iii) To protect the professional interests of a Chartered Accountant in legal proceedings; or

  (iv) To comply with technical and professional standards, including ethics requirements.

Breaches of confidentiality may occur in the scenario like insider trading, where chartered accountants must avoid using or sharing material information of the entity for personal gain.

Similarly, hiding material facts which require disclosure like reporting fraud, illegal activities, or non-compliance with laws and regulations does not constitute confidentiality. Chartered accountants have an ethical duty to report fraudulent or manipulative activities that could impact the end users.

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Nonetheless, confidentiality should be applied cautiously with justifiable legal or ethical grounds, and professional judgment and after due legal advice, wherever necessary.

A Chartered Accountant shall continue to comply with the principle of confidentiality even after the end of the relationship between the accountant and a client or employing organization. When changing employment or acquiring a new client, the accountant is entitled to use prior experience but shall not use or disclose any confidential information acquired or received as a result of a professional or employment relationship.

7. PROFESSIONAL BEHAVIOUR

When promoting himself and his work, a Chartered Accountant shall not bring the profession into disrepute. A Chartered Accountant is required to conduct his affairs in a manner that he remains outside the boundaries of professional and other misconduct. A Chartered Accountant shall be honest and truthful and shall not make:

(a) Exaggerated claims for the services offered by, or the qualifications or experience of, the accountant; or

(b) Disparaging references or unsubstantiated comparisons to the work of others.

Any direct or indirect measures to advertise any professional/other facts which are in violation of Advertisement Guidelines issued by the Council of the Institute from time to time.

THE CONCEPTUAL FRAMEWORK

The ***Chartered Accountant shall apply the*** conceptual framework to ***identify, evaluate and address threats to compliance with the fundamental principles***.

(a) Identify threats to compliance with the fundamental principles;

(b) Evaluate the threats identified; and

(c) Address the threats by eliminating or reducing them to an acceptable level.

When applying the conceptual framework, the Chartered Accountant shall:

(a) Exercise professional judgment;

(b) Remain alert for new information and to changes in facts and circumstances; and

Use the reasonable and informed third party test.

Exercise of Professional Judgment

Professional judgment involves the application of relevant training, professional knowledge, skill and experience commensurate with the facts and circumstances, including the nature and scope of the particular professional activities, and the interests and relationships involved. In relation to undertaking professional activities, the exercise of professional judgment is required when the

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Chartered Accountant applies the conceptual framework in order to make informed decisions about the courses of actions available, and to determine whether such decisions are appropriate in the circumstances.

An understanding of known facts and circumstances is a prerequisite to the proper application of the conceptual framework. Determining the actions necessary to obtain this understanding and coming to a conclusion about whether the fundamental principles have been complied with also require the exercise of professional judgment.

In exercising professional judgment to obtain this understanding, the Chartered Accountant might consider, among other matters, whether:

- There is reason to be concerned that potentially relevant information might be missing from the facts and circumstances known to the accountant.
- There is an inconsistency between the known facts and circumstances and the accountant's expectations.
- The accountant's expertise and experience are sufficient to reach a conclusion.
- There is a need to consult with others with relevant expertise or experience.
- The information provides a reasonable basis on which to reach a conclusion.
- The accountant's own preconception or bias might be affecting the accountant's exercise of professional judgment.
- There might be other reasonable conclusions that could be reached from the available information.

Reasonable and Informed Third Party

The reasonable and informed third party test is a consideration by the Chartered Accountant about whether the same conclusions would likely be reached by another party. Such consideration is made from the perspective of a reasonable and informed third party, who weighs all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made. The reasonable and informed third party does not need to be an accountant but would possess the relevant knowledge and experience to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

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PART 2: CHARTERED ACCOUNTANTS IN SERVICE

A. CONFLICTS OF INTEREST

A Chartered Accountant shall not allow a conflict of interest to compromise professional or business judgment.

Examples of circumstances that might create a conflict of interest include:

(a) Serving in a management or governance position for two employing organizations and acquiring confidential information from one organization that might be used by the Chartered Accountant to the advantage or disadvantage of the other organization.

(b) Undertaking a professional activity for each of two parties in a partnership, where both parties are employing the accountant to assist them to dissolve their partnership.

(c) Preparing financial information for certain members of management of the accountant's employing organization who are seeking to undertake a management buy-out.

(d) Being responsible for selecting a vendor for the employing organization when an immediate family member of the accountant might benefit financially from the transaction.

(e) Serving in a governance capacity in an employing organization that is approving certain investments for the company where one of those investments will increase the value of the investment portfolio of the accountant or an immediate family member.

1. Conflict Identification

A Chartered Accountant shall take reasonable steps to identify circumstances that might create a conflict of interest, and therefore a threat to compliance with one or more of the fundamental principles. Such steps shall include identifying:

(a) The nature of the relevant interests and relationships between the parties involved; and

(b) The activity and its implication for relevant parties.

2. Threats created by Conflict of Interest

In general, the more direct the connection between the professional activity and the matter on which the parties' interests conflict, the more likely the level of the threat is not at an acceptable level.

An example of an action that might eliminate threats created by conflicts of interest is withdrawing from the decision-making process related to the matter giving rise to the conflict of interest.

Examples of actions that might be safeguards to address threats created by conflicts of interest include:

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(a) Restructuring or segregating certain responsibilities and duties.

(b) Obtaining appropriate oversight, for example, acting under the supervision of an executive or non-executive director.

3. Disclosure and Consent

It is generally necessary to:

(a) Disclose the nature of the conflict of interest and how any threats created were addressed to the relevant parties, including to the appropriate levels within the employing organization affected by a conflict; and

(b) Obtain consent from the relevant parties for the Chartered Accountant to undertake the professional activity when safeguards are applied to address the threat.

When addressing a conflict of interest, the Chartered Accountant is encouraged to seek guidance from within the employing organization or from the Institute, legal counsel or another accountant. When making such disclosures or sharing information within the employing organization and seeking guidance of third parties, the principle of confidentiality applies.

Illustration 3:

Alaap Ltd.'s directors feel that the company needs a significant injection of capital in order to modernize plant and equipment as the company has been promised firm orders if it can produce goods of international standards. The current lending policies of the banks require prospective borrowers to demonstrate strong projected cash flows, coupled with a Debt Service Coverage Ratio exceeding 10. However, the current projected statement of cash flows does not satisfy the bank's criteria for lending. The directors have told the bank that the company is in an excellent financial position, the financial results and cash flow projections will meet the criteria and the chartered accountant will submit a report to this effect shortly. The chartered accountant has recently joined Alaap Ltd. and has openly stated that he cannot afford to lose his job because of financial commitments.

Required:

Discuss the potential ethical conflicts which may arise in the above scenario and the ethical principles which would guide how the chartered accountant should respond to the situation.

Solution

The given scenario presents a twofold conflict of interest:

(i) *Pressure to obtain finance and chartered accountant's personal circumstances*

The chartered accountant is under pressure to provide the bank with a projected cash flow statement that will meet the bank's criteria when in fact the actual projections do not meet

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the criteria. The chartered accountant's financial circumstances mean that he cannot lose his job, thus **the ethical and professional standards required of the accountant are at odds with the pressures of his personal circumstances**.

(ii) *Duty to shareholders, employees and bank*

The **directors have a duty to act in the best interests of the company's shareholders and employees, and a duty to present fairly any information the bank may rely on**. The injection of capital to modernise plant and equipment appears to be for capacity expansion which will lead to greater profits, thus being in the interests of the shareholders and the employees. However, if such finance is obtained based on misleading information, it could actually be detrimental to the going concern status of the company.

It could be argued that there is a **conflict between the short-term and medium-term interests of the company** (the need to modernise the company) **and its long-term interests** (the detriment to the company's reputation if its directors do not conform to ethics).

Ethical principles guiding the chartered accountant's response

The chartered accountant's financial circumstances coupled with the pressure from the directors could end up in him knowingly disclosing incorrect information to the bank, thereby compromising the fundamental principles of **objectivity, integrity** and **professional competence**.

By exhibiting **bias** due to the **risk of losing his job** through reporting favourable cash flows to the bank, **objectivity** is compromised. Further, **integrity** is also compromised as by not acting in a straightforward and honest manner, **incorrect information is knowingly disclosed**. Forecasts, unlike financial statements, do not specify that they have been prepared in accordance with Ind AS. However, the principle of **professional competence** requires the accountant to prepare the cash flow projections to the **best of his professional judgment** which would not be the case if the projections showed a more positive position than what is actually anticipated.

Appropriate action

The **chartered accountant faces an immediate ethical dilemma** and must apply his moral and ethical judgment. As a professional, he is responsible for presenting the truth, and not to indulge in 'creative accounting' owing to pressure.

Thus, **the chartered accountant should put the interests of the company and professional ethics first** and insist that the report to the bank be an honest reflection of the company's current financial position. Being an advisor to the directors, he must prevent deliberate misrepresentation to the bank, no matter what the consequences to him are personally. The accountant should not allow any undue influence from the directors to override his professional judgment or integrity. This is in the long-term interests of the company and its survival.

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It is suggested that the chartered accountant should communicate to the directors to submit the projected statement of cash flows to the bank, which reflects the current position of the company.

Knowingly providing incorrect information is considered as professional misconduct. To prevent such misconduct, a chartered accountant should not provide incorrect projected cash flows to the bank and colour the financial position of the entity. By adhering to the ethical principles, the chartered accountant will maintain his professional integrity and contribute to the trust and reliability placed in the work expected from him.

However, if he submits the incorrect projected statement of cash flows, he would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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B. PREPARATION AND PRESENTATION OF INFORMATION

When preparing or presenting information, a Chartered Accountant shall:

(a) Prepare or present the information in accordance with a relevant reporting framework, where applicable;

(b) Prepare or present the information in a manner that is intended neither to mislead nor to influence contractual or regulatory outcomes inappropriately;

(c) Exercise professional judgment to:

  (i) Represent the facts accurately and completely in all material respects;

  (ii) Describe clearly the true nature of business transactions or activities; and

  (iii) Classify and record information in a timely and proper manner; and

(d) Not omit anything with the intention of rendering the information misleading or of influencing contractual or regulatory outcomes inappropriately.

An example of influencing a contractual or regulatory outcome inappropriately is using an unrealistic estimate with the intention of avoiding violation of a contractual requirement such as a debt covenant or of a regulatory requirement such as a capital requirement for a financial institution.

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1. Use of Discretion in Preparing or Presenting Information

Preparing or presenting information might require the exercise of discretion in making professional judgments. The Chartered Accountant shall not exercise such discretion with the intention of misleading others or influencing contractual or regulatory outcomes inappropriately.

Examples of ways in which discretion might be misused to achieve inappropriate outcomes include:

- Determining estimates, for example, determining fair value estimates in order to misrepresent profit or loss.
- Selecting or changing an accounting policy or method among two or more alternatives permitted under the applicable financial reporting framework, for example, selecting a policy for accounting for long-term contracts in order to misrepresent profit or loss.
- Determining the timing of transactions, for example, timing the sale of an asset near the end of the fiscal year in order to mislead.
- Determining the structuring of transactions, for example, structuring financing transactions in order to misrepresent assets and liabilities or classification of cash flows.
- Selecting disclosures, for example, omitting or obscuring information relating to financial or operating risk in order to mislead.

When performing professional activities, the Chartered Accountant shall exercise professional judgment to identify and consider:

(a) The purpose for which the information is to be used;

(b) The context within which the information is given; and

(c) The audience to whom it is addressed.

For example, when preparing or presenting pro forma reports, budgets or forecasts, the inclusion of relevant estimates, approximations and assumptions, where appropriate, would enable those who might rely on such information to form their own judgments.

2. Relying on the Work of Others

A Chartered Accountant who intends to rely on the work of others, either internal or external to the employing organization, shall exercise professional judgment to determine what steps to take, if any, in order to fulfil the responsibilities.

Factors to consider in determining whether reliance on others is reasonable include:

- The reputation and expertise of, and resources available to, the other individual or organization.

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- Whether the other individual is subject to applicable professional and ethics standards.

Such information might be gained from prior association with, or from consulting others about, the other individual or organization.

3. Addressing Information that Is or Might be Misleading

When the Chartered Accountant knows or has reason to believe that the information with which the accountant is associated is misleading, the accountant shall take appropriate actions to seek to resolve the matter.

- Actions that might be appropriate include:
- Discussing concerns that the information is misleading with the Chartered Accountant's superior and/or the appropriate level(s) of management within the accountant's employing organization or those charged with governance and requesting such individuals to take appropriate action to resolve the matter. Such action might include:
    - Having the information corrected.
    - If the information has already been disclosed to the intended users, informing them of the correct information.

Consulting the policies and procedures of the employing organization (for example, an ethics or whistle-blowing policy) regarding how to address such matters internally

The Chartered Accountant might determine that the employing organization has not taken appropriate action. If the accountant continues to have reason to believe that the information is misleading, the following further actions might be appropriate provided that the accountant remains alert to the principle of confidentiality:

- Consulting with:
    - The Institute
    - The internal or external auditor of the employing organization
    - Legal counsel.
- Determining whether any requirements exist to communicate to:
    - Third parties, including users of the information.
    - Regulatory and oversight authorities.

If after exhausting all feasible options, the Chartered Accountant determines that appropriate action has not been taken and there is reason to believe that the information is still misleading, the accountant shall refuse to be or to remain associated with the information.

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In such circumstances, it might be appropriate for a Chartered Accountant to resign from the employing organization.

Illustration 4:

Sunshine Ltd., a listed company in the cosmetics industry, has debt covenants attached to some of its borrowings which are included in Financial Liabilities in the Balance Sheet. These covenants mandate the company to repay the debt in full if Sunshine Ltd. fails to maintain a liquidity ratio and operating margin above the specified limit.

The directors alongwith the CFO of the Company who is a chartered accountant are considering entering into a fresh five-year leasing arrangement but are concerned about the negative impact any potential lease obligations may have on the above-mentioned covenants. Accordingly, the directors and CFO propose that the lease agreement be drafted in such a way that it is a series of six ten-month leases rather than a single five-year lease in order to utilize the short-term lease exemption available under Ind AS 116, Leases. This would then enable accounting for the leases in their legal form. The directors believe that this treatment will meet the requirements of the debt covenant, though such treatment may be contrary to the accounting standards.

Required:

Discuss the ethical and accounting implications of the above issue from the perspective of CFO.

Solution

Lease agreement substance presentation

Stakeholders make informed and accurate decisions based on the information presented in the financial statements and as such, ensuring the financial statements are reliable and of utmost importance. The directors of Sunshine Ltd. are ethically responsible to produce financial statements that comply with Ind AS and are transparent and free from material error. Lenders often attach covenants to the terms of the agreement in order to protect their interests in an entity. They would also be of crucial importance to potential debt and equity investors when assessing the risks and returns from any future investment in the entity.

The proposed action by Sunshine Ltd. appears to be a deliberate attempt to circumvent the terms of the covenants. The legal form would require treatment as a series of short-term leases which would be recorded in the profit or loss, without any right-of-use asset and lease liability being recognized as required by Ind AS 116, *Leases*. This would be a form of 'off-balance sheet finance' and would not report the true assets and obligations of Sunshine Ltd. As a result of this proposed action, the liquidity ratios would be adversely misrepresented. Further, the operating profit margins would also be adversely affected, as the expenses associated with the lease are likely to

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be higher than the deprecation charge if a leased asset was recognized, hence the proposal may actually be detrimental to the operating profit covenant.

Sunshine Ltd. is aware that the proposed treatment may be contrary to Ind AS. Such manipulation would be a clear breach of the fundamental principles of objectivity and integrity as outlined in the Code of Ethics. It is important for a chartered accountants to exercise professional behaviour and due care all the time. The proposals by Sunshine Ltd. are likely to mislead the stakeholders in the entity. This could discredit the profession by creating a lack of confidence within the profession. The directors of Sunshine Ltd. must be reminded of their ethical responsibilities and persuaded that the accounting treatment must fully comply with the Ind AS and principles outlined within the framework should they proceed with the financing agreement.

However, if the CFO fails to comply with his professional duties, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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C. ACTING WITH SUFFICIENT EXPERTISE

A Chartered Accountant shall not intentionally mislead an employing organization as to the level of expertise or experience possessed.

A self-interest threat to compliance with the principle of professional competence and due care might be created if a Chartered Accountant has:

- Insufficient time for performing or completing the relevant duties.
- Incomplete, restricted or otherwise inadequate information for performing the duties.
- Insufficient experience, training and/or education.
- Inadequate resources for the performance of the duties.

Examples of actions that might be safeguards to address such a self-interest threat include:

- Obtaining assistance or training from someone with the necessary expertise.
- Ensuring that there is adequate time available for performing the relevant duties.

If a threat to compliance with the principle of professional competence and due care cannot be addressed, a Chartered Accountant shall determine whether to decline to perform the duties in

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question. If the accountant determines that declining is appropriate, the accountant shall communicate the reasons.

Illustration 5:

Agastya Ltd. is a listed company engaged in the manufacturing of automotive spare parts. The company is preparing the financial statements for the year ended 31 March 20X3. The directors of Agastya Ltd. are entitled to an incentive based on the operating profit margin of the company. You have been appointed as a consultant to advise on the preparation of the financial statements, and you notice the following issue:

Issue:

On 1 April 20X2, Agastya Ltd.'s defined benefit pension scheme was amended to increase the pension entitlement from 12% of final salary to 18.5% of final salary. This amendment was made due to the salary cuts made on account of the pandemic. The chartered accountant has shown such increase in the pension entitlement (amounting to ₹ 85 crores) under the head 'Employee Benefits' forming part of the operating profit. The directors are unhappy with this presentation. They believe that the pension scheme is not integral to the operations of the company since it is paid post-retirement of the employees, and thus insist that such presentation would be misleading in computing the operating profit or loss. Accordingly, the directors propose a change in accounting policy so that all such gains or losses on pension scheme would be recognized under Other Comprehensive Income. The directors believe that this policy choice will make the financial statements more consistent, understandable thereby justifying the same on grounds of fair presentation as defined in the Framework. The pension scheme of Agastya Ltd. is currently in deficit.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate from the perspective of the consultant.

Solution

Ethical Implications of change in accounting policy

Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors only permits a change in accounting policy if the change is: (i) required by an Ind AS or (ii) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. A retrospective adjustment is required unless the change arises from a new accounting policy with transitional arrangements to account for the change. It is permissible to depart from the requirements of Ind AS but only in extremely rare circumstances where compliance would be so

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misleading that it would conflict with overall objectives of the financial statements. Practically, this override is rarely, if ever, invoked.

Ind AS 19, Employee Benefits requires all gains and losses on a defined benefit pension scheme to be recognised in profit or loss except for the remeasurement component relating to plan assets and defined benefit obligations, which must be recognized in Other Comprehensive Income. Accordingly, current service cost, past service cost and net interest cost on the net defined benefit obligation must all be recognized in profit or loss. Ind AS 19 does not offer any alternative treatment as an accounting policy choice in terms of Ind AS 8, and therefore the directors' proposals cannot be justified on the grounds of fair presentation. The directors are ethically bound to prepare financial statements which reflect a true and fair view of the entity's performance and financial position and comply with all Ind AS.

It is the self-interest in the pension scheme that is making the directors consider a change in accounting policy in order to maximize profits for maximizing their bonus potential. The amendment to the pension scheme is a past service cost in terms of Ind AS 19 which should be expensed to the profit or loss during the period such plan amendment has occurred, i.e., immediately. This would impact the operating profits of Agastya Ltd. thereby reducing the potential bonus.

Additionally, it appears that the directors wish to manipulate aspects of the pension scheme such as current service cost and, since the pension scheme is given to be in deficit, the net finance cost. The directors are purposely manipulating the presentation of these items by recording them in equity instead of Profit or Loss. The financial statements would not be compliant with Ind AS and would not give a reliable picture of the true costs to the company of operating the pension scheme and this treatment would make the financial statements less comparable with other entities correctly applying Ind AS 19. Further, the explicit statement given in the financial statements stating that all compliance with Ind AS is achieved would be an incorrect statement to make in the event of the above non-compliance. Further, such treatment would be against the fundamental principles of objectivity, integrity and professional behaviour as stated in the Code of Ethics. The directors need to understand their ethical responsibilities and avoid implementing the proposed change in policy.

As a meaningful addition, the directors could use other tools/indicators within the financial statements to explain the company's results such as drawing attention of the users to the cash generated from operations which would exclude the non-cash pension expense. Alternative measures such as EBITDA could be disclosed where non-cash items are consistently eliminated for comparison purposes.

When a Chartered Accountant discovers that a company's financial position has been compromised through misstatement, they have two options. They can either report the non-

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compliance to the authorities or consider withdrawing from the engagement. Both the actions ensure integrity, transparency, and the interests of stakeholders at large.

In case the consultant-chartered accountant is influenced by the director's suggestions and report accordingly, he will be subject to professional misconduct under Clauses 5,7 and 8 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 5 states that a Chartered Accountant is guilty of professional misconduct when he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

Clause 7 states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

Clause 8 of Part I of the Second Schedule of the Chartered Accountants Act 1949 states that a CA is guilty of professional misconduct when he fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

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D. FINANCIAL INTERESTS, COMPENSATION AND INCENTIVES LINKED TO FINANCIAL REPORTING AND DECISION MAKING

A Chartered Accountant shall not manipulate information or use confidential information for personal gain or for the financial gain of others.

Chartered Accountants might have financial interests or might know of financial interests of immediate or close family members that, in certain circumstances, might create threats to compliance with the fundamental principles. Financial interests include those arising from compensation or incentive arrangements linked to financial reporting and decision making.

Examples of circumstances that might create a self-interest threat include situations in which the Chartered Accountant or an immediate or close family member:

- Has a motive and opportunity to manipulate price- sensitive information in order to gain financially.
- Holds a direct or indirect financial interest in the employing organization and the value of that financial interest might be directly affected by decisions made by the accountant.
- Is eligible for a profit-related bonus and the value of that bonus might be directly affected by decisions made by the accountant.
- Holds, directly or indirectly, deferred bonus share rights or share options in the employing organization, the value of which might be affected by decisions made by the accountant.

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- Participates in compensation arrangements which provide incentives to achieve targets or to support efforts to maximize the value of the employing organization's shares. An example of such an arrangement might be through participation in incentive plans which are linked to certain performance conditions being met.

Illustration 6:

The directors of Spinz Ltd. are eligible for an incentive computed as a percentage of 'Cash Generated from Operations' as defined in Ind AS 7, Statement of Cash Flows in accordance with the terms of their appointment. Due to the onset of the pandemic, the company has not performed well, and it has, in fact, lost Cash from Operations. In order to meet the cash requirements, the directors of Spinz Ltd. are planning to dispose off under-utilized equipment and investments (not subsidiaries or associates). The directors opine that since the cash generated from sale of such equipment and investments would be used for operations, the inflows on such sale would be presented in the Statement of Cash Flows under 'Cash from Operations'. The directors are concerned about meeting the targets in order to ensure security of their jobs and feel that this treatment would enhance the 'cash flow picture' of the business. The inflows on sale of such equipment and investments have the potential to make the 'Cash from Operations' figure positive.

Required:

Discuss the ethical responsibility of Spinz Ltd.'s Chartered Accountant who is an employee to ensure that the manipulation of the Statement of Cash Flows, as suggested by the directors, does not occur.

Solution

In order to meet targets, it is quite possible that management may want to **present a company's results in a favourable manner**. Such an objective could be achieved by employing creative accounting techniques such as window dressing, or as can be seen in the case, **inaccurate classification**.

As per para 16 of Ind AS 7, separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Example of cash flows arising from investing activities are cash receipts from sales of property, plant and equipment, intangibles and other long-term assets.

Presenting proceeds of sale of investments and under-utilized equipment as part of 'Cash from Operations' gives a **misleading picture** of the financial statements. Operating cash flows are crucial for the long-term survival of the company, and a negative cash from operations figure could be a possible indicator of cash shortage in the short-term, and possibly question the going concern

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assumption of the entity in the long-run. Further, operating cash flows are recurring, whereas investing and financing cash flows tend to be one-off.

In the given case, it may appear that to meet cash requirements for its operations, the company is selling its investments and equipment. Selling of equipment and investments is not usually a part of trading operations. Such sales generate short-term cash flow and cannot be repeated on a regular basis. The proposed misclassification could be regarded as a deliberate attempt to mislead stakeholders about the performance of Spinz Ltd. and its future performance, which is unethical.

Chartered Accountants have a duty, not only to the **company** they work for, but also to their **professional body (i.e., ICAI)**, and to the **stakeholders** of the company. Proceeds received from sale of equipment and investment should be presented under **'Cash Flows from Investing Activities'** (instead of 'Operating Activities') in accordance with Ind AS 7, Statement of Cash Flows. As per the Code of Ethics, a Chartered Accountant should follow the fundamental principle of **professional competence and due care** which includes preparing financial statements in compliance with Ind AS. In case the accountant permits the treatment of the matter as proposed by the management, it would result in a breach of the principle of professional competence and due care. This treatment may be permitted by the accountant under pressure from the management.

The chartered accountant should **prevent the management not to proceed with the aforesaid accounting treatment** which violates Ind AS 7. In case the management insists on continuing with their suggested treatment, then the chartered accountant must **bring this to the attention of the auditors**. Otherwise, the chartered accountant would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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Illustration 7:

Infostar Ltd. is a listed company engaged in the provision of IT services in India. The directors are paid a bonus based on the profits achieved by the company during the year as per the bonus table given below:

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Profit Range	*Bonus to Directors*
NIL < Profit < ₹ 1 crore	*NIL*
₹ 1 crore < Profit < ₹ 5 crores	*2% of Net Profit*
₹ 5 crores < Profit < ₹ 10 crores	*4% of Net Profit*
₹ 10 crores < Profit < ₹ 20 crores	*6% of Net Profit*
₹ 20 crores < Profit < ₹ 30 crores	*8% of Net Profit*
Profit > ₹ 30 crores	*10% of Net Profit*

The draft Statement of Profit and Loss for the year ended 31 March 20X2 currently shows a profit of ₹ 2 crores.

Issue:

The employees of Infostar Ltd. have historically been paid an individual-performance-based discretionary incentive for the last 15 years. Based on the past trends and performance, the bonus amount for the year 20X1-20X2 would be ₹ 3 crores. In view of the possibility of the directors not receiving the bonus on account of the company's poor performance, Infostar Ltd.'s Chief Financial Officer (CFO), who is a chartered accountant, has suggested that the discretionary incentive usually payable to the employees could be avoided in the current year, which would result in the company reporting profits. As a part of its annual report, Infostar Ltd. reports employee satisfaction scores, staff attrition rates, gender equality and employee absenteeism rates as non-financial performance measures. The CFO has also told the directors over mail that no stakeholder reads the non-financial information anyway, and thus his aforesaid suggestion of not paying the discretionary incentive would not impact the company greatly.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate from perspective of CA. Sushil Bhupathy.

Solution

Ethical Considerations

Long-term success of any organization strongly depends on the fair treatment of employees, which in turn is based on the ethical behaviour of the management as well as how the same is perceived by the stakeholders. In the given case, the CFO has suggested not paying the discretionary bonus, which the directors are considering as it will enable the company to record profits of ₹ 2 crores, thereby ensuring a bonus pay out to the directors. This suggestion is not illegal at all as the bonus is discretionary rather than statutory/contractual. In other words, the company has no

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legal obligation to pay the bonus to the employees. However, the reason behind non-payment of the bonus is what gives rise to ethical considerations. The suggestion by the CFO will have the aforesaid impact of reducing expenses and improving profits.

On a moral ground, the suggestion is likely to have negative consequences for the company. The employees would be dissatisfied that the bonus has been withdrawn, and further, when they would see the directors withdrawing bonuses out of the profits arising on a saving in bonus costs, it would have a negative impact on employee morale, which would result in low employee satisfaction scores and poor retention rates, which are reported as non-financial information in the financial statements. Companies are also under increasing pressure to reduce the wage gap between the management and its employees. By not paying a bonus, this metric will be adversely affected.

The CFO's statement that the above action will not negatively impact the company as the non-financial reporting indicators are not widely read by the users is misleading. The non-financial information is becoming increasingly important to the users of financial statements as they care about companies' treatment of their employees and view it as being important in the long-term success of the company.

A chartered accountant has a responsibility to exercise due diligence and clearly consider both financial and non-financial information while discharging his professional duty. It would be unethical for a chartered accountant to guide the management on matters which may result into any kind of disadvantage (it includes even non-financial matters) to the stakeholders.

Further, a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A chartered accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable chartered accountants to meet their responsibility to act in the public interest. *(Refer Section 100.1 A1, Code of Ethics issued by ICAI)*

Hence, it is essential for a chartered accountant to uphold the professional standards and act in accordance with the ethical principles by ensuring transparency and accuracy in financial reporting.

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E. INDUCEMENTS, INCLUDING GIFTS AND HOSPITALITY

An inducement is an object, situation, or action that is used as a means to influence another individual's behaviour, but not necessarily with the intent to improperly influence that individual's behaviour. Inducements can range from minor acts of hospitality between business colleagues to

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acts that result in non-compliance with laws and regulations. An inducement can take many different forms, for example:

- Gifts.
- Hospitality.
- Entertainment.
- Political or charitable donations.
- Appeals to friendship and loyalty.
- Employment or other commercial opportunities.
- Preferential treatment, rights or privileges

1. Immediate or Close Family Members

A Chartered Accountant shall remain alert to potential threats to the accountant's compliance with the fundamental principles created by the offering of an inducement:

(a) By an immediate or close family member of the accountant to a counterparty with whom the accountant has a professional relationship; or

(b) To an immediate or close family member of the accountant by a counterparty with whom the accountant has a professional relationship.

Where the Chartered Accountant becomes aware of an inducement being offered to or made by an immediate or close family member and concludes there is intent to improperly influence the behaviour of the accountant or of the counterparty or considers a reasonable and informed third party would be likely to conclude such intent exists, the accountant shall advise the immediate or close family member not to offer or accept the inducement.

One of the factors that is relevant in determining whether there is actual or perceived intent to improperly influence the behaviour of the Chartered Accountant or of the counterparty is the nature or closeness of the relationship, between:

(a) The accountant and the immediate or close family member;

(b) The immediate or close family member and the counterparty; and

(c) The accountant and the counterparty.

For example, the offer of employment, outside of the normal recruitment process, to the spouse of the accountant by a counterparty with whom the accountant is negotiating a significant contract might indicate such intent.

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F. RESPONDING TO NON-COMPLIANCE WITH LAWS AND REGULATIONS IN CASE OF EMPLOYMENT WITH LISTED ENTITIES

A Chartered Accountant might encounter or be made aware of non-compliance or suspected non-compliance in the course of carrying out professional activities. This section guides the accountant in assessing the implications of the matter and the possible courses of action when responding to non-compliance or suspected non-compliance with:

(a) Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the employing organization's financial statements; and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the employing organization's financial statements, but compliance with which might be fundamental to the operating aspects of the employing organization's business, to its ability to continue its business, or to avoid material penalties.

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. When responding to non-compliance or suspected noncompliance, the objectives of the Chartered Accountant are:

(a) To comply with the principles of integrity and professional behaviour;

(b) By alerting management or, where appropriate, those charged with governance of the employing organization, to seek to:

  (i) Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or

  (ii) Deter the non-compliance where it has not yet occurred; and

  (iii) To take such further action as appropriate in the public interest.

Non-compliance with laws and regulations ("non-compliance") comprises acts of omission or commission, intentional or unintentional, which are contrary to the prevailing laws or regulations committed by the following parties:

(a) The Chartered Accountant's employing organization;

(b) Those charged with governance of the employing organization;

(c) Management of the employing organization; or

(d) Other individuals working for or under the direction of the employing organization.

Examples of laws and regulations which this section addresses include those that deal with:

- Fraud, corruption and bribery.
- Money laundering, terrorist financing and proceeds of crime.
- Securities markets and trading.

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- Banking and other financial products and services.
- Data protection.
- Tax and pension liabilities and payments.
- Environmental protection.
- Public health and safety.

1. Responsibilities of All Chartered Accountants

If protocols and procedures exist within the Chartered Accountant's employing organization to address non-compliance or suspected non-compliance, the accountant shall consider them in determining how to respond to such non-compliance.

2. Responsibilities of Senior Chartered Accountants in Service

Senior Chartered Accountants in service ("senior Chartered Accountants") are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources. There is a greater expectation for such individuals to take whatever action is appropriate in the public interest to respond to non-compliance or suspected noncompliance than other Chartered Accountants within the employing organization. This is because of senior Chartered Accountants' roles, positions and spheres of influence within the employing organization.

1. Addressing the Matter

If the senior Chartered Accountant identifies or suspects that non-compliance has occurred or might occur, the accountant shall, subject to the considerations mentioned above under the responsibilities for all Chartered Accountants, discuss the matter with the accountant's immediate superior, if any. If the accountant's immediate superior appears to be involved in the matter, the accountant shall discuss the matter with the next higher level of authority within the employing organization.

The senior Chartered Accountant shall also take appropriate steps to:

(a) Have the matter communicated to those charged with governance;

(b) Comply with applicable laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority;

(c) Have the consequences of the non-compliance or suspected non-compliance rectified, remediated or mitigated;

(d) Reduce the risk of re-occurrence; and

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(e) Seek to deter the commission of the non-compliance if it has not yet occurred.

In addition to responding to the matter in accordance with the provisions of this section, the senior Chartered Accountant shall determine whether disclosure of the matter to the employing organization's external auditor, if any, is needed.

Such disclosure would be pursuant to the senior Chartered Accountant's duty or legal obligation to provide all information necessary to enable the auditor to perform the audit.

2. Determining Whether Further Action Is Needed

The senior Chartered Accountant shall assess the appropriateness of the response of the accountant's superiors, if any, and those charged with governance.

Examples of circumstances that might cause the senior Chartered Accountant no longer to have confidence in the integrity of the accountant's superiors and those charged with governance include situations where:

- The accountant suspects or has evidence of their involvement or intended involvement in any non-compliance.
- Contrary to legal or regulatory requirements, they have not reported, or authorized the reporting of, the matter to an appropriate authority within a reasonable period.

Further action that the senior Chartered Accountant might take includes:

- Informing the management of the parent entity of the matter if the employing organization is a member of a group.
- Disclosing the matter to an appropriate authority as specified under respective law.
- Resigning from the employing organization.

Resigning from the employing organization is not a substitute for taking other actions that might be needed to achieve the senior Chartered Accountant's objectives under this section. However, there might be limitations as to the further actions available to the accountant. In such circumstances, resignation might be the only available course of action.

3. Seeking Advice

As assessment of the matter might involve complex analysis and judgments, the senior Chartered Accountant might consider:

- Consulting internally.
- Obtaining legal advice to understand the accountant's options and the professional or legal implications of taking any particular course of action.
- Consulting on a confidential basis with the Institute.

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4. Determining Whether to Disclose the Matter to an Appropriate Authority

Disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation. Otherwise, the purpose of making disclosure is to enable an appropriate authority to cause the matter to be investigated and action to be taken in the public interest.

5. Responsibilities of Chartered Accountants Other than Senior Chartered Accountants

If, in the course of carrying out professional activities, a Chartered Accountant becomes aware of information concerning non-compliance or suspected non-compliance, the accountant shall seek to obtain an understanding of the matter. This understanding shall include the nature of the non-compliance or suspected non-compliance and the circumstances in which it has occurred or might occur.

If the Chartered Accountant identifies or suspects that noncompliance has occurred or might occur, the accountant shall, subject to the considerations mentioned above under the responsibilities for all Chartered Accountants, inform an immediate superior to enable the superior to take appropriate action. If the accountant's immediate superior appears to be involved in the matter, the accountant shall inform the next higher level of authority within the employing organization.

In exceptional circumstances, the Chartered Accountant may determine that disclosure of the matter to an appropriate authority is an appropriate course of action. If the accountant does so, that disclosure is permitted. When making such disclosure, the accountant shall act in good faith and exercise caution when making statements and assertions.

Illustration 8:

Agastya Ltd. is a listed company engaged in the manufacturing of automotive spare parts. The company is preparing the financial statements for the year ended 31 March 20X3. The directors of Agastya Ltd. are entitled to an incentive based on the operating profit margin of the company. You have been appointed as a consultant to advise on the preparation of the financial statements, and you notice the following issue:

Issue:

The draft financial statements include an amount of ₹ 75 lakhs given as loan to a director. The loan has no specific repayment terms; the same is repayable on demand. The directors have included such loan under the heading 'Cash and Cash Equivalents'. They have reasoned that since such loan, which is advanced to one of the directors, is repayable on demand, it is readily convertible to cash. Further the directors opine that such presentation should not be a problem even under the Ind AS Framework as financial statements are essentially prepared in accordance

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with accounting policies which is the choice of the company, and in this case, Agastya Ltd. has made a policy choice to show such loan as a cash equivalent.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate.

Solution

The directors have included a loan made to a director as a part of Cash and Cash Equivalents. It appears that the directors have misunderstood the definition of Cash and Cash Equivalents, believing the loan to be a cash equivalent. As per Ind AS 7, *Statement of Cash Flows*, cash equivalents are short-term, highly liquid investments readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value. However, the loan given to the directors is not in place to enable Agastya Ltd. to manage its short-term cash commitments, it has no fixed repayment date and the likelihood of the director defaulting is also not known. Thus, the classification as a cash equivalent is inappropriate.

Instead, the loan should be regarded as a financial asset under Ind AS 109, *Financial Instruments*. Further information would be required, for example is ₹ 75 lakhs fair value? It could be said that the loan will never be repaid, and accordingly could be regarded as a component of directors' remuneration, and if so, the same should be expensed and disclosed accordingly. Further, since the director is likely to fall into the category of key management personnel, related party disclosures under Ind AS 24, *Related Party Disclosures* are likely to be necessary.

The treatment of loan as a cash equivalent breached two fundamental qualitative characteristics prescribed in the Conceptual Framework for Financial Reporting, namely:

(i) Relevance: The information should be disclosed separately as it is relevant to users.

(ii) Faithful representation: Information must be complete, neutral and free from error. Clearly, this will not be the case if loan to a director is shown as Cash Equivalents.

The said treatment is also violative of the Conceptual Framework's key enhancing qualitative characteristics:

(i) **Understandability:** if the loan is shown as Cash Equivalents, it masks the true nature of company's practices, thereby reducing the understandability of the financial statements to the users.

(ii) **Verifiability:** Verifiability ensures that different knowledgeable and independent observers can reach consensus that a particular depiction of a transaction / account balance is a faithful representation. Verifiability gives assurance to the users that the information faithfully

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represents the economic phenomena it intends to represent. The treatment given by the directors of Agastya Ltd. does not meet this benchmark as it reflects the subjective bias of the directors.

(iii) **Comparability:** For financial statements to be comparable year-on-year and with other companies, transactions must be correctly classified and presented, which is not happening here. If the cash balance of one year includes a loan to a director and the next year it does not, then you are not comparing like with like.

There is a potential **conflict of interest** between that of the director and that of the company, which mandates a separate disclosure as a minimum. Further, issues with compliance of section 185 of the Companies Act, 2013 would arise, which is why probably the directors want to hide such loan balance under cash equivalents. Directors are responsible for the financial statements required by statute, and thus it is their responsibility to put right any errors that result in the financial statements not complying with Ind AS. The directors are also legally bound to maintain proper accounting records and recording a loan as cash equivalent clashes with this requirement.

By masking the nature of the transaction, it is possible that the directors are **motivated by personal interest** and are thus failing in their duty to act honestly and ethically. If one transaction is misleading, it casts doubt on the credibility of the financial statements as a whole.

As a consultant, it becomes his responsibility to get the financial statements rectified and guide the directors about the principles enunciated in Ind AS and the correct treatment in accordance with the standards. Otherwise, he will be subject to professional misconduct under Clause 6 and 7 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 6 of Part I of the Second Schedule of the Chartered Accountants Act 1949 states that a CA is guilty of professional misconduct when he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

The Clause 7, states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

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G. PRESSURE TO BREACH THE FUNDAMENTAL PRINCIPLES

A Chartered Accountant shall not:

(a) Allow pressure from others to result in a breach of compliance with the fundamental principles; or

(b) Place pressure on others that the accountant knows, or has reason to believe, would result in the other individuals breaching the fundamental principles.

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A Chartered Accountant might face pressure that creates threats to compliance with the fundamental principles, for example an intimidation threat, when undertaking a professional activity. Pressure might be explicit or implicit and might come from:

- Within the employing organization, for example, from a colleague or superior.
- An external individual or organization such as a vendor, customer or lender.
- Internal or external targets and expectations.

Examples of pressure that might result in threats to compliance with the fundamental principles include:

- Pressure related to conflicts of interest:
    - Pressure from a family member bidding to act as a vendor to the Chartered Accountant's employing organization to select the family member over another prospective vendor.

Discussing the circumstances creating the pressure and consulting with others about those circumstances might assist the Chartered Accountant to evaluate the level of the threat. Such discussion and consultation, which requires being alert to the principle of confidentiality, might include:

- Discussing the matter with the individual who is exerting the pressure to seek to resolve it.
- Discussing the matter with the accountant's superior, if the superior is not the individual exerting the pressure.
- Escalating the matter within the employing organization, including when appropriate, explaining any consequential risks to the organization, for example with:
    - Higher levels of management.
    - Internal or external auditors.
    - Those charged with governance.
- Disclosing the matter in line with the employing organization's policies, including ethics and whistleblowing policies, using any established mechanism, such as a confidential ethics hotline.
- Consulting with:
    - A colleague, superior, human resources personnel, or another Chartered Accountant;
    - Institute or industry associations; or
    - Legal counsel.

An example of an action that might eliminate threats created by pressure is the Chartered Accountant's request for a restructure of, or segregation of, certain responsibilities and duties so that the accountant is no longer involved with the individual or entity exerting the pressure.

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Illustration 9:

As at 31 March 20X4, Mitra Ltd. had a plan to dispose off its 75% subsidiary Dosti Ltd. This plan had been approved by the board and was reported in the media as well as to the Stock Exchange where Mitra Ltd. was listed. It is expected that Jaya Ltd., the non-controlling shareholder in Dosti Ltd. holding 25% stake, will acquire the 75% equity interest as well. The sale is expected to be completed by October 20X4. Dosti Ltd. is expected to have substantial trading losses in the period up to the sale. Mr. X, a chartered accountant, who is an employee in the finance department of Mitra Ltd., wishes to show Dosti Ltd. as held for sale in the financial statements and to create a restructuring provision to include the expected costs of disposal and future trading losses. However, the Chief Operating Officer (COO) does not wish Dosti Ltd. to be categorized as held for sale nor to provide for the expected losses. The COO is concerned as to how this may affect the sales and would surely result in bonus targets not being met. He has argued that as the management, it is his duty to secure a high sales price to maximize the return for shareholders of Mitra Ltd. He has also hinted that Mr. X's job could be at stake if such a provision were to be made in the financial statements. The expected costs from the sale are as follows:

Future Trading Losses:	*₹ 20 crores*
Various legal costs of sale	*₹ 1.5 crores*
Redundancy costs for Dosti Ltd.'s employees	*₹ 4 crores*
Impairment losses on Property, Plant and Equipment	*₹ 7 crores*

Required:

(a) Discuss the accounting treatment which Mitra Ltd. should adopt to address the issue above for the financial statements.

(b) Discuss the ethical issues which may arise in the above scenario, including any actions which Mitra Ltd. and Mr. X should take.

Solution

(a) In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, an entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be *highly probable*.

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For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the **sale should be expected to qualify for recognition as a completed sale within one year from the date of classification**, except in specific cases as permitted by the Standard, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The probability of required approvals (as per the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

An entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out above are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

Based on the provisions highlighted above, the disposal of Dosti Ltd. appears to meet the criteria of **held for sale**. Jaya Ltd. is the probable acquirer, and the sale is highly probable, expected to be completed seven months after the year end, well within the 12-months criteria highlighted above. Accordingly, Dosti Ltd. should be treated as a disposal group, since a single equity transaction is the most likely form of disposal. In case Dosti Ltd. is deemed to be a separate major component of business or geographical area of the group, the losses of the group should be presented separately as a discontinued operation within the Financial Statements of Mitra Ltd.

In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, an entity shall measure a non-current asset (or disposal group) classified as held for sale at the **lower of its carrying amount and fair value less costs to sell**. The carrying amount of Dosti Ltd. (i.e., the subsidiary of Mitra Ltd.) comprises of the net assets and goodwill less the non-controlling interest. The impairment loss recognised to reduce Dosti Ltd. to fair value less costs to sell should be allocated first to goodwill and then on a pro-rata basis across the other non-current assets of the Company.

The Chief Operating Officer (COO) is incorrect to exclude any form of restructuring provision in the Financial Statements. Since the disposal is communicated to the media as well as the Stock Exchange, a constructive obligation exists. However, ongoing costs of business should not be provided for, only **directly attributable costs of restructuring** should be provided. Future operating losses should be excluded as no obligating event has arisen, and no provision is required for impairment losses of Property, Plant and Equipment as it is already

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considered in the remeasurement to fair value less costs to sell. Thus, a provision is required for ₹ 5.5 crores (₹ 1.5 crores + ₹ 4 crores).

(b) **Ethics**

Accountants have a duty to ensure that the financial statements are **fair**, **transparent** and **comply with the accounting standards**. Mr. X have committed several mistakes. In particular, he was unaware of which costs should be included within a restructuring provision and has failed to recognise that there is no obligating event in relation to future operating losses. A chartered accountant is expected to carry his work with **due care and attention** for lending credibility to the financial statements. Accordingly, he must update his knowledge and ensure that work is carried out in accordance with relevant ethical and professional standards. Failure to do so would be a breach of **professional competence**. Accordingly, Mr. X must ensure that this issue is addressed, for example by attending regular training and professional development courses.

It appears that the chief operating officer is looking for means to **manipulate** the financial statements for meeting the bonus targets. Neither is he is willing to reduce the profits of the group by applying held for sale criteria in respect of Dosti Ltd. nor is he willing to create appropriate restructuring provisions. Both the adjustment which comply with the requirements of Ind AS will result in reduction of profits. His argument that the management has a duty to maximize the returns for the shareholders is true, but such maximization must not be achieved at the cost of **objective** and **faithful representation** of the performance of the Company. In the given case, it appears that the chief operating officer is motivated by bonus targets under the garb of maximizing returns for the shareholders, thereby resulting in misrepresentation of the results of the group.

Further, by threatening to dismiss Mr. X, the COO has acted unethically. **Threatening and intimidating behaviour** is unacceptable and against all ethical principles. This has given rise to an **ethical dilemma** for Mr. X. He has a duty to produce financial statements but doing so in a fair manner could result in a loss of job for him. The chartered accountant should approach the chief operating officer and remind him the basic ethical principles and communicate him to do the necessary adjustments in the accounts so that they are fair and objective.

In case Mr. X, falls under undue influence of COO and applies the incorrect accounting treatment, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, for contravening the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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TEST YOUR KNOWLEDGE

Question

1. Shastra Ltd. desires to upgrade its production process since the directors believe that technology-led production is the only way the company can remain competitive. On 1 April 20X5, the company entered into a property lease arrangement in order to obtain tax benefits. However, the draft financial statements do not show a lease asset or a lease liability as on date.

   A new financial controller, CA. Sunil Raghavan, joined Shastra Ltd. before the financial year ending 31 March 20X6 and was engaged in the review of financial statements to prepare for the upcoming audit and to begin making a loan application to finance the new technology. CA. Sunil Raghavan believes that the lease arrangement should be recognized in the Balance Sheet. However, the Managing Director, Ms. Anusha Shrivastava, an MBA (Finance), strongly disagrees. She wishes to charge the lease rentals to the Statement of Profit or Loss. Her opinion is based on the understanding that the lease arrangement is merely a monthly rental payment, without any corresponding asset or obligation, since there is no 'invoice' for transfer of asset to Shastra Ltd. Her disagreement also stems from the fact that showing a lease obligation in the Financial Statements would impact the gearing ratio of the company, which could have an adverse impact on the upcoming loan application. Ms. Anusha has made it clear to CA. Sunil Raghavan that at stake is not only the loan application but also his future prospects at Shastra Ltd.

   Required:

   Discuss the potential ethical conflicts which may arise in the above scenario and the ethical principles which would guide how the financial controller should respond to the situation.

Answer

1. As per Ind AS 116, Leases, at the inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

   In accordance with the above definition, Shastra Ltd. must recognise a right-of-use asset representing the property and a corresponding lease liability for the obligation to make lease payments. At the commencement date, the right-of-use asset so recognised would include:

   - The amount of the initial measurement of lease liability;

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- Any initial direct costs;
- Any costs to be incurred for dismantling or removing the underlying asset or restoring the site at the end of the lease term.

The liability for the lease obligation would be measured as the present value of future lease payments including payments that would be made towards any residual value guarantee, discounted using the rate implicit in the lease or the incremental rate of borrowing of the lessor, whichever is available.

The fact that there is no 'invoice' evidencing transfer of the asset cannot be a reason to avoid recognition of the right-of-use asset. In fact, what is being recognised is not an asset, since ownership rights are not transferred. What is sought to be recognised under Ind AS 116 is the right to use the asset in the manner required by the lessee Shastra Ltd. Further, since the lease represents an obligation to pay lease rentals in the future, a corresponding lease liability should be recognised. Not recognising the right-of-use asset or lease liability would not only be a violation of Ind AS 116, Leases, but would also be an incorrect presentation of the financial position, which is critical given that Shastra Ltd. is interested in taking a loan for its operations.

Ethical issues:

The managing director's threat to the financial controller results in an ethical dilemma for the financial controller. This pressure is greater because the financial controller is new.

Threats to fundamental principles

The fact that the position of the financial controller has been threatened if the treatment suggested by the managing director is not followed indicates that there is an **intimidation threat** to the fundamental principles of **objectivity** and **integrity**.

Further, as the manging director has flagged the risk that the company may not obtain loan financing if the lease obligation is recorded in the balance sheet, there is an **advocacy threat** because the financial controller may be compelled to follow an incorrect treatment to maximise the chances of obtaining the loan. This pressure again is greater because the financial controller is new.

Professional competence

When preparing the financial statements, the financial controller should ensure that the fundamental principle of **professional competence** should be followed, which requires that accounts should be prepared in **compliance with Ind AS**.

Thus, since the arrangement meets the Ind AS 116 criteria for a lease, the right-of-use asset and a corresponding lease liability should be recognised, as otherwise the liabilities of

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Shastra Ltd. would be understated. The ICAI Code of Ethics and Conduct sets boundaries beyond which accountants should not act. If the managing director refuses application of Ind AS 116, Leases, the financial controller should **disclose this to the appropriate internal governance authority**, and thus feel confident that his actions were ethical.

If the financial controller were to bend under pressure and **accept the managing director's proposed treatment**, this would contravene Ind AS 116 and **breach the fundamental principle of professional competence**. In such a case, he would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949, which states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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NOTES

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CHAPTER 17

ACCOUNTING AND TECHNOLOGY



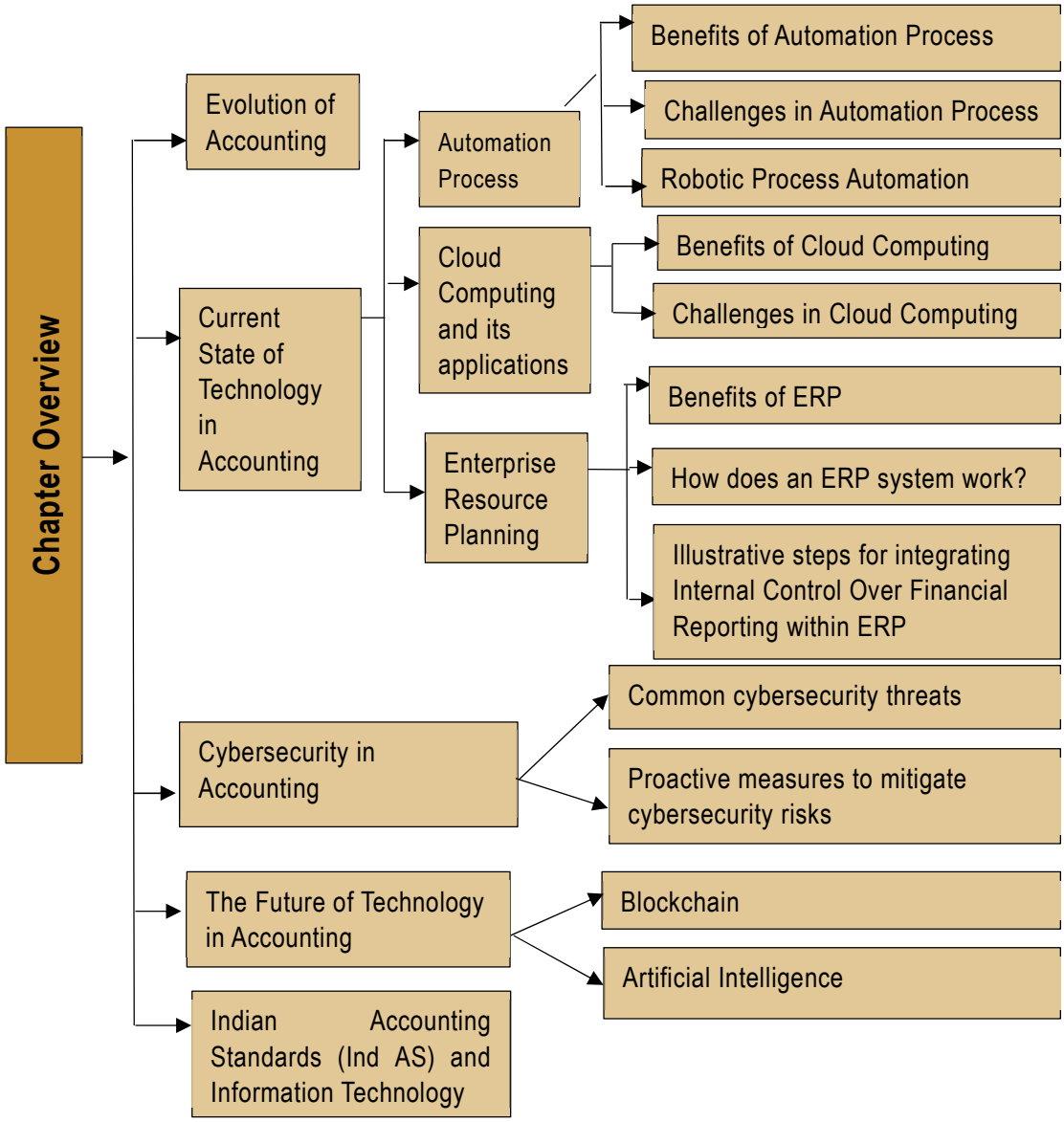
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Delve into various technologies that have had a significant impact on the accounting profession like Cloud Computing, Artificial Intelligence and Cybersecurity etc.
- Recognise the benefits of each technology and how they have changed the way accountants perform their tasks.
- Examine the challenges that accounting professionals face in adapting to new technologies.
- Appreciate the importance of accounting professionals staying up-to-date with the latest technologies.
- Automate the accounting process with various technologies for various Ind AS based situations.

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CHAPTER OVERVIEW



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1. INTRODUCTION

Accounting is a critical function for all businesses, as it enables them to track and manage their financial transactions, budgets, and investments. The field of accounting has undergone significant changes in recent years, primarily due to advancements in technology. As businesses have embraced digital transformation, the accounting profession has evolved, becoming more efficient and accurate with the help of new technologies.

It is not the intent of the chapter to discuss a particular accounting software in detail, hence this chapter will not contain for instance, commands to pass vouchers in software like Tally or SAP. This chapter intends to provide an overview of the impact of technology on the accounting profession. It highlights the trends that are transforming the industry and the challenges that accounting professionals face in adapting to new technologies.

The chapter commences with a discussion on the history of accounting and its evolution over time. Accounting practices were once manual and paper-based, but advancements in technology have enabled automation, making accounting processes faster and more efficient.

The chapter then delves into the various technologies that have had a significant impact on the accounting profession. These technologies include cloud computing, artificial intelligence, and cybersecurity etc. The chapter discusses the benefits of each technology and how they have changed the way accountants perform their tasks. For example, cloud computing has made it possible for accountants to access financial data from anywhere in the world.

The chapter also examines the challenges that accounting professionals face in adapting to new technologies. For example, the implementation of new technologies can be costly, and many businesses may not have the resources to invest in them. Additionally, some accounting professionals may be resistant to change, preferring to stick with the traditional methods they are comfortable with.

The chapter concludes by highlighting the importance of accounting professionals staying up-to-date with the latest technologies. As businesses continue to embrace digital transformation, accountants must be able to adapt to new technologies to remain competitive in the industry. The chapter emphasizes the need for ongoing education and training to ensure that accounting professionals have the skills they need to succeed in an increasingly digital world.

2. EVOLUTION OF ACCOUNTING

This section provides a detailed history of accounting from its earliest origins to modern-day practices. Understanding the history of accounting is essential to comprehending the current state of the profession and the role technology has played in its evolution.

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The origins of accounting can be traced back to ancient civilizations such as the Egyptians, Greeks, and Romans. In these early civilizations, accounting primarily involved record-keeping for tax purposes and for the management of government resources. These early accounting systems were manual and paper-based, and the process was labour intensive. By the time of the Roman Empire, the government had access to detailed financial information.

In India, Chanakya authored a manuscript similar to a financial management book during the period of the Mauryan Empire. His book 'Arthashastra' contains few detailed aspects of maintaining books of accounts for a sovereign state.

The Italian Luca Pacioli, recognized as The Father of accounting and bookkeeping was the first person to publish a work on double-entry bookkeeping, thereby introducing the field in Italy. Subsequently, accounting practices evolved to include double-entry bookkeeping. This system enabled businesses to create a balance sheet, which showed the financial position of the company at a given time. The introduction of double-entry bookkeeping was a significant milestone in the history of accounting and laid the foundation for modern-day accounting practices.

With the industrial revolution, significant changes came to the accounting profession. Due to the advent of machines and mass production, accounting became more complex, requiring more detailed records of financial transactions. This period also saw the rise of the accounting profession, with the establishment of the first professional accounting organizations. The Institute of Chartered Accountants of Scotland is the world's oldest and first professional chartered accountants' body, being established by the Royal Charter in 1854. Subsequently, organizations such as the Institute of Chartered Accountants in England and Wales, Certified Practising Accountant Australia, American Institute of Certified Public Accountants and Chartered Accountants Ireland were established in the 19th Century. With the advent of the 20th Century, the Association of Chartered Certified Accountants was established, followed by organizations such as the Institute of Chartered Accountants of India and the Institute of Singapore Chartered Accountants.

In the post-industrial period, technological advancements such as the computer, transformed the accounting profession. The introduction of computers enabled accountants to automate many of the manual processes associated with accounting, making the process faster and more accurate. To elucidate further, interest calculation in banks, which is currently system driven was once computed manually by the bank staff. Given the huge volume of transactions, interest computation usually took over a month for each branch, and the chances of errors were very high since the same was manual.

Currently, there is an upsurge of technology in the accounting field on account of cloud computing and artificial intelligence, all of which are transforming the accounting profession, making it more efficient and accurate. However, these new technologies also present challenges for accounting professionals, who must adapt to new systems and processes to remain competitive.

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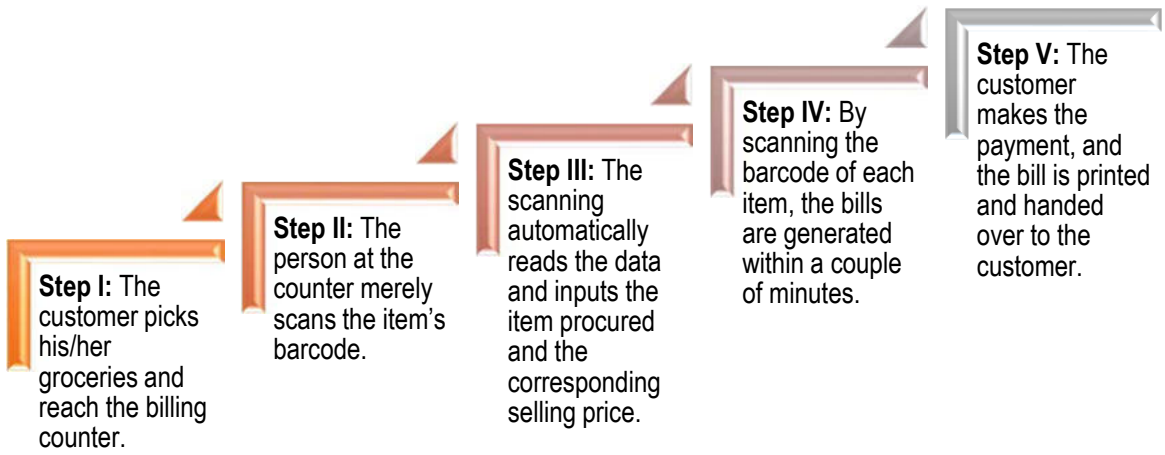
3. THE CURRENT STATE OF TECHNOLOGY IN ACCOUNTING

This section provides an in-depth overview of the current state of technology in the accounting profession. It discusses the various technologies used in accounting and their impact on the profession, including automation, cloud computing, and artificial intelligence

3.1 Automation Process

The major change visible is the automation of the accounting process. Automation is the use of software and other tools to automate manual processes, making them faster and more accurate. We can understand this with the help of the below example:

For instance, let us consider the activities involved in the process of procuring groceries from a departmental store such as Walmart or Reliance Smart Bazaar **at the Front-End.**



The entire process happens in a fraction of a second, saving valuable time and mitigating all errors.

However, **at the backend, the below activities take place:**

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As and when the barcode of an item is scanned at the billing counter, the inventory of the said item at the departmental store is simultaneously updated recording the issue/sale of the same. This ensures accuracy in maintenance of inventory data.

A periodical physical check of inventory will give conclusive evidence of the correctness of data generated by the system, thereby giving comfort on the management assertions of accuracy, valuation and existence of the inventory.

In certain cases, the software is so programmed that the indirect taxes (GST) levied on the sale value as per the invoice is updated simultaneously, which can get uploaded on the GST portal at the end of the day by the accounting team in the backend.

This ensures accuracy in returns uploaded, thereby minimizing the need for manual reconciliation and data maintenance.

Software are also programmed to ensure that the bill amount is automatically displayed on the Point of Sale Machine, through which the customer makes the payment either through debit/credit card or through UPI. In case the customer opts to make payment in cash, entering the amount on the Screen will open the cash drawer in which the cash paid is deposited.

Since the cash drawer is opened through the system only after logging in by the concerned person, in case of mismatch in cash balances, the concerned person can be identified, thereby reducing the chances of misappropriation of cash.

3.1.1 Benefits of Automation Process

1. **Streamlining Data Entry:** Automation tools, such as optical character recognition (OCR) or barcode recognition technology, can help to automate the entry of data from source documents such as receipts and invoices. This can reduce the amount of time and effort required for manual data entry, as well as minimizing the potential for human error.
2. **Accelerating Data Processing:** Automation can help to process large amounts of data / large volumes of transactions more quickly and accurately than manual methods. For example, software can automatically categorize transactions into the appropriate accounts, calculate tax amounts, and generate financial statements, among other tasks.
3. **Enhancing Accuracy:** Automation can help to reduce errors and discrepancies in accounting processes. By automating tasks such as data entry and calculations, businesses can minimize the risk of errors caused by human error, improving the accuracy and reliability of their financial data.

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4. **Improving Decision-Making:** Automation can provide real-time insights into financial data, enabling businesses to make informed decisions more quickly. With automated reporting, the time spent on routine tasks is greatly minimized, enabling businesses to gain deeper insights into their financial performance, identify trends and patterns, and adjust their strategies accordingly.

5. **Saving Time and Money:** Automation reduces the amount of time and resources required to perform manual tasks such as data entry and reconciliations. This results in businesses saving on staffing costs and increases productivity and enabling accountants to focus on higher-level tasks such as analysis and planning.

6. **Facilitating Compliance:** Automation helps business to stay compliant with regulations and standards by ensuring accounting practices meet the necessary requirements. As seen above, automation ensures accurate data for the purposes of return filing. Further, in case the systems are so programmed, reporting tools can generate financial statements that meet the criteria of Ind AS or Indian GAAP as the case may be. This would ensure minimizing the risk of non-compliance and potential penalties.

3.1.2 Challenges in Automation Process

Automation also comes with its own set of potential drawbacks and challenges, some of them are mentioned below:

- It arises the need for ongoing training and education to keep up with the latest technology.
- Automation also presents a risk of data breaches and cyber-attacks, which can compromise the security and confidentiality of financial data.
- Due to automation, there exists potential loss of jobs. However, this can be mitigated by ensuring appropriate training to the workforce to remain updated with the technology.

To summarize, automation helps businesses achieve efficiency, accuracy and decision-making in accounting while saving time and money and facilitating compliance with regulations and standards.

3.1.3 Robotic Process Automation

Robotic Process Automation (RPA) is an emerging technology that revolutionizes financial reporting processes. RPA utilizes software robots or "bots" to automate manual and repetitive tasks in financial data processing, analysis, and reporting. By mimicking human interactions with digital systems, RPA bots can extract and consolidate data, perform calculations, generate reports, and ensure compliance with accounting standards. The adoption of RPA in financial reporting improves accuracy, enhances efficiency, and frees up valuable time for finance professionals to focus on more strategic activities. Moreover, RPA enables organizations to

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achieve timely reporting, cost savings, and increased data integrity, ultimately leading to more reliable and insightful financial information.

Example 1: Using RPA in Financial Reporting

Let us consider XYZ Company, a group of companies that prepares consolidated financial statements in accordance with Ind AS 110. To streamline their financial reporting processes, XYZ Company decides to leverage Robotic Process Automation (RPA). In that case, the steps involved would be:

- As XYZ Company has multiple subsidiaries, each maintaining their own financial data, RPA bots are implemented to automate the process of extracting financial data from the subsidiary systems and consolidating it into the parent company's financial system.
- The bots retrieve the relevant financial information, perform necessary currency conversions, and reconcile intercompany transactions, ensuring accurate and timely consolidation.
- As per Ind AS 110, intercompany transactions need to be eliminated to avoid double counting and provide a true representation of the group's financial position. RPA bots are programmed to identify intercompany transactions within the consolidated financial data.
- The bots automatically eliminate these transactions by adjusting the corresponding accounts and generating elimination entries, simplifying the process and reducing the potential for errors.
- The bots retrieve the consolidated financial data from the parent company's financial system and apply the necessary consolidation adjustments.
- They perform calculations for non-controlling interests, equity, and comprehensive income attributable to the parent and non-controlling interests.
- The bots generate the consolidated balance sheet, income statement, statement of changes in equity, and cash flow statement, ensuring accuracy and consistency in the financial reporting process.

3.2 Cloud Computing

Cloud computing refers to the delivery of computing services over the internet. It allows accountants to access their data and software from any device with an internet connection.

The entire world was hit in 2020 with probably the biggest black swan event of the past couple of decades– the COVID-19 pandemic. The continuous lockdowns severely impacted businesses, and operations came to a standstill. This in turn led to viewing cloud computing as a serious alternative compared to traditional client-server architecture in physical locations controlled by the entities themselves.

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With the advent of cloud computing, persons could access the systems from their respective locations, work remotely during the lockdown and ensure that the accounting process and reporting requirements did not suffer adversely.

3.2.1 Common Applications / Cases of Cloud Computing

1. **Cloud Storage**: Services like Dropbox, Google Drive, and Microsoft OneDrive offer cloud storage solutions that allow users to store and access their files and data from anywhere with an internet connection. Users can save documents, photos, videos, and other files in the cloud and synchronize them across multiple devices.
2. **Software as a Service (SaaS)**: SaaS platforms provide cloud-based software applications that users can access and utilize via the internet. Examples include Salesforce for customer relationship management (CRM), Slack for team collaboration, and QuickBooks Online for accounting and financial management.
3. **Infrastructure as a Service (IaaS)**: IaaS providers offer virtualized computing resources, including servers, storage, and networking infrastructure, on a pay-as-you-go basis. Examples include Amazon Web Services (AWS), Microsoft Azure, and Google Cloud Platform. These platforms allow businesses to scale their IT infrastructure based on demand without the need for physical hardware.
4. **Platform as a Service (PaaS)**: PaaS providers offer cloud-based platforms that enable developers to build, deploy, and manage applications without the complexity of infrastructure management. Examples include Microsoft Azure App Service, and Google App Engine.
5. **Cloud-based Communication and Collaboration**: Applications like Microsoft Teams, Google Workspace (formerly G Suite), and Zoom provide cloud-based communication and collaboration tools that facilitate real-time messaging, video conferencing, file sharing, and project management.
6. **Cloud-based E-commerce**: Few platforms enable businesses to set up and manage online stores using cloud infrastructure. These platforms provide features like product catalogues, payment processing, inventory management, and customer analytics.
7. **Big Data Analytics**: Cloud computing enables organizations to process and analyze large volumes of data efficiently. Services like Amazon Redshift, Google BigQuery, and Microsoft Azure Data Lake Analytics provide scalable infrastructure for big data processing and analytics, empowering businesses to derive valuable insights from their data.

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3.2.2 Benefits of Cloud Computing

Following are some of the ways in which Cloud Computing has positively impacted accounting:

1. **Improved accessibility:** Cloud-based accounting software allows users to access their financial data from any location with an internet connection. This has increased accessibility and flexibility for accountants and business owners, allowing them to work remotely and collaborate in real-time.
2. **Enhanced security:** Cloud-based accounting software providers typically offer advanced security features such as encryption, firewalls, and multi-factor authentication helping in the protection of sensitive financial data from cyber threats and data breaches.
3. **Increased scalability:** Cloud-based accounting software allows businesses to easily scale up or down based on their changing needs. As a business grows, it can easily add new users and features without having to invest in additional hardware or software.
4. **Reduced costs:** Cloud-based accounting software typically requires less upfront investment in hardware and software, as well as ongoing maintenance costs. This can help businesses save money on IT expenses and redirect those funds to other areas of the business. For example, the costs of installing Microsoft Office Suite on a laptop or desktop is far more expensive than subscribing to the Office 365 Suite, which is a web-based download. Further, the web-based download also provides the options of continuous free updates unlike its Office Suite offline counterpart.
5. **Streamlined collaboration:** Cloud-based accounting software allows multiple users to collaborate in real-time, reducing the need for manual data entry and communication. This can help to streamline workflows and reduce errors caused by miscommunication.
6. **Improved reporting and analytics:** Cloud-based accounting software often includes powerful reporting and analytics tools that allow businesses to gain deeper insights into their financial performance. This can help businesses make more informed decisions and identify areas for improvement.

3.2.3 Challenges in Cloud Computing

Following are the potential challenges which may emerge in cloud computing:

- Since cloud-based software are completely online, they could be prone to hackers who could 'steal' data or passwords or compromise the integrity of the processed data, thereby causing disruptions to the businesses.
- Strong net connectivity is a must for cloud-computing to be a success. Though there has been a huge surge in network and mobile connectivity in the past decade, connectivity in

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non-metros, tier-2 or tier-3 cities is not well-developed, which could create accessibility issues to the users of the cloud-based accounting software.

Example 2: Using Cloud Computing

The finance team at XYZ Company, consisting of chartered accountants and financial analysts, collaborates on the preparation of the Income Statement. They utilize cloud-based collaboration tools, such as Microsoft Teams or Google Workspace, to enhance their efficiency and ensure accuracy in the reporting process.

- Using cloud-based spreadsheets or shared documents, the finance professionals from various locations input the relevant financial data into the Income Statement template. They update revenue figures, operating expenses, cost of goods sold, and other relevant information, ensuring accurate and comprehensive data collection.
- Through cloud collaboration platforms, team members can work on the Income Statement simultaneously, regardless of their physical locations. They can review, edit, and make real-time updates to the document. For example, the finance team in Mumbai can update the revenue figures based on the sales data received, while the team in Bengaluru can revise the operating expenses based on the cost information provided.
- Cloud-based collaboration tools offer version control features, allowing the team to track changes made to the Income Statement over time. This ensures that the latest version is always accessible and helps in maintaining an audit trail for any revisions or modifications made during the reporting process.
- Once the Income Statement is prepared, the finance team can use cloud-based communication channels, such as instant messaging or video conferencing, to discuss the document and address any queries or concerns. The team lead or finance manager can review the Income Statement, provide feedback, and approve the final version before submission.
- Cloud-based collaboration ensures that all team members have secure access to the Income Statement from their respective locations. User access controls and permissions can be managed to restrict access to authorized personnel only, maintaining data confidentiality and security.

3.3 Enterprise Resource Planning (ERP)

Enterprise resource planning (ERP) is a type of software that organizations use for managing day-to-day business activities like procurement, project management, accounting, risk management, compliance, and supply chain operations.

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ERP systems connects and corelates a multitude of business processes and enable the flow of data between them. It collects an organization's shared transactional data from multiple sources and thus eliminate data duplication and provide data integrity with a single source of authentication.

Nowadays, ERP systems are used by many organisations as it is critical for managing thousands of businesses of varied sizes covering all industries. Cloud-based ERP applications are embedded with next-generation technologies, such as AI, machine learning (ML), and digital assistants.

ERP systems are designed around a single, defined data structure (schema) that typically has a common database. This helps to ensure that the information used across the enterprise is normalized and based on common definitions and user experiences. These core constructs are then interconnected with business processes driven by workflows across business departments (e.g. finance, human resources, engineering, marketing, and operations), connecting systems and the people who use them.

Since data is the lifeblood of every modern company, ERP makes it easier to collect, organize, analyze, and distribute this information to every individual and system that needs it to best fulfill their role and responsibility. ERP also ensures that these data fields and attributes roll up to the correct account in the company's general ledger so that all costs are properly tracked and represented.

A key ERP principle is the central collection of data for wide distribution. With a secure and centralized data repository, everyone in the organization can be confident that data is correct, up-to-date, and complete. Data integrity is assured for every task performed throughout the organization, from a quarterly financial statement to a single outstanding receivables report.

3.3.1 Benefits of ERP

It's impossible to ignore the impact of ERP in today's business world. As enterprise data and processes are caged into ERP systems, businesses can align separate departments and improve workflows, resulting in significant bottom-line savings. Examples of specific business benefits include:

1. Improved business insight from real-time information generated by reports
2. Less operational costs through streamlined business processes and best practices
3. Enhanced collaboration of users sharing data in contracts, requisitions, and purchase orders
4. Better efficiency through a common user experience across many business functions and well-defined business processes
5. Consistent infrastructure from the back office to the front office

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6. Increased user-adoption rates from a common user experience and design
7. Reduction in risk through improved data integrity and financial controls
8. Less management and operational costs through uniform and integrated systems

3.3.2 How does an ERP system work?

ERP systems work by using a defined, standard data structure. Information entered by one department is immediately available to authorized users across the business. This uniform structure helps keep everyone on the same page.

Real-time data is then woven into business processes and workflows across departments. Managers check if one location is doing significantly better than another site and can figure out why. Finance department can use ERP for comparison of sales, profits and other financial data to help executives in understanding the performance of the organisation and also for setting new targets.

ERP systems deliver the most value when a company has modules for each major business function and ensures timely and accurate data entry. When a company uses business systems from multiple vendors, integrations are generally possible to make data automatically flow into the ERP. This real-time data can then be used throughout the ERP instance to benefit any process or workflow.

3.3.3 Illustrative steps for integrating Internal Control Over Financial Reporting with an ERP

Integrating Internal Control over Financial Reporting (ICOFR) with an Enterprise Resource Planning (ERP) system offers the key advantage of streamlining financial processes, ensuring data integrity, and promoting effective internal controls. By automating and standardizing procedures, the ERP system reduces manual effort and minimizes the risk of errors. It enables segregation of duties, real-time visibility into financial data, comprehensive audit trails, enhanced reporting capabilities, and proactive risk mitigation. This integration strengthens financial control, accuracy, and compliance, ultimately enabling better decision-making and reducing the likelihood of fraud or errors.

The following are illustrative steps for integrating ICOFR within ERP:

1. Verify that the process includes identification and updating of internal and external financial reporting requirements and deadlines.

   The finance team regularly reviews the regulatory guidelines and reporting requirements set by the regulators and ensures that the ERP system's financial closing process is aligned with these requirements. Examples are listed companies to declare quarterly results as per LODR, filing of periodical returns under GST, Income Tax, Labour laws, etc.,

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2. Review the documented process to ensure it aligns with the organization's financial reporting policies and regulatory guidelines.

   The finance team reviews the documented process in the ERP system and cross-checks it with the organization's financial reporting policies and regulatory guidelines to ensure consistency. Examples are accounting polices relating to Property plant and equipment, depreciation, Inventory etc.,

3. Use the ERP system's change management functionality to track and validate changes made to the financial closing and reporting process.

   When changes are made to the financial closing and reporting process, the finance team uses the ERP system's change management functionality to track and record these changes. They review system logs and audit trail for changes made to the financial closing and reporting process are as per defined roles and responsibilities for change control, including change initiators, approvers, and change management teams.

4. Verify that changes to the process are authorized by designated individuals with appropriate authority using system logs.

   The finance team reviews the system logs, audit trail and confirms that any changes to the financial closing and reporting process were authorized by designated individuals with the appropriate authority, such as the CFO or finance manager.

5. Review the change requests, approvals, and documentation within the ERP system to ensure proper authorization and validation of process changes.

6. Validate that roles and responsibilities in the financial closing and reporting process are clearly defined within the ERP system by reviewing users access matrix configurations and system logs.

   Review system logs and audit trail with Responsibility assignment matrix (RAM). RAM is a tool used in project management and enterprise resource planning (ERP) implementations to define and communicate the roles and responsibilities of individuals or teams involved in a project or process. The matrix clarifies who is responsible, accountable, consulted, and informed for each task or deliverable within the ERP implementation.

7. Assess the qualifications and training records of individuals assigned to financial reporting roles within the ERP system.

8. Validate that individuals responsible for financial reporting have the necessary understanding of the organization's operations and appropriate accounting knowledge.

   The finance team validates that individuals responsible for financial reporting within the ERP system have a comprehensive understanding of the organization's operations and possess

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appropriate accounting knowledge. For example, verify HR records of those involved in accounting have appropriate knowledge.

9. Validate that decisions on alternative accounting treatments for significant events or transactions are documented and approved by management.

   Reviewing the Journal vouchers listing by identifying non routine transactions. Review the system of Standardizing voucher types. This involves defining a set of predefined templates or formats for different types of journal entries to ensure consistency and accuracy in recording financial data.

10. Review the ERP system for documentation of accounting treatment decisions, including approvals and communication to the audit committee.

    Documentation of accounting treatment decisions refers to the process of recording and maintaining comprehensive documentation regarding the rationale, analysis, and conclusions related to accounting treatments chosen for specific transactions or events like recognising long term construction projects.

11. Review the ERP system's user administration functionality to ensure appropriate individuals have access to the financial reporting process.

    Review system logs and audit trail with Responsibility assignment matrix (RAM).

12. Review whether proper KYC validation controls are in place for creating account masters and review the process for identifying related party transactions.

    Separate ledger coding for related parties for auto tabulating transactions to present as per Schedule III of Companies Act, 2013.

13. Validate that the ERP system captures and documents the appropriate accounting treatment for each non-routine event, transaction, and account balance by reviewing Journal Vouchers listing.

14. Use the ERP system's audit trail and reporting capabilities to validate that all postings have occurred in the correct accounting period reviewing accounting period configuration controls.

    In an ERP system, the accounting date and transaction date are captured and stored as part of the transactional data. They are used in various processes, such as journal entry creation, financial statement generation, period-end closing activities, and audit trails. Understanding the distinction between these dates is important for accurate financial reporting, compliance, and analysis of business transactions within the ERP system.

15. Review the system's controls for preventing backdating or unauthorized adjustments to postings by reviewing the posting date and transactions date of entries.

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4. CYBERSECURITY IN ACCOUNTING

This section seeks to provide an overview of cybersecurity threats and risks and explores the impact of cybersecurity breaches on accounting firms and their clients which may range from accessing the financial data of the firm or client, to an extent of modifying the financial statements without the knowledge of the management. This section also discusses best practices for mitigating cybersecurity risks. This section seeks to provide an overview of cybersecurity threats and risks and explores the impact of cybersecurity breaches on accounting firms and their clients which may range from accessing the financial data of the firm or client, to an extent of modifying the financial statements without the knowledge of the management. Protecting financial information is crucial to prevent unauthorized access and data breaches. Legal and regulatory frameworks, like the Information Technology Act, 2000 (Amended in 2008), govern the collection, storage, and transmission of financial data. Non-compliance with data protection laws can lead to financial penalties and reputational damage. This section also discusses best practices for mitigating cybersecurity risks.

Organizations have legal and ethical obligations to disclose cybersecurity incidents with financial implications. Cybersecurity incidents can affect financial reporting through financial losses, reputational damage, and legal consequences. Reporting guidelines of various regulators such as SEBI, RBI etc., address the disclosure of cybersecurity incidents in financial statements.

Cybersecurity is a critical concern for accounting professionals, as sensitive financial data is often stored and transmitted digitally. With the increasing reliance on technology in accounting, the risk of cybersecurity threats and breaches has also increased. A cybersecurity breach can have significant consequences, including financial losses, reputational damage, and loss of sensitive client data. Some of the common cybersecurity threats are highlighted below. In all the cases, the aim of the attack would be either stealing sensitive financial data or disrupting operations or demand ransom money.

4.1 Common cybersecurity threats

(a) **Phishing attacks:** Phishing attacks are a common cybersecurity threat that involves tricking users into clicking on malicious links or providing sensitive information.

(b) **Malware attacks:** Malware attacks involve infecting computers or networks with malicious software that can steal data or disrupt operations.

(c) **Ransomware attacks:** Ransomware attacks involve encrypting files or locking users out of systems and demanding a ransom payment in exchange for restoring access.

(d) **Insider threats:** Insider threats involve malicious actions by employees or other insiders who have access to sensitive data.

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(e) **Denial of Service (DoS) attacks:** DoS attacks involve overwhelming a system or network with traffic to disrupt operations.

(f) **Supply chain attacks:** Supply chain attacks involve compromising third-party software or hardware to gain access to a system or network.

4.2 Proactive measures to mitigate cybersecurity risks

In view of the cybersecurity attacks and threats discussed above, it is important to taking proactive measures to mitigate cybersecurity risks as listed below:

(a) **Password management:** Strong passwords are critical for protecting sensitive financial data. Accounting professionals should ensure that all passwords are complex and changed regularly.

(b) **Encryption:** Encryption can be used to protect sensitive data during transmission and storage. The IT Team of an organization should ensure that all sensitive data is encrypted using appropriate methods.

(c) **Access control:** Access control is critical for preventing unauthorized access to financial data. Accounting professionals should ensure that access to sensitive data is limited to authorized personnel and that appropriate access controls are in place. The access controls should be continuously reviewed and updated based on any changes in the management or employee structure.

(d) **Network security:** Network security is critical for protecting financial data from cyberattacks. It should be ensured that firewalls and other security measures are in place to prevent unauthorized access to the network.

(e) **Employee training:** Employee training is critical for ensuring that all staff members are aware of the importance of cybersecurity and understand how to protect sensitive financial data.

(f) **Data backup:** Regular data backups are critical for ensuring that financial data is not lost in the event of a cyberattack. Accounting professionals should ensure that data backups are performed regularly and that backups are stored securely.

(g) **Incident response planning:** Accounting professionals should have a clear incident response plan in place in the event of a cyberattack. This plan should include procedures for detecting, containing, and mitigating the impact of a cyberattack.

Overall, cybersecurity is a critical concern for accounting professionals, and it is essential to take appropriate measures to protect sensitive financial data

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5. THE FUTURE OF TECHNOLOGY IN ACCOUNTING

5.1 Blockchain

Blockchain technology is revolutionizing the financial landscape, and its impact on financial statement preparation is undeniable. As a Chartered Accountant involved in financial reporting, understanding blockchain is crucial for staying ahead in this rapidly evolving digital era. At its core, blockchain is a decentralized and transparent ledger that enables secure and immutable transactions. Unlike traditional centralized systems, blockchain offers a distributed network where information is shared and verified by multiple participants, eliminating the need for intermediaries and enhancing data integrity. From a financial statement preparation perspective, blockchain holds immense potential to streamline processes, enhance transparency, and improve the accuracy and reliability of financial reporting. By leveraging blockchain, financial professionals can ensure trustworthy and real-time financial information, revolutionizing how financial statements are prepared, audited, and shared with stakeholders. In this dynamic landscape, embracing blockchain technology is essential for Chartered Accountants to navigate the future of financial reporting effectively.

5.1.1 Key impacts of blockchain on financial reporting

1. **Enhanced Transparency**: Blockchain technology provides a decentralized and immutable ledger, where transactions are recorded and stored in a transparent and tamper-proof manner. This increased transparency ensures that financial data is accurately captured and can be easily audited, promoting trust and reliability in financial reporting.

2. **Improved Data Integrity**: Blockchain's distributed ledger ensures that each transaction is verified and encrypted, preventing unauthorized modifications or tampering. This feature enhances data integrity, reducing the risk of fraudulent activities and errors in financial reporting.

3. **Streamlined Audit Processes**: Blockchain technology enables real-time access to financial data, eliminating the need for time-consuming and manual data reconciliation processes. Auditors can directly access the blockchain ledger to verify transactions, reducing audit time and enhancing efficiency in financial reporting.

4. **Enhanced Security**: Blockchain incorporates advanced cryptographic algorithms, making it highly secure against unauthorized access or data breaches. Financial data stored on the blockchain is encrypted and protected, minimizing the risk of data manipulation or unauthorized disclosure, thus strengthening the security of financial reporting.

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5. **Simplified Reconciliation**: Blockchain's decentralized ledger eliminates the need for reconciling multiple versions of data across different systems. With a single shared source of truth, financial reporting processes become more streamlined, reducing reconciliation efforts and potential errors.

6. **Cost Reduction**: By eliminating intermediaries and central authorities, blockchain reduces the costs associated with traditional financial reporting processes. It eliminates the need for third-party verification and reconciliation, leading to cost savings for organizations.

7. **Enhanced Audit Trail**: Blockchain maintains a comprehensive and immutable audit trail of all transactions, providing a transparent and traceable record of financial activities. This audit trail simplifies the identification and investigation of any irregularities or discrepancies, improving the accuracy and reliability of financial reporting.

8. **Real-time Financial Reporting**: With blockchain's real-time data availability and consensus mechanism, financial reporting can be performed more frequently and with greater accuracy. Organizations can generate up-to-date financial statements, enabling stakeholders to make informed decisions based on the most current financial information.

Examples 3 – 5 : Using Blockchain

3. Imagine a finance professional working for a multinational corporation that engages in complex supply chain operations. With blockchain technology, the company can create a decentralized ledger that records every step of the supply chain process, from raw material sourcing to final product delivery. Each transaction is securely recorded on the blockchain, providing real-time visibility and transparency to all stakeholders involved. The finance professional can easily access the blockchain to verify the authenticity and accuracy of transactions, ensuring compliance with regulatory requirements and building trust with customers, investors, and auditors.

4. Consider a finance professional responsible for conducting an audit of a large e-commerce platform. Traditionally, audits involve manually reviewing numerous financial transactions and reconciling data from different sources, which can be time-consuming and prone to errors. However, with blockchain technology, the e-commerce platform can implement a blockchain-based payment system that automatically records and timestamps every transaction. During the audit process, the finance professional can access the blockchain ledger to instantly verify transaction details, reconcile data, and ensure compliance with accounting standards and regulatory guidelines. This streamlined approach improves audit efficiency, reduces the risk of human error, and enhances the accuracy of financial reporting.

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5. Imagine a finance professional working for a financial institution that handles sensitive customer data, such as personal information and transaction records. By utilizing blockchain technology, the institution can implement a secure and encrypted blockchain network to store and share customer data. The finance professional can ensure the integrity and security of the data by leveraging blockchain's cryptographic algorithms and consensus mechanisms. This eliminates the risk of unauthorized access, data tampering, or data loss. With blockchain, the finance professional can confidently handle customer data, knowing that it is protected by a robust and transparent system, enhancing data privacy, and maintaining the trust of customers and regulatory bodies.

5.2 Artificial Intelligence (AI)

AI refers to the simulation of human intelligence in machines, enabling them to perform tasks that would typically require human intervention. Apart from the aspects of automation, accuracy, fraud detection and cost savings, the most important feature is enabling predictive analytics. AI can be used to analyze large amounts of data and make predictions about future trends, which can be useful for forecasting financial performance and identifying potential risks. Thus, AI has the potential to transform the accounting profession by enabling accountants to provide more accurate and timely financial information to their clients.

While technology has transformed the accounting profession, it has also presented challenges such as the need for ongoing training and education, the risk of data breaches, and the potential loss of jobs due to automation. However, technology also presents opportunities for accountants to expand their skill sets, offer new services to clients, and automate routine activities thereby freeing up human resources for tasks requiring greater application of knowledge and skill sets.

This section seeks to provide an understanding of how AI and machine learning are transforming/disrupting the accounting profession. The chapter provides an introduction to AI and machine learning, explores their applications in accounting, and discusses the benefits and challenges associated with their adoption.

Artificial Intelligence (AI) and Machine Learning (ML) are technologies that enable computers to learn and perform tasks without being explicitly programmed to do so. AI and ML are having a significant impact on the accounting profession, enabling accounting professionals to automate routine tasks, improve decision-making processes, and reduce errors.

5.2.1 Benefits of AI and ML when used in accounting

1. **Automated Data Entry:** AI and ML algorithms can process and extract data from invoices, receipts, and other documents, reducing the need for manual data entry. If programmed, AI and ML algorithms can also review bank statements and pass entries in the system, followed

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by a bank reconciliation, thereby automating the entire process, saving time and improving efficiency.

2. **Fraud Detection:** AI can help detect fraud by analysing large amounts of data and identifying patterns that may indicate fraudulent activity.

3. **Financial Forecasting:** ML can be used to develop predictive models that can forecast financial performance based on historical data, market trends, and other factors. The predictive models can be of particular advantage where estimates are required to be made in financial reporting. For instance, where a store sells goods and offers a voucher giving the customer a discount on subsequent purchases, Ind AS 115 requires a degree of estimation of the likelihood of availing such discount to record Revenue. Predictive models can track customers' preferences and likelihood of availing the voucher, in which case the estimation of revenue as required under Ind AS 115 becomes more realistic.

4. **Accounting Automation:** AI can analyse financial statements and other data to identify errors or inconsistencies, making accounting more efficient and accurate.

5. **Tax Compliance:** AI can help automate tax compliance by analysing financial data and identifying tax obligations, ensuring that businesses remain compliant with tax regulations.

5.2.2 Challenges with Artificial Intelligence

Along with the advantages of AI and ML, there are following potential challenges and risks associated with the adoption of AI and machine learning like:

1. data privacy
2. security concerns
3. technical complexity
4. need to train employees in an organization to extract capabilities of AI from the system

AI and ML technology is expected to continue transforming the accounting landscape, with the development of more advanced applications such as natural language processing and cognitive computing. However, the adoption of AI and ML in accounting will require careful consideration of its benefits and risks, as well as ongoing education and training for accounting professionals.

Emerging technologies are changing the accounting landscape and holds a future for accounting professionals.

Emerging technologies, such as artificial intelligence (AI), machine learning (ML), and Robotic Process Automation (RPA), have had a revolutionary impact on the accounting profession. These technologies have the potential to revolutionize the way accounting is done, by automating routine tasks, reducing errors, and providing real-time insights into business performance. For example,

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AI and machine learning can be used to automate tasks such as data entry, account reconciliation, and financial analysis.

The potential benefits of these technologies for accounting professionals could include increased efficiency, accuracy, and cost savings. However, technology also comes with its own potential challenges and risks, such as the need for specialized skills and expertise, the risk of job displacement, and the need to maintain security and privacy.

Accounting professionals must be willing to adapt to these changes and develop new skills and competencies to stay relevant in the industry. The preceding sections emphasize the need for ongoing education and training to ensure that accounting professionals have the skills and knowledge required to leverage these emerging technologies.

The emergence of these technologies is likely to lead to significant changes in the industry, such as the need for new business models and the rise of new types of accounting services. As accounting professionals, it becomes imperative to understand new business models based on which accounting can be done to give a true and fair view of the affairs of the business. Accounting professionals who are willing to adapt to these changes and develop new skills and competencies will be better positioned to provide value-added services to their clients or organizations and maintain a competitive edge in the industry.

Illustrative examples on the use of Artificial Intelligence in Financial Reporting:

Examples: 6 – 9 : Using Artificial Intelligence in Financial Reporting

6. XYZ Company, a large multinational corporation, needs to prepare its financial statements according to Ind AS. The company has a vast amount of financial data stored in various formats, including spreadsheets, PDFs, and scanned documents. Manually extracting and analysing this data is time consuming and error prone. By implementing AI-driven optical character recognition (OCR) technology, the company automates the data extraction process from diverse sources and converts it into structured formats. This enables seamless analysis and financial reporting, reducing human effort and minimizing the risk of errors.

7. PQR Company, a financial institution, needs to comply with Ind AS requirements while monitoring and mitigating fraud risks. AI-powered algorithms can analyse large volumes of financial transactions, identify patterns, and detect potential anomalies indicative of fraudulent activities. By implementing machine learning techniques, the company can create predictive models that learn from historical data, enabling early detection of suspicious transactions and reducing the risk of financial fraud.

8. ABC Company, a manufacturing entity, wants to forecast its financial performance based on various scenarios to comply with Ind AS guidelines. AI can assist in generating accurate financial forecasts by analysing historical data, market trends, and relevant external factors.

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By leveraging machine learning algorithms, the company can simulate different scenarios, such as changes in market demand, input costs, or regulatory requirements. This helps management make informed decisions, assess potential risks, and develop robust financial strategies in accordance with Ind AS principles.

9. A to Z Company Ltd., a publicly listed entity, faces the challenge of timely financial reporting and compliance with Ind AS regulations. AI-powered tools can integrate with the company's financial systems and automatically extract relevant data in real-time. These tools apply data validation rules, perform calculations, and generate accurate financial reports. By leveraging natural language processing (NLP), AI systems can also assist in reviewing financial statements, identifying potential errors, and ensuring compliance with Ind AS requirements. This improves the accuracy, efficiency, and speed of financial reporting processes.

6. INDIAN ACCOUNTING STANDARDS (IND AS) AND INFORMATION TECHNOLOGY

Ind AS is predominantly a principle-based framework. Ind AS consists of specific principles for various accounting topics, such as revenue recognition, leasing, financial instruments, employee benefits, consolidation, and many more. These principles provide detailed guidance on how to account for transactions in accordance with the principles of measurement and recognition.

For implementation of Ind AS, the technology will play key role in automating the process of validating while generating the reports. However, the role of technology for such processing is directly related to the configuration at the Account level with rule-based validations. Configuration implements pre-defined validation rules within the system to identify discrepancies or non-compliance with Ind AS.

If the account level configuration is not done properly, then the next phase of using technology will be after generating the reports. In such scenario, the use of technology is about applications such as Microsoft Excel or Google Sheets which can be used to perform such validations from the Ind AS point of view and then generate the report. This is purely dependent on human intelligence rather than on technology, except for the cases where Artificial Intelligence is involved with proper training using machine learning.

Illustration 1

A listed company's financial transactions are carried out in ERP. Following financial reporting weaknesses were observed during internal control over financial reporting:

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1. *There is no appropriate documented process with respect to financial closing and reporting, including the identification and updating of internal and external financial reporting requirements and deadlines.*
2. *Changes made to the financial closing and reporting process are not valid and properly authorised.*
3. *Roles and responsibilities in the financial closing and reporting process are not clearly defined, documented, updated, and not communicated to appropriate departments and individuals on a timely basis.*
4. *Individuals in financial reporting roles do not have the necessary understanding of the organisation's operations and appropriate accounting knowledge to properly perform their assigned responsibilities.*
5. *When alternative accounting treatments are available for a significant event or transaction, the decisions on which treatments to select are not documented, approved by management, and are not communicated to the audit committee.*
6. *General policies are not established and documented regarding permissible overrides of existing policies and procedures for the financial closing and reporting process.*
7. *User profiles (on General Ledger (G/L) system) are not monitored / maintained to ensure that appropriate individuals have access to financial reporting process.*
8. *The appropriate accounting treatment is not specified for each non-routine event, transaction, and account balance, including those requiring the use of accounting estimates and judgment in the selection and application of accounting principles.*
9. *Relevant, sufficient, and reliable data necessary to record, process, and report each non-routine event or transaction is not captured.*
10. *There are no procedures to ensure all postings have occurred in the correct period.*
11. *The application of the entity's accounting policies to each non-routine event or transaction is not performed on a timely basis and appropriately documented by knowledgeable and qualified personnel using approved methods and formats.*
12. *All non-routine events and transactions are not accurately processed in the appropriate accounting period.*
13. *There is no independent review of application of the entity's accounting policies to each non-routine event or transaction for appropriateness and absence of bias by an individual with the appropriate level of authority and experience.*

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14. *There is no basis for significant estimates and judgments associated with each non-routine event or transaction.*
15. *No analysis is prepared accurately and consistently in accordance with the entity's defined financial closing process and in the appropriate accounting period.*
16. *All sources of information for routine and non-routine events and transactions are not identified and analysed.*
17. *There are no reconciliations for all significant accounts and no independent review of such reconciliation.*
18. *All intercompany transactions and balances are not identified, reconciled, and appropriately eliminated in consolidation in the appropriate accounting period.*
19. *All suspense accounts are not identified and monitored.*
20. *The trial balance(s) used to prepare the financial statements are not generated from the final general ledger(s).*
21. *All trial-balance accounts are not appropriately and consistently grouped for presentation in the financial statements for accounting periods presented.*
22. *There are no restrictions to access and to run transactions in the automated consolidation software which may compromise the integrity of financial data*
23. *All related-party events and transactions are not identified and authorised, appropriately accounted for, and disclosed in the appropriate accounting period.*
24. *There are no procedures to ensure all postings have occurred in the correct period.*
25. *Entries recorded directly to the financial statements are not valid.*

Provide illustrative steps for Financial Closing and Reporting.

Solution

Following are the illustrative steps for Financial Closing and Reporting:

1. Verify that the process includes identification and updating of internal and external financial reporting requirements and deadlines.
2. Review the documented process to ensure it aligns with the organization's financial reporting policies and regulatory guidelines.
3. Use the ERP system's change management functionality to track and validate changes made to the financial closing and reporting process using system logs and audit trail.

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4. Verify that changes to the process are authorized by designated individuals with appropriate authority using system logs.
5. Review the change requests, approvals, and documentation within the ERP system to ensure proper authorization and validation of process changes.
6. Validate that roles and responsibilities in the financial closing and reporting process are clearly defined within the ERP system by reviewing users access matrix configurations and system logs
7. Assess the qualifications and training records of individuals assigned to financial reporting roles within the ERP system.
8. Validate that individuals responsible for financial reporting have the necessary understanding of the organization's operations and appropriate accounting knowledge.
9. Validate that decisions on alternative accounting treatments for significant events or transactions are documented and approved by management by reviewing the Journal vouchers listing.
10. Review the ERP system for documentation of accounting treatment decisions, including approvals and communication to the audit committee.
11. Review the ERP system's user administration functionality to ensure appropriate individuals have access to the financial reporting process.
12. Review whether proper KYC validation controls in place for creating account masters and review the process for identifying related party transactions.
13. Validate that the ERP system captures and documents the appropriate accounting treatment for each non-routine event, transaction, and account balance by reviewing Journal Vouchers listing.
14. Use the ERP system's audit trail and reporting capabilities to validate that all postings have occurred in the correct accounting period reviewing accounting period configuration controls.
15. Review the system's controls for preventing backdating or unauthorized adjustments to postings by reviewing the posting date and transactions date of entries.

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Illustration 2

Company XYZ is a manufacturing company that implements Ind AS 2 and wants your advice on utility of an ERP system for inventory management. They also aim to integrate ICOFR controls into their ERP system to ensure accurate inventory valuation, minimize the risk of inventory fraud,

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and enhance process efficiency and accordingly they need your guidance in integrating ICOFR in ERP system.

Also, advice the steps to be followed if the company cannot afford a ERP system but still want to ensure proper implementation of Ind AS 2 to the extent possible.

Solution

A. ERP System for inventory management

ERP system integrates all relevant modules, such as inventory management, production, purchasing, and cost accounting. This ensures data consistency and reduces manual errors in recording and processing transactions. Following illustrative steps may be followed to configure and enable ERP with following modules:

- Maintain an updated and accurate Bill of Materials (BOM) Management within the ERP system, specifying the components required for each control unit. This allows the system to calculate the total cost of materials accurately by considering the quantities and costs of each component.
- Implement Purchase order controls within the ERP system to manage the procurement process effectively. This includes verifying purchase requisitions, obtaining appropriate approvals, and ensuring that the correct quantities and costs of materials are recorded.
- Define appropriate costing methods within the ERP system to allocate costs to inventory accurately. The ERP system should be configured to apply the chosen costing method consistently across all inventory transactions.
- Track labour costs within the ERP system by integrating with timekeeping or attendance systems. This ensures accurate recording of the number of hours worked by production workers and enables the calculation of labour costs based on the defined hourly rate.
- Define an overhead absorption rate within the ERP system to allocate production overheads to inventory. This rate should be based on the normal level of production per month. The ERP system should apply the overhead rate consistently to all units produced during the period.
- Integrate the ERP system with the general ledger and expense allocation modules to accurately allocate non-production expenses such as factory rent, energy costs, and selling and administrative costs. This ensures that these expenses are appropriately recorded and reflected in the cost of inventory.
- Perform periodic reconciliations between the inventory records within the ERP system and physical inventory counts. This helps identify any discrepancies and ensures the accuracy of inventory valuation.

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- Utilise the reporting and analytics capabilities of the ERP system to generate accurate and timely reports on inventory costs. These reports should provide detailed breakdowns of material costs, labour costs, overheads, and any other relevant cost components.

Integration of ICOFR in ERP system:

The management of company XYZ may integrate ICOFR controls in ERP system by using following points:

1. The integration of ICOFR into ERP system is configured to enforce segregation of duties within the inventory management process. For example, the system restricts the ability to initiate purchase orders, receive goods, and update inventory records to separate individuals. This segregation ensures that no single employee has the ability to manipulate inventory quantities or values without appropriate checks and balances.
2. ICOFR is incorporated by implementing access controls in the ERP system. Users are granted access to inventory-related functions based on their roles and responsibilities. For instance, only authorized personnel can modify inventory master data, update cost information, or perform inventory counts. This prevents unauthorized access and reduces the risk of data manipulation or theft.
3. To ensure proper authorization, the ERP system includes workflow approval processes for inventory transactions. For example, when a purchase requisition is raised, the system automatically routes it through predefined approval hierarchies based on transaction value or other criteria. This ensures that inventory purchases are authorized by the appropriate individuals before they are processed.
4. The company utilizes barcode or radio-frequency identification (RFID) technology to enhance inventory control and accuracy. The ERP system is integrated with barcode scanners or RFID readers, allowing real-time tracking of inventory movements. This reduces manual data entry errors and provides accurate and up-to-date inventory information within the system.
5. ICOFR requires periodic physical inventory counts to verify the accuracy of recorded inventory quantities. The ERP system supports this process by generating inventory count sheets or reports based on predefined criteria such as product categories or locations. The system can also reconcile the physical count results with the recorded quantities, highlighting any discrepancies for further investigation and adjustment.
6. Technology-driven data analytics tools can be integrated into the ERP system to identify inventory-related exceptions or anomalies. For example, the system can analyse inventory turnover ratios, slow-moving or obsolete items, or abnormal inventory cost fluctuations. These analytics help in detecting potential control weaknesses or irregularities, enabling timely action by management.

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7. The ERP system can provide management dashboards or customized reports that display key inventory control indicators. These dashboards summarize information such as inventory turnover, stock levels, and valuation accuracy. They facilitate monitoring and decision-making, enabling management to assess the effectiveness of ICOFR controls and take corrective actions if needed.

B. Inventory management in the absence of efficient ERP system

In the absence of ERP system or in the absence of properly configured ERP system, the alternative procedure available is by exporting the data to a spreadsheet and perform the following steps:

1. Export the relevant data from the accounting package, including information such as quantities, costs, labour hours, and overhead expenses into a spreadsheet. Ensure that the exported data contains all the necessary details to calculate the inventory costs accurately.
2. Organize the exported data in appropriate columns. Label each column with the corresponding data, such as item codes, quantities, costs, labour hours, and overhead expenses.
3. Use the formulas to calculate the material costs for each item. Multiply the quantities of each component by their respective costs. If there are multiple components, sum up the costs of all components to get the total material cost for each item.
4. Use the formulas to calculate the labour costs for each item. Multiply the labour hours for each item by the defined hourly rate to obtain the labour cost.
5. Determine the overhead absorption rate based on the normal level of production per month. Multiply the rate by the total labour hours to calculate the total overhead cost. Divide the overhead cost by the total quantity of items produced to get the overhead cost per item.
6. If there are non-production expenses such as rent, energy costs, or administrative costs, allocate them to each item using an appropriate method. This can be based on quantities, labour hours, or other relevant factors. Apply formulas to distribute the expenses accordingly.
7. Sum up the material costs, labour costs, overhead costs, and allocated non-production expenses for each item to obtain the total inventory cost.
8. If you have physical inventory counts, compare the calculated inventory costs in spreadsheet with the physical counts. Identify any discrepancies and investigate the causes. Adjust the inventory costs as necessary to reconcile them with the physical counts.
9. Create reports in spreadsheet that provide a breakdown of the inventory costs for each item. Include material costs, labour costs, overhead costs, and allocated non-production expenses. Use formatting and charts to present the information clearly.

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Illustration 3

Company Z is engaged in the business of importing oil seeds for further processing as well as trading purposes. It enters into the following types of contracts as on 1st October 20X1:

Particulars	Contract 1	Contract 2	Contract 3
Nature of Contract	Import of oil seeds from a foreign supplier	Purchase of oil seeds from a domestic producer / supplier	Contract to sell oil seeds on the commodity exchange
Quantity and rate	100 MT at USD 400 per MT to be delivered as on 31st March 20X2	50 MT at ` 30,000 per MT to be delivered as on 31st January 20X2	50 MT at USD 450 per MT, maturing as on 15th January 20X2
Net settlement clause included in the contract	Yes	Yes	Yes
Net settlement in practice for similar contracts	There have also been several instances of the oil seeds being sold prior to or shortly after taking delivery. These instances of net settlement constitute approximately 30 per cent of the value of total import contracts.	Yes – company Z has net settled some of the domestic purchase contracts. However, these instances constitute only 1 per cent of the total domestic purchase contracts in value. The remaining contracts are settled by taking delivery of oil seeds which are used for further processing.	Yes – these contracts are required to be net settled with the exchange on the maturity date. Company Z enters into these types of derivative contracts to hedge the risks on its domestic oil seeds purchase contracts

Company Z wants to determine if the contracts entered into for purchase and sale of oil seeds are derivatives within the scope of Ind AS 109 or are executory contracts outside the scope of Ind AS 109. Though the Company Z is using an ERP accounting package it is not properly configured to provide the required reports for above said decision making. Therefore, Company Z requires your

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advice on whether such process of determining the nature of contracts is possible through use of external sources of technology.

Solution

Yes, it is possible by extracting the data from the accounting package or by connecting to the database of the accounting package.

For example, the same can be done by connecting the spreadsheet with database through ODBC connectivity or by extracting the data from accounting package into a spreadsheet. In case the data is being extracted from accounting package, the following steps may be followed:

1. Identify the relevant data fields in the accounting package that contain the contract information, such as contract particulars, quantities, rates, and settlement details.
2. Export the required data from the accounting package in a compatible format (e.g., CSV, Excel, or other supported formats).
3. Open the exported data in Microsoft Excel.
4. Clean the data by removing any unnecessary or irrelevant columns and rows.
5. Ensure that the data is properly formatted and aligned for further analysis.
6. Define the rules or criteria for categorizing the contracts as derivative or executory based on the requirements of Ind AS 109.
7. Establish conditions using Excel formulas or logical functions to evaluate the contract data.
8. Apply the defined rules or criteria to the contract data using Excel formulas or logical functions.
9. Use functions such as IF, AND, OR, or VLOOKUP to evaluate the conditions and determine the nature of each contract.
10. Create additional columns in Excel to categorize the contracts based on the analysis results.
11. Assign appropriate labels or values to indicate whether a contract is a derivative or an executory contract.

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Illustration 4

An entity provides broadband services to its customers along with voice call service. Customer buys modem from the entity. However, customer can also get the connection from the entity and modem from any other vendor. The installation activity requires limited effort and the cost involved

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is almost insignificant. It has various plans where it provides either broadband services or voice call services or both.

Comment on how to identify whether the performance obligations under the contract is distinct by using an automated process?

Solution

To identify the performance obligations under the contract and determine if they are distinct, an automated process can be implemented using technology. The following steps can be taken:

a. Analyze the clauses in the contract related to the services provided (broadband services, voice call services, modem sales).

b. Each clause should be codified using appropriate parameters or tags to capture the relevant information.

c. Assign Boolean values (0 or 1) to each parameter or tag in the codified clauses.

d. Use "0" to represent "No" and "1" to represent "Yes" for each parameter.

e. Define the criteria for evaluating the performance obligations based on the parameters and their Boolean values.

f. Consider factors such as the type of service involved, benefits derived by the customer, and promises made in the contract regarding the transfer of goods or services.

g. Develop an automated algorithm or script that evaluates the Boolean values of the parameters according to the defined criteria.

h. Calculate scores or weights for each parameter based on their significance in determining performance obligations.

i. Utilize the scores or weights assigned to the parameters to determine if the performance obligations are distinct.

j. If the total score exceeds a certain threshold, consider it a separate performance obligation.

The automated process should flag and identify these distinct performance obligations based on the evaluation results.

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TEST YOUR KNOWLEDGE

Questions

1. T Ltd is engaged in transport sector, running a fleet of buses at different routes. T Ltd has identified 3 operating segments:

- Segment 1: Local Route
- Segment 2: Inter-city Route
- Segment 3: Contract Hiring

The characteristics of each segment are as under:

Segment 1: The local transport authority awards the contract to ply the buses at different routes for passengers. These contracts are awarded following a competitive tender process; the ticket price paid by passengers are controlled by the local transport authority. T Ltd would charge the local transport authority on a per kilometer basis.

Segment 2: T Ltd operates buses from one city to another, prices are set by T Ltd on the basis of services provided (Deluxe, Luxury or Superior).

Segment 3: T Ltd also leases buses to schools under a long-term arrangement.

While Segment 1 has been showing significant decline in profitability, Segment 2 is performing well in respect of higher revenues and improved margins. The management of the company is not sure why is the segment information relevant for users when they should only be concerned about the returns from overall business. They would like to aggregate the Segment 1 and Segment 2 for reporting under 'Operating Segment'.

Required

What are the steps involved to automate the process to determine whether it is appropriate to aggregate Segments 1 and 2 with reference to Ind AS 108 'Operating Segments'?

2. New Way Ltd. decides to enter a new market that is currently experiencing economic difficulty and expects that in future the economy will improve. New Way Ltd. enters into an arrangement with a customer in the new region for networking products for promised consideration of ` 12,50,000.

At contract inception, New Way Ltd. wants to

(i) Define criteria for identifying contracts with customers, such as enforceable rights and obligations, agreement terms, and consideration.

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(ii) Establish rules to link relevant transactions to specific contracts and assign unique identifiers to each contract

Required

Advice the steps to automate the process to perform the above tasks on behalf of New Way Ltd.

Answers

1. Following steps should be followed to automate the process to determine whether it is appropriate to aggregate Segments 1 and 2 with reference to Ind AS 108 'Operating Segments':

1. Extract the relevant financial data related to Segments 1 and 2 from your accounting system.
2. Ensure that the data includes segment-specific information such as revenue, expenses, assets, liabilities, and any other relevant metrics.
3. Define the criteria for evaluating whether the segments should be aggregated.
4. Consider factors such as the nature of the business activities, economic characteristics, customer base, pricing policies, and risks and returns associated with each segment.
5. Utilize automated analysis tools or software capable of processing large volumes of financial data.
6. Apply predefined algorithms or rules to evaluate the financial performance and characteristics of Segments 1 and 2 based on the defined criteria.
7. Conduct a comparative analysis of the financial metrics and performance indicators between Segments 1 and 2.
8. Based on the analysis and findings, evaluate whether it is appropriate to aggregate Segments 1 and 2.
9. Document the rationale behind the decision, including the analysis results and supporting evidence.
10. Use tools such as business intelligence software, data visualization platforms, or custom-built reporting modules to present the aggregated and segmented data in a meaningful way.

2. A contract management system may be implemented which allows to store and organize contract documents electronically. This system can help you define and capture key contract details, such as enforceable rights and obligations, agreement terms, and consideration.

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Accordingly, the said contract management system shall be enabled to configure a mechanism to assign unique identifiers to each contract.

- Integrate the contract management system or accounting software with other operational systems, such as sales, CRM, or project management systems. This integration allows for the automatic capture and synchronization of contract-related data, ensuring that transactions associated with specific contracts are accurately linked.
- Assign specific tags or attributes to contracts based on the defined criteria, such as contract type, customer name, contract start and end dates, or specific service offerings, to enable efficient searching, filtering, and grouping of contracts based on various criteria.
- Use custom queries or predefined templates to extract information on the number of contracts identified, their characteristics, and the associated transactions. This provides visibility into the implementation of Ind AS 115 and helps to monitor compliance.

In addition to the above, the following may be adopted:

- Consider utilizing OCR technology to extract relevant information automatically. OCR can convert printed or handwritten text into machine-readable format, enabling efficient extraction of contract details for further processing and analysis.
- Apply machine learning and Neuro-Linguistic Programming (NLP) techniques to analyze and extract contract data automatically. These technologies can help identify specific contract terms, clauses, or obligations, aiding in the accurate identification and classification of contracts based on predefined criteria.
- Utilize workflow automation tools to streamline the contract identification process. Establish predefined rules or triggers within your system that automatically identify new contracts based on specific criteria and assign unique identifiers. This automation reduces manual effort and ensures consistency in contract identification.

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