



Financial
Reporting

Question Bank

VOLUME-4



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FINANCIAL REPORTING

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IND AS 115 – REVENUE FROM CONTRACTS WITH CUSTOMERS

Illustration 1

New way limited decides to enter a new market that is currently experiencing economic difficulty and expects that in future economy will improve. New way enters into an arrangement with a customer in the new region for networking products for promised consideration of ₹1,250,000. At contract inception, New way expects that it may not be able to collect the full amount from the customer.

Determine how New way will recognise this transaction?

Solution

Assuming the contract meets the other criteria covered within the scope of the model in Ind AS 115, New way need to assesses whether collectability is probable.

In making this assessment, New way considers whether the customer has the ability and intent to pay the estimated transaction price, which may be an amount less than the contract price.

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 an additional 90 CCTV Cameras. Hence, contract is for 10 units.

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.

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.

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?

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.

Illustration 8

On 1 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 1 October 20X1, KLC Ltd. and Mr. K agree to modify the contract to reduce the amount of services from ₹55,000 per month to ₹45,000 per month.

Determine the effect of change in the contract?

Solution

The next six months of services are distinct from the services provided in the first six months before modification in contract,

Therefore, KLC Ltd. will account for the contract modification as if it were a termination of the existing contract and the creation of a new contract.

The consideration allocated to remaining performance obligation is ₹270,000, which is the sum of

- The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and had not yet been recognized as revenue. This amount is zero.
- The consideration promised as part of the contract modification ie ₹270,000.

Illustration 9 – (MTP – Oct'21)

Growth Ltd enters into an arrangement with a customer for infrastructure outsourcing deal.

Based on its experience, Growth Ltd determines that customising the infrastructure will take approximately 200 hours in total to complete the project and charges ₹150 per hour.

After incurring 100 hours of time, Growth Ltd and the customer agree to change an aspect of the project and increases the estimate of labour hours by 50 hours at the rate of ₹100 per hour.

Determine how contract modification will be accounted as per Ind AS 115?

(5 Marks)

Solution

Considering that the remaining goods or services are not distinct, the modification will be accounted for on a cumulative catch up basis, as given below:

Particulars	Hours	Rate (₹)	Amount (₹)
Initial contract amount	200	150	30,000
Modification in contract	50	100	5,000
Contract amount after modification	250	140*	35,000
Revenue to be recognised	100	140	14,000
Revenue already booked	100	150	15,000
Adjustment in revenue			(1,000)

*35,000 / 250 = 140.

Illustration 10 – (MTP – April, 2021)

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?

(4 Marks)

Solution

Determining whether a good or service represents a performance obligation on its own or is required to be aggregated with other goods or services can have a significant impact on the timing of revenue recognition. In order to determine how many performance obligations are present in the contract, the company applies the guidance above. While the customer may be able to benefit from each promised good or service on its own (or together with other readily available resources), they do not appear to be separately identifiable within the context of the contract. That is, the promised goods and services are subject to significant integration, and as a result will be treated as a single performance obligation.

This is consistent with a view that the customer is primarily interested in acquiring a single asset (a water purification plant) rather than a collection of related components and services.

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 good or service either on its own or together with other resources that are readily available to the customer, and
- entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract For broadband and voice call services -
- Broadband and voice services are separately identifiable from other promises as company has various plans to provide the two services separately. These two services are not dependant or interrelated. Also the customer can benefit on its own from the services received.

For sale of modem -

- Customer can either buy product from entity or third party. No significant customisation or modification is required for selling product.

Based on the evaluation we can say that there are three separate performance obligation: -

- Broadband Service
- Voice Call services

- Modem

Illustration 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 has not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

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 good or service to be "substantially the same." Management should evaluate this requirement based on the nature of its promise to customer. For example, a promise to provide hotel management services for a specified contract term may meet the series criteria. This is because the entity is providing the same service of "hotel management" each period, even though some of the 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.

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 installation of all of the materials. Several of these goods and services could be considered separate performance obligations because Entity A frequently sells the services, such as architectural consulting and engineering services, as well as standalone construction services based on third party design, separately. Entity A may require to continually alter the design of the shopping centre and parking facility during construction as well as continually assess the propriety of the materials initially selected for the project.

Determine how many performance obligations does the entity A have?

Solution

Entity A analyses that it will be required to continually alter the design of the shopping centre and parking facility during construction as well as continually assess the propriety of the materials initially selected for the project. Therefore, the design and construction phases are highly dependent on one another (i.e., the two phases are highly interrelated). Entity A also determines that significant customisation and modification of the design and construction services is required in order to fulfil the performance obligation under the contract. As such, Entity A concludes that the design and construction services will be bundled and accounted for as one performance obligation.

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.

The entity also considers the factors of Ind AS 115 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises. In particular, the entity observes that the installation service does not significantly modify or customise the software itself and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

- The software license
- An installation service
- Software updates
- Technical support

Illustration 16

The promised goods and services are the same as in the above Illustration, except that the contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer. The customised installation service can be provided by other entities.

Determine how many performance obligations does the entity have?

Solution

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity observes that the terms of the contract result in a promise to provide a

significant service of integrating the licensed software into the existing software system by performing a customised installation service as specified in the contract. In other words, the entity is using the license and the customised installation service as inputs to produce the combined output (i.e. a functional and integrated software system) specified in the contract. In addition, the software is significantly modified and customised by the service. Although the customised installation service can be provided by other entities, the entity determines that within the context of the contract, the promise to transfer the license is not separately identifiable from the customised installation service and, therefore, the criterion on the basis of the factors is not met. Thus, the software license and the customised installation service are not distinct.

The entity concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to the customer are separately identifiable from each of the other promises.

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

- a) customised installation service (that includes the software license);
- b) software updates; and
- c) technical support.

Illustration 17 – (MTP Oct'21, April'22)

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?

(6 Marks)

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.
- 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.

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.

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.
- 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.

Illustration 20

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

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 recognised when control of the vehicle is transferred to the dealer. Revenue from the maintenance services is recognised separately as and when the maintenance services are provided to the retail customer.

Illustration 22 (MTP April'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 recognised in the first year and the amount of contract liability against the option given to the customer for renewing the membership at discount. (5 Marks)

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 $\{(100 \times 7,500) + (50 \times 6,000) + (25 \times 6,000)\}$ Allocated price per membership is ₹ 6,857 approx. $(12,00,000 / 175)$

Basis on above, it is to be noted that although entity has collected ₹ 7,500 but revenue can be recognised 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 – (Past Exam Nov'22)

An entity enters into a contract for the sale of Product A for ₹1,000. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to ₹1,000 in the next 30 days. The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

The entity believes there is 80% likelihood that a customer will redeem the voucher and on an average, a customer will purchase ₹ 500 of additional products.

Determine how many performance obligations does the entity have and their stand-alone selling price and allocated transaction price? (4 Marks)

Solution

Since all customers will receive a 10% discount on purchases during the next 30 days, the only additional discount that provides the customer with a material right is the incremental discount of 30% on the products purchased. The entity accounts for the promise to provide the incremental discount as a separate performance obligation in the contract for the sale of Product A.

The entity believes there is 80% likelihood that a customer will redeem the voucher and on an average, a customer will purchase ₹500 of additional products. Consequently, the entity's estimated stand-alone selling price of the discount voucher is ₹120 $(₹500 \text{ average purchase price of additional products} \times 30\% \text{ incremental discount} \times 80\% \text{ likelihood of exercising the option})$. 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	$(₹ 1000 ÷ ₹ 1120 \times ₹ 1000)$	₹ 890
Discount voucher	$(₹ 120 ÷ ₹ 1120 \times ₹ 1000)$	₹ 110
Total		₹ 1000

The entity allocates ₹890 to Product A and recognises revenue for Product A when control transfers. The entity allocates ₹110 to the discount voucher and recognises revenue for the voucher when the customer redeems it for goods or services or when it expires.

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 recognise revenue on its cable television service regardless of the contract's time period.

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.

Solution

Manufacturer M determines that control has not been transferred to Retailer A on delivery, for the following reasons:

- Retailer A does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;
- 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
- Manufacturer M is able to require the return of the dresses or transfer them to another retailer.

Manufacturer M determines that control of the dresses transfers when they are sold to an end customer i.e. when Retailer A has an unconditional obligation to pay Manufacturer M and can no longer return or otherwise transfer the dresses.

Manufacturer M recognises revenue as the dresses are sold to the end customer.

Illustration 26 – (Past Exam – Nov 2020)

An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and will pay for those tickets even if it is not able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance. The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased; therefore, there is no credit risk.

The entity also assists the customers in resolving complaints with the service provided by airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

Determine whether the entity is a principal or an agent.

4 Marks

Solution

To determine whether the entity's performance obligation is to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for another party to provide those goods or services (i.e. the entity is an agent), the entity considers the nature of its promise. The entity determines that its promise is to provide the customer with a ticket, which provides the right to fly on the specified flight or another flight if the specified flight is changed or cancelled. The entity considers the following indicators for assessment as principal or agent under the contract with the customers:

- (a) the entity is primarily responsible for fulfilling the contract, which is providing the right to fly. However, the entity is not responsible for providing the flight itself, which will be provided by the airline.
- (b) the entity has inventory risk for the tickets because they are purchased before they are sold to the entity's customers and the entity is exposed to any loss as a result of not being able to sell the tickets for more than the entity's cost.
- (c) the entity has discretion in setting the sales prices for tickets to its customers.

The entity concludes that its promise is to provide a ticket (i.e. a right to fly) to the customer. On the basis of the indicators, the entity concludes that it controls the ticket before it is transferred to the customer. Thus, the entity concludes that it is a principal in the transaction and recognises revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred.

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.

Is D 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. directly works with customers to ensure that the services are

performed to their requirements. Even though D Ltd. does not bear inventory risk 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 a principal in this case.

Illustration 28

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.

Illustration 29

XYZ Limited enters into a contract with a customer to build a sophisticated machinery. The promise to transfer the asset is a performance obligation that is satisfied over time. The promised consideration is ₹2.5 crores, but that amount will be reduced or increased depending on the timing of completion of the asset. Specifically, for each day after 31 March 20X1 that the asset is incomplete, the promised consideration is reduced by ₹1 lakh. For each day before 31 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 lakhs.

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:

- 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 crores, 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.
- 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 lakhs or ₹ Nil) and it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.

Illustration 30 – (MTP - April 2021)

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 crores.

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 crores 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.

(5 Marks)

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 crores, calculated as shown in the following table:

Bonus %	Amount of bonus (₹ in crores)	Probability	Probability-weighted amount (₹ in crores)
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 crores 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 crores.

Illustration 31

HT Limited enters into a contract with a customer on 1 April 20X1 to sell Product X for ₹1,000 per unit. If the customer purchases more than 100 units of Product A in a financial year, the contract specifies that the price per unit is retrospectively reduced to ₹900 per unit. Consequently, the consideration in the contract is variable.

For the first quarter ended 30 June 20X1, the entity sells 10 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 100 unit threshold required for the volume discount in the financial year. HT Limited determines that it has significant experience with this product and with the purchasing pattern of the customer. Thus, HT Limited concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (i.e. ₹1,000 per unit) will not occur when the uncertainty is resolved (i.e. when the total amount of purchases is known).

Further, in May 20X1, the customer acquires another company and in the second quarter ended 30 September 20X1 the entity sells an additional 50 units of Product A to the customer. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 100 unit threshold for the financial year and therefore it will be required to retrospectively reduce the price per unit to ₹900.

Determine the amount of revenue to be recognise by HT Ltd. for the quarter ended 30 June 20X1 and 30 September 20X1.

Solution

The entity recognises revenue of ₹10,000 (10 units × ₹1,000 per unit) for the quarter ended 30 June 20X1.

HT Limited recognises revenue of ₹44,000 for the quarter ended 30 September 20X1. That amount is calculated from ₹45,000 for the sale of 500 units (50 units × ₹900 per unit) less the change in transaction price of ₹1,000 (10 units × ₹100 price reduction) for the reduction of revenue relating to units sold for the quarter ended 30 June 20X1.

Illustration 32 – (Past Exam – Dec 2021)

An entity has a fixed fee contract for ₹1 million to develop a product that meets specified performance criteria. Estimated cost to complete the contract is ₹950,000. The entity will transfer control of the product over five years, and the entity uses the cost-to-cost input method to measure progress on the contract. An incentive award is available if the product meets the following weight criteria:

Weight (kg)	Award % of fixed fee	Incentive fee
951 or greater	0%	—
701–950	10%	₹ 100,000
700 or less	25%	₹ 250,000

The entity has extensive experience creating products that meet the specific performance criteria. Based on its experience, the entity has identified five engineering alternatives that will achieve the 10 percent incentive and two that will achieve the 25 percent incentive. In this case, the entity determined that it has 95 percent confidence that it will achieve the 10 percent incentive and 20 percent confidence that it will achieve the 25 percent incentive.

Based on this analysis, the entity believes 10 percent to be the most likely amount when estimating the transaction price. Therefore, the entity includes only the 10 percent award in the transaction price when calculating revenue because the entity has concluded it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved due to its 95 percent confidence in achieving the 10 percent award.

The entity reassesses its production status quarterly to determine whether it is on track to meet the criteria for the incentive award. At the end of the year four, it becomes apparent that this contract will fully achieve the weight-based criterion. Therefore, the entity revises its estimate of variable consideration to include the entire 25 percent incentive fee in the year four because, at this point, it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when including the entire variable consideration in the transaction price.

Evaluate the impact of changes in variable consideration when cost incurred is as follows:

Year	₹
1	50,000
2	1,75,000
3	4,00,000
4	2,75,000
5	50,000

Calculate yearly Revenue, Operating Profit and Margin (%). For simplification purposes, calculate 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.

(10 Marks)

Solution

[Note: For simplification purposes, the table calculates revenue for the year independently based on costs incurred during the year divided by total expected costs, with the assumption that total expected costs do not change.]

Fixed consideration	A	1,000,000				
Estimated costs to complete*	B	950,000				
		<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Total estimated variable consideration	C	100,000	100,000	100,000	250,000	250,000
Fixed revenue	$D=A \times H/B$	52,632	184,211	421,053	289,474	52,632
Variable revenue	$E=C \times H/B$	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	$F=L \times M-P$		99,343

Illustration 33

On 1 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 31 March 20X2, the client's assets under management are ₹ 100 crores. In addition, the entity receives a performance-based incentive fee of 20 per cent of the fund's return in excess of the return of an observable market index over the five-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.

Analyse the revenue to be recognised on 31 March, 20X2.

Solution

The entity accounts for the services as a single performance obligation because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

The entity observes that the promised consideration is dependent on the market and thus is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognised would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception—the variability of the fee based on the market index indicates that the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognised would not occur if the entity included its estimate of the incentive fee in the transaction price.

At 31 March 20X2, the client's assets under management are ₹ 100 crores. Therefore, the resulting quarterly management fee and the transaction price is ₹ 2 crores.

At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters.

Consequently, the entity recognises ₹2 crores as revenue for the quarter ended 31 March 20X2.

Illustration 34 – (MTP April'19), (Past Exam Dec'21)

An entity enters into 1,000 contracts with customers. Each contract includes the sale of one product for ₹ 50 (1,000 total products × ₹ 50 = ₹ 50,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is ₹ 30.

The entity applies the requirements in Ind AS 115 to the portfolio of 1,000 contracts because it reasonably expects that, in accordance with paragraph 4, the effects on the financial statements from applying these requirements to the portfolio would not differ materially from applying the requirements to the individual contracts within the portfolio. Since the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of Ind AS 115) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 970 products will not be returned.

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

Determine the amount of revenue, refund liability and the asset to be recognised by the entity for the said contracts. (4 Marks)

Solution

The entity also considers the requirements in paragraphs 56–58 of Ind AS 115 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of ₹48,500 (₹ 50 × 970 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 57 of Ind AS 115 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (ie the 30-day return period). Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (i.e. ₹48,500) will not occur as the uncertainty is resolved (i.e. over the return period).

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

Upon transfer of control of the 1,000 products, the entity does not recognise revenue for the 30 products that it expects to be returned. Consequently, in accordance with paragraphs 55 and B21 of Ind AS 115, the entity recognises the following:

- (a) revenue of ₹ 48,500 (₹ 50 × 970 products not expected to be returned);
- (b) a refund liability of ₹ 1,500 (₹ 50 refund × 30 products expected to be returned); and
- (c) an asset of ₹ 900 (₹ 30 × 30 products for its right to recover products from customers on settling the refund liability).

Illustration 35

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 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 derecognise inventory and recognise cost of goods sold)			

The entity derecognises 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 recognises the contract liability associated with the service-type warranty as revenue during the contract warranty period and recognises 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 recognised as an expense as incurred.

Illustration 36

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 years two through five 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 recognised as revenue over the service warranty period (years 2 - 5). The costs of providing the service warranty are recognised as incurred. The assurance warranty obligation is used / derecognised 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.

Illustration 37

A commercial airplane component supplier enters into a contract with a customer for promised consideration of ₹7,000,000. Based on an evaluation of the facts and circumstances, the supplier concluded that ₹140,000 represented a insignificant financing component because of an advance payment received in excess of a year before the transfer of control of the product.

State whether company needs to make any adjustment in determining the transaction price.

What if the advance payment was larger and received further in advance, such that the entity concluded that ₹1,400,000 represented the financing component based on an analysis of the facts and circumstances.

Solution

The entity may conclude that ₹ 140,000, or 2 percent of the contract price, is not significant, and the entity may not need to adjust the consideration promised in determining the transaction price.

However, when the advance payment was larger and received further in advance, such that the entity may conclude that ₹1,400,000 represents the financing component based on an analysis of the facts and

circumstances. In such a case, the entity may conclude that ₹1,400,000, or 20 percent of the contract price, is significant, and the entity should adjust the consideration promised in determining the transaction price.

Note: In this illustration, the entity's conclusion that 2 percent of the transaction price was not significant and 20 percent was significant is a judgment based on the entity's facts and circumstances. An entity may reach a different conclusion based on its facts and circumstances.

Illustration 38 – (MTP Oct'21)

NKT Limited sells a product to a customer for ₹121,000 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new and the entity has no relevant historical evidence of product returns or other available market evidence.

The cash selling price of the product is ₹100,000 which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is ₹80,000. The contract includes an implicit interest rate of 10 per cent (i.e. the interest rate that over 24 months discounts the promised consideration of ₹121,000 to the cash selling price of ₹100,000). Analyse the above transaction with respect to its financing component.

Solution

(5 Marks)

The contract includes a significant financing component. This is evident from the difference between the amount of promised consideration of ₹121,000 and the cash selling price of ₹100,000 at the date that the goods are transferred to the customer.

The contract includes an implicit interest rate of 10 per cent (i.e. the interest rate that over 24 months discounts the promised consideration of ₹121,000 to the cash selling price of ₹100,000). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception.

Until the entity receives the cash payment from the customer, interest revenue would be recognised in accordance with Ind AS 109. In determining the effective interest rate in accordance with Ind AS 109, the entity would consider the remaining contractual term.

Illustration 39

VT Limited enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is ₹1 crore plus a 10% contractual rate of interest, payable in 60 monthly instalments of ₹212,470.

Determine the discounting rate and the transaction price when

Case A—Contractual discount rate reflects the rate in a separate financing transaction

Case B—Contractual discount rate does not reflect the rate in a separate financing transaction i.e. 14%.

Solution

Case A—Contractual discount rate reflects the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, VT Limited observes that the 10% contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (i.e. the contractual rate of interest of 10% reflects the credit characteristics of the customer).

The market terms of the financing mean that the cash selling price of the equipment is ₹1 crore. This amount is recognised as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with Ind AS 109.

Case B—Contractual discount rate does not reflect the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 10% contractual rate of interest is significantly lower than the 14% interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (i.e. the contractual rate of interest of 10% does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than ₹1 crore.

VT Limited determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 14% interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is ₹9,131,346 (60 monthly payments of ₹212,470 discounted at 14%). The entity recognizes revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with Ind AS 109.

Illustration 40

ST Limited enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (i.e. the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options:

- 1) Payment of ₹5,000 in two years when the customer obtains control of the asset or
- 2) Payment of ₹4,000 when the contract is signed. The customer elects to pay ₹4,000 when the contract is signed.

ST Limited concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

The interest rate implicit in the transaction is 11.8 per cent, which is the interest rate necessary to make the two alternative payment options economically equivalent. However, the entity determines that, the rate that should be used in adjusting the promised consideration is 6%, which is the entity's incremental borrowing rate.

Pass journal entries showing how the entity would account for the significant financing component

Solution

Journal Entries showing accounting for the significant financing component:

- (a) Recognise a contract liability for the ₹4,000 payment received at contract inception:

Cash	Dr.	₹ 4,000
	To Contract liability	₹ 4,000

- (b) During the two years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration and accretes the contract liability by recognising interest on ₹ 4,000 at 6% for two years:

Interest expense	Dr.	₹ 494*
	To Contract liability	₹ 494

* ₹ 494 = ₹ 4,000 contract liability × (6% interest per year for two years).

- (c) Recognise revenue for the transfer of the asset:

Contract liability	Dr.	₹ 4,494

To Revenue

₹ 4,494

Illustration 41

ABC Limited enters into a contract for the construction of a power plant that includes scheduled milestone payments for the performance by ABC Limited throughout the contract term of three years. The performance obligation will be satisfied over time and the milestone payments are scheduled to coincide with the expected performance by ABC Limited. The contract provides that a specified percentage of each milestone payment is to be withheld as retention money by the customer throughout the arrangement and paid to the entity only when the building is complete.

Analyse whether the contract contains any financing component.

Solution

ABC Limited concludes that the contract does not include a significant financing component since the milestone payments coincide with its performance and the contract requires amounts to be retained for reasons other than the provision of finance. The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

Illustration 42

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

A computer hardware vendor enters into a three-year arrangement with a customer to provide support services. For customers with low credit ratings, the vendor requires the customer to pay for the entire arrangement in advance of the provision of service. Other customers pay over time.

Analyse whether there is any significant financing component in the contract or not.

Solution

Due to this customer's credit rating, the customer pays in advance for the three-year term. Because there is no difference between the amount of promised consideration and the cash selling price (that is, the customer does not receive a discount for paying in advance), the vendor requires payment in advance only to protect against customer non-payment, and no other factors exist to suggest the arrangement contains a financing, the vendor concludes this contract does not provide the customer or the entity with a significant benefit of financing.

Illustration 44

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

An EPC contractor enters into a two-year contract to develop customized machine for a customer. The contractor concludes that the goods and services in this contract constitute a single performance obligation.

Based on the terms of the contract, the contractor determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to the customer. The customer agrees to provide the contractor monthly progress payments, with the final 25 percent payment (holdback payment) due upon contract completion. As a result of the holdback payment, there is a gap between when control transfers and when consideration is received, creating a financing component.

Analyse whether there is any significant financing component in the contract or not.

Solution

There is no difference between the amount of promised consideration and the cash selling price (that is, the customer did not pay a premium for paying a portion of the consideration in arrears). The payment terms included a holdback payment only to ensure successful completion of the project, and no other factors exist to suggest the arrangement contains a financing. Hence, the contractor concludes this contract does not provide the customer or the contractor with a significant benefit of financing.

Illustration 46

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 crores. The consideration will be paid by the customer related to costs incurred near the time Company Z incurs such costs. However, the ₹ 100 crores 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 crores 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 crores in the transaction price related to the variable consideration pursuant to guidance within Ind AS 115. Further, the entity has concluded it should recognize revenue over time for a single performance obligation using a cost-to-cost input method.

Analyse whether there is any significant financing component in the contract or not.

Solution

Company Z will transfer control over time beginning shortly after the contract is executed, but will not receive the cash consideration related to the award fee component from Company X for more than one year in the future. Hence, Company Z should assess whether the award fee represents a significant financing component.

The intention of the parties in negotiating the award fee due upon completion of the test fire, and based on the results of that test fire, was to provide incentive to Company Z to produce high functioning missiles that achieved successful scoring from Company X. Therefore, it was determined the contract does not contain a significant financing component, and Company Z should not adjust the transaction price.

Illustration 47

Company H enters into a two-year contract to develop customized software for Company C. Company H concludes that the goods and services in this contract constitute a single performance obligation.

Based on the terms of the contract, Company H determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to Company C.

Company C agrees to provide Company H monthly progress payments. Based on the expectation of the timing of costs to be incurred, Company H concludes that progress payments are being made such that the timing between the transfer of control and payment is never expected to exceed one year.

Analyse whether there is any significant financing component in the contract or not.

Solution

Company H concludes it will not need to further assess whether a significant financing component is present and does not adjust the promised consideration in determining the transaction price, as they are applying the practical expedient under Ind AS 115.

As per Ind AS 115.65, an entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of profit and loss. Interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer.

Illustration 48

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on 1st April 20X1 and work begins immediately. The entity concludes that the service is a single performance obligation. This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

In exchange for the service, the customer promises its 100 equity shares per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

How should the entity decide the transaction price?

Solution

The entity measures its progress towards complete satisfaction of the performance obligation as each week of service is complete. To determine the transaction price (and the amount of revenue to be recognised), the entity has to measure the fair value of 100 shares that are received upon completion of each weekly service. The entity shall not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

Illustration 49

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 crores for the project. RT Limited will receive a bonus of 10 lakhs 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 crores plus 10 lakhs equity shares at ₹ 100 per share for total consideration of ₹ 360 crores.

Illustration 50

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.

Illustration 51

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 crores at contract inception. SK Limited determines that each steering system represents a single performance obligation and that control of the steering system transfers to MS Limited upon delivery.

SK Limited may use the tooling for other projects and determines that it obtains control of the tooling.

Determine the transaction price?

Solution

As a result, at contract inception, SK Limited includes the fair value of the tooling in the transaction price at contract inception, which it determines to be ₹ 27 crores (₹ 25 crores for the steering systems and ₹ 2 crores for the tooling).

Illustration 52

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 crores of products during the year. The contract also requires the entity to make a non-refundable payment of ₹ 1.5 crores to the customer at the inception of the contract. The ₹1.5 crores payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products. The entity does not obtain control of any rights to the customer's shelves.

Determine the transaction price.

Solution

The entity considers the requirements in paragraphs 70 – 72 of Ind AS 115 and concludes that the payment to the customer is not in exchange for a distinct good or service that it 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 crores payment is a reduction of the transaction price.

The entity applies the requirements in paragraph 72 of Ind AS 115 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognises revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 per cent $[(₹ 1.5 \text{ crores} \div ₹ 15 \text{ crores}) \times 100]$. Therefore, in the first month in which the entity transfers goods to the customer, the entity recognises revenue of ₹ 1.125 crores (₹ 1.25 crores invoiced amount less ₹ 0.125 crore of consideration payable to the customer).

Illustration 53

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 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 × 24 month) – ₹ 2,000]. D Ltd. will recognise the reduction in the transaction price as the promised goods or services are transferred.

Illustration 54

An entity enters into a contract with a customer to sell Products A, B and C in exchange for ₹10,000. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately and therefore the stand-alone selling price is directly observable. The stand-alone selling prices of Products B and C are not directly observable.

Because the stand-alone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the stand-alone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximises the use of observable inputs.

The entity estimates the stand-alone selling prices as follows:

Product	Stand-alone selling price	Method
	₹	
Product A	5,000	Directly observable
Product B	2,500	Adjusted market assessment approach
Product C	<u>7,500</u>	Expected cost plus a margin approach
Total	<u>15,000</u>	

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	

Illustration 55 – (Past Exam – July 21)

An entity regularly sells Products X, Y and Z individually, thereby establishing the following stand-alone selling prices:

Product	Stand-alone selling price
	₹
Product X	50,000
Product Y	25,000

Product Z	45,000
Total	1,20,000

In addition, the entity regularly sells Products Y and Z together for ₹ 50,000.

Case A—Allocating a discount to one or more performance obligations

The entity enters into a contract with a customer to sell Products X, Y and Z in exchange for ₹100,000. The entity will satisfy the performance obligations for each of the products at different points in time; or Product Y and Z at same point of time. Determine the allocation of transaction price to Product Y and Z.

Case B—Residual approach is appropriate

The entity enters into a contract with a customer to sell Products X, Y and Z as described in Case A. The contract also includes a promise to transfer Product Alpha. Total consideration in the contract is ₹ 130,000. The stand-alone selling price for Product Alpha is highly variable because the entity sells Product Alpha to different customers for a broad range of amounts (₹15,000 – ₹45,000). Determine the stand-alone selling price of Products, X, Y, Z and Alpha using the residual approach.

Case C—Residual approach is inappropriate

The same facts as in Case B apply to Case C except the transaction price is ₹1,05,000 instead of ₹130,000. (12 Marks)

Solution

Case A—Allocating a discount to one or more performance obligations

The contract includes a discount of ₹20,000 on the overall transaction, which would be allocated proportionately to all three performance obligations when allocating the transaction price using the relative stand-alone selling price method.

However, because the entity regularly sells Products Y and Z together for ₹50,000 and Product X for ₹50,000, it has evidence that the entire discount should be allocated to the promises to transfer Products Y and Z in accordance with paragraph 82 of Ind AS 115.

If the entity transfers control of Products Y and Z at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate ₹ 50,000 of the transaction price to the single performance obligation and recognise revenue of ₹ 50,000 when Products Y and Z simultaneously transfer to the customer.

If the contract requires the entity to transfer control of Products Y and Z at different points in time, then the allocated amount of ₹ 50,000 is individually allocated to the promises to transfer Product Y (stand-alone selling price of ₹ 25,000) and Product Z (stand-alone selling price of ₹45,000) as follows:

Product	Allocated transaction price	
	₹	
Product Y	17,857	(₹ 25,000 ÷ ₹ 70,000 total stand-alone selling price × ₹ 50,000)
Product Z	32,143	(₹ 45,000 ÷ ₹ 70,000 total stand-alone selling price × ₹ 50,000)
Total	50,000	

Case B—Residual approach is appropriate

Before estimating the stand-alone selling price of Product Alpha using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract.

As in Case A, because the entity regularly sells Products Y and Z together for ₹50,000 and Product X for ₹50,000, it has observable evidence that ₹100,000 should be allocated to those three products and a ₹20,000 discount should be allocated to the promises to transfer Products Y and Z in accordance with paragraph 82 of Ind AS 115.

Using the residual approach, the entity estimates the stand-alone selling price of Product Alpha to be ₹30,000 as follows:

Product	Stand-alone selling price	Method
	₹	
Product X	50,000	Directly observable
Products Y and Z	50,000	Directly observable with discount
Product Alpha	<u>30,000</u>	Residual approach
Total	<u>130,000</u>	

The entity observes that the resulting ₹ 30,000 allocated to Product Alpha is within the range of its observable selling prices (₹ 15,000 – ₹ 45,000).

Case C—Residual approach is inappropriate

The same facts as in Case B apply to Case C except the transaction price is ₹105,000 instead of ₹130,000. Consequently, the application of the residual approach would result in a stand-alone selling price of ₹ 5,000 for Product Alpha (₹ 105,000 transaction price less ₹ 100,000 allocated to Products X, Y and Z).

The entity concludes that ₹ 5,000 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product Alpha, because ₹ 5,000 does not approximate the stand-alone selling price of Product Alpha, which ranges from ₹ 15,000 – ₹ 45,000.

Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the stand-alone selling price of Product Alpha using another suitable method. The entity allocates the transaction price of ₹ 1,05,000 to Products X, Y, Z and Alpha using the relative stand-alone selling prices of those products in accordance with paragraphs 73–80 of Ind AS 115.

Illustration 56 - MTP (March 2019)

An entity enters into a contract with a customer for two intellectual property licences (Licences A and B), which the entity determines to represent two performance obligations each satisfied at a point in time. The stand-alone selling prices of Licences A and B are ₹1,600,000 and ₹2,000,000, respectively. The entity transfers Licence B at inception of the contract and transfers Licence A one month later.

Case A—Variable consideration allocated entirely to one performance obligation

The price stated in the contract for Licence A is a fixed amount of ₹1,600,000 and for Licence B the consideration is three per cent of the customer's future sales of products that use Licence B. For purposes of allocation, the entity estimates its sales-based royalties (i.e. the variable consideration) to be ₹2,000,000. 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 ₹600,000 and for Licence B the consideration is five per cent of the customer's future sales of products that use Licence B. The entity's estimate of the sales-based royalties (ie the variable consideration) is ₹3,000,000. Here, Licence A is transferred 3 months later. The royalty due from the customer's first month of sale is ₹ 4,00,000.

Allocate the transaction price and determine the revenue to be recognised for each licence and the contract liability, if any.

Solution

Case A—Variable consideration allocated entirely to one performance obligation

To allocate the transaction price, the entity considers the criteria in paragraph 85 and concludes that the variable consideration (ie the sales-based royalties) should be allocated entirely to Licence B. The entity concludes that the criteria are met for the following reasons:

- a) the variable payment relates specifically to an outcome from the performance obligation to transfer Licence B (ie the customer's subsequent sales of products that use Licence B).
- b) (b) allocating the expected royalty amounts of ₹2,000,000 entirely to Licence B is consistent with the allocation objective in paragraph 73 of Ind AS 115. This is because the entity's estimate of the amount of sales-based royalties (₹2,000,000) approximates the stand-alone selling price of Licence B and the fixed amount of ₹1,600,000 approximates the stand-alone selling price of Licence A. The entity allocates ₹1,600,000 to Licence A. This is because, based on an assessment of the facts and circumstances relating to both licences, allocating to Licence B some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 73 of Ind AS 115.

The entity transfers Licence B at inception of the contract and transfers Licence A one month later. Upon the transfer of Licence B, the entity does not recognise revenue because the consideration allocated to Licence B is in the form of a sales-based royalty. Therefore, the entity recognises revenue for the sales-based royalty when those subsequent sales occur.

When Licence A is transferred, the entity recognises as revenue the ₹ 1,600,000 allocated to Licence A.

Case B—Variable consideration allocated on the basis of stand-alone selling prices

To allocate the transaction price, the entity applies the criteria in paragraph 85 of Ind AS 115 to determine whether to allocate the variable consideration (ie the sales-based royalties) entirely to Licence B.

In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer Licence B (ie the customer's subsequent sales of products that use Licence B), allocating the variable consideration entirely to Licence B would be inconsistent with the principle for allocating the transaction price. Allocating ₹600,000 to Licence A and ₹3,000,000 to Licence B does not reflect a reasonable allocation of the transaction price on the basis of the stand-alone selling prices of Licences A and B of ₹ 1,600,000 and ₹ 2,000,000, respectively. Consequently, the entity applies the general allocation requirements of Ind AS 115.

The entity allocates the transaction price of ₹ 600,000 to Licences A and B on the basis of relative stand-alone selling prices of ₹1,600,000 and ₹ 2,000,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative stand-alone selling price basis. However, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognise revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

Licence B is transferred to the customer at the inception of the contract and Licence A is transferred three months later. When Licence B is transferred, the entity recognises as revenue ₹333,333 $[(₹2,000,000 + ₹3,600,000) \times ₹600,000]$ allocated to Licence B. When Licence A is transferred, the entity recognises as revenue ₹ 266,667 $[(₹ 1,600,000 + ₹ 3,600,000) \times ₹ 600,000]$ allocated to Licence A.

In the first month, the royalty due from the customer's first month of sales is ₹ 400,000. Consequently, the entity recognises as revenue ₹ 222,222 $(₹ 2,000,000 + ₹ 3,600,000 \times ₹400,000)$ allocated to Licence B (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognises a contract liability for the ₹ 177,778 $(₹ 1,600,000 + ₹ 3,600,000 \times ₹ 400,000)$ allocated to Licence A. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

Illustration 57

On 1 April 20X0, a consultant enters into an arrangement to provide due diligence, valuation, and software implementation services to a customer for ₹2 crores. The consultant can earn ₹ 20 lakhs bonus if it completes the software implementation by 30 September 20X0 or ₹10 lakhs bonus if it completes the software implementation by 31 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 lakhs
- Valuation – ₹ 20 lakhs
- Software implementation – ₹ 1 crore

At contract inception, the consultant believes it will complete the software implementation by 30 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 1 July 20X0, the consultant notes that the project has progressed better than expected and believes that implementation will be completed by 30 September 20X0 based on a revised forecast. As a result, the consultant updates its estimated transaction price to reflect a bonus of ₹20 lakhs.

After reviewing its progress as of 1 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 1 July 20X0, the consultant allocates the bonus of ₹20 lakhs to the software implementation performance obligation, for total consideration of ₹1.2 crores allocated to that performance obligation, and adjusts the cumulative revenue to date for the software implementation services to ₹ 72 lakhs (60 percent of ₹1.2 crores).

Illustration 58

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 recognised 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 recognise the credit over the remaining term of the contract.

Illustration 59

Minitex Ltd. is a payroll processing company. Minitex Ltd. enters into a contract to provide monthly payroll processing services to ABC Limited for one year. Determine how entity will recognise the revenue?

Solution

Payroll processing is a single performance obligation. On a monthly basis, as Minitex Ltd carries out the payroll processing –

- The customer, ie, ABC Limited simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction.
- Further, once the services have been performed for a particular month, in case of termination of the agreement before maturity and contract is transferred to another entity, then such new entity will not need to re-perform the services for expired months.

Therefore, it satisfies the first criterion, ie, services completed on a monthly basis are consumed by the entity at the same time and hence, revenue shall be recognised over the period of time.

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 Mumbai to Colombo. T&L is responsible for shipping the goods from Mumbai port to Colombo port.

Whether T&L's performance obligation is met over period of time?

Solution

T&L has a single performance to ship the goods from one port to another. The following factors are critical for assessing how services performed by T&L are consumed by the customer –

- As the voyage is performed, the service undertaken by T&L is progressing, such that no other entity will need to re-perform the service till so far as the voyage has been performed, if T&L was to deliver only part-way.
- The customer is directly benefitting from the performance of the voyage as & when it progresses.

Therefore, such performance obligation is said to be met over a period of time.

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 recognising revenue over a period of time or at a point in time, Ind AS 115 requires one of the following criterion to be met –

Criterion (a) – whether the customer simultaneously receives and consumes the benefits from services provided by AFS: Company shall benefit only when the audit opinion is provided upon completion. And in case the contract was to be terminated, any other firm engaged to perform similar services will have to substantially re-perform.

Hence, this criterion is not met.

Criterion (b) – An asset created that customer controls: This is service contract and no asset created, over which customer acquires control.

Criterion (c) – no alternate use to entity and right to seek payment:

- The services provided by AFS are specific to the company – WBC and do not have any alternate use to AFS
- Further, AFS has a right to enforce payment if contract was early terminated, for reasons other than AFS's failure to perform. And the profit margin approximates what entity otherwise earns.

Therefore, criterion (c) is met and such performance obligation is said to be met over a period of time.

Illustration 62:

Space Ltd. enters into an arrangement with a government agency for construction of a space satellite. Although Space Ltd is in this business for building such satellites for various customers across the world, however the specifications for each satellite may vary based on technology that is incorporated in the satellite. In the event of termination, Company has right to enforce payment for work completed to date.

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time.

Solution:

While evaluating the pattern of transfer of control to the customer, the Company shall evaluate conditions laid in para 35 of Ind AS 115 as follows:

Criterion (a) – whether the customer simultaneously receives and consumes the benefits: Customer can benefit only when the satellite is fully constructed and no benefits are consumed as its constructed. Hence, this criterion is not met.

Criterion (b) – An asset created that customer controls: Per provided facts, the customer does not acquire control of the asset as its created.

Criterion (c) – no alternate use to entity and right to seek payment:

- The asset is being specifically created for the customer. The asset is customised to customer's requirements; such that any diversion for a different customer will require significant work. Therefore, the asset has practical limitation in being put to alternate use.
- Further, Space Ltd. has a right to enforce payment if contract was early terminated, for reasons other than Space Ltd.'s failure to perform.

Therefore, criterion (c) is met and such performance obligation is said to be met over a period of time.

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.

Solution:

The Company shall evaluate conditions laid in para 35 of Ind AS 115 as follows:

Criterion (a) – whether the customer simultaneously receives and consumes the benefits: Customer can benefit only when the asset is fully constructed and no benefits are consumed as its constructed. Hence, this criterion is not met.

Criterion (b) – An asset created that customer controls: Per provided facts, the customer does not acquire control of the asset as its created.

Criterion (c) – no alternate use to entity and right to seek payment:

- The customer has specific right over the asset and company does not have right to divert it for any alternate use. In other words, there is contractual restriction to use the asset for any alternate purpose.
- In the event of early termination, Company has a right to retain any payments made by the customer. However, such payments need not necessarily compensate the selling price of the partially constructed asset, if the customer was to stop making payments.

Therefore, Company does not have a legally enforceable right to payment for work completed to date and the criterion under para 35 is not. Thus, revenue cannot be recognised over a period of time.

Illustration 64

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay CU100 per month. The entity's promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes.

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time. If yes, how should an entity measure its progress of service provided?

Solution

The entity shall determine if revenue should be recognised over a period of time by evaluating the conditions laid in para 35 of Ind AS 115.

- Applying the first criterion of para 35 to establish if the customer simultaneously receives and consumes the benefits, as the entity provides service – The health club provides access to services uniformly through the year. The extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The customer therefore simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available.
- Consequently, the entity's performance obligation is satisfied over time
- Once the pattern of satisfying performance obligation is defined, the Company then determines how progress should be measured. The services are uniformly provided to the customer through the year. Therefore, the best measure of progress is to recognise revenue on a straight line basis over the year.

Illustration 65 – Past Exam (May 2019)

On 01 January, 20X1, an entity contracts to renovate a building including the installation of new elevators. The entity estimates the following with respect to the contract:

Particulars	Amount (₹)
Transaction price	5,000,000
Expected costs:	
(a) Elevators	1,500,000
(b) Other costs	2,500,000
Total	4,000,000

The entity purchases the elevators and they are delivered to the site six months before they will be installed. The entity uses an input method based on cost to measure progress towards completion. The entity has incurred actual other costs of 500,000 by March 31, 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.

- The elevators are part of the overall construction project and are not a distinct performance obligation
- The cost of elevators is substantial to the overall project and are incurred well in advance.
- Upon delivery at site, customer acquires control of such elevators.
- And there is no modification done to the elevators, which the company only procures and delivers at site. Nevertheless, as part of materials used in overall construction project, the company is a principal in the transaction with the customer for such elevators also.

Therefore, applying the guidance on Input method –

- The measure of progress should be made based on percentage of costs incurred relative to the total budgeted costs.
- The cost of elevators should be excluded when measuring such progress and revenue for such elevators should be recognized to the extent of costs incurred.

The revenue to be recognized is measured as follows:

Particulars	Amount (₹)
Transaction price	5,000,000
Costs incurred:	
(a) Cost of elevators	1,500,000
(b) Other costs	500,000
Measure of progress:	500,000 / 2,500,000 = 20%
Revenue to be recognised:	
(a) For costs incurred (other than elevators)	Total attributable revenue = 3,500,000 % of work completed = 20% Revenue to be recognised = 700,000
(b) Revenue for elevators	1,500,000 (equal to costs incurred)
Total revenue to be recognised	1,500,000 + 700,000 = 2,200,000

Therefore, for the year ended 31 March 20X1, the Company shall recognize revenue of ₹ 2,200,000 on the project.

Illustration 66

An entity enters into a contract with a customer for the sale of a tangible asset on 1 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 December 31, 20X1.

How would the entity account for this transaction?

Solution

In the above case, where the entity has a right to call back the goods upto a certain date --

- The customer cannot be said to have acquired control, owing to the repurchase right with the seller entity
- Since the original selling price (₹ 1 million) is lower than the repurchase price (₹1.1 million), this is construed to be a financing arrangement and accounted as follows:
 - Amount received shall be recognized as 'liability'

- b) Difference between sale price and repurchase price to be recognised as 'finance cost' and recognised over the repurchase term.

Illustration 67

An entity enters into a contract with a customer for the sale of a tangible asset on 1 January 20X1 for ₹1,000,000. The contract includes a put option that gives the customer the right to sell the asset for ₹900,000 on or before December 31, 20X1. The market price for such goods is expected to be ₹750,000

How would the entity account for this transaction?

Solution

In the above case, where the entity has an obligation to buy back the goods upto a certain date –

- The entity shall evaluate if the customer has a significant economic incentive to return the goods. Since the repurchase price is significantly higher than market price, therefore, customer has a significant economic incentive to return the goods. There are no other factors which entity may affect this assessment.
- Therefore, company determines that 'control' of goods is not transferred to the customer till 31 December 20X1, i.e, till the put option expires.
- Against payment of ₹1,000,000; the customer only has a right to use the asset and put it back to the entity for ₹900,000. Therefore, this will be accounted as a lease transaction in which difference between original selling price (ie, ₹1,000,000) and repurchase price (ie, ₹900,000) shall be recognized as lease income over the period of lease.
- At the end of repurchase term, ie, 31 December 20X1, if the customer does not exercise such right, then the control of goods would be passed to the customer at that time and revenue shall be recognized for sale of goods for repurchase price (ie, ₹ 900,000).

Illustration 68 – (Past Exam May'22)

An entity enters into a contract with a customer on 1 April 20X1 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On 31 March 20X3, the customer pays for the machine and spare parts, but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.

How will the Company recognise revenue for sale of machine and spare parts? Is there any other performance obligation attached to this sale of goods?

(6 Marks)

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 31 March 20X3. Accordingly, revenue for sale of machinery shall be recognised on 31 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.
(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 31 March 20X3.

- Custodial services: Such services shall be given for a period of 2 to 4 years from 31 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.

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 recognised?

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 recognises 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.

Illustration 70

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 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

Basis 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 good 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.

Illustration 71

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.

Illustration 72

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 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 recognised 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 good or a service to M as they occur (i.e. the team playing games does not transfer a good 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.

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 ₹400,000 designing and building the technology platform needed to accommodate outsourcing contract:

Design services	₹ 50,000
Hardware	₹ 140,000
Software	₹ 100,000
Migration and testing of data centre	₹ 110,000
TOTAL	₹ 400,000

How should such costs be treated?

Solution

Design services	₹ 50,000	Assess under Ind AS 115. Any resulting asset would be amortised over 7 years (i.e. include renewals)
Hardware	₹ 140,000	Account for asset under Ind AS 16
Software	₹ 100,000	Account for asset under Ind AS 38
Migration and testing of data centre	₹ 110,000	Assess under Ind AS 115. Any resulting asset would be amortised over 7 years (i.e. include renewals)
TOTAL	₹ 400,000	

Illustration 74

An entity enters into a service contract with a customer and incurs incremental costs to obtain the contract and costs to fulfil the contract. These costs are capitalised as assets in accordance with Ind AS 115. The initial term of the contract is five years but it can be renewed for subsequent one-year periods up to a maximum of 10 years. The average contract term for similar contracts entered into by entity is seven years.

Determine appropriate method of amortisation?

Solution

The most appropriate amortisation period is likely to be seven years (i.e. the initial term of five years plus two anticipated one year renewals) because that is the period over which the entity expects to provide services under the contract to which the capitalised costs relate.

Illustration 75 – (Past Exam Nov'22)

A Ltd. is in the business of the infrastructure and has two divisions under the same; (I) Toll Roads and (II) Wind Power. The brief details of these business and underlying project details are as follows:

- I. Bhilwara-Jabalpur Toll Project - The Company has commenced the construction of the project in the current year and has incurred total expenses aggregating to ₹50 crores 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 crores;
 - Fair Value of the construction services is ₹110 crores;
 - Total Cash Flow guaranteed by the Government under the concession agreement is ₹200 crores;
 - Finance revenue over the period of operation phase is ₹15 crores;
 - 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 crores. The fair value of such construction cost is approximately ₹200 crores. The said concession agreement is Toll based project and the Company needs to collect the toll from the users of the expressway. Under IGAAP, UK Ltd. has recorded the expenses incurred on the said project as an Intangible Asset.

Required

- i) What would be the classification of Bhilwara-Jabalpur Toll Project as per applicable Ind AS? Give brief reasoning for your choice.
- ii) What would be the classification of Kolhapur-Nagpur Expressway Toll Project as per applicable Ind AS? Give brief reasoning for your choice.
- iii) Also, suggest suitable accounting treatment for preparation of financial statements as per Ind AS for the above 2 projects.

(10 Marks)

Solution

- i) Here the operator has a contractual right to receive cash from the grantor. The grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator. Hence, operator recognizes a financial asset to the extent it has a contractual right to receive cash.
- ii) Here the operator has a contractual right to charge users of the public services. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service. Therefore, the operator shall recognise an intangible asset to the extent it receives a right (a licence) to charge users of the public service.
- iii) Accounting treatment for preparation of financial statements

Bhilwara-Jabalpur Toll Project

Journal Entries

Particulars	Dr. (₹ in crores)	Cr. (₹ in crores)
During construction:		

1	Financial asset A/c To Construction revenue [To recognise revenue relating to construction services, to be settled in case]	Dr.	110	110
2	Cost of construction (profit or loss) To Bank A/c (As and when incurred) [To recognise costs relating to construction services]	Dr.	100	100
During the operation phase:				
3	Financial asset To Finance revenue (As and when received or due to receive) [To recognise interest income under the financial asset model]	Dr.	15	15
4	Financial asset To Revenue [(200-110) - 15] [To recognise revenue relating to the operation phase]	Dr.	75	75
5	Bank A/c To Financial asset [To recognise cash received from the grantor]	Dr.	200	200

Kolhapur-Nagpur Expressway Intangible asset**Journal Entries**

	Particulars	Dr. (₹ in crores)	Cr. (₹ in crores)
1	During construction: Cost of construction (profit or loss) To Bank A/c (As and when incurred) [To recognise costs relating to construction services]	Dr. 110	110
2	Intangible asset To Revenue [To recognise revenue relating to construction services provided for non-cash consideration]	Dr. 200	200

During the operation phase:			
3	Amortisation expense	Dr.	200
	To Intangible asset (accumulated amortisation)		200
	[To recognise amortisation expense relating to the operation phase over the period of operation]		
4	Bank A/c	Dr.	?
	To Revenue		?
	[To recognise revenue relating to the operation phase]		

Note: Amount in entry 4 is kept blank as no information in this regard is given in the question.

Illustration 76

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 Deshabandhu. How revenue for these nonmonetary transactions in the area of advertising will be recognised and measured?

Solution

Paragraph 5(d) of Ind AS 115 excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

In industries with homogenous products, it is common for entities in the same line of business to exchange products in order to sell them to customers or potential customers other than parties to exchange. The current scenario, on the contrary, will be covered under Ind AS 115 since the same is exchange of dissimilar goods or services because both of the entities deal in different mode of media, i.e., one is print media and another is electronic media and both parties are acting as customers and suppliers for each other.

Further, in the current scenario, it seems it is for consumption by the said parties and hence it does not fall under paragraph 5(d). It may also be noted that, even if it was to facilitate sales to customers or potential customers, it would not be scoped out since the parties are not in the same line of business.

As per paragraph 47 of Ind AS 115, "An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both".

Paragraph 66 of Ind AS 115 provides that to determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of non-cash consideration) at fair value.

In accordance with the above, QTV and Deshabandhu should measure the revenue promised in the form of non-cash consideration as per the above referred principles of Ind AS 115.

Illustration 77

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 Re.0.50 per minute and B Ltd. charges ₹2.5 per unit. How should revenue be measured in this case?

Solution

Paragraph 5(d) of Ind AS 115 excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

However, the current scenario will be covered under Ind AS 115 since the same is exchange of dissimilar goods or services.

As per paragraph 47 of Ind AS 115, "an entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both".

Paragraph 66 of Ind AS 115 provides that to determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of noncash consideration) at fair value.

On the basis of the above, revenue recognised by A Ltd. will be the consideration in the form of power units that it expects to be entitled for talktime sold, i.e. ₹50,000 (20,000 units x ₹2.5). The revenue recognised by B Ltd. will be the consideration in the form of talk time that it expects to be entitled for the power units sold, i.e., ₹ 50,000 (1,00,000 minutes x Re. 0.50).

Illustration 78

Company X enters into an agreement on January 1, 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 airconditioners.

Company X determines that it acts as a principal in accordance with paragraphs B34-B38 of Ind AS 115 because it obtains control of the air conditioners before they are transferred to the customer. The customer obtains control of the air conditioners when they are delivered to the hospital premises.

Company X uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation.

As at March 31, 20X1, other costs incurred excluding the air conditioners are ₹6,00,000.

Whether Company X should include cost of the air conditioners in measure of its progress of performance obligation? How should revenue be recognised for the year ended March 20X1?

Solution

Paragraph B19 of Ind AS 115 inter alia, states that, "an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 39, do not depict the entity's performance in transferring control of goods or services to the customer".

In accordance with the above, Company X assesses whether the costs incurred to procure the air conditioners are proportionate to the entity's progress in satisfying the performance obligation. The costs incurred to procure the air conditioners (₹10,00,000) are significant relative to the total costs to completely

satisfy the performance obligation. (₹40,00,000). Also, Company X is not involved in manufacturing or designing the air conditioners.

Company X concludes that including the costs to procure the air conditioners in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph B19 of Ind AS 115, the entity adjusts its measure of progress to exclude the costs to procure the air conditioners from the measure of costs incurred and from the transaction price. The entity recognises revenue for the transfer of the air conditioners at an amount equal to the costs to procure the air conditioners (i.e., at a zero margin).

Company X assesses that as at March 20X1, the performance is 20 per cent complete (i.e., ₹6,00,000/₹30,00,000). Consequently, Company X recognises the following-

As at March 31, 20X1

	Amount in ₹
Revenue	18,00,000
Cost of goods sold	16,00,000
Profit	2,00,000

Revenue recognised is calculated as (20 per cent × ₹ 40,00,000) + ₹10,00,000.

(₹40,00,000 = ₹ 50,00,000 transaction price — ₹ 10,00,000 costs of air conditioners.)

Cost of goods sold is ₹ 6,00,000 of costs incurred + ₹ 10,00,000 costs of air conditioners.

Illustration 79 - (RTP - Nov 2019)

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. recognise revenue from sale of machinery to P Ltd. in accordance with Ind AS 115?

Solution

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:

- 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;
- the entity can identify each party's rights regarding the goods or services to be transferred;
- the entity can identify the payment terms for the goods or services to be transferred;
- 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
- 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 recognised, 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 recognise 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 recognise 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 are subsequently met. Depending on the facts and circumstances relating to the contract, the liability recognised 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.

Illustration 80 – (RTP – MAY 2020) + (MTP – March 2021)

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 at least ₹ 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?

(3 Marks)

Solution

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.

Illustration 81 - (RTP May'20) (MTP Mar'21 May'23) (Past Exam May'22)

On 1 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

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 at the end of first quarter?

(4 Marks / 3 Marks)

Solution

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 recognised will not occur when the uncertainty is resolved. Revenue is therefore recognised at a selling price of ₹ 90 per container as each container is sold. Entity J will recognise 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.

Illustration 82 – (RTP – May 2020) + (MTP – March 2021)

Entity K sells electric razors to retailers for ₹ 50 per unit. A rebate coupon is included inside the electric razor package that can be redeemed by the end consumers for ₹ 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?

(3 Marks)

Solution

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 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.

Illustration 83 – (RTP - May 2020) + (MTP – March 2021)

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?

(3 Marks)

Solution

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 recognise 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.

Illustration 84

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%
₹ 500	20%
₹ 1000	10%

Determine the transaction price.

Solution

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 × 70%) + (₹ 4,500 × 20%) + (₹ 4,000 × 10%).

Illustration 85

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.

Solution:

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.

Illustration 86

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.

Solution:

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 good or service to F.

Therefore, Y Ltd. recognises the up-front fee over the 10-year franchise period.

MOCK TEST PAPER / REVISION TEST PAPER / PAST PAPER

Question 1 - (MTP Oct'2019, May'19, Oct'20)

KK Ltd. runs a departmental store which awards 10 points for every purchase of Rs. 500 which can be discounted by the customers for further shopping with the same merchant. Unutilised points will lapse on expiry of two years from the date of credit. Value of each point is Rs. 0.50. During the accounting period 20X1-20X2, the entity awarded 1,00,00,000 points to various customers of which 18,00,000 points remained undiscounted. The management expects only 80% will be discounted in future of which normally 60-70% are redeemed during the next year.

The Company has approached your firm with the following queries and has asked you to suggest the accounting treatment (Journal Entries) under the applicable Ind AS for these award points:

(a)	How should the recognition be done for the sale of goods worth Rs. 10,00,000 on a particular day?
(b)	How should the redemption transaction be recorded in the year 20X1-20X2? The Company has requested you to present the sale of goods and redemption as independent transaction. Total sales of the entity is Rs. 5,000 lakhs.
(c)	How much of the deferred revenue should be recognised at the year-end (20X1-20X2) because of the estimation that only 80% of the outstanding points will be redeemed?
(d)	In the next year 20X2-20X3, 60% of the outstanding points were discounted Balance 40% of the outstanding points of 20X1-20X2 still remained outstanding. How much of the deferred revenue should the merchant recognize in the year 20X2-20X3 and what will be the amount of balance deferred revenue?
(e)	How much revenue will the merchant recognized in the year 20X2-20X3, if 3,00,000 points are redeemed in the year 20X2-20X3?

(10 Marks)**Solution**

(a) Points earned on Rs. 10,00,000 @ 10 points on every Rs. 500 = $[(10,00,000/500) \times 10] = 20,000$ points.

Value of points = 20,000 points x Rs. 0.5 each point = Rs. 10,000

Revenue recognized for sale of goods	Rs. 9,90,099	$[10,00,000 \times (10,00,000/10,10,000)]$
Revenue for points deferred	Rs. 9,901	$[10,00,000 \times (10,000/10,10,000)]$

Journal Entry

		Rs.	Rs.
Bank A/c	Dr.	10,00,000	
To Sales A/c			9,90,099
To Liability under Customer Loyalty programme			9,901

(b) Points earned on Rs. 50,00,00,000 @ 10 points on every Rs. 500 = $[(50,00,00,000/500) \times 10] = 1,00,00,000$ points.

Value of points = 1,00,00,000 points x Rs. 0.5 each point = Rs. 50,00,000

Revenue recognized for sale of goods = Rs. 49,50,49,505 $[50,00,00,000 \times (50,00,00,000 / 50,50,00,000)]$

Revenue for points = Rs. 49,50,495 $[50,00,00,000 \times (50,00,000 / 50,50,00,000)]$

Journal Entry in the year 20X1

		Rs.	Rs.
Bank A/c	Dr.	50,00,00,000	
To Sales A/c			49,50,49,505
To Liability under Customer Loyalty programme			49,50,495
(On sale of Goods)			
Liability under Customer Loyalty programme	Dr.	42,11,002	
To Sales A/c			42,11,002
(On redemption of (100 lakhs -18 lakhs) points)			

Revenue for points to be recognized

Undiscounted points estimated to be recognized next year $18,00,000 \times 80\% = 14,40,000$ points

Total points to be redeemed within 2 years $= [(1,00,00,000 - 18,00,000) + 14,40,000] = 96,40,000$

Revenue to be recognised with respect to discounted point

$= 49,50,495 \times (82,00,000 / 96,40,000) = 42,11,002$

(c) Revenue to be deferred with respect to undiscounted point in 20X1-20X2 $= 49,50,495 - 42,11,002 = 7,39,493$

(d) In 20X2-20X3, KK Ltd. would recognize revenue for discounting of 60% of outstanding points as follows:

Outstanding points $= 18,00,000 \times 60\% = 10,80,000$ points

Total points discounted till date $= 82,00,000 + 10,80,000 = 92,80,000$ points Revenue to be recognized in the year 20X2-20X3 $= [(49,50,495 \times (92,80,000 / 96,40,000)) - 42,11,002] = \text{Rs. } 5,54,620$.

Liability under Customer Loyalty programme	Dr.	5,54,620	
To Sales A/c			5,54,620
(On redemption of further 10,80,000 points)			

The Liability under Customer Loyalty programme at the end of the year 20 X2-20X3 will be $\text{Rs. } 7,39,493 - 5,54,620 = 1,84,873$.

(e) In the year 20X3-20X4, the merchant will recognized the balance revenue of Rs. 1,84,873 irrespective of the points redeemed as this is the last year for redeeming the points. Journal entry will be as follows:

Liability under Customer Loyalty programme	Dr.	1,84,873	
To Sales A/c			1,84,873
(On redemption of remaining points)			

Question 2 - (RTP Nov'20) (MTP April'22)

A contractor enters into a contract with a customer to build an asset for ₹ 1,00,000, with a performance bonus of ₹ 50,000 that will be paid based on the timing of completion. The amount of the performance

bonus decreases by 10% per week for every week beyond the agreed-upon completion date. The contract requirements are similar to those of contracts that the contractor has performed previously, and management believes that such experience is predictive for this contract. The contractor concludes that the expected value method is most predictive in this case.

The contractor estimates that there is a 60% probability that the contract will be completed by the agreed-upon completion date, a 30% probability that it will be completed one week late, and a 10% probability that it will be completed two weeks late.

Determine the transaction price

(4 Marks)

Solution:

The transaction price should include management's estimate of the amount of consideration to which the entity will be entitled for the work performed.

Probability-weighted	Consideration
₹1,50,000(fixed fee plus full performance bonus) x 60%	₹90,000
₹1,45,000 (fixed fee plus 90% of performance bonus) x 30%	₹43,500
₹1,40,000 (fixed fee plus 80% of performance bonus) x 10%	₹14,000
Total probability-weighted consideration	₹1,47,500

The total transaction price is ₹ 1,47,500, based on the probability-weighted estimate. The contractor will update its estimate at each reporting date

Question 3 - (PAST EXAM Nov'19, MTP Nov'21)

Nivaan Limited commenced work on two long-term contracts during the financial year ended on 31st March, 2019.

The first contract with A & Co. commences on 1st June, 2018 and had a total sales value of ₹ 40 lakh. It was envisaged that the contract would run for two years and that the total expected costs would be ₹ 32 lakh. On 31st March, 2019, Nivaan Limited revised its estimate of the total expected cost to ₹ 34 lakh on the basis of the additional rectification cost of ₹ 2 lakh incurred on the contract during the current financial year. An independent surveyor has estimated at 31st March, 2019 that the contract is 30% complete. Nivaan Limited has incurred costs up to 31st March, 2019 of ₹ 16 lakh and has received payments on account of ₹ 13 lakh.

The second contract with B & Co. commenced on 1st September, 2018 and was for 18 months. The total sales value of contract was ₹ 30 lakh and the total expected cost is ₹ 24 lakh. Payments on account already received were ₹ 9.50 lakh and total costs incurred to date were ₹ 8 lakh. Nivaan Limited has insisted on a large deposit from B & Co. because the companies had not traded together prior to the contract. The independent surveyor estimated that on 31st March, 2019 the contract was 20% complete.

The two contracts meet the requirement of Ind AS 115 'Revenue from Contracts with Customers' to recognize revenue over time as the performance obligations are satisfied over time.

The company also has several other contracts of between twelve and eighteen months in duration. Some of these contracts fall into two accounting periods and were not completed as at 31st March, 2019. In absence of any financial data relating to the other contracts, you are advised to ignore these other contracts while preparing the financial statements of the company for the year ended 31st March, 2019.

Prepare financial statement extracts for Nivaan Limited in respect of the two construction contracts for the year ending 31st March, 2019.

(12 Marks)

Solution:

(a) Extracts of Balance Sheet of Nivaan Ltd. as on 31st March, 2019

	₹ in lakh
Current Assets	
Contract Assets- Work-in-progress (Refer W.N. 3)	9.0
Current Liabilities	
Contract Liabilities (Advance from customers) (Refer W.N. 2)	4.5

Extracts of Statement of Profit and Loss of Nivaan Ltd. as on 31st March, 2019

	₹ in lakh
Revenue from contracts (Refer W.N. 1)	18
Cost of Revenue (Refer W.N. 1)	(16.4)
Net Profit on Contracts (Refer W.N. 1)	1.6

Working Notes:

1. Table showing calculation of total revenue, expenses and profit or loss on contract for the year

	₹ in lakh		
	A & Co.	B & Co.	Total
Revenue from contracts	$(40 \times 30\%) = 12$	$(30 \times 20\%) = 6$	18
Expenses due for the year	$(34 \times 30\%) = 10.2$	$(24 \times 20\%) = 4.8$	15
Profit or loss on contract	1.8	1.2	3

***Note:** Additional rectification cost of ₹ 2 lakh has been treated as normal cost. Hence total expected cost has been considered as ₹ 34 lakh. However, in case this ₹ 2 lakh is treated as abnormal cost then expense due for the year would be ₹ 11.6 lakh (ie 30% of ₹ 32 lakh plus ₹ 2 lakh). Accordingly, with respect to A & Co., the profit for the year would be ₹ 0.4 lakh and work-in-progress recognised at the end of the year would be ₹ 4.4 lakh.

2. Calculation of amount due from / (to) customers

	₹ in lakh		
	A & Co.	B & Co.	Total
Billing on the basis of revenue recognised in the books	12	6	18
Payments received from the customers	(13)	(9.5)	(22.5)
Advance received from the customers	1	3.5	4.5

3. Work in Progress recognised as part of contract asset at the end of the year

	₹ in lakh		
	A & Co.	B & Co.	Total
Total actual cost incurred during the year	16	8	24

Less: Cost recognised in the books for the year 31.3.2019	(10.2)	(4.8)	(15)
Work-in-progress recognised at the end of the year	5.8	3.2	9.0

Question 4 - (Past Exam Nov'20) (MTP May'23)

ABC Limited supplies plastic buckets to wholesaler customers. As per the contract entered into between ABC Limited and a customer for the financial year 2019 -2020, the price per plastic bucket will decrease retrospectively as sales volume increases within the stipulated time of one year.

The price applicable for the entire sale will be based, on sales volume bracket during the year.

Price per unit (INR)	Sales volume
90	0 - 10,000 units
80	10,001 - 35,000 units
70	35,001 units & above

- Suggest how revenue is to be recognised in the books of accounts of ABC Limited as per expected value method, considering a probability of 15%, 75% and 10% for sales volumes of 9,000 units, 28,000 units and 36,000 units respectively. For workings, assume that ABC Limited achieved the same number of units of sales to the customer during the year as initially estimated under expected value method for the financial year 2019-2020.
- In case ABC Limited decides to measure revenue, based on most likely method instead of expected value method, how will be the revenue recognised in the books of accounts of ABC Limited based on above available information? For workings, assume that ABC Limited achieved the same number of units of sales to the customer during the year as initially estimated under most likely value method for the financial year 2019-2020.
- You are required to pass Journal entries in the books of ABC Limited if the revenue is accounted for as per expected value method for financial year 2019-2020.

14 Marks

Solution:

- (i) **Determination of how revenue is to be recognised in the books of ABC Ltd. as per expected value method**

Calculation of probability weighted sales volume

Sales volume (units)	Probability	Probability-weighted sales volume (units)
9,000	15%	1,350
28,000	75%	21,000
36,000	10%	3,600
		<u>25,950</u>

Calculation of probability weighted sales value

Sales volume (units)	Sales price per unit (₹)	Probability	Probability-weighted sales value (₹)
9,000	90	15%	1,21,500
28,000	80	75%	16,80,000
36,000	70	10%	2,52,000
			<u>20,53,500</u>

Average unit price = Probability weighted sales value / Probability weighted sales volume

$$= 20,53,500 / 25,950 = ₹ 79.13 \text{ per unit}$$

Revenue is recognised at ₹ 79.13 for each unit sold. First 10,000 units sold will be booked at ₹ 90 per unit and liability is accrued for the difference price of ₹ 10.87 per unit (₹ 90 – ₹ 79.13), which will be reversed upon subsequent sales of 15,950 units (as the question states that ABC Ltd. achieved the same number of units of sales to the customer during the year as initially estimated under the expected value method for the financial year 2019-2020). For, subsequent sale of 15,950 units, contract liability is accrued at ₹ 0.87 (80 – 79.13) per unit and revenue will be deferred.

(ii) Determination of how revenue is to be recognised in the books of ABC Ltd. as per most likely method

Note: It is assumed that the sales volume of 28,000 units given under the expected value method, with highest probability is the sales estimated under most likely method too.

Transaction price will be:

$$28,000 \text{ units} \times ₹ 80 \text{ per unit} = ₹ 22,40,000 \text{ Average unit price applicable} = ₹ 80$$

First 10,000 units sold will be booked at ₹ 90 per unit and liability of ₹ 1,00,000 is accrued for the difference price of ₹ 10 per unit (₹ 90 – ₹ 80), which will be reversed upon subsequent sales of 18,000 units (as question states that ABC Ltd. achieved the same number of units of sales to the customer during the year as initially estimated under the most likely method for the financial year 2019-2020).

Note: Alternatively, the question may be solved based on 25,950 units (as calculated under expected value method assuming that the targets were met) as follows:

Transaction price will be :

$$25,950 \text{ units} \times ₹ 80 \text{ per unit} = ₹ 20,76,000 \text{ Average unit price applicable} = ₹ 80.$$

First 10,000 units sold will be booked at ₹ 90 per unit and liability is accrued for the difference price of ₹ 10 per unit (₹ 90 – ₹ 80), which will be reversed upon subsequent sales of 15,950 units.

(iii)

Journal Entries in the books of ABC Ltd.

(when revenue is accounted for as per expected value method for financial year 2019-2020)

		₹	₹
1.	Bank A/c (10,000 x ₹ 90) Dr. To Revenue A/c (10,000 x ₹ 79.13) To Liability (10,000 x ₹ 10.87) (Revenue recognised on sale of first 10,000 units)	9,00,000	7,91,300 1,08,700
2.	Bank A/c [(25,950 x ₹ 80) - 9,00,000] Dr. Liability Dr. To Revenue A/c (15,950 x ₹ 79.13) (Revenue recognised on sale of remaining 15,950 units (25,950 - 10,000). Amount paid by the customer will be the balance amount after adjusting the excess paid earlier since, the customer falls now in second slab)	11,76,000 86,124	12,62,124
3.	Liability (1,08,700 - 86,124) Dr. To Revenue A/c [25,950 x (80-79.13)] (On reversal of liability at the end of the financial year 2019-2020 i.e. after completion of stipulated time)	22,576	22,576

Alternatively, in place of first two entries, one consolidated entry may be passed as follows:

Bank A/c (25,950 x ₹ 80) Dr.	20,76,000	
To Revenue A/c (25,950 x ₹ 79.13)		20,53,424
To Liability (25,950 x ₹ 0.87)		22,576
(Revenue recognised on sale of 25,950 units)		

Note: In 2nd journal entry, it is assumed that the customer had paid balance amount of ₹ 11,76,000 after adjusting excess ₹ 1,00,000 paid with first lot of sale of 10,000 unit. However, one can pass journal entry with total sales value of ₹ 12,76,000 (15,950 units x ₹ 80 per unit) and later on pass third entry for refund. In such a situation, alternatively, 2nd and 3rd entries would be as follows:

Bank A/c (15,950 x ₹ 80)	Dr.	12,76,000	
To Revenue A/c (15,950 x ₹ 79.13)			12,62,124
To Liability			13,876
(Revenue recognised on sale of remaining 15,950 units (25,950 - 10,000))			
Liability (1,08,700 + 13,876)	Dr.	1,22,576	
To Revenue A/c [25,950 x (80-79.13)]			22,576
To Bank			1,00,000
(On reversal of liability at the end of the financial year 2019-2020 i.e. after completion of stipulated time and excess amount refunded)			

Question 5 - (RTP – May 2021)

A property sale contract includes the following:

- Common areas
- Construction services and building material
- Property management services
- Golf membership
- Car park
- Land entitlement

Analyse whether the above items can be considered as separate performance obligations as per the requirements of Ind AS 115?

Solution:

Paragraph 22 of Ind AS 115 provides that at contract inception, an entity evaluates the promised goods or services to determine which goods or services (or bundle of goods or services) are distinct and therefore constitute a performance obligation.

A performance obligation is a promise in a contract to transfer to the customer either:

- a good or service (or a bundle of goods or services) that is distinct; and
- series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

As per paragraph 27 of Ind AS 115, a good or service that is promised to a customer is distinct if both of the following criteria are met:

- (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e. the good or service is capable of being distinct); and
- (b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. the promise to transfer the good or service is distinct within the context of the contract).

Each performance obligation is required to be accounted for separately.

Based on the above guidance, the following table discusses whether the common goods and services in property sale contract should be considered as separate performance obligation or not:

Goods/Service	Whether a separate Performance obligation (PO) or not	Reason

Common areas	Unlikely to be separate PO	Common areas are unlikely to be a separate performance obligation because the interests received in common areas are typically undivided interests that are not separable from the property itself. However, if the common areas were sold separately by the developer, then they could be considered as a separate performance obligation provided that it is distinct in the context of the contract.
Construction services and building material	Unlikely to be separate PO	Construction services and building materials can meet the first criterion as they are items that can be used in conjunction with other readily available goods or services. However, the developer would be considered to be providing a significant integration service as it is bringing together all the separate elements to deliver a complete building.
Property management services and Golf membership	Likely to be separate PO	Property management services and golf membership are likely to be separate performance obligations as they may be used in isolation or with the property already acquired, i.e., management services can be used with the property. These types of services are not significantly customised, integrated with, or dependent on the property. This is because there is no change in their function with or without the property. Also, a property management service could be undertaken by a third party.
Car park and Land entitlement	Analysis required	Items such as car parks and land entitlements generally meet the first criterion – i.e., capable of being distinct – as the buyer benefits from them on their own. Whether the second criterion is met depends on the facts and circumstances. For example, if the land entitlement can be sold separately or pledged as security as a separate item, it may indicate that it is not highly dependent on, or integrated with, other rights received in the contract. In an apartment scenario, the customer can receive an undivided interest in the land on which the apartment block sits. This type of right is generally considered as highly inter-related with the apartment itself.*

* However, if title to the land is transferred to the buyer separately – for example in a single party development – then the separately identifiable criterion may be met.

PS: Other facts and circumstances of each contract should also be carefully examined to determine performance obligations.

Question 6 - (MTP – April 2021)

Entity AB Ltd. enters into a three-year service contract with a customer CD Ltd. for Rs. 4,50,000 (Rs.1,50,000 per year). The standalone selling price for one year of service at inception of the contract is Rs.1,50,000 per year. AB Ltd. accounts for the contract as a series of distinct services.

At the beginning of the third year, the parties agree to modify the contract as follows: the fee for the third year is reduced to Rs.1,20,000; and

CD Ltd. agrees to extend the contract for another three years for Rs.3,00,000 (Rs.1,00,000 per year).

The standalone selling price for one year of service at the time of modification is Rs. 1,20,000. How should AB Ltd. account for the modification? Analyze. (5 Marks)

Solution:

Paragraph 20 of Ind AS 115, inter alia, states that, "An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

the scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 26–30); and

the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract.

In accordance with the above, it may be noted that a contract modification should be accounted for prospectively if the additional promised goods or services are distinct and the pricing for those goods or services reflects their stand-alone selling price.

In the given case, even though the remaining services to be provided are distinct, the modification should not be accounted for as a separate contract because the price of the contract did not increase by an amount of consideration that reflects the standalone selling price of the additional services. The modification would be accounted for, from the date of the modification, as if the existing arrangement was terminated and a new contract created (i.e. on a prospective basis) because the remaining services to be provided are distinct.

AB Ltd. should reallocate the remaining consideration to all of the remaining services to be provided (i.e. the obligations remaining from the original contract and the new obligations). AB Ltd. will recognise a total of Rs.4,20,000 (Rs.1,20,000 + Rs.3,00,000) over the remaining four-year service period (one year remaining under the original contract plus three additional years) or Rs.1,05,000 per year.

Question 7 - (Past Exam Jan'21), (MTP Nov'22)

A Ltd. is a company which is in the business of manufacturing engineering machines and providing after sales services. The company entered into a contract with Mr. Anik to supply and install a machine, namely 'model pi' on 1st April 2018 and to service this machine on 30th September 2018 and 1st April 2019. The cost of manufacturing the machine to A Ltd. was ₹ 1,60,000.

It is possible for a customer to purchase both the machine 'model pi' and the maintenance services separately. Mr. Anik is contractually obliged to pay A Ltd ₹ 4,00,000 on 1st April, 2019.

The prevailing rate for one-year credit granted to trade customers in the industry is 5 percent per six-month period.

As per the experience, the servicing of the machine 'model pi' sold to Mr. Anik is expected to cost A Ltd. ₹ 30,000 to perform the first service and ₹ 50,000 to perform the second service. Assume actual costs equal expected costs. When A Ltd. provides machine services to customers in a separate transaction it earns a margin of 50 % on cost. On 1st April, 2018, the cash selling price of the machine 'model pi' sold to Mr. Anik is ₹ 2,51,927. The promised supply of machine 'model pi' and maintenance service obligations are satisfactorily carried out in time by the company.

You are required to:

- (i) Segregate the components of the transaction that A Ltd. shall apply to the revenue recognition criteria separately as per Ind AS 115;
- (ii) Calculate the amount of revenue which A Ltd. must allocate to each component of the transaction;
- (iii) Prepare journal entries to record the information set out above in the books of accounts of A Ltd. for the years ended 31st March 2019 and 31st March 2020; and
- (iv) Draft an extract showing how revenue could be presented and disclosed in the financial statements of A Ltd. for the year ended 31st March 2019 and 31st March 2020. (12 Marks)

Solution

(i) As per para 27 of Ind AS 115, a good or service that is promised to a customer is distinct if both of the following criteria are met:

- the customer can benefit from the good or service either on its own or together with other resources that are readily available to them. A readily available resource is a good or service that is sold separately (by the entity or another entity) or that the customer has already obtained from the entity or from other transactions or events; and
- the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Factors that indicate that two or more promises to transfer goods or services to a customer are separately identifiable include, but are not limited to, the following:

- significant integration services are not provided (i.e. the entity is not using the goods or services as inputs to produce or deliver the combined output called for in the contract)
- the goods or services does not significantly modify or customize other promised goods or services in the contract.
- the goods or services are not highly inter-dependent or highly interrelated with other promised goods or services in the contract

Accordingly, on 1st April, 2018, entity A entered into a single transaction with three identifiable separate components:

- Sale of a good (i.e. engineering machine);
- Rendering of services (i.e. engineering machine maintenance services on 30th September, 2018 and 1st April, 2019); and
- Providing finance (i.e. sale of engineering machine and rendering of services on extended period credit).

(ii) Calculation and allocation of revenue to each component of the transaction

Date	Opening balance	Finance income	Goods	Services	Payment received	Closing balance
1st April, 2018	—	—	2,51,927	—	—	2,51,927
30th Sept, 2018	2,51,927	12,596 (Note 1)	—	45,000	—	3,09,523
31 st March 2019	3,09,523	15,477 (Note 2)	—	—	—	3,25,000
1st April, 2019	3,25,000	—	—	75,000	(4,00,000)	

Notes:

- Calculation of finance income as on 30th September, 2018
 $= 5\% \times 2,51,927 = ₹ 12,596$
- Calculation of finance income as on 31st March, 2019
 $= 5\% \times 3,09,523 = ₹ 15,477$

(iii) Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
1st April, 2018	Mr. Anik Dr. To Revenue - sale of goods (Profit or loss A/c) (Being revenue recognised from the sale of the machine on credit)	2,51,927	
			2,51,927

	Cost of goods sold (Profit or loss) Dr.	1,60,000	
	To Inventories (Being cost of goods sold recognised)		1,60,000
30th September 2018	Mr. Anik Dr. To Finance Income (Profit or loss) (Being finance income recognised)	12,596	12,596
	Mr. Anik Dr. To Revenue- rendering of services (Profit or loss) (Being revenue from the rendering of maintenance services recognised)	45,000	
			45,000
	Cost of services (Profit or loss) Dr. To Cash/Bank or payables (Being the cost of performing maintenance services recognised)	30,000	
			30,000
31st March 2019	Mr. Anik Dr. To Finance Income (Profit or loss) (Being finance income recognised)	15,477	15,477
1st April, 2019	Mr. Anik Dr. To Revenue-rendering of services (Profit or loss) (Being revenue from the rendering of maintenance services recognised)	75,000	
			75,000
	Cost of services (Profit or loss) Dr. To Cash/Bank or payables (Being the cost of performing maintenance services recognised)	50,000	
			50,000
	Cash/Bank Dr. To Mr. Anik (Being the receipt of cash from the customer recognised)	4,00,000	4,00,000

(iv) Extract of Notes to the financial statements for the year ended 31st March, 2019 and 31st March, 2020

Note on Revenue

	2019-2020	2018-2019
	₹	₹
Sale of goods	—	2,51,927
Rendering of machine - maintenance services	75,000	45,000
Finance income	—	28,073
	<u>75,000</u>	<u>3,25,000</u>

Question 8 - (RTP Dec 2021)

Prime Ltd. is a technology company and regularly sells Software S, Hardware H and Accessory A. The stand-alone selling prices for these items are stated below:

Software S – ₹ 50,000 Hardware H – ₹1,00,000 and Accessory A – ₹ 20,000.

Since the demand for Hardware H and Accessory A is low, Prime Ltd. sells H and A together at ₹ 100,000. Prime Ltd. enters into a contract with Zeta Ltd. to sell all the three items for a consideration of ₹1,50,000.

What will be the accounting treatment for the discount in the financial statements of Prime Ltd., considering that the three items are three different performance obligations which are satisfied at different points in time? Further, what will be the accounting treatment if Prime Ltd. would have transferred the control of Hardware H and Accessory A at the same point in time.

Solution

Paragraph 82 of Ind AS 115 states that, "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:

- the entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;
- 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
- the discount attributable to each bundle of goods or services described in paragraph 82(b) 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".

In the given case, the contract includes a discount of ₹ 20,000 on the overall transaction, which should have been allocated proportionately to all three performance obligations when allocating the transaction price using the relative stand-alone selling price method (in accordance with paragraph 81 of Ind AS 115). However, as Prime Ltd. meets all the criteria specified in paragraph 82 above, i.e., it regularly sells Hardware H and Accessory A together for ₹ 1,00,000 and Software S for ₹ 50,000, accordingly, it is evident that the entire discount should be allocated to the promises to transfer Hardware H and Accessory A.

In the given case, since the contract requires the entity to transfer control of Hardware H and Accessory A at different points in time, then the allocated amount of ₹ 1,00,000 should be individually allocated to the promises to transfer Hardware H (stand-alone selling price of ₹ 1,00,000) and Accessory A (stand-alone selling price of ₹20,000).

Product	Allocated transaction price (₹)
Hardware H	83,333 $(1,00,000 / 120,000 \times 100,000)$
Accessory A	16,667 $(20,000 / 120,000 \times 100,000)$
Total	1,00,000

However, if Prime Ltd. would have transferred the control of Hardware H and Accessory A at the same point in time, then the Prime Ltd. could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, Prime Ltd. could allocate ₹ 1,00,000 of the transaction price to the single performance obligation and recognise revenue of ₹ 1,00,000 when Hardware H and Accessory A simultaneously transfer to Zeta Ltd.

Question 9 (RTP May'22) (MTP Nov'22, May'23) (Past Exam May'23)

On 1st April, 20X1, S Limited enters into a contract with Corp Limited to construct heavy-duty equipment for a promised consideration of ₹ 20,00,000 with a bonus of ₹ 2,50,000 if the equipment is completed within 24 months. At the inception of the contract, S Limited correctly accounts for the promised bundle of goods and services as a single performance obligation in accordance with Ind AS 115. At the inception of the contract, the Company expects the costs to be ₹ 11,00,000 and concludes that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will occur. Completion of the heavy-duty equipment is highly susceptible to factors outside of the Company's influence, mainly due to difficulties with the supply of components.

At 31st March, 20X2, S Limited has satisfied 65% of its performance obligation on the basis of costs incurred to date and concludes that the variable consideration is still constrained in accordance with Ind AS 115. However, on 4 June 20X2, the contract is modified with the result that the fixed consideration and expected costs increase by

₹ 1,50,000 and ₹ 80,000 respectively. The time allowable for achieving the bonus is extended by six months with the result that S Limited concludes that it is highly probable that the bonus will be achieved and that the contract remains a single performance obligation.

S Limited wants your opinion on the accounting treatment of contract with Corp Limited in light of Ind AS 115, for the year 20X1-20X2 and 20X2-20X3. (10 to 12 Marks)

Solution

For the year 20X1-20X2

S Limited accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with Ind AS 115. At the inception of the contract, S Limited expects the following:

Transaction price – ₹ 20,00,000

Expected costs – ₹ 11,00,000

Expected profit (45%) – ₹ 9,00,000

At contract inception, S Limited excludes the ₹ 2,50,000 bonus from the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Completion of the heavy-duty equipment is highly susceptible to factors outside the entity's influence.

By the end of the first year, the entity has satisfied 65% of its performance obligation on the basis of costs incurred to date. Costs incurred to date are therefore ₹ 7,15,000 and S Limited reassesses the variable consideration and concludes that the amount is still constrained. Therefore at 31st March, 20X2, the following would be recognised:

Revenue	(A)	– ₹ 13,00,000 (₹ 20,00,000 x 65%)
Costs	(B)	– ₹ 7,15,000 (₹ 11,00,000 x 65%)
Gross profit	(C) i.e.(A-B)	– ₹ 5,85,000

For the year 20X2-20X3

On 4th June, 20X2, the contract is modified. As a result, the fixed consideration and expected costs increase by ₹ 1,50,000 and ₹ 80,000, respectively.

The total potential consideration after the modification is ₹ 24,00,000 which is ₹ 21,50,000 fixed consideration + ₹ 2,50,000 completion bonus. In addition, the allowable time for achieving the bonus is extended by six months with the result that S Limited concludes that it is highly probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognised in accordance with Ind AS 115. Therefore, the bonus of ₹ 2,50,000 can be included in the transaction price.

S Limited also concludes that the contract remains a single performance obligation. Thus, S Limited accounts for the contract modification as if it were part of the original contract. Therefore, S Limited updates its estimates of costs and revenue as follows:

S Limited has satisfied 60.60% of its performance obligation (₹ 7,15,000 actual costs incurred compared to ₹ 11,80,000 total expected costs). The entity recognises additional revenue of ₹ 1,54,400 [(60.60% of ₹ 24,00,000) – ₹ 13,00,000 revenue recognised to date] at the date of modification i.e. on 4th June, 20X2 as a cumulative catch-up adjustment.

Question 10 (MTP March'22)

As a part of its sales promotion activities, MIL distributes office utility articles along with its product catalogues to medical practitioners to familiarize & encourage them to prescribe medicines manufactured by it. No conditions are attached with the items distributed.

Whether the distribution of office utility articles to medical practitioners is covered by Ind AS 115 'Revenue from Contracts with Customers'? If not, how should the same be accounted by MIL? Give reasons.

(5 Marks)

Solution:

The term 'contract' is defined in Ind AS 115 as an agreement between two or more parties that creates enforceable rights and obligations. In the given case:

- Gifts are distributed by MIL to doctors as a part of its sales promotion activities without there being an agreement between MIL and the doctors creating enforceable rights and obligations.
- The doctors to whom gifts are distributed are not 'customers' of MIL as they have not contracted with it to obtain goods or services in exchange for consideration.
- The items distributed as gifts are not an output of MIL ordinary activities.

In view of the above, the distribution of gifts to doctors does not fall under the scope of Ind AS 115.

As per Ind AS 38, sometimes expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised. In the case of the supply of goods, the entity recognises such expenditure as an expense when it has a right to access those goods.

Examples of expenditure that is recognised as an expense when it is incurred include expenditure on advertising and promotional activities (including mail order catalogues).

Items acquired by MIL to be distributed as gifts as a part of sales promotion activities have no other purpose than to undertake those activities. In other words, the only benefit of those items for MIL is to develop or create brands or customer relationships, which in turn generate revenue. Ind AS 38 requires an entity to recognise expenditure on such items as an expense when the entity has a right to access those goods. Ind AS 38 states that an entity has a right to access goods when it owns them, or otherwise has a right to access them regardless of when it distributes the goods.

In view of the above, MIL should recognise the cost of the items to be distributed as gifts as an expense when it owns those items, or otherwise has a right to access them, regardless of when it distributes the items to doctors.

Question 11 (MTP March '22)

During 20X1-20X2, XYZ Ltd. completed a large contract to supply a customized equipment for one customer for a total consideration of ₹ 5,00,000 received fully in cash. As a special arrangement and in order to procure the customer's order, XYZ Ltd agreed to maintain the equipment for three years from the date of installation. Had there been no maintenance requirement, the sale would have been for an amount of ₹ 4,85,500. If maintenance alone was required, it would have cost the customer ₹ 12,500 per annum.

Explain the requirements of Ind AS in relation to the XYZ Ltd.'s supply of customized contract and the maintenance that has been agreed to be provided to the customer. Ignore discounting and calculate the amounts to be recognized in the financial statements as at 31 st March, 20X2.

(4 Marks)

Solution:

As per para 81 of Ind AS 115

- 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.

- except when an entity has observable evidence in accordance with paragraph 82 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.

Amount to be recognised:

In this case, there are two separately identifiable performance obligations one being sale of the equipment and second being maintenance contract for three years.

For recognition of revenue, relative stand-alone selling price of the individual components may be taken and the consideration allocated in proportion of relative fair values, i.e. 4,85,500: 37,500* (i.e. 12,500 x 3). Hence, the sale of equipment should be recognised at ₹ 4,64,149 [$₹ 5,00,000 \times \{4,85,500 / (4,85,500 + 37,500)\}$] when all other conditions for sale of the equipment are fulfilled and the revenue from maintenance services of ₹ 35,851 [$₹ 5,00,000 \times \{37,500 / (4,85,500 + 37,500)\}$] should be the service revenue recognised over a period of three years as per its stage of completion.

Question 12 (RTP Nov'22)

A Ltd. owns 20 resorts across India. Every customer who stays in any of the resorts owned by A Ltd. is entitled to get points on the basis of total amount paid by him. Under this scheme, 1 point is granted for every ₹ 100 spent for stay in the resort. As per the past experience of A Ltd., the likelihood of exercise of the points is 100% and the standalone price of each such point is ₹ 5. Customer X spends ₹ 10,000 in one of the resorts of A Ltd. What is the accounting treatment for the points granted by A Ltd.?

Solution:

Paragraph B40 of Ind AS 115, inter alia, states that, "if in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a separate performance obligation only if the option provides a material right to the customer that it would not receive without entering into that contract".

Further, paragraph B41 states that if a customer has the option to acquire an additional good or service at a price that would reflect the stand-alone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those 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.

In the given case, the customer does get a material right by way of a discount of ₹ 500 for every 100 points that he would not receive without the previous stay in that resort. Thus, the customer in effect pays the entity in advance for future goods and the entity recognises revenue when the goods are transferred.

According to paragraph B42, paragraph 74 requires an entity to allocate the transaction price to performance obligations on a relative stand-alone selling price basis. If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity shall estimate it on the basis of percentage discount the customer may obtain upon exercising the option and the likelihood of the option getting exercised.

In accordance with above, an entity shall account for award credit as a separate performance obligation of the sales transactions in which they are initially granted. The value of the consideration the entity expects to be entitled in respect of the initial sale shall be allocated between the award credits and the other components of the sale.

In the current case, the standalone selling price of the 100 points is ₹ 500. A Ltd. should allocate the fair value of the consideration (i.e. ₹ 10,000) between the points and the other components of the sale as ₹ 476 ($500/10,500 \times 10,000$) and ₹ 9,524 ($10,000/10,500 \times 10,000$) respectively in proportion of their standalone selling price. Since A Ltd. supplies the awards itself (i.e. it acts as a principal), it should recognise ₹ 476 as revenue when points are redeemed.

IND AS 116 - LEASES

Illustration 1- Short-term lease

Scenario A:

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. Whether the lessee can take a short-term exemption in accordance with Ind AS 116?

Scenario B:

Assume the same facts as Scenario A except, at the lease commencement date, the lessee is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain. Will your answer be different in this case?

Solution:

Scenario A:

As the lessee is reasonably certain to exercise the extension option (Refer section 3.2 lease term), the lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee will not account for the lease as a short-term lease.

Scenario B:

In this case, the lease term is less than 12 months, i.e., nine months. Thus, the lessee may account for the said lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis

Illustration 2 - Asset implicitly specified in a contract

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of rolling stock specifically designed for Customer XYZ.

The rolling stock is designed to transport materials used in Customer XYZ's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract but, Supplier ABC owns only one rolling stock that is suitable for Customer XYZ's use. If the rolling stock does not operate properly, the contract requires Supplier ABC to repair or replace the rolling stock.

Whether there is an identified asset?

Solution

Yes, the said rolling stock is an identified asset.

Though the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier ABC must use it to fulfil the contract.

Illustration 3 – (Asset implicitly specified in a contract):

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of a car. The specification of the car is specified in the contract (i.e., brand, type, colour, options, etc.). At inception of the contract, the car is not yet built.

Whether there is an identified asset?

Solution

Yes, the said car is an identified asset.

Though the car cannot be identified at inception of the contract, it is implicitly specified at the time the same will be made available to Customer XYZ.

Illustration 4 - Substantive Substitution Rights

Scenario A:

An electronic data storage provider (supplier) provides services through a centralised data centre that involve the use of a specified server (Server No. 10). The supplier maintains many identical servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use.

Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Whether the substitution rights are substantive and whether there is an identified asset?

Scenario B:

Assume the same facts as in Scenario A except that Server No. 10 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Whether the substitution rights are substantive and whether there is an identified asset?

Solution

Scenario A:

The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. Thus, there is no identified asset.

However, if the customer could not readily determine whether the supplier had a substantive substitution right (for e.g., there is insufficient transparency into the supplier's operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

Scenario B:

The substitution right is not substantive, and Server No. 10 would be an identified asset because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset. In this case, neither of the conditions of a substitution right is met (whereas both the conditions must be met for the supplier to have a substantive substitution right). Therefore, Server No 10 will be considered as an identified asset.

Illustration 5 - (Identified Asset – Physically Distinct):

Customer XYZ enters into a 15-year contract with Supplier ABC for the right to use five fibres within a fibre optic cable between Mumbai and Pune. The contract identifies five of the cable's 25 fibres for use by Customer XYZ. The five fibres are dedicated solely to Customer XYZ's data for the duration of the contract term. Assume that Supplier ABC does not have a substantive substitution right.

Whether there is an identified asset?

Solution

Yes, the said five fibres are identified assets because they are physically distinct and explicitly specified in the contract

Illustration 6 - (Identified Asset – Not Physically Distinct):

Scenario A:

Customer XYZ enters into a ten-year contract with Supplier ABC for the right to transport oil from India to Bangladesh through Supplier ABC's pipeline. The contract provides that Customer XYZ will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Whether there is an identified asset?

Scenario B:

Assume the same facts as in Scenario A, except that Customer XYZ has the right to use 65% of the pipeline's capacity throughout the term of the arrangement.

Whether there is an identified asset?

Solution

Scenario A:

Yes, the capacity portion of the pipeline is an identified asset.

While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the entire pipeline and thereby provides Customer XYZ with the right to obtain substantially all of the economic benefits from use of the pipeline.

Scenario B:

No, the capacity portion of the pipeline is NOT an identified asset.

Since 65% of the pipeline's capacity is less than substantially all of the capacity of the pipeline, Customer XYZ does not have the right to obtain substantially all of the economic benefits from use of the pipeline.

Illustration 7- (Right to use for a portion of the term of contract):

ABC Ltd enters into a contract with XYZ Ltd, which grants ABC Ltd exclusive rights to use a specific grain storage facility over a five-year period in the months of May and June. During these months, ABC Ltd has the right to decide which crops are placed in storage and when to remove them. XYZ Ltd provides the loading and unloading services for the warehouse activities. During the other ten months each year, XYZ Ltd has the right to determine how the warehouse will be used.

Which party has the right to control the use of the identified asset during the period of use?

Solution:

In the above case, ABC Ltd has the right to control the use of the identified asset during the period of use because they have the power to determine how the warehouse will be used during the contractually defined usage periods. The analysis should focus on the rights and economics of the use of the warehouse for the specified usage periods (May and June). During the period of use, ABC Ltd has the rights to determine how much of a crop to place in storage, and the timing of placing and removing it from storage. These rights are more significant to the economics of the use of the asset than the loading and unloading services performed by XYZ Ltd during the same period. ABC Ltd receives all of the economic benefit from use of the asset during those specified time periods. Therefore, contract contains a lease for the specified period of term.

Illustration 8 - (Right to obtain substantially all of the economic benefits):

Company MNO enters into a 15-year contract with Power Company PQR to purchase all of the electricity produced by a new solar farm. PQR owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and MNO will receive renewable energy credits that accrue from use of the solar farm.).

Who has the right to substantial benefits from the solar farm?

Solution:

Company MNO has the right to obtain substantially all of the economic benefits from use of the solar farm over the 15-year period because it obtains:

- the electricity produced by the farm over the lease term — i.e. the primary product from use of the asset; and

- the renewable energy credits — i.e. the by-product from use of the asset.

Although PQR receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the ownership of the solar farm. The tax credits do not relate to use of the solar farm and therefore are not considered in this assessment.

Illustration 9 - Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a five-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (for e.g., if it breaks down). Under the contract:

- Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (for e.g., hires a driver).
- Customer X decides how to use the vehicle (within contractual limitations). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.
- Supplier Y prohibits certain uses of the vehicle (for e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.

Whether Customer X has the right to direct the use of the vehicle throughout the period of lease?

Solution:

Yes, Customer X has the right to direct the use of the identified vehicle throughout the period of use because it has the right to change how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered protective rights that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

Illustration 10 - Right to direct the use of an asset

Entity A contracts with Supplier H to manufacture parts in a facility. Entity A designed the facility and provided its specifications. Supplier H owns the facility and the land. Entity A specifies how many parts it needs and when it needs the parts to be available. Supplier H operates the machinery and makes all operating decisions including how and when the parts are to be produced, as long as it meets the contractual requirements to deliver the specified number on the specified date. Assuming supplier H cannot substitute the facility and hence is an identified asset.

Which party has the right to control the use of the identified asset (i.e., equipment) during the period of use?

Solution:

Entity A does not direct the use of the asset that most significantly drives the economic benefits because Supplier H determines how and when the equipment is operated once the contract is signed. Therefore, Supplier H has the right to control the use of the identified asset during the period of use. Although Entity A stipulates the product to be provided and has input into the initial decisions regarding the use of the asset through its involvement in the design of the asset, it does not have decision making rights over how and for what purpose the asset will be used over the asset during the period of use. This arrangement is a supply agreement, not a lease.

Illustration 11 - Right to direct the use of an asset

Entity L enters into a five—year contract with Company A, a ship owner, for the use of an identified ship. Entity L decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent

Entity L from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. Company A operates and maintains the ship, and is responsible for safe passage.

Who has the right to direct the use of the ship during the period of use?

Solution:

Entity L has the right to direct the use of the ship. The contractual restrictions are protective rights. In the scope of its right of use, Entity L determines how and for what purpose the ship is used throughout the five — year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. Entity L has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.

Illustration 12 - Identifying and separating lease components

Scenario A:

A lessee enters a lease of an excavator and the related accessories (for e.g., excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine. How many lease and non-lease components are there?

Scenario B:

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (for e.g., to transport iron ores at another mine).

Solution:

Scenario A:

The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories. Thus, from the perspective of the lessee, the contract contains one lease component.

Scenario B:

The lessee can benefit from the loading truck on its own or together with other readily available resources because the loading truck could be deployed for other uses independent of the excavator. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

Thus, from the perspective of the lessee, the contract contains two lease components, viz. a lease of the excavator (together with the accessories) and a lease of the loading truck.

Illustration 13 - Identifying different components in the contract

Entity L rents an office building from Landlord M for a term of 10 years. The rental contract stipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also requires Landlord M to perform all common area maintenance (CAM) during the term of the arrangement. Entity L makes single monthly rental payment and does not pay for the maintenance separately. The office building has a useful life of 40 years and the HVAC system and office furniture each has a life of 15 years.

What are the units of account in the lease?

Solution:

There are three components in the arrangement – the building assets (office building and HVAC), the office furniture, and the maintenance agreement.

The office building and HVAC system are one lease component because they cannot function independently of each other. The HVAC system was designed and tailored specifically to be integrated into the office building and cannot be removed and used in another building without incurring substantial costs. These building assets are a lease component because they are identified assets for which Entity L directs the use.

The office furniture functions independently and can be used on its own. It is also a lease component because it is a group of distinct assets for which Entity L directs the use. The maintenance agreement is a non-lease component because it is a contract for service and not for the use of a specified asset.

Illustration 14 - Activities which are not components of a lease contract

Scenario A:

A lessee enters into a five-year lease of equipment, with fixed annual payments of ₹ 10,000. The contract contains fixed annual payments as follows: ₹ 8,000 for rent, ₹ 1,500 for maintenance and ₹ 500 of administrative tasks. How the consideration would be allocated?

Scenario B:

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition. How the consideration would be allocated?

Solution:

Scenario A:

The contract contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee.

Assuming that the lessee does not elect to use the practical expedient as per para 15 of Ind AS 116, both the lessee and the lessor account for the lease of equipment and maintenance components separately and the administration charge is included in the total consideration to be allocated between those components. Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B:

The contract still contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term.

Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Illustration 15 - Allocating contract consideration to lease and non-lease components – Lessees

A lessee enters into a lease of an equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	₹ 80,000
Maintenance	₹ 10,000
Total	₹ 90,000

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximizing the use of observable information, of the lease and non-lease components, as follows:

Lease	₹ 85,000
Maintenance	₹ 15,000
Total	₹1,00,000

In the given scenario, assuming lessee has not opted the practical expedient, how will the lessee allocate the consideration to lease and non-lease component?

Solution:

The stand-alone price for the lease component represent 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%

Illustration 16 - Determining the lease term

Scenario A:

Entity ABC enters into a lease for equipment that includes a non-cancellable term of six years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity ABC is reasonably certain to exercise the renewal option. What is the lease term?

Scenario B:

Entity XYZ enters into a lease for a building that includes a non-cancellable term of eight years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity XYZ pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of eight years, and that value can only be realised through continued occupancy of the leased property. What is the lease term?

Scenario C:

Entity PQR enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity PQR for only the months of October, November and December during a non-cancellable term of seven years. The lessor agrees to provide the same retail space for each of the seven years. What is the lease term?

Solution:

Scenario A:

At the lease commencement date, the lease term is six years (being the non-cancellable period). The renewal period of two years is not taken into consideration since it is mentioned that Entity ABC is not reasonably certain to exercise the option.

Scenario B:

At the lease commencement, Entity XYZ determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period of eight years. Thus, at the lease commencement, Entity XYZ concludes that the lease term is ten years (being eight years of non-cancellable period plus the renewal period of two years where the lessee is reasonably certain to exercise the option).

Scenario C:

At the lease commencement date, the lease term is 21 months (three months per year over the seven annual periods as specified in the contract), i.e., the period over which Entity PQR controls the right to use the underlying asset.

Illustration 17 - Re-assessment of exercise of lease extension option

Retailer M enters into a five-year lease for a building floor, followed by two successive five-year renewal options. On the commencement date, Retailer M is not reasonably certain to exercise the extension option. At the end of third year, Retailer M extended to include another floor from year 4 due to a business acquisition. For this purpose, the lessee concludes a separate seven-year lease for an additional floor in the building already leased. Is Retailer M required to reassess the lease term in this case?

Solution

Ind AS 116 requires a lessee to reassess the lease term if there is change in business decision of the company which is directly relevant to exercising or not exercising an option to renew / extend the lease. In the given case, the Retailer M at the end of third year has extended to include another floor in the same building on account of acquiring another company. As Retailer M has entered into fresh lease of another floor for a seven-year term, it is reasonably certain to exercise the renewal option of original lease for a further five-year term. Hence Retailer M will have to reassess the lease term at the end of third year.

Illustration 18 - Re-assessment of non-cancellable period of lease

Company N has taken 10 vehicles on lease for an initial period of 5 years with an extension option at the option of the lessee for a further period of 5 years at the same rental amount. The remaining useful life of the vehicles as on the commencement date of the lease is 15 years. Company N has determined at the commencement date that it is reasonably certain to exercise the extension option and hence it has taken a period of 10 years for the lease. At the end of 4th year, there is an announcement by the government that all the cars of this particular model have to be discontinued from the road within 1 year due to the change in the pollution norms in the country. Will the lease term be reassessed in this case?

Solution:

In the given case, as per Ind AS 116, the announcement by the government to discontinue the use of the underlying asset will prohibit the lessee from exercising the extension option that was already included in the non-cancellable period by Company N and hence, Company N will reassess the non-cancellable period to exclude the extension option of 5 years.

Illustration 19 - Determining the fixed payments

Entity M and Lessor A enter into a 10-year lease of an office building for fixed annual lease payments of ₹ 200,000. Per the terms of the lease agreement, annual fixed lease payments comprise ₹ 170,000 for rent and ₹ 30,000 for real estate taxes.

What are the fixed lease payments for purposes of classifying the lease?

Solution:

The fixed lease payments are ₹ 2,00,000. Although real estate taxes are explicitly stated in the lease contract, they do not represent a separate non-lease component as they do not provide a separate good or service. The right to use the office building is the only component. The annual lease payments of ₹ 2,00,000 represent payments related to that single lease component.

Illustration 20 - In substance fixed lease payments

Entity Q enters into a seven-year lease for a piece of machinery. The contract sets out the lease payments as follows.

- If Q uses the machinery within a given month, then an amount of 2,000 accrues for that month.
- If Q does not use the machinery within a given month, then an amount of 1,000 accrues for that month.

What is considered as lease payment in this case?

Solution:

Q considers the contract and notes that although the lease payments contain variability based on usage, and there is a realistic possibility that Q may not use the machinery in some months, a monthly payment of 1,000 is unavoidable. Accordingly, this is an in-substance fixed payment, and is included in the measurement of the lease liability.

Illustration 21 - In-substance fixed lease payment

Entity P enters into a five-year lease for office space with Entity Q. The initial base rent is ₹ 1 lakh per month. Rents increase by the greater of 1% of Entity P's generated sales or 2% of the previous rental rate on each anniversary of the lease commencement date. What are the lease payments for purposes of measuring lease liability?

Solution:

In the given case, the lease payments for purposes of classifying the lease are the fixed monthly payments of ₹ 1 lakh plus the minimum annual increase of 2% of the previous rental rate. Entity P is required to pay no less than a 2% increase regardless of the level of sales activity; therefore, this minimum level of increase is in substance fixed lease payment.

Illustration 22 - In substance fixed lease payments

Company N leases a production line. The lease payments depends on the number of operating hours of the production line – i.e., N has to pay ₹ 1,000 per hour of use. The annual minimum payment is ₹ 10,00,000. The expected usage per year is 1,500 hours

Solution:

The lease contains in substance fixed payments of ₹ 10,00,000 per year, which are included in the initial measurement of the lease liability. The additional ₹ 5,00,000 that Company N expects to pay per year are variable payments that do not depend on an index or a rate but usage.

Illustration 23 - Variable lease payments that depend on an index or rate

An entity enters into a 10-year lease of property. The lease payment for the first year is ₹ 1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108. What should be included in lease payments?

Solution:

At the lease commencement date, the lease payments are ₹ 1,000 per year for 10 years. The entity does not take into consideration the potential future changes in the index. At the end of year one, the payments have not changed and hence, the liability is not updated.

At the end of year two, when the lease payments change, the entity updates the remaining eight lease payments to ₹ 1,080 per year (i.e., ₹ 1,000 / 100 x 108)

Illustration 24 - Variable lease payments that do not depend on an index or rate

Entity XYZ is a medical equipment manufacturer and a supplier of the related consumables. Customer ABC operates a medical centre. Under the agreement entered into by both parties, Entity XYZ grants Customer ABC the right to use a medical laboratory machine at no cost and Customer ABC purchases consumables for use in the equipment from Entity XYZ at ₹ 100 each.

The consumables can only be used for that equipment and Customer ABC cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer ABC estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer ABC has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract. Whether these payments affect the calculation of lease liability and ROU Asset? How does Entity XYZ and Customer ABC would allocate these lease payments?

Solution:

There are two components in the arrangement, viz., a lease of equipment and the purchase of consumables.

Even though Customer ABC may believe that it is highly unlikely to purchase lesser than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (for Entity XYZ and Customer ABC) and lease classification (for Entity XYZ).

Entity XYZ and Customer ABC would allocate the payments associated with the future payments to the lease and consumables component of the contract. (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

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.

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.

Illustration 27 - Initial measurement of lease liability

Entity L enters into a lease for 10 years, with a single lease payment payable at the beginning of each year. The initial lease payment is ₹ 100,000. Lease payments will increase by the rate of LIBOR each year. At the date of commencement of the lease, LIBOR is 2 per cent.

Assume that the interest rate implicit in the lease is 5 per cent. How lease liability is initially measured?

Solution:

In the given case, the lease payments depend on a rate (i.e., LIBOR) and hence is included in measuring lease liability. As per Ind AS 116, the lease payments should initially be measured using the rate (i.e. LIBOR) as at the commencement date. LIBOR at that date is 2 per cent; therefore, in measuring the lease liability, it is assumed that each year the payments will increase by 2 per cent, as follows

Year	Lease Payment	Discount factor @ 5%	PV of lease payments
1	1,00,000	1	100,000
2	1,02,000	0.952	97,102
3	1,04,040	0.907	94,364
4	1,06,121	0.864	91,689

5	1,08,243	0.823	89,084
6	1,10,408	0.784	86,560
7	1,12,616	0.746	84,012
8	1,14,869	0.711	81,672
9	1,17,166	0.677	79,321
10	1,19,509	0.645	77,083
			8,80,887

Therefore, the lease liability is initially measured at ₹ 8,80,887

Illustration 28 - Measuring right-of-use asset

Entity Y and Entity Z execute a 12-year lease of a railcar with the following terms on January 1, 2016:

- The lease commencement date is February 1, 2016.
- Entity Y must pay Entity Z the first monthly rental payment of ₹ 10,000 upon execution of the lease.
- Entity Z will pay Entity Y ₹ 50,000 cash incentive to enter into the lease payable upon lease execution.

Entity Y incurred ₹ 1,000 of initial direct costs, which are payable on February 1, 2016. Entity Y calculated the initial lease liability as the present value of the lease payments discounted using its incremental borrowing rate because the rate implicit in the lease could not be readily determined; the initial lease liability is ₹ 850,000.

How would Lessee Company measure and record this lease?

Solution:

Entity Y would calculate the right-of-use asset as follows:

Initial measurement of lease liability	8,50,000
Lease payments made to Entity Z at or before the commencement date	10,000
Lease incentives received from Entity Z	(50,000)
Initial direct cost	1,000
Initial measurement of right-of-use asset	8,11,000

Illustration 29 - Dismantling costs to be included in initial measurement of ROU Asset

Company H leases an aircraft for a period of 5 years. The aircraft must undergo a planned check after every 100,000 flight hours. At the end of the lease, company H must have a check performed (or refund the costs to the lessor), irrespective of the actual number of flight hours. What are the lease payments for purposes of calculating ROU asset?

Solution:

In the given case, the legal requirement to perform a check after every 1,00,000 flight hours does not directly lead to an obligation as it depends on future circumstances. However, as the check must be carried out at the end of the lease irrespective of the actual number of flight hours gives rise to an obligation.

As a result, company H has to recognize a provision for the costs of the final check ("present value of the expected cost") at the beginning of the lease term. At the same time, these costs must be included in the cost of the right-of-use (ROU) asset pursuant to para 24 (d) of Ind AS 116.

Illustration 30 - Lessee Accounting

Entity ABC (lessee) enters into a three-year lease of equipment. Entity ABC agrees to make the following annual payments at the end of each year:

₹ 20,000 in year one

₹ 30,000 in year two

₹ 50,000 in year three.

For simplicity purposes, there are no other elements to the lease payments (like purchase options, lease incentives from the lessor or initial direct costs). Assumed a discount rate of 12% (which is Entity ABC's incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined). Entity ABC depreciates the ROU Asset on a straight-line basis over the lease term.

How would Entity ABC would account for the said lease under Ind AS 116?

Solution:

At the commencement date, Entity ABC would initially recognise ROU Asset and the corresponding Lease Liability of ₹ 77,364 which is calculated as follows:

Year	Payments (Cash flows)	Discounting Factor @12%	Discounted Cash flows / Present Value
1	20,000	0.8929	17,858
2	30,000	0.7972	23,916
3	50,000	0.7118	35,590
	1,00,000		77,364

Then, the next step would be to prepare a schedule for Lease Liability and ROU Asset as follows:

Lease Liability

Year	Opening balance	Interest Expense	Payments	Closing balance
1	77,364	9,284	(20,000)	66,648
2	66,648	7,998	(30,000)	44,646
3	44,646	5,354*	(50,000)	-

* Difference of ₹ 4 is due to approximation.

ROU Asset (assuming no lease incentives, no initial direct costs, etc.):

Year	Opening balance	Depreciation	Closing balance
1	77,364	(25,788)	51,576
2	51,576	(25,788)	25,788
3	25,788	(25,788)	-

At lease commencement, Entity ABC would recognise the Lease Liability and the corresponding ROU Asset as follows:

ROU Asset	Dr.	77,364	
To Lease Liability			77,364
<i>To initially recognise the Lease Liability and the corresponding ROU Asset</i>			

The following journal entries would be recorded in the first year:

Interest Expense	Dr.	9,284	
To Lease Liability			9,284
<i>To record interest expense and accrete the lease liability using the effective interest method (₹ 77,364 x 12%)</i>			

Depreciation ExpenseDr.	25,788	
To ROU Asset		25,788
<i>To record interest expense and accrete the lease liability using the straight line method (₹ 77,364 / 3 years)</i>		

Lease Liability Dr.	20,000	
To Cash / Bank		20,000
<i>To record lease payment</i>		

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
<u>Lease Expense Recognised:</u>				
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
<u>Balance Sheet:</u>				
ROU Asset	77,364	51,576	25,788	-
Lease Liability	(77,364)	(66,648)	(44,646)	-

Illustration 31 - Subsequent measurement using cost model - (MTP May'20)

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.

Year	Payment	Principal paid at the beginning of the year	Interest paid	Interest expense	Lease Liability (end of the year)
	a	b = a - c	c = (d of pvs. Year)	d = [(e of pvs. year - a) x 9.04%]	e = (e of pvs. Year + d - a)
Commencement					50,00,000
Year 1	5,00,000	5,00,000	-	4,06,800	49,06,800
Year 2	3,15,000*	(91,800)	4,06,800	4,15,099	50,06,899
Year 3	5,30,450	1,15,351	4,15,099	4,04,671	48,81,120
Year 4	5,46,364	1,41,693	4,04,671	3,91,862	47,26,618
Year 5	5,62,754	1,70,892	3,91,862	3,76,413	45,40,277
Year 6	5,79,637	2,03,224	3,76,413	3,58,042	43,18,682
Year 7	5,97,026	2,38,984	3,58,042	3,36,438	40,58,094
Year 8	6,14,937	2,78,499	3,36,438	3,11,261	37,54,418
Year 9	6,33,385	3,22,124	3,11,261	2,82,141	34,03,174
Year 10	6,52,387	3,70,246	2,82,141	2,49,213*	30,00,000
Year 10	30,00,000	27,50,787	2,49,213*	-	-
Total	85,31,940	50,00,000	35,31,940	35,31,940	

*(5,00,000 + increased by 3% - lease incentive paid amounting to 2,00,000)

Although the lease was for 10 years, the asset had an economic life of 40 years. When Company EFG exercises its purchase option at the end of the 10-year lease, it would have fully extinguished its lease liability but continue depreciating the asset over the remaining useful life.

Working Notes

1. Calculating PV of lease payments, less lease incentive:

Year	Lease Payment (A)	Present value factor @ 9.04% (B)	Present value of lease payments (A*B=C)
Year 1	5,00,000	1	5,00,000
Year 2	3,15,000	0.92	2,89,800
Year 3	5,30,450	0.84	4,45,578
Year 4	5,46,364	0.77	4,20,700
Year 5	5,62,754	0.71	3,99,555

Year 6	5,79,637	0.65	3,76,764
Year 7	5,97,026	0.59	3,52,245
Year 8	6,14,937	0.55	3,38,215
Year 9	6,33,385	0.50	3,16,693
Year 10	6,52,387	0.46	3,00,098
Total			37,39,648

2. Calculating PV of purchase option at end of lease term:

Year	Payment on purchase option (A)	Present value factor @ 9.04% (B)	Present value of purchase option (A*B=C)
Year 10	30,00,000	0.42	12,60,000
Total			12,60,000

The discount rate for year 10 is different in the above calculations because in the earlier one its beginning of year 10 and in the later one its end of the year 10.

Illustration 32 - Remeasurement of a lease with variable lease payments (Past Exam – Dec 2021)

Entity W entered into a contract for lease of retail store with Entity J on January 01/01/2017. The initial term of the lease is 5 years with a renewal option of further 3 years. The annual payments for initial term and renewal term is ₹ 100,000 and ₹ 110,000 respectively. The annual lease payment will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 01/01/18 will be based on the CPI available at 31/12/17.

Entity W's incremental borrowing rate at the lease inception date and as at 01/01/2020 is 5% and 6% respectively and the CPI at lease commencement date and as at 01/01/2020 is 120 and 125 respectively.

At the lease commencement date, Entity W did not have a significant economic incentive to exercise the renewal option. In the first quarter of 2020, Entity W installed unique lease improvements into the retail store with an estimated five-year economic life. Entity W determined that it would only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

Is Entity W required to remeasure the lease in the first quarter of 2020?

(10 Marks)**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)

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%. 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	1	0.943	0.890	0.840	0.792	
Present value	1,04,000	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
<i>Being lease liability and ROU asset adjusted on account of remeasurement.</i>		

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

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		

Illustration 33 - Modification that is a separate lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

How should the said modification be accounted for?

Solution:

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease because the modification grants Lessee an additional right to use an underlying asset, and the increase in

consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a ROU Asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

Illustration 34 - Modification (MTP April'22)

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? Pass the journal entry for the said modification

(10 Marks)

Solution:

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on:

- (a) An eight-year remaining lease term
- (b) Annual payments of ₹ 1,00,000 and
- (c) Lessee's incremental borrowing rate of 7% p.a.

The modified lease liability equals ₹ 5,97,100 (W.N.1). The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is ₹ 3,46,355 (W.N.3). Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (i.e., ₹ 2,50,745) (W.N. 4) as an adjustment to the ROU Asset.

Working Notes:

1. Calculation of modified lease liability:

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A*B=C)
7	100,000	0.935	93,500
8	100,000	0.873	87,300
9	100,000	0.816	81,600
10	100,000	0.763	76,300
11	100,000	0.713	71,300
12	100,000	0.666	66,600
13	100,000	0.623	62,300
14	100,000	0.582	58,200
Modified lease liability			5,97,100

2. Calculation of Lease liability as at commencement date:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300

2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at modification date			7,35,900

3. Calculation of Lease liability immediately before modification date:

Year	Opening 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 (MTP April'21) (Past Exam Nov'22)

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are ₹ 30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% p.a.

How should the said modification be accounted for?

(8 to 10 Marks)

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

	Lease Liability	ROU asset

Year	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		

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

- (a) a five-year remaining lease term,
 (b) annual payments of ₹ 30,000 and
 (c) Lessee's incremental borrowing rate of 5% p.a.

Year	Lease Payment(A)	Present value factor @ 5% (B)	Present value of lease payments (A x B = C)
6	30,000	0.952	28,560
7	30,000	0.907	27,210
8	30,000	0.864	25,920
9	30,000	0.823	24,690
10	30,000	0.784	23,520
Total			1,29,900

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 2,500 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (₹ 1,83,975) is ₹ 91,987.50.

50% of the pre-modification lease liability (₹ 2,10,546) is ₹ 1,05,273.

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 91,987.50 and the carrying amount of the lease liability by ₹ 1,05,273. Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,05,273 – ₹ 91,987.50 = ₹ 13,285.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

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

Illustration 36 - Modification that is a change in consideration only

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from ₹ 1,00,000 per year to ₹ 95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a. The annual lease payments are payable at the end of each year.

How should the said modification be accounted for?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090			

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

- (a) a five-year remaining lease term,
- (b) annual payments of ₹ 95,000, and
- (c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	95,000	0.935	88,825

2	95,000	0.873	82,935
3	95,000	0.816	77,520
4	95,000	0.763	72,485
5	95,000	0.713	67,735
			3,89,500

Lessee recognises the difference between the carrying amount of the modified liability (₹ 3,89,500) and the lease liability immediately before the modification (₹ 4,21,090) of ₹ 31,590 as an adjustment to the ROU Asset.

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at modification date			7,35,900

Illustration 37 - Modification that both increases and decreases the scope of the lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a.

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to:

- include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and
- reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is ₹ 1,50,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

How should the said modification be accounted for?

Solution:

The pre-modification ROU Asset and the pre-modification lease liability in relation to the lease are as follows:

Lease liability	ROU Asset

Year	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 ₹ 1,50,000 and
- (c) Lessee's incremental borrowing rate of 7% p.a.)

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	1,50,000	0.935	1,40,250
2	1,50,000	0.873	1,30,950
3	1,50,000	0.816	1,22,400
Modified lease liability			3,93,600

The modified liability equals ₹ 3,93,600, of which (a) ₹ 1,31,200 relates to the increase of ₹ 50,000 in the annual lease payments from Year 6 to Year 8 and (refer note 1) (b) ₹ 2,62,400 relates to the remaining three annual lease payments of ₹ 1,00,000 from Year 6 to Year 8 with reduction of lease term (Refer Note 3)

Decrease in the lease term:

At the effective date of the modification (at the beginning of Year 6), the pre-modification ROU Asset is ₹ 3,67,950. Lessee determines the proportionate decrease in the carrying amount of the ROU Asset based on the remaining ROU Asset for the original 2,000 square metres of office space (i.e., a remaining three-year lease term rather than the original five-year lease term). The remaining ROU Asset for the original 2,000 square metres of office space is ₹ 2,20,770 [i.e., ₹ (3,67,950 / 5) x 3 years].

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is ₹ 4,21,090. The remaining lease liability for the original 2,000 square metres of office space is ₹ 2,67,300 (i.e., present value of three annual lease payments of ₹ 1,00,000, discounted at the original discount rate of 6% p.a.) (refer note 2).

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,47,180 (₹ 3,67,950 – ₹ 2,20,770), and the carrying amount of the lease liability by ₹ 1,53,790 (₹ 4,21,090 – ₹ 2,67,300). Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,53,790 – ₹ 1,47,180 = ₹ 6,610) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease Liability Dr.	1,53,790	
To ROU Asset		1,47,180
To Gain		6,610

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7% p.a., which is ₹ 4,900 (₹ 2,67,300 – ₹ 2,62,400*), as an adjustment to the ROU Asset.

*(Refer note 3)

Lease Liability Dr.	4,900	
To ROU Asset		4,900

Increase in the leased space:

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in leased space of ₹ 1,31,200 (i.e., present value of three annual lease payments of ₹ 50,000, discounted at the revised interest rate of 7% p.a.) as an adjustment to the ROU Asset.

ROU Asset Dr.	1,31,200	
To Lease Liability		1,31,200

The modified ROU Asset and the modified lease liability in relation to the modified lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 7%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
6	3,93,600	27,552	(1,50,000)	2,71,152	3,47,100**	(1,15,700)	2,31,380
7	2,71,152	18,981	(1,50,000)	1,40,133	2,31,380	(1,15,700)	1,15,690
8	1,40,133	9,867*	(1,50,000)	-	1,15,690	(1,15,700)	-

Difference is due to approximation.

**Refer Note 5

Working Notes:

1. Calculation of lease liability on increased consideration:

Year	Lease Payments (A)	Present value @7% (B)	Present value of lease payments (A x B = C)
1	50,000	0.935	46,750
2	50,000	0.873	43,650
3	50,000	0.816	40,800
Modified lease liability			1,31,200

2. Calculation of remaining lease liability for the original contract of 2000 square meters at Original discount rate:

Year	Lease Payments (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
Remaining lease liability			2,67,300

3. Calculation of remaining lease liability for the original contract of 2000 square meters at revised discount rate:

Year	Lease Payments (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)

1	1,00,000	0.935	93,500
2	1,00,000	0.873	87,300
3	1,00,000	0.816	81,600
Remaining lease liability			<u>2,62,400</u>

4. Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at modification date			<u>7,35,900</u>

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
	<u>3,47,070</u>

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.

At lease commencement, Lessor accounts for the finance lease, as follows:

Net investment in the lease	₹ 1,11,000(a)	
Cost of goods sold	₹ 92,340(b)	
Revenue		₹ 1,03,340(c)
Property held for lease		₹ 1,00,000(d)

To record the net investment in the finance lease and derecognise the underlying asset.

(a) The net investment in the lease consists of:

(1) the present value of 10 annual payments of ₹ 15,000 plus the guaranteed residual value of ₹ 30,000, both discounted at the interest rate implicit in the lease, which equals ₹ 1,03,340 (i.e., the lease payment) (Refer note 1) AND

(2) the present value of unguaranteed residual asset of ₹ 20,000, which equals ₹ 7,660 (Refer note 2).

Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet.

(b) Cost of goods sold is the carrying amount of the equipment of ₹ 1,00,000 (less) the present value of the unguaranteed residual asset of ₹ 7,660.

(c) Revenue equals the lease receivable.

(d) The carrying amount of the underlying asset.

At lease commencement, Lessor recognises selling profit of ₹ 11,000 which is calculated as = lease payment of ₹ 1,03,340 – [carrying amount of the asset (₹ 1,00,000) – net of any unguaranteed residual asset (₹ 7,660) i.e. which equals ₹ 92,340]

Year 1 Journal entry for a finance lease

Cash	₹ 15,000(e)	
Net investment in the lease		₹ 3,813(f)
Interest income		₹ 11,187(g)

(e) Receipt of annual lease payments at the end of the year.

(f) Reduction of the net investment in the lease for lease payments received of ₹ 15,000, net of interest income of ₹ 11,187

(g) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Please refer the computation below:

The following table summarises the interest income from this lease and the related amortisation of the net investment over the lease term:

Year	Annual Rental Payment	Annual Interest Income (h)	Net investment at the end of the year
Initial net investment			1,11,000
1	15,000	11,187	1,07,187
2	15,000	10,802	1,02,989
3	15,000	10,379	98,368
4	15,000	9,914	93,282

5	15,000	9,401	87,683
6	15,000	8,837	81,520
7	15,000	8,216	74,736
8	15,000	7,532	67,268
9	15,000	6,779	59,047
10	15,000	5,953	50,000(i)

(h) Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For e.g., Year 1 annual interest income is calculated as ₹ 1,11,000 (initial net investment) x 10.078%.

(i) The estimated residual value of the equipment at the end of the lease term.

Working Notes:

1. Calculation of net investment in lease:

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
1	15,000	0.908	13,620
2	15,000	0.825	12,375
3	15,000	0.750	11,250
4	15,000	0.681	10,215
5	15,000	0.619	9,285
6	15,000	0.562	8,430
7	15,000	0.511	7,665
8	15,000	0.464	6,960
9	15,000	0.421	6,315
10	15,000	0.383	5,745
10	30,000	0.383	11,480*
			1,03,340

* Figure has been rounded off for equalization of journal entry.

2. Calculation of present value of unguaranteed residual asset

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
10	20,000	0.383	7,660

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 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.

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 the major part of the lorries' economic life. Furthermore, there are no other indicators that the lease would have transferred substantially all of 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:

- 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
- 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.

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.

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
- (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).

Illustration 45 - Sale and leaseback transaction – (Past Exam – Nov 2020)

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?

8 Marks (Only Seller-lessee was asked in exam)

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.

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 $[(A / B) \times C]$	6,63,333

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer- lessor, calculated as follows:

Fair Value (at the date of sale) (A)	27,00,000
Carrying Amount (B)	15,00,000
Discounted lease payments for the 20-year ROU asset (C)	11,94,000
Gain on sale of building (D) = (A - B)	12,00,000
Relating to the right to use the building retained by Seller-lessee (E) = $[(D / A) \times C]$	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

Illustration 46 - Transition Approaches – (MTP Oct'21)

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

(16 Marks)

Solution:

Full Retrospective Approach:

Under the full retrospective approach, the lease liability and the ROU asset are measured on the commencement date (i.e., 1 April 2017 in this case) using the incremental borrowing rate at lease commencement date (i.e., 12% p.a. in this case). The lease liability is accounted for by the interest method subsequently and the ROU asset is subject to depreciation on the straight-line basis over the lease term of three years. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Present Value Factor @12%	Discounted Cash flows / Present Value
31 Mar 2018	2,00,000	0.8929	1,78,580
31 Mar 2019	2,00,000	0.7972	1,59,440
31 Mar 2020	2,00,000	0.7118	1,42,360
	6,00,000		4,80,380

Lease Liability Schedule:

Year	Opening	Interest Expense @ 12%	Payments	Closing
31 Mar 2018	4,80,380	57,646	(2,00,000)	3,38,026
31 Mar 2019	3,38,026	40,563	(2,00,000)	1,78,589
31 Mar 2020	1,78,589	21,411*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2018	4,80,380	(1,60,126)	3,20,254
31 Mar 2019	3,20,254	(1,60,127)	1,60,127
31 Mar 2020	1,60,127	(1,60,127)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
01 Apr 2017	4,80,380	4,80,380	-	-	-
31 Mar 2018	3,20,254	3,38,026	-	-	-
01 Apr 2018	3,20,254	3,38,026	-	-	(17,772)
31 Mar 2019	1,60,127	1,78,589	40,563	1,60,127	-
01 Apr 2019	1,60,127	1,78,589	-	-	-
31 Mar 2020	-	-	21,411	1,60,127	-

Ind AS 116 is applicable for the financial year beginning from 1st April 2019. Hence, 2019-20 is the first year of adoption and using Full retrospective method the comparative for 2018-19 needs to be restated and 1st April 2018 (i.e. the opening of the comparative) is taken as transition date for adoption of this standard. At adoption, the lessee would record the ROU asset and lease liability at the 1 April 2018 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1 April 2018 (assuming that only the 2018-19 financial information is included as comparatives).

ROU Asset Dr.	3,20,254	
Retained Earnings Dr.	17,772	
To Lease Liability		3,38,026
<i>To initially recognise the lease-related asset and liability as of 1 April 2018.</i>		

The following journal entries would be recorded during 2018-19:

Interest expense Dr.	40,563	
To Lease Liability		40,563
<i>To record interest expense and accrete the lease liability using the interest method.</i>		
Depreciation expense Dr.	1,60,127	
To ROU Asset		1,60,127
<i>To record depreciation expense on the ROU asset.</i>		
Lease Liability Dr.	2,00,000	
To Cash		2,00,000
<i>To record lease payment.</i>		

The following journal entries would be recorded during 2019-20:

Interest expense Dr.	21,411	
To Lease Liability		21,411
<i>To record interest expense and accrete the lease liability using the interest method.</i>		
Depreciation expense Dr.	1,60,127	
To ROU Asset		1,60,127
<i>To record depreciation expense on the ROU asset.</i>		
Lease Liability Dr.	2,00,000	
To Cash		2,00,000
<i>To record lease payment.</i>		

Modified Retrospective Approach (Alternative 1):

Under the modified retrospective approach (Alternative 1), the lease liability is measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 01 April 2019 to 31 March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial application being 01 April 2019 (i.e. 10% p.a. in this case). The ROU asset is at its carrying amount as if Ind AS 116 had been applied since the commencement date (i.e., 01 April 2017 in this case) by using incremental borrowing rate as at transition date. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Discounting Factor @10%	Discounted Cash flows / Present Value
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		1,81,820

Lease Liability Schedule:

Year	Opening Balance	Interest Expense @ 10%	Payments	Closing Balance
31 Mar 2020	1,81,820	18,182	(2,00,000)	-

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2020	1,65,790***	(1,65,790)	-

*** (Refer Note No 3)

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
01 Apr 2017	4,97,360*	4,97,360**	-	-	-
31 Mar 2018	3,31,574	3,47,096	49,737	1,65,786	-
31 Mar 2019	1,65,787	1,81,806	34,710	1,65,787	(16,019)
01 Apr 2019	1,65,787	1,81,806	-	-	-
31 Mar 2020	-	-	18,194	1,65,787	-

*(Refer note no 1)

**(Refer note no 2)

At adoption, the lessee would record the ROU asset and lease liability at the 1 April 2019 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1 April 2019.

ROU Asset	Dr.	1,65,787	
Retained Earnings	Dr.	16,019	
To Lease Liability			1,81,806
<i>To initially recognise the lease-related asset and liability as of 1 April 2019.</i>			

The following journal entries would be recorded during 2018-19:

Interest expense	Dr.	18,182	
To Lease Liability			18,182
<i>To record interest expense and accrete the lease liability using the interest method.</i>			

Depreciation expense	Dr.	1,65,787	
To ROU Asset			1,65,787
<i>To record depreciation expense on the ROU asset.</i>			

Lease Liability	Dr.	2,00,000	

To Cash		2,00,000
To record lease payment.		

Note 1:

Calculation of Present value of lease payments as at commencement date i.e., 01/04/2017

Year	Payments (Cash flows)	Discounting Factor @10%	Discounted Cash flows / Present Value
31 Mar 2018	2,00,000	0.9091	1,81,820
31 Mar 2019	2,00,000	0.8264	1,65,280
31 Mar 2020	2,00,000	0.7513	1,50,260
	6,00,000		4,97,360

Lease Liability Schedule:

Year	Opening	Interest Expense @ 10%	Payments	Closing
31 Mar 2018	4,97,360	49,736	(2,00,000)	3,47,096
31 Mar 2019	3,47,096	34,710	(2,00,000)	1,81,806
31 Mar 2020	1,81,806	18,194*	(2,00,000)	-

*Difference is due to approximation

Calculation of ROU asset as at transition date i.e., April 01, 2019

Year	Opening	Depreciation	Closing
31 Mar 2018	4,97,360	(1,65,786)	3,31,574
31 Mar 2019	3,31,574	(1,65,787)	1,65,787
31 Mar 2020	1,65,787	(1,65,787)	-

Modified Retrospective Approach (Alternative 2):

Under the modified retrospective approach (Alternative 2), the lease liability is also measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 01 April 2019 to 31 March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial application being 01 April 2019 (i.e. 10% p.a. in this case). The carrying amount of the ROU asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items and hence, no impact on retained earnings as on the transition date.

Let us first calculate the Lease Liability and ROU Asset as follows

Year	Payments (Cash flows)	Discounting Factor @10%	Discounted Cash flows / Present Value
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		1,81,820

Lease Liability Schedule:

Year	Opening Balance	Interest Expense @ 10%	Payments	Closing Balance
31 Mar 2020	1,81,820	18,182	(2,00,000)	-

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2020	1,81,820	(1,81,820)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
01 Apr 2019	1,81,820	1,81,820	-	-	-
31 Mar 2020	-	-	18,182	1,81,820	-

At adoption, the lessee would record the ROU asset and lease liability at the 1 April 2019 by taking values from the above table and there will be no impact on retained earnings on the transition date being 1 April 2019 since under this alternative, ROU Asset is equal to the Lease Liability.

ROU Asset Dr.	1,81,820	
To Lease Liability		1,81,820
<i>To initially recognise the lease-related asset and liability as of 1 April 2019.</i>		

The following journal entries would be recorded during 2019-20:

Interest expense Dr.	18,182	
To Lease Liability		18,182
<i>To record interest expense and accrete the lease liability using the interest method.</i>		

Depreciation expense Dr.	1,81,820	
To ROU Asset		1,81,820
<i>To record depreciation expense on the ROU asset.</i>		

Lease Liability Dr.	2,00,000	
To Cash		2,00,000
<i>To record lease payment.</i>		

A summary of the lease contract's accounting (assuming there are no changes due to reassessments) is, as follows:

Particulars	Full Retrospective Approach	Modified Retrospective Approach (Alternative 1)	Modified Retrospective Approach (Alternative 2)
Opening balance sheet impact as on 1 April 2019:			
ROU Asset	1,60,126	1,65,787	1,81,820
Lease Liability	1,78,589	1,81,806	1,81,820
Period ended 31 March 2020 activity:			
Cash lease payments	2,00,000	2,00,000	2,00,000
Lease payments recognised:			
Interest expense	21,411	18,194	18,182
Depreciation expense	1,60,127	1,65,787	1,81,820

Total periodic expense	1,81,538	1,83,981	2,00,002

Illustrations 47 to 51 relating to Covid-19 have been deleted

Illustration 47 - Revised consideration is substantially the same as or less than the original consideration ~~Deleted~~

Retailer Q leases a store in a large retail mall. The rent payable is ₹ 1,00,000 per month. As a result of the COVID-19 pandemic, Q agrees with the lessor to defer the rent originally due in the months April, 2020 to June, 2020. As part of this agreement, the rent for the period January, 2021 to March 2021 will be increased by ₹ 1,10,000 per month, which compensates the lessor for the deferred rent as adjusted for the time value of money.

Whether the rent deferral is eligible for the practical expedient if the other conditions are met?

Solution:

The rent deferral satisfies the criteria to apply the practical expedient because:

- (1) It is a rent concession occurring as a direct consequence of the pandemic;
- (2) Increase in rentals during January, 2021 to March 2021 compensates for the time value of money;
- (3) Rent deferral reduces lease payments originally due on or before 30 June 2021; and
- (4) There is no substantive change to other terms and conditions of the lease. Hence, Q considers applying the practical expedient.

Illustration 48 - Consider only payments that were originally due on or before 30 June, 2021 (Past Exam - July 2021) ~~Deleted~~

Lessee P operates a chain of restaurants and leases several outlets. As a result of COVID-19 pandemic, P agrees a rent deferral with the lessor.

Under the terms of the rent deferral, rent originally due in the period July 2020 to December 2020 will be added to the rent due in the period July 2021 to December 2021.

Whether the rent deferral is eligible for the practical expedient if the other conditions are met?

Solution:

The rent deferral satisfies the criteria to apply the practical expedient because:

- (1) It is a rent concession occurring as a direct consequence of the pandemic;
- (2) Recovery of rentals during July, 2021 to December, 2021 is substantially the same as, or less than, the consideration for the lease immediately preceding the change;
- (3) Rent deferral reduces lease payments originally due on or before 30 June 2021; and
- (4) There is no substantive change to other terms and conditions of the lease.

Therefore, P concludes that the rent deferral meets the 'payments due' eligibility criterion.

Illustration 49 - Reduction in rent payments that extends beyond 30 June 2021 (Past Exam – July 2021) ~~Deleted~~

Lessee T leases office buildings from a lessor. As a result of the COVID-19 pandemic, in September 2020, T agrees a rent concession with the lessor, under which the monthly rent will be reduced by 50% per month for the 12 months commencing 1 October 2020.

Whether the rent deferral is eligible for the practical expedient if the other conditions are met?

Solution:

The rent deferral does not satisfies the criteria to apply the practical expedient because out of the listed eligibility criteria given in para 46B of Ind AS 116, rent deferral reduces lease payments starting from October, 2020 and reduction will continue till September, 2021 which is beyond 30 June 2021.

Therefore, T is not permitted to apply the practical expedient.

Illustration 50 - Deferral of rent payments by extending the lease term

A lessee is granted a rent concession by the lessor whereby the lease payments for the period April 2020 to June 2020 are deferred. Three months are added to the end of the lease term at the same monthly rent, and the lessee repays the deferred rent during those additional months. The rent concession is a direct consequence of COVID-19.

Whether the rent deferral is eligible for the practical expedient?

Solution:

The lessee considers applying the practical expedient. In considering whether this rent concession is eligible for the practical expedient, the lessee notes the following.

Firstly, the revised consideration in the lease is substantially the same as the original – i.e. the condition in paragraph 46B(a) of Ind AS 116 is met.

Secondly, the rent concession only reduces lease payments originally due in 2020 – i.e. before 30 June 2021 – so the condition in paragraph 46B(b) of Ind AS 116 is met.

Thirdly, there is a change in the lease term – an extension by three months.

There is no explicit guidance on what is considered 'substantive'. Judgement will need to be applied, considering both qualitative and quantitative factors. The lessee assesses that three-month extension at the end of the lease term with substantially the same lease payments, would not constitute a substantive change.

Hence, the condition in paragraph 46B(c) of Ind AS 116 is met. Since, the rent concession is a direct consequence of COVID-19 and all three conditions in paragraph 46B of Ind AS 116 are met, the lessee concludes that the rent concession is eligible for application of practical expedient.

Illustration 51 - Forgiveness of lease payments

Lessee Z entered into a lease contract with Lessor L to lease 1,500 sqm of retail space for five years. The lease commenced on 1 April 2018 and the rental payments are 100,000 payable quarterly in advance on 1 April, 1 July, 1 October and 1 January. Z's incremental borrowing rate at commencement of the lease is 5% (assume that the interest rate implicit in the lease cannot be readily determined). There are no initial direct costs, lease incentives or dismantling costs. Z's business is severely impacted by the COVID-19 pandemic and L and Z negotiate a rent concession. On 1 June 2020, L agrees to provide Z with an unconditional rent concession that allows Z to forego payment of its rent due on 1 July – i.e. L forgives Z the rent payment of 100,000 due on 1 July.

What will be the accounting treatment in the books of lessee for rent concessions assuming that it is eligible for practical expedient?

Solution:

Z determines that the rent concession is eligible for the practical expedient.

Applying the practical expedient, Z should account for the forgiveness of rent as a negative variable lease payment. The rent concession is unconditional, so the event that triggers the variable lease payment is the agreement between Z and L for the rent concession on 1 June 2020.

Therefore, Z accounts for the rent concession as a negative variable lease payment on 1 June.

Assuming that there are no other changes to the lease, Z continues to use the retail space and the right-of-use asset is not impaired. The lease accounting entries will be as follows:

- recognise the rent concession as a variable lease payment in profit or loss (i.e. record a debit to the lease liability and a corresponding credit in the income statement); and

- continue to accrue interest on the lease liability at the unchanged incremental borrowing rate of 5% (i.e. record a debit to interest expense and a corresponding credit to the lease liability).

After accounting for the impact of the rent concession, Z's lease liability represents the present value of all future lease payments owing to L, discounted at the unchanged incremental borrowing rate. Z has effectively derecognised the portion of the lease liability that has been extinguished by the forgiveness of the quarterly lease payment due on 1 July 2020.

In addition, Z continues to depreciate the carrying amount of the right-of-use asset, which is unchanged as a result of the rent concession.

Illustration 52

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?

Solution

In this case, the rail wagons are stored at lessor's premises and it has a large pool of similar rail wagons and substitution costs to be incurred are minimal. Thus, the lessor has the practical ability to substitute the asset. If at any point, the same become economically beneficial for the lessor to substitute the wagons, he can do so and hence, the lessor's substitution rights are substantive and the arrangement does not contain a lease.

Illustration 53

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?

Solution

In this case, the nature of the solar plant is such that all of the decisions about how and for what purpose the asset is used are predetermined because:

- the type of output (i.e. energy) and the production location are predetermined in the agreement; and
- when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because M designed the solar plant and thereby predetermined any decisions about how and for what purpose it is used, M is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give the supplier the right to direct how and for what purpose the solar plant is used. Hence, M is having a right to control the use of asset.

Illustration 54

A Customer enters into a ten-year contract with a Company (a ship owner) for the use of an identified ship. Customer decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent the company from sailing the ship into waters at a high risk of piracy or carrying explosive materials. The company operates and maintains the ship, and is responsible for safe passage.

Does the customer has the right to direct how and for what purpose the ship is to be used throughout the period of use and whether the arrangement contains a lease?

Solution

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.

Illustration 55

A Lessee enters into a ten-year lease contract with a Lessor to use an equipment. The contract includes maintenance services (as provided by lessor). The Lessor obtains its own insurance for the equipment. Annual payments are ₹ 10,000 (₹ 1,000 relate to maintenance services and ₹ 500 to insurance costs).

The Lessee is able to determine that similar maintenance services and insurance costs are offered by third parties for ₹ 2,000 and ₹ 500 a year, respectively. The Lessee is unable to find an observable stand-alone rental amount for a similar equipment because none is leased without related maintenance services provided by the lessor.

How would the Lessee allocate the consideration to the lease component?

Solution

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.

Illustration 56

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?

Solution

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.

Illustration 57

A Lessee enters into a lease of a five-year-old machine. The non-cancellable lease term is 15 years. The lessee has the option to extend the lease after the initial 15-year period for optional periods of 12 months each at market rents.

To determine the lease term, the lessee considers the following factors:

- The machine is to be used in manufacturing parts for a type of plane that the lessee expects will remain popular with customers until development and testing of an improved model are completed in approximately 15 years.

- The cost to install the machine in lessee's manufacturing facility is significant.
- The non-cancellable term of lessee's manufacturing facility lease ends in 19 years, and the lessee has an option to renew that lease for another twelve years.
- Lessee does not expect to be able to use the machine in its manufacturing process for other types of planes without significant modifications.
- The total remaining life of the machine is 30 years.

What should be the lease term for lease accounting under Ind AS 116?

Solution

The lessee notes that the terms for the optional renewal provide no economic incentive and the cost to install is significant. The lessee has no incentive to make significant modifications to the machine after the initial 15-year period. Therefore, the lessee does not expect to have a business purpose for using the machine after the non-cancellable lease term of 15 years.

Thus, the lessee concludes that the lease term consists of the 15-year non-cancellable period only.

Illustration 58

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?

Solution

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.

Illustration 59 - (RTP Nov'20)

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?

Solution

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.

Illustration 60 - (RTP May'21) (MTP May'23)

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 = Rs. 68. The average rate for Year 1 was Rs. 69 and at the end of year 1, the exchange rate was Rs. 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?

Solution

(8 Marks)

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:

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

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

MOCT TEST PAPER / REVISION TEST PAPER / PAST EXAM

Question 1 - (Past Exam Jan'21)

Coups Limited availed a machine on lease from Ferrari Limited. The terms and conditions of the Lease are as under:

Lease period is 3 years, machine costing ₹ 8,00,000.

- Machine has expected useful life of 5 years.
- Machine reverts back to Ferrari Limited on termination of lease.
- The unguaranteed residual value is estimated at ₹ 50,000 at the end of 3rd year.
- 3 equal annual installments are made at the end of each year.
- Implicit Interest Rate (IRR) = 10%.
- Present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is 0.7513.
- Present value of annuity of ₹ 1 due at the end of 3rd year at 10% IRR is 2.4868.

You are required to ascertain whether it is a Finance Lease or Operating Lease and also calculate Unearned Finance Income with the relevant context to relevant Ind AS.

(6 Marks)

SOLUTION

It is assumed that the fair value of the machine on lease is equivalent to the cost of the machine.

- (i) A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

(ii) Computation of annual lease payment to the lessor

	₹
Cost of equipment / fair value	8,00,000
Unguaranteed residual value	50,000
Present value of residual value after third year @ 10% (50,000 x 0.7513)	37,565
Fair value to be recovered from lease payments (8,00,000 – 37,565)	7,62,435
Present value of annuity for three years is 2.4868	
Annual lease payment = 7,62,435 / 2.4868	3,06,593

The present value of lease payment i.e., ₹ 7,62,435 is more than 95% of the fair market value i.e., ₹ 8,00,000. The present value of minimum lease payments substantially covers the initial fair value of the leased asset and lease term (i.e. 3 years) covers the major part of the life of asset (i.e. 5 years). Therefore, it constitutes a finance lease.

(ii) Computation of Unearned Finance Income

	₹
Total lease payments (₹ 3,06,593 x 3)	9,19,779
Add: Unguaranteed residual value	50,000
Gross investment in the lease	9,69,779
Less: Present value of investment (lease payments and residual value) (37,565 + 7,62,435)	(8,00,000)
Unearned finance income	1,69,779

Question 2 – (RTP Dec'21), (MTP Nov'22)

The Company has entered into a lease agreement for its retail store as on 1st April, 20X1 for a period of 10 years. A lease rental of ₹ 56,000 per annum is payable in arrears. The Company recognized a lease liability of ₹ 3,51,613 at inception using an incremental borrowing rate of 9.5% p.a. as at 1st April 20X1. As per the terms of lease agreement, the lease rental shall be adjusted every 2 years to give effect of inflation. Inflation cost index as notified by the Income tax department shall be used to derive the lease payments. Inflation cost index was 280 for financial year 20X1-20X2 and 301 for financial year 20X3-20X4. The current incremental borrowing rate is 8% p.a.

Show the Journal entry at the beginning of year 3, to account for change in lease.

(5 Marks)

Solution

As per para 27 (b) of Ind AS 116, variable lease payments that depend on an index or a rate, are initially measured using the index or rate as at the commencement date.

At the beginning of the third year, Lessee remeasures the lease liability at the present value of eight payments of ₹ 60,200 discounted at an original discount rate of 9.5% per annum as per para 43 of Ind AS 116.

Year	Revised lease rental	Discount factor @ 9.5%	Present value
3	$[(56,000 / 280) \times 301] =$	0.913	54,963
4	60,200	0.834	50,207
5	60,200	0.762	45,872
6	60,200	0.696	41,899
7	60,200	0.635	38,277
8	60,200	0.580	34,916
9	60,200	0.530	31,906
10	60,200	0.484	29,137
	60,200		<u>3,27,127</u>

Table showing amortised cost of lease liability

Year	Opening balance	Interest @ 9.5%	Rental paid	Closing balance
1	3,51,613	33,403	56,000	3,29,016
2	3,29,016	31,257	56,000	3,04,273

Difference of ₹ 22,854 (3,27,127 – 3,04,273) will increase the lease liability with corresponding increase in ROU Asset as per para 39 of Ind AS 116.

Journal entry at the beginning of year 3 would be:

Right-of-use asset	Dr.	₹ 22,854	
To Lease liability			₹ 22,854

Question 3 (RTP May'22)**Case I**

Scenario 1: The 'last mile' is a dedicated cable that connects Entity Y's network with the end customer's device. The use of this cable is at the discretion of the customer. Entity Y decides the location of end points and has right to replace the lines (dedicated cable), however it is not practical to replace the lines, since replacement would require additional costs to be incurred without any corresponding benefit. Whether the arrangement would be within the scope of Ind AS 116?

Scenario 2: If it is practical for the Entity Y to replace the lines and Entity Y would benefit from this replacement, would the answer be different?

Case II

Customer X enters into a 10-year contract with a utility company, Entity Y, for the right to use three specified, physically distinct fibers within a larger cable connecting Mumbai to Delhi. Customer makes the decisions about the use of the fibers by connecting each end of the fibers to its electronic equipment. Entity

Y owns extra fibers but can substitute those for Customer's fibers only for reasons of repairs, maintenance or malfunction. The useful life of the fiber is 15 years. Whether this arrangement is covered under Ind AS 116?

Case III

Customer X enters into a 10-year contract with Entity Y for the right to use a specified amount of capacity within a cable connecting Mumbai to Delhi. The specified amount is equivalent to Customer X having the use of the full capacity of three fiber strands within the cable (the cable contains multiple fibers with similar capacities). Entity Y makes decisions about the transmission of data (i.e., Entity Y lights the fibers, makes decisions about which fibers are used to transmit Customer's traffic). The useful life of the fiber is 15 years. Whether this arrangement is covered under Ind AS 116?

Solution:

Case I

Scenario 1:

- (i) As per paragraph B13 of Ind AS 116, 'Last mile' which is a dedicated cable is an identified asset since it is physically distinct.
- (ii) There are no substantive substitution rights with Entity Y, as it does not have the practical ability to substitute alternative assets throughout the period of use.

Thus, this arrangement is within the scope of Ind AS 116.

Scenario 2:

If Entity Y has the practical ability to replace the lines and it would benefit from such replacement, Entity Y has substantive substitution rights. In such case, this arrangement for the 'last mile cable' will not be within the scope of Ind AS 116.

Case II

The fibers are specified in the contract and are physically distinct. Hence, in accordance with paragraph B13 and B20, the said three fibers are identified asset.

Paragraph B18, inter alia, states that the supplier's right or obligation to substitute the asset for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available does not preclude the customer from having the right to use an identified asset.

Further, paragraph B27 provides that although rights such as those to operate or maintain an asset are often essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and can actually be dependent on the decisions about how and for what purpose the asset is used.

In accordance with the above, as Entity Y can substitute these three distinct fibers only for reasons of repairs, maintenance or malfunction, it does not preclude them from being an identified asset.

Further, the Customer X has right to control the use of the identified fibers for 10 year since it has –

- (a) the right to obtain substantially all of the economic benefits from use of the identified fibers throughout the period of use, i.e., 10 years; and
- (b) the right to direct the use of the fibers as it makes the decisions about the use of the fibers, i.e., it has right to direct how and for what purpose the fibers are used throughout the period of use.

Hence, this arrangement is within the scope of Ind AS 116.

Case III

Paragraph B20 specifically provides that a capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber 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. In the given case, the capacity portion that will be provided to Customer X is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable, thus, it is not an identified asset. Further, Entity Y makes all decisions about the transmission of data, (i.e., supplier lights the fibers, makes decisions about which fibers are used to transmit customer's traffic).

Thus, the contract does not contain a lease and is therefore not within the scope of Ind AS 116.

Question 4 (MTP March'22)

The Company has taken a particular application software of a supplier namely, Crystal Systems Limited, which is available on a cloud infrastructure managed and controlled by the Crystal Systems Limited. The Company contracts to pay a fee of ₹ 5,00,000 per month in exchange for a right to receive access to the Crystal Systems Limited's application software for 2 years. The Company accesses the software on need basis over the internet. The contract does not convey any rights to New Age Technology Limited over the tangible assets of the Crystal Systems Limited.

The Chief Accountant of New Age Technology Limited has sought your advice, whether the IT should account for this transaction for use of software with Crystal Systems Limited in terms of Ind AS 116 leases or an intangible asset in terms of Ind AS 38 'Intangible Assets'. Help him to understand your assessment.

(6 Marks)

Solution:

Assessment of applicability of Ind AS 38 in the given scenario

As per Ind AS 38, to be an intangible asset the asset should meet following criteria:

- Identifiability;
- Control over a Resource (Asset); and
- Existence of Future Economic Benefits.

Crystal Systems Limited manages and controls the application software available on a cloud infrastructure and New Age Technology Limited has limited rights to use the same. Merely right to access the application of Crystal Systems Limited, does not give New Age Technology Limited power to obtain future economic benefits flowing from the software itself. Hence, the application software should not be recognised as an asset under Ind AS 38.

Assessment of applicability of Ind AS 116 in the given scenario

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. This right to control the asset throughout the period of use is emphasized ONLY if the customer has both (i) right to obtain substantially all the economic benefits from the use of the identified asset, and (ii) the right to direct the use of the identified asset.

In the given case, the contract gives the New Age Technology Limited only the right to access the Crystal Systems Limited's application software over the contract term, and hence the contract is not a lease contract within the meaning of Ind AS 116.

Conclusion

The right to access the Crystal Systems Limited's application software for a price over a specified period is a service contract. If the Crystal Systems Limited pays amounts for which the services are yet to be received, then the advance payment is a prepayment and an asset for the Crystal Systems Limited.

Question 5 (RTP Nov'22)

A company manufactures specialised machinery. The company offers customers the choice of either buying or leasing the machinery. A customer chooses to lease the machinery. Details of the arrangement are as follows:

- (i) The lease commences on 1st April, 20X1 and lasts for three years.
- (ii) The lessee is required to make three annual rentals payable in arrears of ₹ 57,500.
- (iii) The leased machinery is returned to the lessor at the end of the lease.
- (iv) The fair value of the machinery is ₹ 1,50,000, which is equivalent to the selling price of the machinery
- (v) The machinery cost ₹ 1,00,000 to manufacture. The lessor incurred costs of ₹ 2,500 to negotiate and arrange the lease.

(vi) The expected useful life of the machinery is 3 years. The machinery has an expected residual value of ₹ 10,000 at the end of year three. The estimated residual value does not change over the term of the lease.

(vii) The interest rate implicit in the lease is 10.19%. The lessor classifies the lease as a finance lease.

How should the Lessor account for the same in its books of accounts? Pass necessary journal entries.

Solution:

The cost to the lessor for providing the machinery on lease consists of the book value of the machinery (₹ 1,00,000), plus the initial direct costs associated with entering into the lease (₹ 2,500), less the future income expected from disposing of the machinery at the end of the lease (the present value of the unguaranteed residual value of ₹ 10,000 discounted @ 10.19%, being ₹ 7,470). This gives a cost of sale of ₹ 95,030.

The lessor records the following entries at the commencement of the lease:

Lease receivable	Dr.	1,50,000	
Cost of sales	Dr.	95,030	
To Inventory			1,00,000
To Revenue			1,42,530
To Creditors/Cash			2,500

The sales profit recognised by the lessor at the commencement of the lease is therefore ₹ 47,500 (₹ 1,42,530 - ₹ 95,030). This is equal to the fair value of the machinery of ₹ 1,50,000, less the book value of the machinery (₹ 1,00,000) and the initial direct costs of entering into the lease (₹ 2,500). Revenue is equal to the lease receivable (₹ 1,50,000), less the present value of the unguaranteed residual value (₹ 7,470).

Year	Lease receivable at the beginning of year (₹) (a)	Lease payments (₹) (b)	Interest Income (10.19% per annum) (₹) (c)	Decrease in lease receivable (₹) (d)=(b)-(c)	Lease receivable at the end of year (₹) (e)=(a)-(d)
1	1,50,000	57,500	15,285	42,215	1,07,785
2	1,07,785	57,500	10,983	46,517	61,268
3	61,268	57,500	6,232*	51,268	10,000

*Difference is due to approximation

The lessor will record the following entries:

		₹	₹
Year 1	Cash/Bank Dr.	57,500	
	To Lease receivable		42,215
	To Interest income		15,285
Year 2	Cash/Bank Dr.	57,500	
	To Lease receivable		46,517
	To Interest income		10,983
Year 3	Cash/Bank Dr.	57,500	
	To Lease receivable		51,268
	To Interest income		6,232

At the end of the three-year lease term, the leased machinery will be returned to the lessor, who will record the following entries:

		₹	₹
Inventory	Dr.	10,000	
To Lease receivable			10,000

Question 6 (MTP Nov'22)

Feel Fresh Limited (the Company) is into manufacturing and retailing of FMCG products listed on stock exchanges in India. One of its products is bathing soap which the Company sells under the brand name 'Feel Fresh'. The Company does not have its own manufacturing facilities for soap and therefore it enters into arrangements with a third party to procure the soaps. The Company entered into a long term purchase contract of 10 years with M/s. Radhey. Following are the relevant terms of the contract with M/s. Radhey.

- (i) M/s. Radhey has to purchase a machine costing ₹ 10,00,000 from the supplier as specified by the Company. The machine will be customized to produce the soaps as designed by the Company. This machine cannot be used by M/s. Radhey to produce the soaps for buyers other than the Company due to the design specifications. The machine has a useful life of 10 years and the straight line method of depreciation is best suited considering the use of the machine.
- (ii) The Company will pay ₹ 4.75 per soap for the first year of contract. This is calculated based on the budgeted annual purchase of 7,00,000 soaps as follows:

Particulars	Per soap price
Variable cost of manufacturing	4.00
Cost of machine (₹ 1,74,015 / 7,00,000 soaps)	0.25
M/s. Radhey's margin	0.50
Per soap cost to the Company	4.75

In case the Company purchases more than 7,00,000 (i.e. budgeted number of soaps) soaps in the first year then the cost of the machine (i.e. 0.25 per soap) will not be paid for soaps procured in excess of 7,00,000 units. However, in case Company procures less than budgeted number of soaps, then the Company will pay the differential unabsorbed cost of the machine, at the end of the year. For example, if the Company purchases only 6,00,000 soaps in first year then the differential amount of ₹ 24,015 (1,74,015 - (6,00,000 x 0.25)) will be paid by the Company to M/s. Radhey at the end of the year. Variable cost will be actualized at the end of the year

- (iii) The cost per soap will be calculated for each year in advance based on the budgeted number of soaps to be produced each year. An amount of ₹ 1,74,015 shall be considered each year for the cost of machine for year 1 to year 8 while calculating the cost per soap. Any differential under absorbed amount shall be paid by the Company to M/s. Radhey at the end of that year. A charge of ₹ 1,74,015 per annum for the machine is derived using borrowing cost of 8% p.a. For year 9 and year 10, only variable cost and margins will be paid.
- (iv) M/s. Radhey does not have any right to terminate the contract but the Company has the right to terminate the contract at the end of each year. However, if the Company terminates the contract, it has to compensate M/s. Radhey for any unabsorbed cost of Machine. For example, if the Company terminates the contract at the end of second year then it has to pay ₹ 10,44,090 (i.e. 1,74,015 per year x 6 remaining years). If it terminates the contract after the 8th year then the Company does not have to pay the compensation since the cost of the machine would have been absorbed.
- (v) In the first year, the Company purchases 5,50,000 soaps at ₹ 4.75 per soap.

Evaluate the contract of the Company with M/s. Radhey and provide necessary accounting entries for first year in accordance with Ind AS with working notes. Assume all cash flows occur at the end of the year.

(15 Marks)

Solution

Identification of the contract (by applying para 9 of Ind AS 116)

a) Identified asset

Feel Fresh Ltd. (a customer company) enters into a long-term purchase contract with M/s Radhey (a manufacturer) to purchase a particular type and quality of soaps for 10 year period.

Since for the purpose of the contract M/s Radhey has to buy a customized machine as per the directions of Feel Fresh Ltd. and also the machine cannot be used for any other type of soap, the machine is an identified asset.

b) Right to obtain substantially all of the economic benefits from use of the asset throughout the period of use

Since the machine cannot be used for manufacture of soap for any other buyer, Feel Fresh Ltd. will obtain substantially all the economic benefits from the use of the asset throughout the period of use.

c) Right to direct the use

Feel Fresh Ltd. controls the use of machine and directs the terms and conditions of the contract with respect to recovery of fixed expenses related to machine.

Hence the contract contains a lease.

Lease term

The lease term shall be 10 years assuming reasonable certainty. Though the lessee is not contractually bound till 10th year, i.e., the lessee can refuse to make payment anytime without lessor's permission but, it is assumed that the lessee is reasonably certain that it will not exercise this option to terminate.

Identification of lease payment

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:

- fixed payments (including in-substance fixed payments), less any lease incentives
- variable lease payments that depend on an index or a rate
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

Here in-substance fixed payments in the given lease contract are ₹ 1,74,015 p.a. The present value of lease payment which would be recovered in 8 years @ 8% would be ₹ 10,00,000 (approx.)

Variable lease payments that do not depend on an index or rate and are not, in substance, fixed 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)

Hence, lease liability will be recognized by ₹ 10,00,000 in the books of Feel Fresh Ltd. Since there are no payments made to lessor before commencement date less lease incentives received from lessor or initial direct costs incurred by lessee or estimate of costs for restoration / dismantling of underlying asset, the right of use asset is equal to lease liability

Journal Entries

On initial recognition

ROU Asset	Dr.	10,00,000	
	To Lease Liability		10,00,000
<i>To initially recognise the Lease Liability and the corresponding ROU Asset</i>			

At the end of the first year

Interest Expense	Dr.	80,000	
	To Lease Liability		80,000
<i>To record interest expense and accrete the method (₹ 10,00,000 x 8%) lease Liability using the effective interest</i>			
Depreciation Expense (10,00,000 / 10 years)	Dr.	1,00,000	

To ROU Asset		1,00,000	
To record depreciation on ROU using the straight-line method ($\text{₹ } 10,00,000 / 10 \text{ years}$)			
Lease Liability	Dr.	1,74,015	
To Bank / M/s. Radhey			1,74,015
To record lease payment			
Cost of soap	Dr.	24,75,000	
To Bank / M/s. Radhey $\{5,50,000 \times (4 + 0.5)\}$			24,75,000
To record variable expenses paid as cost of the goods purchased			

IND AS 102 – Share Based Payments

Illustration 1 - Equity Settled Shared Based Payment- Service conditions

ABC Limited granted to its employees, share options with a fair value of ₹ 5,00,000 on 1st April, 20X0, if they remain in the organization upto 31st March, 20X3. On 31st March, 20X1, ABC limited expects only 91% of the employees to remain in the employment. On 31st March, 20X2, company expects only 89% of the employees to remain in the employment. However, only 82% of the employees remained in the organisation at the end of March, 20X3 and all of them exercised their options. Pass the Journal entries?

Solution:

Period	Proportion a	Fair value b	To be vested c	Cumulative expenses d= b x c x a	Expenses e = d-previous period d
Period 1	1/3	5,00,000	91%	1,51,667	1,51,667
Period 2	2/3	5,00,000	89%	2,96,667	1,45,000
Period 3	3/3	5,00,000	82%	4,10,000	1,13,333
					4,10,000

Journal Entries

31st March, 20X1

Employee benefits expenses (Trf 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	Dr.	1,45,000	
To Share based payment reserve (equity)			1,45,000
(2/3 of expected vested equity instruments value)			
31st March, 20X3			
Employee benefits expenses	Dr.	1,13,333	
To Share based payment reserve (equity)			1,13,333
(Final vested equity instruments value)			
Share based payment reserve (equity)	Dr.	4,10,000	
To Share Capital / Securities Premium			4,10,000
(re-allocated and issued shares)			

Illustration 2 - Cash Settled SBP - (Past Exam May'18, Nov'20) (MTP Nov'22)

XYZ issued 10,000 Share Appreciation Rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹ 95. SAR can be exercised any time upto 31st March, 20X3. At the end of period on 31st March, 20X1 it is expected that 95% of total employees will exercise the option, 92% of total employees will exercise the option at the end of next year and finally 89% will be vested only at the end of the 3rd year. Fair Values at the end of each period have been given below:

Fair value of SAR	₹
31 st March, 20X1	112
31 st March, 20X2	109
31 st March, 20X3	114

Pass the Journal entries?

(5 Marks)

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	Dr.	9,50,000	9,50,000
To Share based payment liability			
(Fair value of the SAR recognized)			
31st March, 20X1			
Employee benefits expenses	Dr.	1,14,000	1,14,000
To Share based payment liability			
(Fair value of the SAR re-measured)			
31st March, 20X2			
Share based payment liability	Dr.	61,200	61,200
To Employee benefits expenses			
(Fair value of the SAR re-measured & reversed)			
31st March, 20X3			
Employee benefits expenses	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)			

Illustration 3 - SBP with cash alternative - (MTP Oct'21, May23) (Past Exam Dec'21)

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 20X1. Pass the journal entries.

(6 Marks)

Solution:

	1 st January, 20X1	31 st December, 20X1	31 st December, 20X2
	₹	₹	₹
Equity alternative (1,500 x 102)	1,53,000		
Cash alternative (1,000 x 113)	1,13,000		
Equity option (1,53,000 - 1,13,000)	40,000		
Cash Option (cumulative) (using period end fair value)		(1,000 x 120 x ½) 60,000	1,32,000
Equity Option (cumulative)		(40,000 x ½) 20,000	40,000
Expense for the period			
Equity option		20,000	20,000
Cash Option		60,000	72,000
Total		80,000	92,000

Journal Entries

31st December, 20X1

Employee benefits expenses	Dr.	80,000	
To Share based payment reserve (equity)			20,000
To Share based payment liability			60,000
(Recognition of Equity option and cash settlement option)			

31st December, 20X2

Employee benefits expenses	Dr.	92,000	
To Share based payment reserve (equity)			20,000
To Share based payment liability			72,000
(Recognition of Equity option and cash settlement option)			
Share based payment liability	Dr.	1,32,000	
To Bank/ Cash			1,32,000
(Settlement in cash)			
Share based payment reserve (equity)	Dr.	1,32,000	
To Retained Earnings			1,32,000

Note: *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.

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 oilfields. The services will be settled by issuing 1,000 shares of Reliance. Period for which the service is to be provided is 1st April, 20X1 to 1st July, 20X1 and fair value of the service was estimated using market value of similar contracts for ₹1,00,000. Nominal value per share is ₹10.

Record the transactions?

Solution:

Fair value of services	1,00,000
Number of months	3
Monthly expense	33,333.33

30th April, 20X1 ₹			
Repair & Maintenance	Dr.	33,333.33	
To Share based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			
31st May, 20X1			
Repair & Maintenance	Dr.	33,333.33	
To Share based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			
30th June, 20X1			
Repair & Maintenance	Dr.	33,333.33	
To Share based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			

1st July, 20X1			
Share based payment reserve (equity)	Dr.	1,00,000	
To Equity Shares (1000 x 10)			10,000
To Securities premium (balancing figure)			90,000

Illustration 6 - Share-based payment - Cash & equity alternatives (Past Exam Nov'22)

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:

	Period	₹
Option 1		
No of cash settled shares		74000
Service condition	3 years	
Option II		
No of equity settled shares		90000
Conditions:		
Service	3 years	
Restriction to sell	2 years	
Fair values		
Equity price with a restriction of sale for 2 years		
Fair value grant date		115
Fair value		135
20X0		138
20X1		140
20X2		147

Pass the Journal entries?

(6 Marks)

Solution:

Fair value of Equity option components:		
Fair value of a share with restrictive clause		₹ 115
Number of shares		90,000
Fair value (90,000 x 115)	A	₹ 1,03,50,000
Fair value of a share at the date of grant		₹ 135
Number of cash settled shares		74,000
Fair value (74,000 x 135)	B	₹ 99,90,000
Fair value of equity component in compound instrument (A-B)		₹ 3,60,000

Journal Entries

31/12/20X0		₹	
Employee benefit expenses	Dr.	35,24,000	
To Share based payment reserve (equity) (3,60,000/3)			1,20,000
To Share based payment liability (138 x 74,000) / 3			34,04,000
(Recognition of equity option and cash settlement option)			
31/12/20X1			
Employee benefits expenses	Dr.	36,22,667	
To Share based payment reserve (equity) (3,60,000/3)			1,20,000

To Share based payment liability (140 x 74,000) 2/3 -34,04,000 (Recognition of equity option and cash settlement option)		35,02,667
31/12/20X2		
Employee benefits expenses Dr.	40,91,333	
To Share based payment reserve (equity) (3,60,000/3)		1,20,000
To Share based payment liability (147 x 74,000) 3/3 - (34,04,000 + 35,02,667) (Recognition of equity option and cash settlement option)		39,71,333

Upon cash alternative chosen		
Share based payment liability (147 x 74,000) Dr.	1,08,78,000	
To Bank/ Cash (Being settlement made in cash)		1,08,78,000
Share based payment reserve (equity) Dr.	3,60,000	
To Retained Earnings (Being transfer of equity from one account to another one)		3,60,000
Upon equity alternative chosen		
Share based payment liability Dr.	1,08,78,000	
To Share Capital		90,00,000
To Share Premium		18,78,000
(Being settlement made in equity)		
Share based payment reserve (equity) Dr.	3,60,000	
To Retained Earnings (Being transfer of equity from one account to another one)		3,60,000

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 earnings will continue at a similar rate in 20X2 and expects that the shares will vest at the end of the year 20X2. The company also expects that additional 31 employees will leave the organisation in the year 20X2 and that 440 employees will receive their shares at the end of the year 20X2. At the end of 20X2, company's earnings increased by 18%. Therefore, the shares did not vest. Only 29 employees left the organization during 20X2. Company believes that additional 23 employees will leave in 20X3 and earnings will further increase so that the performance target will be achieved in 20X3. At the end of the year 20X3, only 21 employees have left the organization. Assume that the company's earnings increased to desired level and the performance target has been met.

Determine the expense for each year and pass appropriate journal entries?

Solution:

Since the earnings of the entity is non-market related, hence it will not be considered in fair value calculation of the shares given. However, the same will be considered while calculating number of shares to be vested.

Workings:

	20X1	20X2	20X3
Total employees	500	500	500
Employees left (Actual)	(29)	(58)	(79)
Employees expected to leave in the next year	(31)	(23)	-
Year end – No of employees	440	419	421
Shares per employee	100	100	100
Fair value of share at grant date	122	122	122
Vesting period	1/2	2/3	3/3
Expenses-20X1 (Note 1)	26,84,000		
Expenses-20X2 (Note 2)		7,23,867	
Expenses-20X3 (Note 3)			17,28,333

Note 1:

Expense for 20X1 = Number of employees x Shares per employee x Fair value of share x Proportionate vesting period
 $= 440 \times 100 \times 122 \times \frac{1}{2} = 26,84,000$

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
 $= (419 \times 100 \times 122 \times \frac{2}{3}) - 26,84,000$
 $= 7,23,867$

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
 $= (421 \times 100 \times 122 \times \frac{3}{3}) - (26,84,000 + 7,23,867)$
 $= 17,28,333.$

Journal Entries**31st December, 20X1**

Employee benefits expenses	Dr.	26,84,000	
To Share based payment reserve (equity)			26,84,000
(Equity settled shared based payment expected vesting amount)			

31st December, 20X2

Employee benefits expenses	Dr.	7,23,867	
To Share based payment reserve (equity)			7,23,867
(Equity settled shared based payment expected vesting amount)			

31st December, 20X3

Employee benefits expenses	Dr.	17,28,333	
To Share based payment reserve (equity)			17,28,333
(Equity settled shared based payment expected vesting amount)			
Share based payment reserve (equity)	Dr.	51,36,200	
To Share Capital / Securities Premium			51,36,200
(Share capital Issued)			

Illustration 8 - Equity Settled - Non market conditions (Reversals)

ACC limited granted 10,000 share options to one of its managers. In order to get the options, the manager has to work for next 3 years in the organization and reduce the cost of production by 10% over the next 3 years.

Fair value of the option at grant date was ₹ 95

Cost reduction achieved-

Year 1	12%	Achieved
Year 2	8%	Not expected to vest in future
Year 3	10%	Achieved

How the expenses would be recorded?

Solution:

It is a non-market related condition. Hence the target to achieve cost reduction would be taken while estimating the number of options to be vested.

Year	Options	Fair value		FV of the options vested
Year 1	10,000	95	1/3	3,16,667
Year 2	10,000	95	0	(3,16,667)
Year 3	10,000	95	3/3	9,50,000

The condition to achieve 10% cost reduction each was not fulfilled in the year 2 and there was no expectation to vest this non-market condition in future as well and hence earlier expense amount was reversed in year 2. Since in the year 3 the non-market condition was again met, hence all such expense will be charged to Profit and Loss.

Illustration 9 - Equity Settled - Market based conditions

Apple Limited has granted 10,000 share options to one of its directors for which he must work for next 3 years and the price of the share should increase by 20% over next 3 years.

The share price has moved as per below details -

Year 1	22%
Year 2	19%
Year 3	25%

At the grant date, the fair value of the option was ₹ 120.

How should we recognize the transaction?

Solution:

The share price movement is a market based vesting condition hence its expectations are taken into consideration while calculating the fair value of the option.

Even if the required market condition as required is not fulfilled, there is no requirement to reverse the expense previously booked.

Irrespective of the outcome of the market prices (as it is already taken care of in the fair value of the option), each period an amount of $(120 \times 10,000)/3 = ₹ 4,00,000$ will be charged to profit and loss.

Illustration 10 - Modifications - Equity-settled share based payment

Marathon Inc. issued 150 share options to each of its 1,000 employees subject to the service condition of 3 years. Fair value of the option given was calculated at ₹ 129. Below are the details and activities related to the SBP plan-

Year 1: 35 employees left and further 60 employees are expected to leave Share options re-priced (as MV of shares has fallen) as the FV fell to ₹ 50. After the re-pricing they are now worth ₹80; hence expense is expected to increase by ₹ 30.

Year 2: 30 employees left and further 36 employees are expected to leave

Year 3: 39 employees left

How the modification/re-pricing will be accounted?

Solution:

The re-pricing has been done at the end of year 1, and hence the increased expense would be spread over next 2 years equally.

Total increased value due to modification is	₹ 30	(1/2 weight each years)

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
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
		$(899 \times 150 \times 30 \times 1/2)$	$(896 \times 150 \times 30 \times 2/2) - 20,22,750$

Illustration 11 - Cancellation Equity Settled Share based payment (Past Exam July'21) (MTP May'23)

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 no of Directors to vest the option 8

During the year 2, there was a crisis in the company and Management decided to cancel the such scheme immediately. It was estimated further as below

Fair value of option at the time of cancellation was ₹ 90

Market price of the share at the cancellation date was ₹ 99

There was a compensation which was paid to directors and only 9 directors were currently in employment. At the time of cancellation of such scheme, it was agreed to pay an amount of ₹ 95 per option to each of 9 directors.

How the cancellation would be recorded?

(5 to 6 Marks)

Solution:

	<u>Year 1</u>	<u>Year 2</u>	
A)			
Expected directors to vest	8	9	
Fair value of option	130	130	
Number of options	<u>2,000</u>	<u>2,000</u>	
Total	<u>20,80,000</u>	<u>23,40,000</u>	
Expense weightage	1/3		Full, as it is cancelled
Expense for the year	6,93,333	16,46,667	Remaining amount since cancelled
B) Cancellation compensation			
Number of directors			9
Amount agreed to pay			95
Number of options/ director			2,000
Compensation amount (9 x 95 x 2,000) Also refer working notes 1 and 2			17,10,000

Working Notes:

1. Amount to be deducted from Equity

Number of directors	9
Fair value of option (at the date of cancellation)	90
Number of options/ director	2,000
Total	16,20,000

2. Amount transferred to Profit and Loss

Total cancellation compensation	17,10,000
Less: To deduct from Equity	<u>(16,20,000)</u>
Balance transferred to Profit and Loss	<u>90,000</u>

Illustration 12 - (RTP - May 2019)

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.

The journal entries recorded by the subsidiary for each of the two years are as follows:

Year 1		₹	₹
Remuneration expense	Dr.	2,40,000	
(200 x 100 employees x ₹ 30 x 80% x 1/2)			
	To Equity (Contribution from the parent)		2,40,000
Year 2			
Remuneration expense	Dr.	2,46,000	
[(200 x 81 employees x ₹ 30) - 2,40,000]			
	To Equity (Contribution from the parent)		2,46,000

Illustration 13

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 expense for the year 1 & 2?

Solution:

Year end	% Vest	Expense (current period)
FIRST	97%	$100 \times 1,000 \times 195 \times 97\% \times 1/2 = 94,57,500$
SECOND	91%	$100 \times 1,000 \times 195 \times 91\% \times 2/2 - 94,57,500 = 82,87,500$

Illustration 14

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 expense for years 1 and 2?

Solution:

Year end	Vest	Expense (current period)
FIRST	1/2	$50 \times 170 \times 80 \times 1/2 = 3,40,000$
SECOND	2/2	$50 \times 170 \times 90 \times 2/2 - 3,40,000 = 4,25,000$

- ♦ Liability will be re-measured at each reporting date.
- ♦ Fair value at the end of the year will be used.

Illustration 15 – (RTP - May 2021)

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 -

No. of employees of company B	100
Grant date fair value of share	₹87
No. of shares to each employee granted	25
Vesting conditions	Immediately
Face Value Per Share	₹ 10

Pass the journal entry in the books of company P & company B?

Solution:**Books of Company P**

Particulars	Debit (₹)	Credit (₹)
Investment in Company B Dr.	2,17,500	
To Equity Share Capital A/c (2,500 shares x ₹ 10)		25,000
To Securities Premium A/c (2,500 shares x ₹ 77)		1,92,500
(Being allotment of 25 shares each to 100 employees of B at fair value of ₹ 87 per share)		

Books of Company B

Particulars	Debit (₹)	Credit (₹)
Employee Benefit Expense A/c Dr.	2,17,500	
To Capital Contribution from Parent P		2,17,500
(Being issue of shares by Parent to Employees pursuant to Group Share-based Payment Plan)		

Illustration 16 (Deleted from IND AS 102 & is Shifted to IND AS 103)

Entity X acquired entity Y in a business combination as per Ind AS 103. There is an existing share-based plan in entity Y with a vesting condition for 3 years in which 2 years have already lapsed at the date of such business acquisition. Entity X agrees to replace the existing award for the employees of combined entity. The details are as below -

Acquisition date fair value of share-based payment plan	₹300

No. of years to vest after acquisition 1 year

Fair Value of award which replaces existing plan ₹400

Calculate the share-based payment values as per Ind AS 102?

Solution:

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.

Illustration 17

An entity P issues share-based payment plan to its employees based on the below details

No. 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.

Solution:

Market conditions are required to be considered while calculating fair value at grant date. However, service conditions will be considered as per the expected vesting right to be exercised by the employees and would be re-estimated during vesting period. However, if the market related condition is fulfilled before it is expected then all remaining expenses would immediately be charged off. If market related condition takes longer than the expected period then original expected period will be followed.

a) Market condition is fulfilled in year 3:

Year 1	2,500/4 = 625
Year 2	2,500/4 = 625
Year 3	2,500-625-625=1,250

Year 4	NIL

b) Market condition is fulfilled in year 5:

Year 1	$2,500/4 = 625$
Year 2	$2,500/4 = 625$
Year 3	$2,500/4 = 625$
Year 4	$2,500/4 = 625$
Year 5	NIL

Illustration 18

Entity X grants 10 shares each to its 1000 employees on the conditions as mentioned below-

- To remain in service & entity's profit aftertax (PAT) shall reach to ₹100 million.
- It is expected that PAT should reach to ₹100 million by the end of 3 years.
- Fair value at grant date is ₹100.
- Employees expected for vesting right by 1st year 97%, then it revises to 95% by 2nd year and finally to 93% by 3rd year.

Calculate expenses for next 3 years in respect of share-based payment?

Solution:

Entity's PAT is one of the non-market related condition and hence would be included while making an expectation of vesting shares and there is no requirement to make any changes in the non-market condition whether this is fulfilled or not because it has already been considered in the expectation of vesting rights at the end of each year.

Year -1	$1,000 \times 10 \times 100 \times 97\% \times 1/3 = 3,23,333$
Year-2	$1,000 \times 10 \times 100 \times 95\% \times 2/3 - 3,23,333 = 3,10,000$
Year -3	$1,000 \times 10 \times 100 \times 93\% \times 3/3 - 6,33,333 = 2,96,667$

Illustration 19

At 1st January, 20X1, Ambani Limited grants its CEO an option to take either cash amount equivalent to 800 shares or 990 shares. The minimum service requirement is 2 years. There is a condition to keep the shares for 3 years if shares are opted.

Fair values of the shares	₹
Share alternative fair value (with restrictions)	212
Grant date fair value on 1st January, 20X0	213
Fair value on 31st December, 20X0	220
Fair value on 31st December, 20X1	232

The key management exercises his cash option at the end of 20X2. Pass journal entries.

Solution:

	1 st January, 20X0	31 st December, 20X0	31 st December, 20X1
Equity alternative (990 x 212)	2,09,880		
Cash alternative (800 x 213)	1,70,400		
Equity option (2,09,880 – 1,70,400)	39,480		
Cash Option (cumulative) (using period end fair value)		88,000	1,85,600
Equity Option (cumulative)		19,740	39,480
Expense for the period			
Equity option		19,740	19,740
Cash Option		88,000	97,600
Total		1,07,740	1,17,340

Journal Entries

31 st 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)			
31 st 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)			

Illustration 20

MINDA issued 11,000 share appreciation rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹100. SAR can be exercised any time until 31st March, 20X3. It is expected that out of the total employees, 94% at the end of period on 31st March, 20X1, 91% at the end of next year will exercise the option.

Finally, when these were vested i.e. at the end of the 3rd year, only 85% of the total employees exercised the option.

Fair value of SAR

	₹
31st March, 20X1	132
31st March, 20X2	139
31st March, 20X3	141

Pass the Journal entries?

Solution:

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	11,00,000
To Share based payment liability			
(Fair value of the SAR recognised)			
31st March, 20X1			
Employee benefits expenses	Dr.	2,64,880	2,64,880
To Share based payment liability			
(Fair value of the SAR re-measured)			
31st March, 20X2			
Employee benefits expenses	Dr.	26,510	26,510
To Share based payment liability			
(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)			

Illustration 21 (PAST EXAM Nov'19) (RTP Nov'18) (MTP March'22)

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? **(8 Marks)**

Solution

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. To Liability against 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)	17.25	17.25
31.03.20X4	Profit and Loss account Dr. To Liability for SARs	15.38	15.38

	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X5	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	17.02	17.02

Journal entries in the books of P Ltd (with modification of service period of stock appreciation rights)

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

$$= ₹ 210 \times 400 \text{ awards} \times 75 \text{ employees} \times 1 \text{ year} / 4 \text{ years of service}$$

$$= ₹ 15,75,000$$

For the year ended 31st March 20X3

$$= ₹ 220 \times 400 \text{ awards} \times 75 \text{ employees} \times 2 \text{ years} / 4 \text{ years of service} - ₹ 15,75,000 \text{ previous recognised}$$

$$= ₹ 33,00,000 - ₹ 15,75,000 = ₹ 17,25,000$$

For the year ended 31st March 20X4

$$= ₹ 215 \times 400 \text{ awards} \times 75 \text{ employees} \times 3 \text{ years} / 4 \text{ years of service} - ₹ 33,00,000 \text{ previously recognised}$$

$$= ₹ 48,37,500 - ₹ 33,00,000 = ₹ 15,37,500$$

For the year ended 31st March, 20X5

$$= ₹ 218 \times 400 \text{ awards} \times 75 \text{ employees} \times 4 \text{ years} / 4 \text{ years of service} - ₹ 48,37,500 \text{ previously recognised}$$

$$= ₹ 65,40,000 - ₹ 48,37,500 = ₹ 17,02,500$$

Calculation of expenses for issue of stock appreciation rights with modification of service period

For the year ended 31st March 20X2

$$= ₹ 210 \times 400 \text{ awards} \times 75 \text{ employees} \times 1 \text{ year} / 4 \text{ years of service} = ₹ 15,75,000 \text{ For the year ended 31st March 20X3}$$

$$= ₹ 220 \times 400 \text{ awards} \times 75 \text{ employees} \times 2 \text{ years} / 3 \text{ years of service} - ₹ 15,75,000 \text{ previous recognised}$$

$$= ₹ 44,00,000 - ₹ 15,75,000 = ₹ 28,25,000$$

For the year ended 31st March 20X4

$$= ₹ 215 \times 400 \text{ awards} \times 75 \text{ employees} \times 3 \text{ years} / 3 \text{ years of service} - ₹ 44,00,000 \text{ previous recognised}$$

$$= ₹ 64,50,000 - ₹ 44,00,000 = ₹ 20,50,000.$$

Illustration 22 - (RTP May'20) (MTP Mar'19, Nov'22)

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 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.

The Company has requested you to suggest the suitable accounting treatment for these transaction as on 31st March, 20X3 (6 Marks)

Solution

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.

Accordingly, the amounts recognised in years 1 and 2 are as follows:

Year	Calculation	Compensation expense for period	Cumulative compensation expense
		₹	₹
1	$[1,850 \text{ employees} \times 1,000 \text{ options} \times ₹ 1.20] \times 1/3$	7,40,000	7,40,000
2	$(1,840 \text{ employees} \times 1,000 \text{ options} \times [(\text{₹} 1.20 \times 2/3) + \{(\text{₹} 1.05 - 0.90) \times 0.5/1.5\}] - 7,40,000$	8,24,000	15,64,000

Note: Year 3 calculations have not been provided as it was not required in the question.

Illustration 23

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?

Solution

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.

Journal Entry ₹

Investment in Company S	Dr.	1,250	
Cash/Bank		3,750	
To Equity			5,000
(To recognise the grant of equity instruments to employees of subsidiary less partial reimbursement from subsidiary)			

Illustration 24 - (RTP - May 2020)

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. The 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 Journal entries.

Solution

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	= $36 \times 1,000 \times 12 \times \frac{1}{2}$
31 December 20X6	72,000	2,88,000	= $36 \times 1,000 \times 8$
31 December 20X7	1,62,000*	3,90,000	= $30 \times 1,000 \times 13$
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 ($6 \times 1,000 \times 10$).

** Difference of opening liability (₹ 3,90,000) and actual liability paid [₹ 3,60,000 ($30 \times 1,000 \times 12$)] 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)			
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.

Question 1 – (MTP April'21, May'23) (RTP May'22)

New Age Technology Limited has entered into following Share Based payment transactions:

- On 1st April, 20X1, New Age Technology Limited decided to grant share options to its employees. The scheme was approved by the employees on 30th June, 20X1. New Age Technology Limited determined the fair value of the share options to be the value of the equity shares on 1st April, 20X1.
- On 1st April, 20X1, New Age Technology Limited entered into a contract to purchase IT equipment from Bombay Software Limited and agreed that the contract will be settled by issuing equity instruments of New Age Technology Limited. New Age Technology Limited received the IT equipment on 30th July, 20X1. The share-based payment transaction was measured based on the fair value of 'the equity instruments as on 1st April, 20X1.
- On 1st April, 20X1, New Age Technology Limited decided to grant the share options to its employees. The scheme was approved by the employees on 30th June, 20X1. The issue of the share options was however subject to the same being approved by the shareholders in a general meeting. The scheme was approved in the general meeting held on 30th September, 20X1. The fair value of the equity instruments for measuring the share-based payment transaction was taken on 30th September, 20X1.

Identify the grant date and measurement date in all the 3 cases of Share based payment transactions entered into by New Age Technology Limited, supported by appropriate rationale for the determination?

(8 Marks)**Solution:**

Ind AS 102 defines grant date and measurement dates as follows:

- Grant date:** The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.
- Measurement date:** The date at which the fair value of the equity instruments granted is measured for the purposes of this Ind AS. For transactions with employees and others providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

Applying the above definitions in the given scenarios following would be the conclusion based on the assumption that the approvals have been received prospectively:

Scenario	Grant date	Measurement date	Base for grant date	Base for measurement Date
(i)	30 th June 20X1	30 th June 20X1	The date on which the scheme was approved by the employees	For employees, the measurement date is grant date
(ii)	1 st April 20X1	30 th July 20X1	The date when the entity and the counterparty entered a contract and agreed for settlement by equity instruments	The When the entity Obtain the goods from counterparty
(iii)	30 th September 20X1	30 th September 20X1	The Date When the Approval by Shareholder was Obtained	For employees, the measurement date is grant date

Question 2 - (MTP Oct'21)

Ryder, a public limited company is reviewing certain events which have occurred since its year - end 31st March, 20X4. The financial statements were authorized for issue on 12th May, 20X4. The following events are relevant to the financial statements for the year ended 31st March, 20X4.

The company granted share appreciation rights (SARs) to its employees on 1st April, 20X2 based on 10 million shares. At the date the rights are exercised, the SAR's provide employees with the right to receive cash equal to the appreciation in the company's share price since the grant date. The rights vested on 31st March, 20X4 and payment was made on schedule on 1st May, 20X4.

The FV of the SAR's per share at 31st March, 20X3 was ₹ 6, at 31st March, 20X4 was ₹ 8 and at 1st May, 20X4 was ₹ 9. The company has recognized a liability for the SAR's as at 31st March, 20X2 based upon Ind AS 102 'Share-based Payments' but the liability was stated at the same amount at 31st March, 20X4.

Discuss the accounting treatment of the above events in the financial statements of the Ryder Group for the year ending 31st March, 20X4 taking into account the implications of events occurring after the reporting period. (6 Marks)

Solution

Ind AS 102 'Share-based Payments' requires a company to remeasure the fair value of a liability to pay cash-settled share-based payments at each reporting date and the settlement date until the liability is settled. Share Appreciation rights fall under this category. Hence, the company should recognize a liability of ₹ 80 million (₹ 8 x 10 million) at 31st March, 20X4, the vesting date.

The liability recognised at 31st March, 20X4 was in fact based on the share price at the previous year-end and would have been shown at ₹ 6 x $\frac{1}{2}$ x 10 million shares – half the cost as the SARs vest over 2 years. This liability at 31st March, 20X4 has not been changed since the previous year- end by the company.

The SARs vest over a two-year period and hence on 31st March, 20X4 there would be a weighting of the eventual cost by 1 year / 2 year. Therefore, an additional liability of ₹ 50 million (30 million + 20 million) should be accounted for in the financial statements at 31st March, 20X4.

The SARs would be settled on 1st May, 20X4 at ₹ 90 million (₹ 9 x 10 million). The increase of ₹ 10 million (over and above ₹ 80 million) in the value of the SARs is a non-adjusting event. Hence, the change in the fair value of ₹ 10 million during the year 20X4-20X5 would be charged to profit and loss for the year ended 31st March, 20X5 and not 31st March, 20X4.

Question 3 (RTP Nov'22)

The following particulars in respect of stock options granted by a company are available:

No. of Employees covered	400	Nominal Value per share	₹ 100
No. of options per Employee	60	Exercise price per share	₹ 125

Shares offered were put in three groups. Group 1 was for 20% of shares offered with vesting period one-year. Group II was for 40% of shares offered with vesting period two- years. Group III was for 40% of shares offered with vesting period three-years. Fair value of option per share on grant date was ₹ 10 for Group I, ₹ 12.50 for Group II and ₹ 14 for Group III.

Position on 1st Year	Position on 2nd Year	Position on 3rd Year
- No. of employees left = 40	- Employees left = 35	- Employees left = 28
- Estimate of employees to leave in Year 2 = 36	- Estimate of employees to leave in Year 3 = 30	- Employees exercising Options in Group III = 295
- Estimate of employees to leave in Year 3 = 34	- Employees exercising Options in Group II = 319	
- Employees exercising Options in Group I = 350		

Options not exercised immediately on vesting, were forfeited. Compute expenses to recognise in each year and show important accounts in the books of the company.

Solution:

Total number of Options per employee = 60

Group I - 20% vesting in Year 1	Group II - 40% vesting in Year 2	Group III - 40% vesting in Yr. 3
= 12 options, Vesting period = 1 Yr.	= 24 options, Vesting period = 2 Yrs.	= 24 options, Vesting period = 3 Yrs.

Computation of Expenses for all the years

Group = No. of Options	Group I = 12 Options	Group II = 24 Options		Group III = 24 Options		
	Year 1	Year 1	Year 2	Year 1	Year 2	Year 3
(a) Employees at year end = [Opening No. of Employees - Forfeiture]	400 - 40 = 360	400 - 40 = 360	360 - 35 = 325	400 - 40 = 360	360 - 35 = 325	325 - 28 = 297
(b) Expected to leave in future	NA	36	NA	36 + 34 = 70	30	NA
(c) No. of employees eligible (a - b)	360	324	325	290	295	297
(d) Options expected to Vest = [(c) x No. of Shares]	(360 x 12 sh.) = 4,320	(324 x 24 sh.) = 7,776	(325 x 24 sh.) = 7,800	(290 x 24 sh.) = 6,960	(295 x 24 sh.) = 7,080	(297 x 24 sh.) = 7,128
(e) FV per option =	₹ 10	₹ 12.50	₹ 12.50	₹ 14	₹ 14	₹ 14
(f) Value of Total Options = [d x e]	₹ 43,200	₹ 97,200	₹ 97,500	₹ 97,440	₹ 99,120	₹ 99,792
(g) Total Cumulative Cost of Options		[(f) x 1/2]	[(f) x 2/2]	[(f) x 1/3]	[(f) x 2/3]	[(f) x 3/3]
= [(f) x Completed Yrs/ Total Yrs]	₹ 43,200	₹ 48,600	₹ 97,500	₹ 32,480	₹ 66,080	₹ 99,792
(h) Less: Recognized in last years	0	0	₹ 48,600	0	₹ 32,480	₹ 66,080
(i) Expenses to be recognized	₹ 43,200	₹ 48,600	₹ 48,900	₹ 32,480	₹ 33,600	₹ 33,712
(j) Employees not exercising ESOP	10 Employees	325 - 319 = 6 Employees		297 - 295 = 2 Employees		
(k) Total Expenses for-						
Year 1	₹ 43,200 (Gr. 1) + ₹ 48,600 (Gr. 2) + ₹ 32,480 (Gr. 3) = ₹ 1,24,280					
Year 2	₹ 48,900 (Gr. 2) + ₹ 33,600 (Gr. 3) = ₹ 82,500					
Year 3	₹ 33,712 (Gr. 3 only)					

Employees Benefit Expenses A/c			
Year 1			
	₹		₹
To Share-based Payment Reserve A/c	1,24,280	By Profit and Loss A/c	1,24,280
	1,24,280		1,24,280
Year 2			
To Share-based Payment Reserve A/c	82,500	By Profit and Loss A/c	82,500

	82,500		82,500
Year 3			
To Share-based Payment Reserve A/c	33,712	By Profit and Loss A/c	33,712
	33,712		33,712

Share-based Payment Reserve A/c			
Year 1			
	₹		₹
To Retained Earnings [(360 - 350) Emp x 12 Options x ₹ 10]	1,200	By Employees Benefit Expenses A/c	1,24,280
To Share Capital (350 Emp x 12 Options x ₹ 100)	4,20,000	By Bank A/c (350 Emp x 12 Options x ₹ 125)	5,25,000
To Securities Premium (350 Emp x 12 Options x ₹ 35)	1,47,000		
To Balance c/d	81,080		
	6,49,280		6,49,280
Year 2			
To Retained Earnings [(325 - 319) Emp x 24 Options x ₹ 12.50]	1,800	By Balance b/d	81,080
To Share Capital (319 Emp x 24 Options x ₹ 100)	7,65,600	By Employees Benefit Expenses A/c	82,500
To Securities Premium (319 Emp x 24 Options x ₹ 37.50)	2,87,100	By Bank A/c (319 Emp x 24 Options x ₹ 125)	9,57,000
To Balance c/d	66,080		
	11,20,580		11,20,580
Year 3			
To Retained Earnings [(297 - 295) Emp x 24 Options x ₹ 14]	672	By Balance b/d	66,080
To Share Capital (295 Emp x 24 Options x ₹ 100)	7,08,000	By Employees Benefit Expenses A/c	33,712
To Securities Premium (295 Emp x 24 Options x ₹ 39)	2,76,120	By Bank A/c (295 Emp x 24 Options x ₹ 125)	8,85,000
	9,84,792		9,84,792

Working Note:

Calculation of Securities Premium			
	Group I	Group II	Group III
	Year 1	Year 2	Year 3
Exercise Price received per share	125.00	125.00	125.00

Value of service received per share, being the FV of the Options	<u>10.00</u>	<u>12.50</u>	<u>14.00</u>
Total Consideration received per share	135.00	137.50	139.00
Less: Nominal Value per share	<u>(100.00)</u>	<u>(100.00)</u>	<u>(100.00)</u>
Securities Premium per share	<u>35.00</u>	<u>37.50</u>	<u>39.00</u>

IND AS 103 – BUSINESS COMBINATION

Illustration 1 - Asset acquisition

An entity acquires an equipment and a patent in exchange for ₹1,000 crore cash and land. The fair value of the land is ₹400 crore and its carrying value is ₹100 crore. The fair values of the equipment and patent are estimated to be ₹500 crore and ₹1,000 crore, respectively. The equipment and patent relate to a product that has just recently been commercialised. The market for this product is still developing.

Assume the entity incurred no transaction costs. For ease of convenience, the tax consequences on the gain have been ignored. How should the transaction be accounted for?

Solution:

As per paragraph 2(b) of Ind AS 103, the standard does not apply to "the acquisition of an asset or a group of assets that does not constitute a business. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in Ind AS 38, Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill". In the given case, the acquisition of equipment and patent does not represent acquisition of a business 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 $((₹ 500 / ₹ 1,500) \times ₹ 1,400 = ₹ 467 \text{ crore})$. The patent is recorded at its relative fair value $((₹ 1,000 / ₹ 1,500) \times ₹ 1,400 = ₹ 933 \text{ Crore})$.

Illustration 2

Company A is a pharmaceutical company. Since inception, the Company had been conducting in-house research and development activities through its skilled workforce and recently obtained an intellectual property right (IPR) in the form of patents over certain drugs. The Company's has a production plant that has recently obtained regulatory approvals. However, the Company has not earned any revenue so far and does not have any customer contracts for sale of goods. Company B acquires Company A.

Does Company A constitute a business in accordance with IND AS 103?

Solution

The definition of business requires existence of inputs and processes. In this case, the skilled workforce, manufacturing plant and IPR, along with strategic and operational processes constitutes the inputs and processes in line with the requirements of IND AS 103.

When the said inputs and processes are applied as an integrated set, the Company A will be capable of producing outputs; the fact that the Company A currently does not have revenue is not relevant to the analysis of the definition of business under IND AS 103. Basis this and presuming that Company A would have been able to obtain access to customers that will purchase the outputs, the present case can be said to constitute a business as per IND AS 103.

Illustration 3

Modifying the above illustration, if Company A had revenue contracts and a sales force, such that Company B acquires all the inputs and processes other than the sales force, then whether the definition of the business is met in accordance with IND AS 103?

Solution

Though the sales force has not been taken over, however, if the missing inputs (i.e., sales force) can be easily replicated or obtained by the market participant to generate output, it may be concluded that Company A has acquired business. Further, if Company B is also into similar line of business, then the existing sales force of Company B may also be relevant to mitigate the missing input. As such, the definition of business is met in accordance with IND AS 103.

Illustration 4 - Potential voting rights – (MTP May'23)

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

After the above transaction, the shareholdings of Company P's two other original shareholders are 35,000 and 25,000. Each of these shareholders also has currently exercisable options to acquire 2,000 additional shares. Assess whether control is acquired by Company P. **(5 Marks)**

Solution

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

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

By considering all the above factors, Company P concludes that with the acquisition of the 40,000 shares together with the potential voting rights, it has obtained control of Company X.

Illustration 5 - (RTP - Nov 2020)

Veera Limited and Zeera Limited are both in the business of manufacturing and selling of Lubricant. Veera Limited and Zeera Limited shareholders agree 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's shareholders and 50 shares to Zeera Limited's 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 gets the voting rights in Meera Limited based on their respective shareholding.

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 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's shareholder gets 66.67% share ($100 / 150 \times 100$) and Zeera Limited's shareholder gets 33.33% share in Meera Limited. Hence, Veera Limited is acquirer as per the principles of Ind AS 103.

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. Can Super Ltd. be identified as the acquirer in this business combination?

Solution:

Paragraph 6 of Ind AS 103 states that for each business combination, one of the combining entities shall be identified as the acquirer.

While paragraph 7 states that the guidance in Ind AS 110 shall be used to identify the acquirer that is the entity that obtains control of another entity called the acquiree. If a business combination has occurred but applying the guidance in Ind AS 110 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14-B18 of Ind AS 103 shall be considered in making that determination.

Further, paragraph B15 provides that, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

- a) The relative voting rights in the combined entity after the business combination: The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.
- b) The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest: The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

- c) The composition of the governing body of the combined entity: The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.
- d) The composition of the senior management of the combined entity: The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.
- e) The terms of the exchange of equity interests: The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

The key drivers of the accounting are identifying the party on whose behalf the new entity has been formed and identifying the business acquired. In this scenario, as Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and has the ability to dominate the management of the Focus Ltd. Accordingly, Super Ltd. will be identified as the acquirer unless there are conditions to conclude to the contrary.

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 within 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 shareholders meeting is scheduled to happen on 30th April. If the shareholders' approval is not received for issue of new shares, then the consideration will be settled in cash. What is the acquisition date?

Solution

The acquisition date in the above case is 1st April. This is because, in the above scenario, even if the shareholders don't approve the shares, consideration will be settled through payment of cash.

Illustration 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. What is the date of acquisition?

Solution

IND AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

Further 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, 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 acquire - the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

Therefore, in this case, notwithstanding that the price is based on the net assets at 1st January, 20X1 and that XYZ Ltd.'s shareholders do not receive any dividends after that date, the date of acquisition for accounting purposes will be 1st March, 20X1. It is only on 1st March, 20X1 and not 1st January, 20X1, that ABC Ltd. has the power to direct the relevant activities of XYZ Ltd. so as to affect its returns from its involvement with XYZ Ltd. Accordingly, the date of acquisition is 1st March, 20X1.

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)

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 acquire - 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.

Illustration 11 - (MTP - Oct 2020)

(8 marks)

On 1st April, 20X1, PQR Ltd. acquired 30% of the voting ordinary shares of XYZ Ltd. for ₹8,000 crore. PQR Ltd. accounts its investment in XYZ Ltd. using equity method as prescribed under IND AS 28. At 31st March, 20X2, PQR Ltd. recognised its share of the net asset changes of XYZ Ltd. using equity accounting as follows:

	(₹ in crore)
Share of profit or loss	700
Share of exchange difference in OCI	100
Share of revaluation reserve of PPE in OCI	50

The carrying amount of the investment in the associate on 31st March, 20X2 was therefore ₹8,850 crore (8,000+700+100+50).

On 1st April, 20X2, PQR Ltd. acquired the remaining 70% of XYZ Ltd. for cash ₹25,000 crore. The following additional information is relevant at that date:

	(₹ in crore)
Fair value of the 30% interest already owned:	9,000
Fair value of XYZ's identifiable net assets:	30,000

How should such business combination be accounted for?

Solution:

Paragraph 42 of Ind AS 103 provides that in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Applying the above, PQR Ltd. records the following entry in its consolidated financial statements:

		(₹ in crore)	
		Debit	Credit
Identifiable net assets of XYZ Ltd.	Dr.	30,000	
Goodwill (W.N.1)	Dr.	4,000	
Foreign currency translation reserve	Dr.	100	
RPE revaluation reserve	Dr.	50	
To Cash			25,000
To Investment in associate -XYZ Ltd.			8,850
To Retained earnings (W.N.2)			50
To Gain on previously held interest in XYZ recognised in Profit or loss (W.N.3)			250
(To recognise acquisition of XYZ Ltd.)			

Working Notes:

1. Calculation of Goodwill:

	₹ in crore
Cash consideration	25,000
Add: Fair value of previously held equity interest in XYZ Ltd.	9,000
Total consideration	34,000
Less: Fair value of identifiable net assets acquired	(30,000)
Goodwill	4,000

2. The credit to retained earnings represents the reversal of the unrealized gain of ₹ 50 crore in Other Comprehensive Income related to the revaluation of property, plant and equipment. In accordance with Ind AS 16, this amount is not reclassified to profit or loss.
3. The gain on the previously held equity interest in XYZ Ltd. is calculated as follows:

	₹ in crore
Fair Value of 30% interest in XYZ Ltd. at 1 st April, 20X2	9,000
Carrying amount of interest in XYZ Ltd. at 1 st 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

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.

You are required to 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 - 70 crores) in business combination achieved through contract alone when NCI is measured at fair value.

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 effect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception.

Note: The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The stamp duty payable for transfer of assets in connection with the business combination is an acquisition-related cost as described under paragraph 53 of Ind AS 103. Stamp duty is a cost incurred by the acquirer in order to effect the business combination and it is not part of the fair value exchange between the buyer and seller for the business. In such cases, the stamp duty is incurred to acquire the ownership rights in land in order to complete the process of transfer of assets as part of the overall

business combination transaction but it does not represent consideration paid to gain control over business from the sellers.

It may be noted that the accounting treatment of stamp duty incurred for separate acquisition of an item of property, plant and equipment (i.e. not as part of business combination) differs under Ind AS 16, Property, Plant and Equipment. Unlike Ind AS 16, the acquisition accounting as per Ind AS 103 requires assets and liabilities acquired in a business combination to be measured at fair value. While incurred in connection with a business combination, stamp duty does not increase the future economic benefits from the net assets comprising the business (which would be recognised at fair value) and hence cannot be capitalised. The examples of costs given in paragraph 53 is only an inclusive list; they are only indicative and do not preclude any other cost to be considered as acquisition-related cost. In the given case, the transfer of land and the related stamp duty is required to be accounted as part of the business combination transaction as per requirements of Ind AS 103 and not as a separate transaction under Ind AS.

Accordingly, stamp duty incurred in relation to land acquired as part of a business combination transaction are required to be recognised as an expense in the period in which the acquisition is completed and given effect to in the financial statements of the acquirer.

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 effect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The payment to the regulator represents a transaction cost and will be regarded as acquisition related cost incurred to effect the business combination. Applying the requirements of para 53 of Ind AS 103, it should be expensed as it is incurred. Transfer of rights in the instant case cannot be construed to be separate from the business combination because the transfer of the rights to ABC Ltd. is an integral part of the business combination itself.

It may be noted that had the right been acquired separately (i.e. not as part of business combination), the transaction cost is required to be capitalised as part of the intangible asset as per the requirements of Ind AS 38, Intangible Assets.

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 lakhs 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.

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 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.

Illustration 17

Company A, FMCG company acquires an online e-commerce company E, with the intention to start doing retailing. The e-commerce company has over the period have 10 million registered users. However, the e-commerce company E does not have any intention to sale the customer list. Should this customer list be recorded as an intangible in a business combination?

Solution

In this situation the customer database does not give rise to legal or contractual right. Accordingly, the assessment of its separability will be assessed. The database can be useful to other players and 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.

Illustration 18

ABC Ltd. a pharmaceutical group acquires XYZ Ltd. another pharmaceutical business. XYZ Ltd. has incurred significant research costs in connection with two new drugs that have been undergoing clinical trials. Out of the two drugs, one drug has not been granted necessary regulatory approvals. However, ABC Ltd. expects that approval will be given within two years. The other drug has recently received regulatory approval. The drugs' revenue-earning potential was one of the principal reasons why entity ABC Ltd. decided to acquire entity XYZ Ltd. Whether the research and development on either of the drugs be recognised as an intangible asset in the books of ABC Ltd.?

Solution:

Ind AS 38, Intangible Assets provides explicit guidance on recognition of acquired in-process research and development.

Paragraph 21 of Ind AS 38 provides guidance regarding general recognition conditions which require it to be probable that expected future economic benefits will flow to the entity before an intangible asset can be recognised and for the cost to be measured reliably.

As per paragraph 33 of Ind AS 38, both of the standard's general recognition criteria, i.e. probability of benefits and reliable measurement, are always considered to be satisfied for intangible assets acquired in a business combination.

The fair value of an intangible asset reflects expectations about the probability of these benefits, despite uncertainty about the timing or the amount of the inflow. There will be sufficient information to measure the fair value of the asset reliably if it is separable or arises from contractual or other legal rights. If there is a range of possible outcomes with different probabilities, this uncertainty is taken into account in the measurement of the asset's fair value.

Paragraph 34 of Ind AS 38, provides that in accordance with this Standard and Ind AS 103, an acquirer recognises at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognised by the acquiree before the business combination.

This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset. An acquiree's in-process research and development project meets the definition of an intangible asset when it:

- (a) meets the definition of an asset; and
- (b) is identifiable, i.e. is separable or arises from contractual or other legal rights. In accordance with above,
 - (i) The fair value of the first drug reflects the probability and the timing of the regulatory approval being obtained. As per the standard, the recognition criterion of probable future economic benefits is considered to be satisfied in respect of the asset acquired accordingly an asset is recognised. 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 38 and are recognised. The approval means it is probable that future economic benefits will flow to ABC Ltd. This will be reflected in the fair value assigned to the intangible asset.

Thus, recognising in-process research and development as an asset on acquisition applies different criteria to those that are required for internal projects. The research costs of internal R&D projects may under no circumstances be capitalised as an intangible asset. It may be pertinent to note that entities will be required to recognise on acquisition some research and development expenditure that they would not have been able to recognise if it had been an internal project. Although the amount attributed to the project is accounted for as an asset, Ind AS 38 requires that any subsequent expenditure incurred after the acquisition of the project is to be accounted for in accordance with paragraphs 54 to 62 of Ind AS 38.

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 operates number of store in south India. Vadapav Ltd. decided to acquire Efficient Ltd due to its huge distribution network and accordingly purchased the outstanding shares on 1st April, 20X2.

On the acquisition date, Vadapav Ltd. determines that the license agreement reflects current market terms.

Solution

Vadapav will record the franchisee right as an intangible asset (reacquired right) while doing purchase price allocation and since it is at market terms no gain or loss will be recorded on settlement.

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 [$(₹ 2,50,000 \times 6/10) + 20\%$].

ABC Ltd. has acquired PQR Ltd., because it sees high potential in the European market and wishes to exploit it. ABC Ltd. calculates that under current economic conditions and at current prices it could grant a six-year franchise for a price of ₹ 4,50,000.

How is the license accounted for as part of the business combination?

Solution:

Paragraph B51 of Ind AS 103 provides that "the acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant)."

Further, paragraph B52 of Ind AS 103 provides that "if the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:

- (a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.
- (b) for a pre-existing contractual relationship, the lesser of (i) and (ii):
 - i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)
 - ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

If (ii) is less than (i), the difference is included as part of the business combination accounting.

The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements."

Based on the above in the instant case, the license is recognised at ₹ 4,50,000, the fair value at market rates of a license based on the remaining contractual life.

The gain or loss on settlement of the contract is the lower of:

- ₹ 3,00,000, which is the amount by which the right is unfavorable to ABC Ltd. compared to market terms. This is the difference between the amount that ABC Ltd. could receive for granting a similar right, ₹ 4,50,000, compared to the carrying value (or the unamortised value) that it was granted for, ₹ 1,50,000 ($2,50,000 \times 6/10$).
- ₹ 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.

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 ($₹ 20 \text{ crore} \times 0.20$). The gain on the bargain purchase then would be ₹ 1 crore ($₹ 20 \text{ crore} - (₹ 15 \text{ crore} + ₹ 4 \text{ crore})$).

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.

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 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.

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 the ₹20 million being the fair value of the litigation liability will be considered as paid for settling the litigation claim and will be not included in the business combination. Accordingly, the purchase price will reduce by 20 million and the difference between 20 and 10 will be recorded in income statement of the Progressive limited as loss on settlement of the litigation.

Illustration 25

KKV Ltd acquires a 100% interest in VIVA Ltd, a company owned by a single shareholder who is also the KMP in the Company, for a cash payment of USD 20 million and a contingent payment of USD 2 million. The terms of the agreement provide for payment 2 years after the acquisition if the following conditions are met:

- the EBIDTA margins of the Company after 2 years after the acquisition is 21%.
- the former shareholder continues to be employed with VIVA Ltd for at least 2 years after the acquisition. No part of the contingent payment will be paid if the former shareholder does not complete the 2 year employment period.

Solution

In the above scenario the former shareholder is required to continue in employment and the contingent consideration will be forfeited if the employment is terminated or if he resigns.

Accordingly, only USD 20 million is considered as purchase consideration and the contingent consideration is accounted as employee cost and will be accounted as per the other IND AS.

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 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.

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, $500 \times \frac{2}{5} = 200$ 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.

Illustration 28

P a real estate company acquires Q another construction company which has an existing equity settled share based payment scheme. The awards vest after 5 years of employee service. At the acquisition date, Company Q's employees have rendered 2 years of service. None of the awards are vested at the acquisition date. P did not replace the existing share-based payment scheme but reduced the remaining vesting period from 3 years to 2 year. Company P determines that the market-based measure of the award at the acquisition date is ₹ 500 (based on measurement principles and conditions at the acquisition date as per IND AS 102).

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 NCI and post combination employee compensation expense. The portion allocable to pre-combination period is $500 \times \frac{2}{5} = 200$ 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.

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.

How will the non-controlling interest be measured?

Solution:

Paragraph 19 of Ind AS 103 states that for each business combination, the acquirer shall measure at the acquisition date components of non-controlling interest in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

- fair value; or
- the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by Ind AS.

In accordance with above, non-controlling interests will be measured in either of the following manner:

- Non-controlling interests are measured at fair value**

Under this method, goodwill represents the difference between the fair value of Natural Ltd. and the fair value of its identifiable net assets.

Thus, Classic Ltd. will recognise the business combination as follows:

(₹ in crores)

Identifiable net assets at fair value	Dr	150	
Goodwill*	Dr	12.5	
To Non-controlling interest			65
To Investment in Natural Ltd.			97.5

*Note: Goodwill is calculated as $97.5 + 65 - 150 = 12.5$ or $162.5 - 150 = 12.5$

b) Non-controlling interests are measured at proportionate share of identifiable net assets

Under this method, goodwill represents the difference between the total of the consideration transferred less the fair value of the acquirer's share of net assets acquired and liabilities assumed. The non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the Natural Ltd.'s net assets in the event of liquidation (i.e. the ordinary shares) are measured at the non-controlling interest's proportionate share of the identifiable net assets of Natural Ltd.

Thus, Classic will recognise the business combination as follows:

(₹ In Crores)

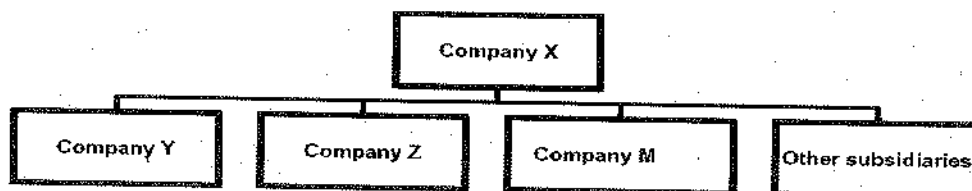
Identifiable net assets at fair value	Dr	150	
Goodwill*	Dr	7.5	
To Non-controlling interest (40% x 150) Cr			60
To Investment in Natural Ltd. Cr			97.5

*Note: Goodwill is calculated as $97.5 + 60 - 150 = 7.5$ or $97.5 - (150 \times 60\%) = 7.5$

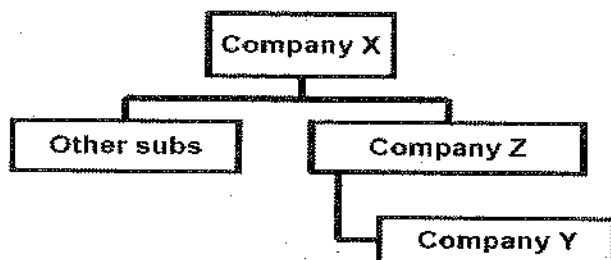
Illustration 30

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 X will directly control the operating and financial policies of Companies Y.

Before- Reorganisation



After-Reorganisation



Analyse the above transaction

Solution

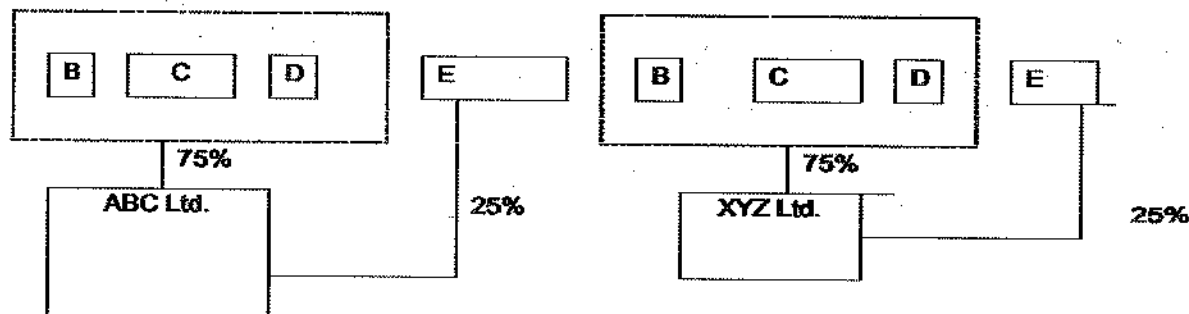
In this situation, Company Z pays consideration to Company X to obtain control of Company Y. The transaction meets the definition of a business combination. Prior to the reorganisation, each of the parties are controlled by Company X. After the reorganisation, although Company Y are now owned by Company Z, all two companies are still ultimately owned and controlled by Company X. From the perspective of Company X, there has been no change as a result of the reorganisation. This transaction therefore meets the definition of a common control combination and is within the scope of IND AS 103.

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.

Whether ABC Ltd. and XYZ Ltd. are under common control?

Solution



Appendix C to IND AS 103 defines common control business combination as a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraphs 6 and 7 of Appendix C to IND AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of IND AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one having entities under common control. Also, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

In the instant case, both ABC Ltd. and XYZ Ltd. are jointly controlled by group of individuals (B, C and D) as a result of contractual arrangement. Therefore, in the current scenario, ABC Ltd. and XYZ Ltd. are considered to be under common control.

Illustration 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.

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.

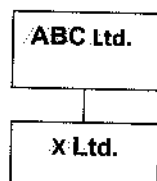
Further as per paragraphs 6 and 7 of Appendix C to IND AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of IND AS. 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.

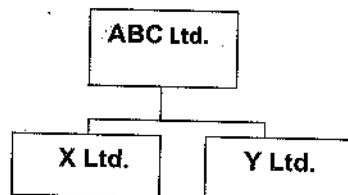
Illustration 33

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.?

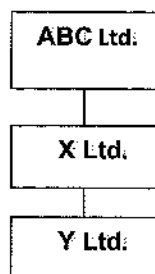
Before:



Intermediate:



After:



Solution

Appendix C to IND AS 103 defines common control business combination as business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraph 7 of Appendix C to IND AS 103, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

The term 'transitory' has been included as part of Appendix C to IND AS 103.

The word 'transitory' has been included in the common control definition to ensure that acquisition accounting applies to those transactions that look as though they are combinations involving entities under common control, but which in fact represent genuine substantive business combinations with unrelated parties.

Based on above, if the intermediate step had been omitted and instead X Ltd. had been the ABC group's vehicle for the acquisition of Y Ltd. - i.e. going straight to the 'after' position - then X Ltd. would have been identified as the acquirer.

Considering X Ltd. and Y Ltd. are under common control (with common parent), it might seem that acquisition accounting is not required because of the specific requirement for common control business combination. However, X Ltd. should be identified as the acquirer and should account for its combination with Y Ltd. using acquisition accounting. This is because X Ltd. would have applied acquisition accounting for Y Ltd. if X Ltd. had acquired Y Ltd. directly rather than through ABC Ltd. Acquisition accounting cannot be avoided in the financial statements of X Ltd. simply by placing X Ltd. and Y Ltd. under the common control of ABC shortly before the transaction.

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 1 October 20X9. The year end of ABC Ltd is 31 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 1 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 1 April 20X8. Additionally, the results of current year of PQR Ltd will be required to include XYZ's financial statements for the period from 1 April 20X9 to 30 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 1 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 1 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.

Illustration 36 – (Past Exam – May 2018), (MTP – March 2021)

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
Total	200	200	400

Division Mobiles along with its assets and liabilities was sold for ₹25 crores to Turnaround Ltd. a new company, who allotted 1 crore equity shares of ₹10 each at a premium of ₹15 per share to the members of Enterprise Ltd. in full settlement of the consideration, in proportion to their shareholding in the company. One of the members of the Enterprise Ltd. was holding 52% shareholding of the Company.

Assuming that there are no other transactions, you are asked to:

- Pass journal entries in the books of Enterprise Ltd.
- Prepare the Balance Sheet of Enterprise Ltd. after the entries in (i).
- Prepare the Balance Sheet of Turnaround Ltd.

(10 Marks)

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:

- Any other alternative set of entries, with the same net effect on various accounts, may be given by the students.
- 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
		<u>225</u>
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		25
Other equity (Surplus)		175
Liabilities		
Current liabilities		
Current liabilities		25
		<u>225</u>

Notes to Accounts

		(₹ in crores)
1.	Other Equity	
	Surplus (175-100)	75
	Add: Capital Reserve on reconstruction	100
		<u>175</u>

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
		<u>600</u>
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
		<u>600</u>

Notes to Accounts

	(₹ in crores)
1. Share Capital: Issued and Paid-up capital 1 crore Equity shares of ₹ 10 each fully paid up (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.)	10
2. Other Equity: Securities Premium Capital reserve [25- (600 – 700)]	15 <u>(125)</u> <u>(110)</u>

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	<u>(500)</u>	<u>(100)</u>	<u>(600)</u>
W.D.V. (A)	<u>100</u>	<u>200</u>	<u>300</u>
Current assets	400	300	700
Less: Current liabilities	<u>(100)</u>	<u>(100)</u>	<u>(200)</u>
(B)	<u>300</u>	<u>200</u>	<u>500</u>
Total (A+B)	<u>400</u>	<u>400</u>	<u>800</u>
Financed by :			
Loan funds (A)	=	<u>100</u>	<u>100</u>
(secured by a charge on property, plant and equipment)			
Own funds:			
Equity capital			50
(fully paid up ₹ 10 per share)			
Other Equity			<u>650</u>
(B)	<u>?</u>	<u>?</u>	<u>700</u>
Total (A+B)	<u>400</u>	<u>400</u>	<u>800</u>

It is decided to form a new company Mini Ltd. to take over the assets and liabilities of Mini division.

Accordingly, Mini Ltd. was incorporated to take over at Balance Sheet figures, the assets and liabilities of that division. Mini Ltd. is to allot 5 crore equity shares of ₹10 each in the company to the members of Maxi Mini Ltd. in full settlement of the consideration. The members of Maxi Mini Ltd. are therefore to become members of Mini Ltd. as well without having to make any further investment.

- (a) You are asked to pass journal entries in relation to the above in the books of Maxi Mini Ltd. and Mini Ltd. Also show the Balance Sheets of the 2 companies as on the morning of 1st November, 20X2,

showing corresponding previous year's figures.

- (b) The directors of the 2 companies ask you to find out the net asset value of equity shares pre and post demerger.
- (c) Comment on the impact of demerger on "share holders wealth".

Solution:

Demerged Company: Mini Division of "Maxi Mini Ltd"

Resulting Company: "Mini Ltd."

a) Journal of Maxi Mini Ltd. (Demerged Company)

		(₹ in crores)	
		Dr.	Cr.
Current liabilities A/c	Dr.	100	
Loan fund (secured) A/c	Dr.	100	
Provision for depreciation A/c	Dr.	100	
Loss on reconstruction (Balancing figure)	Dr.	300	
To Property, Plant and Equipment A/c			300
To Current assets A/c			300
(Being the assets and liabilities of Mini division taken out of the books on transfer of the division to Mini Ltd., the consideration being allotment to the members of the company of one equity share of ₹ 10 each of that company at par for every share held in the company vide scheme of reorganisation)			

Note : Any other alternatives set of entries, with the same net effect on various accounts, may be given by the students. In the absence of additional information on fair value of the assets transferred it has been assumed that the group of shareholders control both the demerged and the resultant entity. It is expected that students should evaluate all reorganization from common control parameters and aptly highlight the assumptions in the note while solving the question.

Journal of Mini Ltd.

		(₹ in crores)	
		Dr.	Cr.
Property, Plant and Equipment (300-100) A/c	Dr.	200	
Current assets A/c	Dr.	300	
To Current Liabilities A/c			100
To Secured loan funds A/c			100
To Equity share capital A/c			50
To Capital reserve			250
(Being the assets and liabilities of Mini division of Maxi Mini Ltd. taken over and allotment of 5 crores equity shares of ₹ 10 each at par as fully paid up to the members of Maxi Mini Ltd.)			

Maxi Mini Ltd.

Balance Sheet as at 1st November, 20X2

₹ in crore

ASSETS	Note No.	After Reconstruction	Before Reconstruction
Non-current assets			
Property, Plant and Equipment	2	100	300
Current assets			
Other current assets		400	700
		500	1,000
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		50	50
Other equity	1	350	650
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings		-	100
Current liabilities			
Current liabilities		100	200
		500	1,000

Notes to Accounts

	After Reconstruction	Before Reconstruction
1. Other Equity		
Other Equity	650	650
Less: Loss on reconstruction	(300)	---
	350	650
2. Property, Plant and Equipment	600	900
Less: Depreciation	(500)	(600)
	100	300

Notes to Accounts: Consequent on reconstruction of the company and transfer of Mini division to newly incorporated company Mini Ltd., the members of the company have been allotted 5 crores equity shares of ₹ 10 each at part of Mini Ltd. The demerged entity and the resultant entity are common control and accordingly the transaction has been accounted at book values of the assets transferred in both the entity.

Mini Ltd.

Balance Sheet as at 1st November, 20X2

₹ in crore

ASSETS	Note No.	After reconstruction
Non-current assets		
Property, Plant and Equipment		200
Current assets		
Other current assets		300
		500
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		50
Other equity (capital reserve)		250
Liabilities		
Non-current liabilities		

Financial liabilities		
Borrowings		
Current liabilities		100
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	
(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.)	50

b) Net Asset Value of an equity share

	Pre-demerger	Post-demerger
Maxi Mini Ltd. :	₹ 700 crores / 5 crores = ₹ 140	₹ 400 crores / 5 crores = ₹ 80
Mini Ltd.:	-	₹ 300 crores / 5 crores = ₹ 60

- c) Demerger into two companies has had no impact on "net asset value" of shareholding. Pre- demerger, it was ₹ 140 per share. After demerger, it is ₹ 80 plus ₹ 60 i.e. ₹ 140 per original share. It is only yield valuation that is expected to change because of separate focusing on two distinct businesses whereby profitability is likely to improve on account of demerger.

Illustration 38 – (Past Exam Dec'21) (MTP May'23)

AX Ltd. and BX Ltd. amalgamated on and from 1st January, 20X2. A new Company ABX Ltd. with shares of ₹10 each was formed to take over the businesses of the existing companies.

Summarized Balance Sheet as on 31-12-20X2

(₹ in '000)

ASSETS	Note No.	AX Ltd	BX Ltd
Non-current assets			
Property, Plant and Equipment		8,500	7,500
Financial assets			
Investment		1,050	550
Current assets			
Inventory		1,250	2,750
Trade receivables		1,800	4,000
Cash and Cash equivalent		450	400
		13,050	15,200
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		6,000	7,000
Other equity		3,050	2,700
Liabilities	1		
Non-current liabilities			

Financial liabilities			
Borrowings (12% Debentures)		3,000	4,000
Current liabilities			
Trade payables		1,000	1,500
		13,050	15,200

Note:

1.	Other equity	AX Ltd	BX Ltd
	General Reserve	1,500	2,000
	Profit & Loss	1,000	500
	Investment Allowance Reserve	500	100
	Export Profit Reserve	50	100
		3,050	2,700

ABX Ltd. issued requisite number of shares to discharge the claims of the equity shareholders of the transferor companies. Also the new debentures were issued in exchange of the old series of both the companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd:

- Assuming that both the entities are under common control
- Assuming BX Ltd is a larger entity and their management will take the control of the entity ABX Ltd.

The fair value of net assets of AX and BX limited are as follows:

Assets	AX Ltd. ('000)	BX Ltd. ('000)
Property, Plant and Equipment	9,500	1,000
Inventory	1,300	2,900
Fair value of the business	11,000	14,000

Note: (In Exam, Only Part B was asked)

(14 Marks)

Solution:

- (Assumption: Common control transaction)

- Calculation of Purchase Consideration

		AX Ltd.		BX Ltd.
		₹ '000		₹ '000
Assets taken over:				
Property, Plant and Equipment		85,00		75,00
Investment		10,50		5,50
Inventory		12,50		27,50
Trade receivables		18,00		40,00
Cash & Cash equivalent		4,50		4,00
Gross Assets		130,50		152,00
Less : Liabilities				
12% Debentures	30,00		40,00	
Trade payables	10,00	(40,00)	15,00	(55,00)

Net Assets taken over		90,50		97,00
Less: Other Equity:				
General Reserve	15,00		20,00	
P & L A/c	10,00		5,00	
Investment Allowance Reserve	5,00		1,00	
Export Profit Reserve	50	(30,50)	1,00	(27,00)
Purchase Consideration		60,00		70,00

Total Purchase Consideration = 130,00 (60,00 of AX Ltd. & 70,00 of BX Ltd.)

2) Discharge of Purchase Consideration

No. of shares to be issued to AX Ltd =

$$\frac{\text{Net Assets taken over of AX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}} \times \text{Purchase Consideration}$$

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.	BX Ltd.
	₹ '000	₹ '000
$130,00 \times \frac{90,50}{187,50} = 6,27,500$ * Equity shares of ₹ 10 each	62,75	67,25
$130,00 \times \frac{97,00}{187,50} = 6,72,500$ Equity shares of ₹ 10 each		

Note: 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.

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

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 i.e. 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 (i.e. 14,000 thousand / 700 thousand shares) = ₹ 11,000 thousand.

Balance Sheet of ABX Ltd. as on 1.1.20X2

₹ in '000

ASSETS		Note No.	Amount
Non-current assets			
Goodwill (Refer Working Note)			900
Property, Plant and Equipment (9500+7500)			17,000
Financial assets			
Investment (1050+550)			1,600
Current assets			
Inventory (1300+2750)			4,050
Trade receivables (1800+4000)			5,800
Cash and Cash equivalent (450+400)			850
			30,200
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		1	12,500
Other equity		2	8,200
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings (12% Debentures)		3	7,000
Current liabilities			
Trade payables			2,500
			30,200

Notes to Accounts

	(₹ 000)	(₹ 000)
1. Share Capital		
1,250,000 Equity Shares of ₹10 each (700,000 to BX Ltd and 550,000 as computed above to AX LTD)		1,25,00
2. Other Equity		
General reserve of BX Ltd	20,00	
P&L of BX Ltd	5,00	
Export Profit Reserve of BX Ltd	1,00	
Investment Allowance Reserve of BX Ltd	1,00	
Security Premium (550 shares x 10)	5,500	8,200
3. Long Term Borrowings		
12% Debentures		70,00

Working Note:

Goodwill Computation:

Assets:		₹ in 000s
Property, Plant and Equipment		9,500
Investment		1,050
Inventory		1,300

Trade Receivable	1,800
Cash & Cash Equivalent	450
Total Assets	14,100
Less : Liabilities:	
Borrowings	3,000
Trade Payable	1,000
Net Assets	10,100
Purchase Consideration	11,000
Goodwill	900

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?

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 acquiree. In the above scenario, the acquisition date will be 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 i.e. the market price on that date. Hence total purchase consideration would be ₹ 10,80,000 (i.e. 12,000 shares x ₹ 90).

Illustration 40 – (MTP – April, 2021), (Past Exam May'22)

The balance sheet of Professional Ltd. and Dynamic Ltd. as of 31st March, 20X2 is given below:

Assets	Professional Ltd	Dynamic Ltd
Non-Current Assets:		
Property, plant and equipment	300	500

Investment	400	100
Current assets:		
Inventories	250	150
Financial assets		
Trade receivables	450	300
Cash and cash equivalents	200	100
Others	400	230
Total	2,000	1,380
Equity and Liabilities		
Equity		
Share capital- Equity shares of ₹ 100 each of Dynamic Ltd. and ₹ 10 each of Professional Ltd.	500	400
Other Equity	810	225
Non-Current liabilities:		
Long term borrowings	250	200
Long term provisions	50	70
Deferred tax	40	35
Current Liabilities:		
Short term borrowings	100	150
Trade payables	250	300
Total	2,000	1,380

Other information:

- a. Professional Ltd. acquired 70% shares of Dynamic Ltd. on 1st April, 20X2 by issuing its own shares in the ratio of 1 share of Professional Ltd. for every 2 shares of Dynamic Ltd. The fair value of the shares of Professional Ltd was ₹40 per share.
- b. The fair value exercise resulted in the following: (all nos. in Lakh)
 - a. Fair value of PPE on 1st April, 20X2 was ₹350 lakhs.
 - b. Professional Ltd also agreed to pay an additional payment as consideration that is higher of 35 lakh and 25% of any excess profits in the first year, after acquisition, over its profits in the preceding 12 months made by Dynamic Ltd. This additional amount will be due after 2 years. Dynamic Ltd has earned ₹10 lakh profit in the preceding year and expects to earn another ₹20 Lakh.
 - c. In addition to above, Professional Ltd also had agreed to pay one of the founder shareholder a payment of ₹20 lakh provided he stays with the Company for two year after the acquisition.
 - d. Dynamic Ltd had certain equity settled share based payment award (original award) which got replaced by the new awards issued by Professional Ltd. As per the original term the vesting period was 4 years and as of the acquisition date the employees of Dynamic Ltd have already served 2 years of service. As per the replaced awards the vesting period has been reduced to one year (one year from the acquisition date). The fair value of the award on the acquisition date was as follows:
 - i. Original award - ₹5 lakh
 - ii. Replacement award - ₹8 lakh.
 - e. Dynamic Ltd had a lawsuit pending with a customer who had made a claim of ₹ 50 lakh. Management reliably estimated the fair value of the liability to be ₹ 5 lakh.
 - f. The applicable tax rate for both entities is 30%.

You are required to prepare opening consolidated balance sheet of Professional Ltd as on 1st April, 20X2. Assume 10% discount rate. (15 Marks)

Solution:

Consolidated Balance Sheet of Professional Ltd as on 1st April, 20X2

(₹ in Lakhs)

	Amount
Assets	
Non-Current Assets:	
Property, plant and equipment	650
Investment	500
Current assets:	
Inventories	400
Financial assets:	
Trade receivables	750
Cash and cash equivalents	300
Others	630
Total	3,230
Equity and Liabilities	
Equity	
Share capital- Equity shares of ₹ 100 each	514
Other Equity	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:

- Fair value adjustment- As per Ind AS 103, the acquirer is required to record the assets and liabilities at their respective fair value. Accordingly, the PPE will be recorded at ₹ 350 lakhs.
- The value of replacement award is allocated between consideration transferred and post combination expense. The portion attributable to purchase consideration is determined based on the fair value of the replacement award for the service rendered till the date of the acquisition. Accordingly, 2.5 (5 x 2/4) is considered as a part of purchase consideration and is credited to Professional Ltd equity as this will be settled in its own equity. 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)
- There is a difference between contingent consideration and deferred consideration. In the given case 35 is the minimum payment to be paid after 2 years and accordingly will be considered as deferred consideration. The other element is if company meet certain target then they will get 25% of that or 35 whichever is higher. In the given case since the minimum what is expected to be paid the fair value of the contingent consideration has been considered as zero. The impact of time value on deferred consideration has been given @ 10%.

- d) The additional consideration of ₹ 20 lakhs to be paid to the founder shareholder is contingent to him/her continuing in employment and hence this will be considered as employee compensation and will be recorded as post combination expenses in the income statement of Dynamic Ltd.

Working 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 Rs. per share		40
		Rs. 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 ie: (5 x 2 / 4) (C)		2.50
PC in lakhs (A+B+C)		87.43

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	
Capital Reserve (Net assets - NCI - PC)		274.12	

Purchase consideration (PC)

87.43

3. Computation of consolidated amounts of Consolidated financial statements

	Professional Ltd	Dynamic Ltd (pre-acquisition)	PPA Allocation	Total
Assets				
Non-Current Assets:				
Property, plant and equipment	300	500	(150)	650
Investment	400	100		500
Current assets:				
Inventories	250	150		400
Financial assets:				
Trade receivables	450	300		750
Cash and cash equivalents	200	100		300
Others	400	230		630
Total	2,000	1,380	(150)	3230

Equity and Liabilities				
Equity				
Share capital- Equity shares of ₹ 100 each	500			
Shares allotted to Dynamic Ltd. (2,00,000 x 70% x ₹ 10 per share)			14	514
Other Equity	810		318.62	1128.62
Replacement award			2.5	2.5
Security Premium (2,00,000 shares x 70% x ₹ 30)			42	42
Capital Reserve			274.12	274.12
Non-controlling interest	0		154.95	154.95
Non-Current liabilities:				
Long term borrowings	250	200		450
Long term provisions	50	70	28.93	148.93
Deferred tax	40	35	(46.5)	28.5
Current Liabilities:				
Short term borrowings	100	150		250
Trade payable	250	300	0	550
Liability for lawsuit damages			5	5
Total	2,000	755	475	3230

Illustration 41 – (Past Exam – Nov 2020)

Company A and Company B are in power business. Company A holds 25% of equity shares of Company B. On 1st November, Company A obtains control of Company B when it acquires a further 65% of Company B's shares, thereby resulting in a total holding of 90%. The acquisition had the following features:

- **Consideration:** Company A transfers cash of ₹59,00,000 and issues 1,00,000 shares on 1st November. The market price of Company A's shares on the date of issue is ₹10 per share. The equity shares issued as per this transaction will comprise 5% of the post-acquisition equity capital of Company A.
- **Contingent consideration:** Company A agrees to pay additional consideration of ₹7,00,000 if the cumulative profits of Company B exceed ₹ 70,00,000 over the next two years. At the acquisition date, it is not considered probable that the extra consideration will be paid. The fair value of the contingent consideration is determined to be ₹3,00,000 at the acquisition date.
- **Transaction costs:** Company A pays acquisition-related costs of ₹ 1,00,000.
- **Non-controlling interests (NCI):** The fair value of the NCI is determined to be ₹7,50,000 at the acquisition date based on market prices. Company A elects to measure non-controlling interest at fair value for this transaction.
- **Previously held non-controlling equity interest:** Company A has owned 25% of the shares in Company B for several years. At 1st November, the investment is included in Company A's consolidated balance sheets at ₹6,00,000, accounted for using the equity method; the fair value is ₹20,00,000.

The fair value of Company B's net identifiable assets at 1st November is ₹60,00,000, determined in accordance with IND AS 103.

Determine the accounting under acquisition method for the business combination by Company A.

Solution:

8 Marks

Identify the acquirer

In this case, Company A has paid cash consideration to shareholders of Company B. Further, the shares issued to Company B pursuant to the acquisition do not transfer control of Company A to erstwhile shareholders of Company B. Therefore, Company A is the acquirer and Company B is the acquiree.

Determine acquisition date

As the control over the business of Company B is transferred to Company A on 1st November, that date is considered as the acquisition date.

Determine the purchase consideration

The purchase consideration in this case will comprise the following:

Cash consideration	₹ 59,00,000
Equity shares issued (1,00,000 x 10 i.e., at fair value)	₹ 10,00,000
Contingent consideration (at fair value)	₹ 3,00,000
Fair value of previously held interest	₹ 20,00,000

As such, the total purchase consideration is ₹ 92,00,000.

Acquisition cost incurred by and on behalf of the Company A for acquisition of Company B should be recognised in the Statement of profit and loss. As such, an amount of ₹ 1,00,000 should be recognised in Statement of profit and loss.

Determine fair value of identifiable assets and liabilities

The fair value of identifiable net assets is determined at ₹ 60,00,000.

Measure NCI

The management has decided to recognise the NCI at its fair value. As such, the NCI will be recognised at ₹ 7,50,000.

Re-measure previously held interests in case business combination is achieved in stages

In this case, the control has been acquired in stages i.e., before acquisition to control, the Company A exercised significant influence over Company B. As such, the previously held interest should be measured at fair value and the difference between the fair value and the carrying amount as at the acquisition date should be recognised in Statement of Profit and Loss. As such, an amount of ₹ 14,00,000 (i.e., 20,00,000 less 6,00,000) will be recognised in Statement of profit and loss.

Determination of goodwill or gain on bargain purchase

Goodwill should be calculated as follows:

Total consideration	92,00,000
Recognised amount of any non-controlling interest	7,50,000
Less: fair value of Lila-Domestic's net identifiable assets	(60,00,000)
Goodwill	39,50,000

Illustration 42

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.

Calculate the fair value of the consideration transferred measure goodwill and prepare consolidated balance sheet as on 31st December, 20X1

Solution:

Identifying the acquirer

As a result of Entity A issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (i.e., 150 of the 250 total issued shares). The remaining 40 per cent are owned by Entity A's shareholders. Thus, the transaction is determined to be a reverse acquisition in which Entity B is identified as the accounting acquirer while Entity A is the legal acquirer.

Calculating the fair value of the consideration transferred

If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B — 60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is 1,600 (40 shares with a fair value per share of 40).

The fair value of the consideration effectively transferred should be based on the most reliable measure. Here, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A's shares — 100 shares with a fair value per share of 16.

Measuring goodwill

Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognised identifiable assets and liabilities, as follows:

Consideration effectively transferred		1,600
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill		300

Consolidated balance sheet at 31st December, 20X1

The consolidated balance sheet immediately after the business combination is:

Current assets [700 + 500]	1,200
Non-current assets [3,000 + 1,500]	4,500
Goodwill	300
Total assets	6,000
Current liabilities [600 + 300]	900
Non-current liabilities [1,100 + 400]	1,500
Total liabilities	2,400
Shareholders' equity	

Issued equity 250 ordinary shares [600 + 1,600]	2,200
Retained earnings	1,400
Total shareholders' equity	3,600
Total liabilities and shareholders' equity	6,000

The amount recognised as issued equity interests in the consolidated financial statements (₹ 2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (₹ 600) and the fair value of the consideration effectively transferred (₹ 1,600). However, the equity structure appearing in the consolidated financial statements (i.e., the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to effect the combination.

Illustration 43

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.

Solution:

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 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.

Illustration 44

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

Solution:

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%)

Illustration 45

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.

Solution:

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.

Illustration 46

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.

Solution:

The amount of B's identifiable net assets exceeds the fair value of the consideration transferred plus the fair value of the NCI in B, resulting in an initial indication of a gain on a bargain purchase. Accordingly, A reviews the procedures it used to identify and measure the identifiable net assets acquired, to measure the fair value of both the NCI and the consideration transferred, and to identify transactions that were not part of the business combination.

Following that review, A concludes that the procedures followed and the resulting measurements were appropriate.

	(₹)
Identifiable net assets	1,00,00,000
Less: Consideration transferred	(50,00,000)
NCI (10 million x 30%)	(30,00,000)
Gain on bargain purchase	20,00,000

Illustration 47

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?

Solution:

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.

Illustration 48

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 an 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?

Solution:

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 lakhs	₹ in lakhs
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 amount of the non

controlling interest would be ₹ 80 ($₹ 400 \times 0.20$). The gain on the bargain purchase then would be ₹ 20 ($₹ 400 - (₹ 300 + ₹ 80)$)

Illustration 49 - (RTP – Nov, 2018), (Past Exam May'22)

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.
- 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.

(5 Marks)

Solution:

Computation of goodwill impairment

	NCI at fair value	NCI at of net assets
	₹ in '000	₹ in '000
Cost of investment		
Share exchange ($12,000 \times 75\% \times 2/3 \times ₹ 6.50$)	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 – $3000 \times ₹ 6$	18,000	
% of net assets – $68,000$ (Refer W.N.) $\times 25\%$		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 $[20\% \times (70,000 - 60,000)]$	(2,000)
	<u>68,000</u>

Illustration 50 – (RTP MAY'19, Nov'22)

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 1 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:
 - an immediate issuance of 10 lakhs shares of A Ltd. having face value of INR 10 per share;
 - 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 INR 1 crore.
 - The fair value of the shares of A Ltd. on the date of acquisition is INR 20 per share. Further, the management has estimated that on the date of acquisition, the fair value of contingent consideration is ₹ 25 lakhs.
 - During the year ended 31 March 20X2, the profit before interest and tax of B Ltd. exceeded ₹ 1 crore. As on 31 March 20X2, the fair value of shares of A Ltd. is ₹ 25 per share.
- Continuing with the fact pattern in (a) above except for:
 - The number of shares to be issued after one year is not fixed.
 - 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.

Solution:

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 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.

- 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 fulfillment 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.

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.

2. The amount of purchase consideration to be recognized on initial recognition shall be as follows:

Fair value 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.

Illustration 51

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:

- 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.

Solution:

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 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 i.e. ₹ 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 Rs. 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

Illustration 52 - (MTP - March 2019 + RTP Nov 2019)

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
1 st November, 2016	15%	The shares were purchased based on the quoted price on the stock exchange on the relevant dates.
1 st January, 2017	45%	

Both the above-mentioned companies have INR as their functional currency. Consequently, H Ltd. acquired control over S Ltd. on 1st January, 2017. Following is the Balance Sheet of S Ltd. as on that date:

Particulars	Carrying value (Rs. in crore)	Fair value (Rs. in crore)
ASSETS:		
<u>Non-current assets</u>		
(a) Property, plant and equipment	40.0	90.0
(b) Intangible assets	20.0	30.0
(c) Financial assets	100.0	350.0
- Investments		
<u>Current assets</u>		
(a) Inventories	20.0	20.0
(b) Financial assets		
- Trade receivables	20.0	20.0
- Cash held in functional currency	4.0	4.5
(c) Other current assets		
Non-current asset held for sale	4.0	4.5
TOTAL ASSETS	208	
EQUITY AND LIABILITIES:		
<u>Equity</u>		
(a) Share capital (face value Rs.100)	12.0	50.4
(b) Other equity	141.0	Not applicable
<u>Non-current liabilities</u>		
(a) Financial liabilities- Borrowings	20.0	20.0
<u>Current liabilities</u>		
(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, 2017:

Particulars	Fair value (Rs. in crore)	Remarks

Law suit filed by a customer for a claim of Rs. 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 in respect of law suit will be tax deductible.
Income tax demand of Rs. 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 Rs. 1 crore.

Rs. 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 Rs. 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, 2017, 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, 2017 is Rs. 10,000 per share.

On 1st January, 2017, H Ltd. has paid Rs. 50 crore in cash to the selling shareholders of S Ltd. Additionally, on 31st March, 2019, H Ltd. will pay Rs. 30 crore to the selling shareholders of S Ltd. if return on equity of S Ltd. for the year ended 31st March, 2019 is more than 25% per annum. H Ltd. has estimated the fair value of this obligation as on 1st January, 2017 and 31st March, 2017 as Rs. 22 crore and Rs. 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, 2016	Rs. 350 per share
As on 1st January, 2017	Rs. 395 per share
As on 31st March, 2017	Rs. 420 per share

On 31st May, 2017, H Ltd. learned that certain customer relationships existing as on 1st January, 2017, 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, 2017. The fair value of such customer relationships as on 1st January, 2017 was Rs. 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, 2017 itself, H Ltd. further learned that due to additional customer relationships being developed during the period 1st January, 2017 to 31st March, 2017, the fair value of such customer relationships has increased to Rs. 4 crore as on 31st March, 2017.

On 31st December, 2017, 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, 2017. 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, 2017? If yes, provide relevant journal entries.

(c) What should be the accounting treatment of the contingent consideration as on 31st March, 2017?

Solution:

(i) 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 required to settle the obligation. Hence H Ltd. will recognize contingent liability of Rs. 2.5 cr.

Since S Ltd. has indemnified for Rs. 1 cr., H Ltd. shall recognise an indemnification asset at the same time for Rs. 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.

(ii) 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.

(iii) 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

Rs. in lakh

Investment in S Ltd.			
On 1 st Nov. 2016	15 %	$[(12/100) \times 395 \times 15\%]$	7.11
On 1 st Jan. 2017	45 %		
Own equity given		$10,000 \times 12\% \times 45\% \times 1/2$	270
Cash			50
Contingent consideration			<u>22</u>
			<u>349.11</u>

(iv) Calculation of defer tax on assets and liabilities acquired as part of the business combination, including current tax and goodwill.

Item	Rs. 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)
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	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)

(v) Calculation of identifiable net assets acquired

	Rs. in crore	Rs. 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

(a) Calculation of NCI by proportionate share of net assets

Net identifiable assets of S Ltd. on 1.1.2017 (Refer W.N.3) = 372.85 crore

NCI on 1.1.2017 = 368.65 crore x 40% = 147.46 crore

Calculation of Goodwill as per Ind AS 103

Goodwill on 1.1.2017 = Purchase consideration + NCI – Net assets

$$= 349.11 + 147.46 - 368.65$$

$$= 127.92 \text{ crore}$$

(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.

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, 2017, 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, 2017.

On 31st May, 2017 (ie within the measurement period), H Ltd. learned that certain customer relationships existing as on 1st January, 2017 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, 2017. Therefore, H Ltd. shall account for the acquisition date fair value of customer relations existing on 1st January, 2017 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, 2017 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 shall be recognised in profit or loss. Change in Fair value of contingent consideration (23 -22) Rs. 1 crore will be recognized in the Statement of Profit and Loss.

Illustration 53 – (RTP Dec'21), (MTP Nov'22)

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.

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 has not been improved in subsequent months and therefore company Z has 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
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.

(20 Marks)**Solution**

- (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.

(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
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
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

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	Carrying Value 33.33% Share	Acquisition Date Value	Remarks
	30.6.20X1			
	₹	₹	₹	
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

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.

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 through unincorporated joint arrangement, this is not a case of step acquisition.

Illustration 54

Entity X acquired entity Y in a business combination as per Ind AS 103. There is an existing share-based plan in entity Y with a vesting condition for 3 years in which 2 years have already lapsed at the date of such business acquisition. Entity X agrees to replace the existing award for the employees of combined entity. The details are as below -

Acquisition date fair value of share-based payment plan	₹300
No. of years to vest after acquisition	1 year
Fair Value of award which replaces existing plan	₹400

Calculate the share-based payment values as per Ind AS 102?

Solution:

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 × 2 = ₹ 200

Value to be recorded as per Ind AS 102 (A) = ₹ 300/3 × 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.

Question 1 - (MTP Aug'18)

In March 2018, Pharma Ltd. acquires Dorman Ltd. in a business combination for a total cost of Rs. 12,000 lakhs. At that time Dorman Ltd.'s assets and liabilities are as follows:

Item	Rs. in lakhs
Assets	
Cash	780
Receivables (net)	5,200
Plant and equipment	7,000
Deferred tax asset	360
Liabilities	
Payables	1,050
Borrowings	4,900
Employee entitlement liabilities	900
Deferred tax liability	300

The plant and equipment has a fair value of Rs. 8,000 lakhs and a tax written down value of Rs. 6,000 lakhs. The receivables are short-term trade receivables net of a doubtful debts allowance of Rs. 300 lakhs.

Bad debts are deductible for tax purposes when written off against the allowance account by Dorman Ltd. Employee benefit liabilities are deductible for tax when paid.

Dorman Ltd. owns a popular brand name that meets the recognition criteria for intangible assets under Ind AS 103 'Business Combinations'. Independent valuers have attributed a fair value of Rs. 4,300 lakhs for the brand. However, the brand does not have any cost for tax purposes and no tax deductions are available for the same.

The tax rate of 30% can be considered for all items. Assume that unless otherwise stated, all items have a fair value and tax base equal to their carrying amounts at the acquisition date.

You are required to:

- Calculate deferred tax assets and liabilities arising from the business combination (do not offset deferred tax assets and liabilities).
- Calculate the goodwill that should be accounted on consolidation.

SOLUTION:

Breakdown of assets and liabilities acquired as part of the business combination, including deferred taxes and goodwill.

Item	Rs. in lakhs				
	Book value	Fair value	Tax base	Taxable (deductible) temporary difference	Deferred tax asset (liability) @ 30%
Cash	780	780 ⁽¹⁾	780 ⁽¹⁾	-	-
Receivables	5,200	5,200 ⁽¹⁾	5,500 ⁽³⁾	(300)	90
Plant and equipment	7,000	8,000 ⁽²⁾	6,000 ⁽⁴⁾	2,000	(600)
Brands		4,300 ⁽²⁾	- ⁽⁵⁾	4,300	(1,290)
Goodwill (Balancing figure)		2,100 ⁽⁶⁾			
Deferred tax asset	360	3,60 ⁽⁷⁾			

Total assets		20,740			
Payables	(1,050)	(1,050) ⁽¹⁾	(1,050) ⁽¹⁾		
Borrowings	(4,900)	(4,900) ⁽¹⁾	(4,900) ⁽¹⁾		
Employee Entitlement liabilities	(900)	(900) ⁽¹⁾		(900)	270
Deferred tax liability	(300)	(1,890) ⁽⁸⁾			
Total liabilities		(8,740)			
Consideration paid		12,000			

Notes

(1) This amount has been derived from Dorman Ltd.'s Balance Sheet as it is stated that 'unless otherwise stated, all items have a fair value and tax base equal to their carrying amounts in Dorman Ltd.'s Balance Sheet at the acquisition date'.

(2) Stated fair value in the fact pattern (different to the carrying amount in Dorman Ltd.'s Balance Sheet at the acquisition date).

(3) Because bad debts are only deductible when written off against the allowance account by Dorman Ltd. the tax base of the receivables is their gross value, i.e., (Rs. 5,200 + Rs. 300) lakhs allowance account.

(4) Tax written down value of the plant and equipment as stated in the fact pattern.

(5) As the brand name does not have a cost for tax purposes and no tax deduction is available in relation to it, its tax base is nil.

(6) As the employee entitlement liabilities are only deductible for tax purposes when paid, their tax base is nil.

(7) The aggregate deferred tax asset is Rs. 360 lakhs, comprised of Rs.90 lakhs in relation to the receivables and Rs.270 lakhs in relation to the employee entitlement liabilities.

(8) The aggregate deferred tax liability is Rs. 1,890 lakhs calculated as follows:

Rs. In lakhs	DTL amount in Dorman Ltd.'s Balance Sheet	Deferred tax impact of fair value adjustments	Total DTL in Pharma Ltd's consolidated financial statements
Plant and equipment	300 $[(7,000-6,000) \times 30\%]$	300 $[(1,000 \times 30\%)]$	600
Brand names	0	1,290 $(4,300 \times 30\%)$	1,290
TOTAL	300	1,590	1,890

(9) Goodwill is effectively the 'balancing item' in the equation, applying the requirements of Ind AS 103, para 32. The consideration transferred is Rs. 12,000 lakhs and the net of the acquisition date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with Ind AS 103, including the deferred tax assets and liabilities arising, is Rs. 9,900 lakhs.

Question 2 - (RTP - November 2018)

Smart Technologies Inc. is a Company incorporated in India in 1998 having business in the field of development and installation of softwares, trading of computer peripherals and other IT related equipment and provision of cloud computing services along with other services incidental thereto. It is one of the leading brands in India.

After witnessing immense popularity and support in its niche market, Smart Technologies further grew by bringing its subsidiaries namely:

Company Name	Principle Activity
Cloudustries India Private Limited	Provision of cloud computing services.
MicroFly India Private Limited	Trading of computer peripherals like mouse, keyboard, printer etc.

Smart Technologies started preparing its financial statements based on Ind AS from 1st April, 2015 on voluntary basis. The Microfly India Pvt. Ltd. is planning to merge the business of Cloudustries India Pvt. Ltd. with its own for which it presented before the members in the meeting the below extract of latest audited Balance Sheet of Cloudustries (prepared on the basis of Ind AS) for the year ended 31st March, 2017:

Balance Sheet as at March 31, 2017**(₹ in crores)**

Assets	
Non-current assets	
Property, plant and Equipment	15.00
Current Assets	15.00
(a) Financial assets	
Trade Receivables	10.00
Cash and cash equivalents	10.00
Other current assets	8.00
	28.00
Total	43.00
Equity and Liabilities	
Equity	
Equity Share Capital	45.00
Other Equity	
Reserves and Surplus (Accumulated Losses)*	(24.80)
	20.20
Liabilities	
Non-current Liabilities	
Financial liabilities	
Borrowings	2.80
Current Liabilities	20.00
	22.80
Total	43.00

*The Tax Loss carried forward of the company is ₹ 27.20 crores

On September 5, 2017, the merger got approved by the Directors. The purchase consideration payable by MicroFly to Cloudustries was fixed at ₹ 18.00 crores payable in cash and that MicroFly take over all the assets and liabilities of Cloudustries.

Present the statement showing the calculation of assets/liabilities taken over a per Ind AS. Also mention the accounting of difference between consideration and assets/liabilities taken over.

Solution

Before the merger, Cloudustries and MicroFly are the subsidiary of Smart Technologies Inc. As the control is not transitory, the proposed merger will fall under the category of Business combination of entities under

common control, it will be accounted as per Appendix C of Ind AS 103 "Business Combination" and Pooling of Interest Method would be applied.

Statement showing the calculation of assets/liabilities taken over and treatment of difference between consideration and assets/liabilities taken over:

(a) Net asset taken over:**(in crore)**

Assets taken over:	
Property, Plant and Equipment	15.00
Cash and cash equivalents	10.00
Other current assets	8.00
Trade Receivables	10.00
Total - A	43.00
Less: Liabilities taken over:	
Borrowings	2.80
Current Liabilities	20.00
Total - B	22.80
Net Asset taken over (A-B)	20.20

(b) Treatment of difference between consideration and assets/liabilities taken over:

Net Asset taken over - A	20.20
Less: Purchase Consideration - B	18.00
Difference (A – B)	2.20

The difference between consideration and assets/liabilities taken over of ₹ 1.80 crore shall be transferred to capital reserve

Question 3 - (PAST EXAM - Nov 2019)

Parent A holds 100% in its subsidiary B. Parent A had acquired B, 10 years back and had decided to account for the acquisition under the purchase method using fair values of the subsidiary B in its consolidated financial statements.

During the current year, A decides to merge B with itself.

For the purpose of this proposed merger, what values of B should be used for accounting under the Ind AS? **(4 Marks)**

Solution:

Reference to be included to Appendix C of Ind AS 103

The acquisition of B Ltd. by A Ltd. is business combination under common control. In such a situation, pooling of interest method should be applied. However, B Ltd. is 100% subsidiary of A Ltd. and A Ltd. in its Consolidated financial statements use to give the carrying values of assets and liabilities of B Ltd. at fair value (as per acquisition under purchase method). Hence the carrying value for the purpose of pooling of interest method will be the values given in Consolidated financial statements and not in Separate financial statements.

In other words, since B Ltd. is merging with A Ltd. (i.e. parent) nothing has changed and the transaction only means that the assets, liabilities and reserves of B Ltd. which were appearing in the consolidated financial statements of Group A immediately before the merger would now be a part of the separate financial statements of A Ltd. Accordingly, it would be appropriate to recognise the carrying value of the assets, liabilities and reserves pertaining to B Ltd as appearing in the consolidated financial statements of A Ltd.

Question 4 - (RTP May'21)

Bima Ltd. acquired 65% of shares on 1 June, 20X1 in Nafa Ltd. which is engaged in production of components of machinery. Nafa Ltd. has 1,00,000 equity shares of ₹ 10 each. The quoted market price of shares of Nafa Ltd. was ₹ 12 on the date of acquisition. The fair value of Nafa Ltd.'s identifiable net assets as on 1 June, 20X1 was ₹ 80,00,000.

Bima Ltd. wired ₹ 50,00,000 in cash and issued 50,000 equity shares as purchase consideration on the date of acquisition. The quoted market price of shares of Bima Ltd. on the date of issue was ₹ 25 per share.

Bima Ltd. also agrees to pay additional consideration of ₹ 15,00,000, if the cumulative profit earned by Nafa Ltd. exceeds ₹ 1 crore over the next three years. On the date of acquisition, Nafa Ltd. assessed and determined that it is considered probable that the extra consideration will be paid. The fair value of this consideration on the date of acquisition is ₹ 9,80,000. Nafa Ltd. incurred ₹ 1,50,000 in relation to the acquisition. It measures Non-controlling interest at fair value.

How will the acquisition of Nafa Ltd. be accounted by Bima Ltd., under Ind AS 103? Prepare detailed workings and pass the necessary journal entry.

Solution:**Computation of Goodwill / Capital reserve on consolidation as per Ind AS 103**

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

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

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

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

Question 5 (RTP May'22)

Entity A acquires entity B. Entity A agrees with the former shareholders of entity B to pay ₹ 900, with an additional payment of ₹ 500 if the subsequent earnings of entity B reach a specified target in three years. The former shareholders also become employees. On the acquisition date, the fair value of the net assets of entity B amount to ₹ 850, and the fair value of additional payment is estimated at ₹ 200. At the acquisition date, the outflow of additional payment is not probable.

Over the next three years, the cumulative earnings of entity B (before considering the effects of the additional payments) amount to ₹ 1,050. At the end of year three, entity A pays ₹ 500 as the conditions were met.

State the impact on the financial position and results of classifying the payments as remuneration and contingent consideration.

Solution:

The impact on the financial position and results of classifying the payments as remuneration and contingent consideration is tabulated as follows:

	Additional Payment is classified as	
	Remuneration	Contingent consideration
Consideration	900	900
Fair value of additional payment	0	200
Total consideration	900	1,100
Fair value of net assets	(850)	(850)
Goodwill at acquisition date	50	250
Subsequent changes in additional payment	0	0
Total Goodwill	50	250
Cumulative earnings (before considering additional payment)	1,050	1,050
Impact of additional payment	(500)	(300)
Reported results across three years	550	750

Question 6 - (Past Exam Nov'19, July'21) (RTP May'19)

MNC Ltd. is in process of setting up a medicine manufacturing business which is at very initial stage. For this purpose, MNC Ltd. as part of its business expansion strategy acquired on 1st April, 2019, 100% shares of Akash Ltd., a company that manufactures pharmacy products. The purchase consideration for the same was by way of a share exchange valued at ₹ 38 crore. The fair value of Akash Ltd.'s assets and liabilities were ₹ 68 crore and ₹ 50 crore respectively, but the same does not include the following:

- A patent owned by Akash Ltd. for an established successful new drug that has a remaining life of 6 years. A consultant has estimated the value of this patent to be ₹ 8 crore. 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 ₹ 12 crore.
- Akash Ltd. has developed and patented another new drug which has been approved for clinical use. The cost of developing the drug was ₹ 13 crore. Based on early assessment of its sales success, a reputed valuer has estimated its market value at ₹ 19 crore.
- Akash 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 on 1st April, 2018 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 valuable asset which assures guaranteed sales and the cost to acquire the license is estimated at ₹ 7 crore of remaining period of life. It is expected to generate at least equivalent revenue.

Suggest the accounting treatment of the above transactions with reasoning under applicable Ind AS in the books of MNC Ltd.
(8 Marks) / (5 Marks)

Solution:

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 Akash Ltd.: The patent owned will be recognised at fair value by MNC Ltd. even though it was not recognised by Akash Ltd. in its financial statements. The patent will be amortised over the remaining useful life of the asset i.e. 6 years. Since the company is awaiting the outcome of the trials, the value of the patent should be valued at ₹ 8 crore. It cannot be estimated at ₹ 12 crore and the extra ₹ 4 crore should only be disclosed as a contingent asset and not recognised.
- ii) Patent internally developed by Akash Ltd.: Further as per para 75 of Ind AS 38 'Intangible Assets', after initial recognition, an intangible asset shall be carried at revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. For the purpose of revaluations under this Standard, fair value shall be determined by reference to an active market.
There is no active market for patents since the fair value is based on early assessment of its sale success. Hence it is suggested to use the cost model and recognise the patent at the actual development cost of ₹ 13 crore.
- iii) Grant of Licence to Akash Ltd. by the Government: As regards to the five-year license, para 44 of Ind AS 38 requires to recognize grant asset at fair value by MNC Ltd. It can recognize both the asset (license) and the grant at ₹ 7 crore to be amortised over 4 remaining years of useful life i.e; ₹ 1.75 crore per annum

Hence the revised working would be as follows:

Fair value of net assets of Akash Ltd. (68-50)	₹ 18 crore
Add: Patent (8 + 13)	₹ 21 crore
Add: License	₹ 7 crore
Less: Grant for License	(₹ 7 crore)
	₹ 39 crores
Purchase Consideration	₹ 38 crores
Capital Reserve (Gain on Bargain Purchase)	₹ 1 crore

Note: This Question is same as Illustration 51 but the treatment of Govt Grant is different

SOLVED EXAMPLE**Example 1: Reverse Acquisition**

The Balance Sheets of Entity A and Entity B immediately before business acquisition are as follows:

Particulars	Amount (₹ in thousands)	
	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.

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 (12000 Shares x 105).

Calculation of Goodwill:

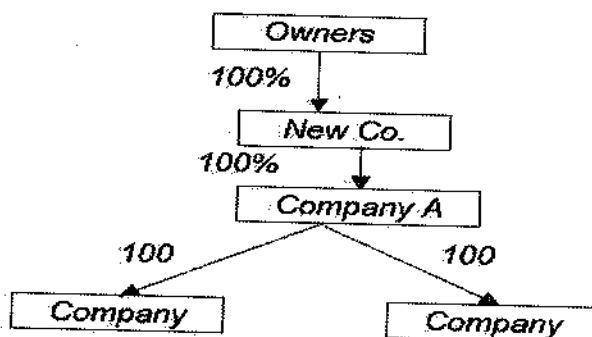
Fair value of Assets less Liabilities Assumed (Entity A) -	₹ 11,00,000
Consideration transferred (by Entity B) -	<u>(₹ 12,60,000)</u>
Goodwill -	<u>₹ 1,60,000</u>

IND AS 27 - SEPARATE FINANCIAL STATEMENTS

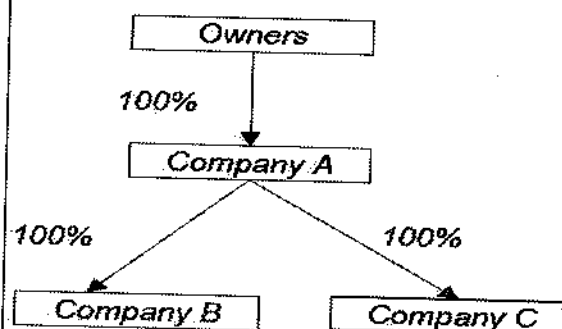
Illustration 1

Following is the existing and proposed group structure of an original parent A Ltd.

Existing structure



Proposed structure



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 the 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:

- New Co. obtains control of Company A by issuing equity instruments to the Owners in exchange for their existing equity instruments of Company A;
- the assets and liabilities of the group immediately before and the proposed restructuring will be same; and
- 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.

MOCK TEST PAPER / REVISION TEST PAPER / PAST EXAM

Question 1 - (RTP Nov'20, Dec'21)

A company, AB Ltd. holds investments in subsidiaries and associates. In its separate financial statements, AB Ltd. wants to elect to account its investments in subsidiaries at cost and the investments in associates as financial assets at fair value through profit or loss (FVTPL) in accordance with Ind AS 109, Financial Instruments. Whether AB Limited can carry investments in subsidiaries at cost and investments in associates in accordance with Ind AS 109 in its separate financial statements?

Solution:

Paragraph 10 of Ind AS 27, Separate Financial Statements inter-alia provides that, when an entity prepares separate financial statements, it shall account for investments in subsidiaries, joint ventures and associates either at cost, or in accordance with Ind AS 109, Financial Instruments in its separate financial statements. Further, the entity shall apply the same accounting for each category of investments.

It may be noted that although the 'category' is used in number of Standards, it is not defined in any of the Ind AS. It seems that subsidiaries, associates and joint ventures would qualify as separate categories. Thus, the same accounting policies are applied for each category of investments - i.e. each of subsidiaries, associates and joint ventures. However, paragraph 10 of Ind AS 27 should not be read to mean that, in all circumstances, all investments in associates are one 'category' of investment and all investments in joint ventures or an associate are one 'category' of investment. These categories can be further divided into sub-categories provided the sub-category can be defined clearly and objectively and results in information that is relevant and reliable. For example, an investment entity parent can have investment entity subsidiary (at fair value through profit or loss) and non-investment entity subsidiary (whose main purpose is to provide services that relate to the investment entity's investment activities) as separate categories in its separate financial statements. In the present case, investment in subsidiaries and associates are considered to be different categories of investments. Further, Ind AS 27 requires to account for the investment in subsidiaries, joint ventures and associates either at cost, or in accordance with Ind AS 109 for each category of Investment. Thus, AB Limited can carry its investments in subsidiaries at cost and its investments in associates as financial assets in accordance with Ind AS 109 in its separate financial statements.

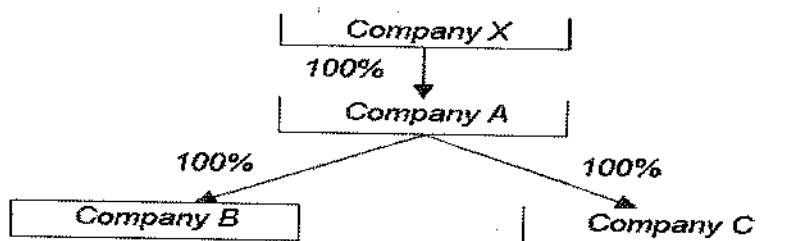
IND AS 110 – CONSOLIDATED FINANCIAL STATEMENTS

THEORETICAL QUESTIONS

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?

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.

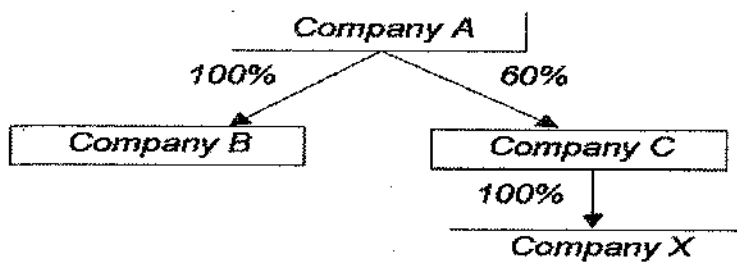
Scenario C:

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. 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.

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.

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.

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.

Illustration 6 - 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.

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.

Illustration 7 - 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 required 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.

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.

Illustration 8 - 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.

Illustration 9 - 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 retail outlet is being set up by PQR Ltd. without 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.

Illustration 10 - 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.

Illustration 11 - 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.

Illustration 12 - 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.

Illustration 13 - 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.

Illustration 14 - 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.

Illustration 15 - 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:

- 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.

Illustration 16 - 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.

Illustration 17 - 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 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.

Illustration 18 - 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 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 controls 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 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.

Illustration 19 - 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. 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.

Illustration 20 - 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.

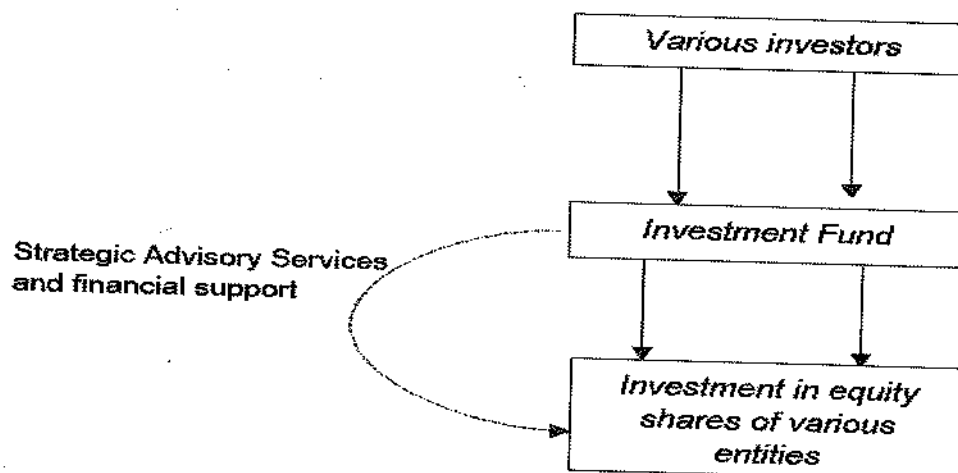
The sponsor is entitled to any residual return of the fund and also provides credit enhancement and liquidity facilities to the fund. The credit enhancement provided by the sponsor absorbs losses of up to 5% of all of the fund's assets, after losses are absorbed by the transferors. The liquidity facilities 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-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.

Illustration 21 - Business purpose of an investment entity

An asset manager has set up an 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.



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.

Illustration 22 - 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.

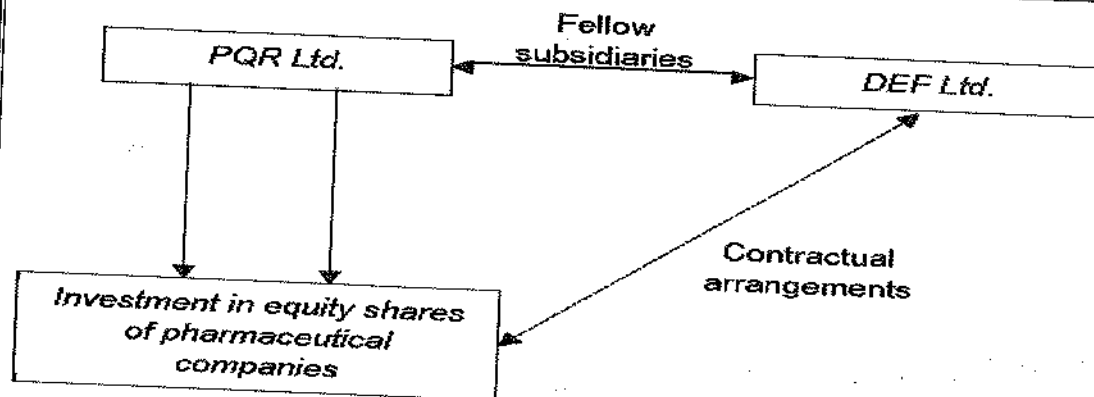
Determine whether the entity fulfils the exit strategy condition of being classified as investment entity?

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.

Illustration 23 - 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 follow 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 than 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 then 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.

Illustration 24

HTF Ltd. Was formed by T Ltd. To invest in technology start-up companies for capital appreciation. T Ltd. Holds a 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:

- 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
- 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.

PRACTICAL QUESTIONS**Illustration 25 - 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

<u>Fair value method</u>	₹ crore
Fair value of consideration transferred	120
Fair value of non-controlling interest	<u>30</u>
	150
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(130)</u>
Goodwill	20
<u>Proportionate share method</u>	₹ crore
Fair value of consideration transferred	120
Proportional share of non-controlling interest in the net identifiable assets of acquiree (130 x 20%)	26
	<u>146</u>
Value of subsidiary's identifiable net assets as per Ind AS 103	<u>(130)</u>
Goodwill	16

Journal entries

<u>Fair value method</u>		₹ crore	
		Dr.	Cr.
Net identifiable assets	Dr.	130	
Goodwill	Dr.	20	
To Cash			120
To Non-controlling interest			30
<u>Proportionate share method</u>		₹ crore	
		Dr.	Cr.
Net identifiable assets	Dr.	130	
Goodwill	Dr.	16	
To Cash			120
To Non-controlling interest			26

Illustration 26 - 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	
Fair value of consideration transferred	₹ lakh
Fair value of non-controlling interest	750
Fair value of non-controlling interest	<u>480</u>
Value of subsidiary's identifiable net assets as per Ind AS 103	1,230
Goodwill	<u>(1,000)</u>
	<u>230</u>

Proportionate share method	
Fair value of consideration transferred	₹ lakh
Proportional share of non-controlling interest in the net identifiable assets of acquiree (1,000 x 40%)	750
	<u>400</u>
Value of subsidiary's identifiable net assets as per Ind AS 103	1,150
Goodwill	<u>(1,000)</u>
	<u>150</u>

Journal entries

Fair value method		₹ lakh	
Net identifiable assets	Dr.	Dr.	Cr.
Goodwill	Dr.	1,000	
To Cash		230	
To Non-controlling interest			750
			480
Proportionate share method		₹ lakh	
Net identifiable assets	Dr.	Dr.	Cr.
Goodwill	Dr.	1,000	
To Cash		150	
To Non-controlling interest			750
			400

Illustration 27 - 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 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 gain on bargain purchase will be different under both the methods. The gain is calculated as per both the methods below:

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.

Illustration 28 - 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

Illustration 29 - 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 is ₹ 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
Net identifiable assets Dr.	Dr. 800	Cr.
Goodwill Dr.	200	
To Cash		
To Investment in associate		700
To Gain on fair valuation of previously held equity interest		100
		200

Illustration 30 - 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.

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 31 - 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 requires an entity to apply uniform accounting policies "for like transactions and events in similar circumstances". If any member of the group follows a different accounting policy for like transactions and events in similar circumstances, appropriate adjustments are to be made in preparing consolidated financial statements.

Paragraph 5 of Ind AS 8 defines accounting policies as "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements."

Ind AS 2 requires inventories to be measured at the lower of cost and net realisable value.

Paragraph 25 of Ind AS 2 states that the cost of inventories shall be assigned by using FIFO or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Elaborating on the requirements of paragraph 25, paragraph 26 of Ind AS 2 illustrates that inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

Paragraph 36(a) of Ind AS 2 requires disclosure of "the accounting policies adopted in measuring inventories, including the cost formula used". Thus, as per Ind AS 2, the cost formula applied in valuing inventories is also an accounting policy.

As mentioned earlier, as per Ind AS 2, different cost formulas may be justified for inventories of a different nature or use. Thus, if inventories of S Limited and A Limited differ in nature or use from inventories of H Limited, then use of cost formula (weighted average cost) different from that applied in respect of inventories of H Limited (FIFO) in consolidated financial statements may be justified. In other words, in such

a case, no adjustment needs to be made to align the cost formula applied by S Limited and A Limited to cost formula applied by H Limited.

Illustration 32 - 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 noncurrent in its balance sheet. The financial year end of the parent's consolidated financial statements is 31st March 31, 20X3. Due to the time lag, the subsidiary's payable falls due within 12 months from the end of the parent's reporting period.

Accordingly, in this case, the payable should be classified as a current liability in the consolidated financial statements of the parent because the amount is repayable within nine months of the end of the parent's reporting period.

Illustration 33 – 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 in the year 20X9. However, during the year ended 31st March, 20X2, it breached one of the conditions of the loan, as a consequence of which the loan became repayable on demand on the reporting date. Subsequent to year end but before the approval of the financial statements, B Inc. rectified the breach and the bank agreed not to demand repayment and to let the loan run for its remaining period to maturity as per the original loan terms. While preparing its standalone financial statements as per IFRS, B Inc. has classified this loan as a current liability in accordance with IAS 1, Presentation of Financial Statements.

Whether A limited is required to classify such loan as current while preparing its consolidated financial statement under Ind AS?

Solution:

As per paragraph 74 of Ind AS 1, where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

The above position under Ind AS 1 differs from the corresponding position under IAS 1. As per paragraph 74 of IAS 1, when an entity breaches a provision of a long-term loan arrangement on or before the end of

the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.

Accordingly, the loan liability recognised as current liability by B Inc. in its standalone financial statements prepared as per IFRS, should be aligned as per Ind AS in the consolidated financial statements of A Limited and should be classified as non-current in the consolidated financial statements of A Limited in accordance with Ind AS 1.

Illustration 34 – 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 & 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

		₹	₹
Bank A/c	Dr.	24,000	
To Profit & Loss A/c			24,000

Calculation of Non- controlling interest and Journal Entry

NCI on 1st April 20X1 = 20% of Fair value on a per-share basis of the purchased interest.

= 20% x ₹ 1,75,000 (W.N 1) = ₹ 35,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	₹
Identifiable net assets	Dr.	1,50,000	
Goodwill (Balancing Figure)	Dr.	25,000	
To Cash			1,40,000
To NCI			35,000

Working Note 1

Fair value on a per-share basis of the purchased interest / Fair Value of Identifiable net assets

= Consideration transferred x 100/80

= 1,40,000 x 100/80 = ₹ 1,75,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

$$= 35,000 + (20,000 \times 20\%) = ₹ 39,000$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received in the annual general meeting.

Illustration 35 - 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:

$$\begin{aligned} \text{NCI on 1st April 20X1} &= 20\% \text{ of Fair value of Identifiable net assets} \\ &= 20\% \times ₹ 1,50,000 = ₹ 30,000 \end{aligned}$$

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	₹
Identifiable net assets	Dr.	1,50,000	
Goodwill (Balancing Figure)	Dr.	20,000	
To Cash			1,40,000
To NCI			30,000

$$\begin{aligned} \text{NCI on 31st March 20X2} &= \text{NCI on 31st March 20X1} + \text{Share of NCI in Profits of 20X1-20X2} \\ &= 30,000 + (20,000 \times 20\%) \\ &= ₹ 34,000 \end{aligned}$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received in the AGM.

Illustration 36 - 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

$$\begin{aligned} \text{NCI on 1st April 20X1} &= 20\% \text{ of the fair value on a pre-share basis of the purchased interest.} \\ &= 20\% \times ₹ 1,75,000 (\text{W.N.1}) = ₹ 35,000 \end{aligned}$$

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

$$= \text{consideration transferred} \times 100/80$$

$$= 1,40,000 \times 100/80 = ₹ 1,75,000$$

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

$$= 35,000 + (20,000 \times 20\%) = ₹ 39,000$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

Illustration 37 - 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.

Solution:

NCI on 1st April 20X1 = 20% of the fair value on identifiable assets.

$$= 20\% \times ₹ 1,60,000 = ₹ 32,000$$

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

$$= 32,000 + (20,000 \times 20\%) = ₹ 36,000$$

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

Illustration 38 - Elimination of intra-group profit on sale of assets by a subsidiary to its parent

A parent owns 60% of a subsidiary. The subsidiary sells some inventory to the parent for ₹35,000 and makes a profit of ₹15,000 on the sale. The inventory is in the parent's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution:

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000 (₹ 35,000 - ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

The double entry on consolidation is as follows:

		₹ '000	₹'000
Consolidated Revenue	Dr	35	
To Cost of sales			20
To Inventory			15

The reduction of group profit of ₹ 15,000 is allocated between the parent company and non-controlling interest in the ratio of their interests – 60% and 40%.

Illustration 39 - Elimination of intra-group profit on sale of assets by a parent to its subsidiary

In the above illustration, assume that it is the parent that makes the sale. The parent owns 60% of a subsidiary. The parent sells some inventory to the subsidiary for ₹35,000 and makes a profit of ₹15,000. On the sale the inventory is in the subsidiary's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution:

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000. (₹ 35,000 – ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

The double entry on consolidation is follows:

	₹'000	₹'000
Consolidated Revenue A/c	Dr 35	
To Cost of sales A/c		20
To Inventory A/c		15

In this case, since it is the parent that has made the sale, the reduction in profit of ₹15,000 is allocated entirely to the parent company.

Illustration 40 - 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).

Illustration 41 - 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 42 - 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 ($\text{₹ } 20 \text{ lakh} \div 10 \text{ years}$). 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

Illustration 43 - Attribution of profit / loss to non-controlling interest

A Ltd. acquired 70% of equity shares of B Ltd. on 1.04.20X1 at cost of ₹10,00,000 when B Ltd. had an equity share capital of ₹10,00,000 and other equity of ₹80,000. In the four consecutive years B Ltd. fared badly and suffered losses of ₹2,50,000, ₹4,00,000, ₹5,00,000 and ₹1,20,000 respectively. Thereafter in 20X5 - 20X6, B Ltd. experienced turnaround and registered an annual profit of ₹50,000. In the next two years i.e. 20X6-20X7 and 20X7-20X8, B Ltd. recorded annual profits of ₹1,00,000 and ₹1,50,000 respectively. Show the non-controlling interests and goodwill at the end of each year for the purpose of consolidation.

Assume that the assets are at fair value. Ignore impairment of goodwill.

Solution:

Year	Profit/loss	Non-controlling Interest (30%)	Additional Consolidated P & L (Dr.) Cr.	NCI's share of losses borne by A Ltd.		Goodwill
				₹	Balance	
At the time of acquisition in 20X1		3,24,000 (W.N.)				
20X1 - 20X2	(2,50,000)	(75,000)	(1,75,000)			2,44,000 (W.N.)
		2,49,000				
20X2-20X3	(4,00,000)	(1,20,000)	(2,80,000)			2,44,000
		1,29,000				
20X3-20X4	(5,00,000)	(1,50,000)	(3,50,000)			2,44,000
		(21,000)				
20X4-20X5	(1,20,000)	(36,000)	(84,000)			2,44,000
		(57,000)				
20X5-20X6	50,000	15,000	35,000			2,44,000
		(42,000)				
20X6-20X7	1,00,000	30,000	70,000			2,44,000
		(12,000)				
20X7-20X8	1,50,000	45,000	1,05,000			2,44,000
		33,000				

Working Note:

Calculation of Non-controlling interest:		₹
Share Capital		10,00,000
Other equity		80,000
Total		10,80,000
NCI (30% x 10,80,000)		3,24,000

NCI is measured at NCI's proportionate share of the acquiree's identifiable net assets. (Considering the carrying amount of share capital & other equity to be fair value).

Calculation of Goodwill:		₹
Consideration		10,00,000
Non-controlling interest		3,24,000
Less: Net Assets		(10,80,000)
Goodwill		2,44,000

Illustration 44 - Non-controlling interest and goodwill (Past Exam Dec 2021)

From the following data, determine in each case:

- (1) Non-controlling interest at the date of acquisition (using proportionate share method) and at the date of consolidation
- (2) Goodwill or Gain on bargain purchase.
- (3) Amount of holding company's profit in the consolidated Balance Sheet assuming holding company's own retained earnings to be ₹2,00,000 in each case

Case	Subsidiary company	% of shares owned	Cost	Date of Acquisition 1.04.20X1		Consolidation date 31.03.20X2	
				Share Capital [A]	Retained earnings [B]	Share Capital [C]	Retained earnings [D]
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000
Case 2	B	85%	1,04,000	1,00,000	30,000	1,00,000	20,000
Case 3	C	80%	56,000	50,000	20,000	50,000	20,000
Case 4	D	100%	1,00,000	50,000	40,000	50,000	56,000

The company has adopted an accounting policy to measure Non-controlling interest at NCI's proportionate share of the acquiree's identifiable net assets. It may be assumed that the fair value of acquiree's net identifiable assets is equal to their book values.

(5 Marks)

Solution:

- (1) **Non-controlling interest** = the equity in a subsidiary not attributable, directly or indirectly, to a parent. Equity is the residual interest in the assets of an entity after deducting all its liabilities i.e. in this given case Share Capital + Statement of Profit & Loss (Assuming it to be the net aggregate value of identifiable assets in accordance with Ind AS)

	% Shares Owned by NCI [E]	Non-controlling interest as at the date of acquisition [E] x [A + B]	Non-controlling interest as at the date of consolidation [E] x [C + D]

Case 1 [100 - 90]	10%	15,000	17,000
Case 2 [100 - 85]	15%	19,500	18,000
Case 3 [100 - 80]	20%	14,000	14,000
Case 4 [100 - 100]	Nil	Nil	Nil

(2) Calculation of Goodwill or Gain on bargain purchase

	Consideration [G]	Non-controlling interest [H]	Net Identifiable assets [A] + [B] = [I]	Goodwill [G] + [H] - [I]	Gain on bargain Purchase [I] - [G] - [H]
Case 1	1,40,000	15,000	1,50,000	5,000	-
Case 2	1,04,000	19,500	1,30,000	-	6,500
Case 3	56,000	14,000	70,000	Nil	Nil
Case 4	1,00,000	0	90,000	10,000	-

(3) 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

Illustration 45 - Sale of 20% interest in a wholly- owned subsidiary

Entity P sells a 20% interest in a wholly- owned subsidiary to outside investors for ₹100 lakh in cash. The carrying value of the subsidiary's net assets is ₹300 lakh, including goodwill of ₹65 lakh from the subsidiary's initial acquisition.

Pass journal entries to record the transaction.

Solution:

The accounting entry recorded on the disposition date for the 20% interest sold as follows:

	₹ in lakh	₹ in lakh
Cash	Dr. 100	
To Non-controlling interest (20% x 300 lakh)		60
To Other Equity (Gain on sale of interest in subsidiary)		40

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between NCI (60 lakhs) is adjusted and fair value of consideration received (100 lakhs) to be attributed to parent in other equity ie. 40 lakhs.

Illustration 46 - Acquisition of additional stake in a subsidiary

Entity A acquired 60% of entity B two years ago for ₹6,000. At the time entity B's fair value was ₹10,000. It had net assets with a fair value of ₹6,000 (which for the purposes of this example was the same as book value). Goodwill of ₹2,400 was recorded (being ₹6,000 – (60% * ₹6,000)). On 1 October 20X0, entity A acquires a further 20% interest in entity B, taking its holding to 80%. At that time the fair value of entity B is ₹20,000 and entity A pays ₹4,000 for the 20% interest. At the time of the purchase the fair value of entity B's net assets is ₹12,000 and the carrying amount of the non- controlling interest is ₹4,000.

Pass journal entries to record the transaction.

Solution:

The accounting entry recorded for the purpose of the non- controlling interest is as follows:

		₹	₹
Non-controlling interest	Dr.	2,000	
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	2,000	
To Cash			4,000

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between NCI (₹ 2,000) is adjusted and fair value of consideration received (₹ 4,000) to be attributed to parent in other equity i.e. ₹ 2,000.

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 = ₹ 3,600. 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 47 - 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 on 1.4.20X0:

	₹ in thousand
Separate financial statements	As on 31.3.20X0
Investment in subsidiary (70% interest) – at cost	14,000
Purchase price for additional 10% interest	2,600
Consolidated financial statements	
Non-controlling interest (30%)	6,600
Consolidated profit & loss account balance	2,000
Goodwill	600

The reporting date of the subsidiary and the parent is 31 March, 20X0. Prepare note showing adjustment for change of non-controlling interest. Should goodwill be adjusted for the change?

Solution:

The following accounting entries are passed:			
		₹ '000	₹ '000
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	400	
Non-controlling interest	Dr.	2,200	
To Bank			2,600

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between NCI (₹ 22,00,000) is adjusted and fair value of consideration received (₹ 26,00,000) to be attributed to parent in other equity ie. ₹ 4,00,000.

Consolidated goodwill is not adjusted.

Illustration 48 - Acquisition of additional stake in a subsidiary

A Ltd. acquired 70% of shares of B Ltd. On 1.4.20X0, when fair value of net assets of B Ltd. was ₹200 lakh. During 20X0-20X1, B Ltd. made profit of ₹100 lakh. Individual and consolidated balance sheets as on 31.3.20X1 are as follows:

(₹ in lakhs)

	A	B	Group
Assets			
Goodwill			10
PPE	627	200	827
Financial Assets:			
Investments	150		
Cash	200	30	230
Other Current Assets	23	70	93
	<u>1,000</u>	<u>300</u>	<u>1,160</u>
Equity and Liabilities			
Share Capital	200	100	200
Other Equity	800	200	870
Non-controlling interest	=	=	90
	<u>1,000</u>	<u>300</u>	<u>1,160</u>

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:

	A	B	Workings	Group
Assets				
Goodwill				10
PPE	627	200		827
Financial Assets:				
Investments (150 + 32)	182	0		
Cash* (200 - 32)	168	30	(200+30)-32	198
Other Current Assets	23	70		93
	<u>1,000</u>	<u>300</u>		<u>1,128</u>
Share Capital	200	100		200
Other Equity	800	200	870-2	868

Non-controlling interest			90-30	60
	<u>1,000</u>	<u>300</u>		<u>1,128</u>

*Cash has been adjusted through Individual Balance Sheet.

Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	2	
Non-controlling interest	Dr.	30	
To Bank			32

Illustration 49 - Reduction in interest in subsidiary

Amla Ltd. purchase a 100% subsidiary for ₹10,00,000 at the end of 20X1 when the fair value of the subsidiary's Lal Ltd. net asset was ₹8,00,000.

The parent sold 40% of its investment in the subsidiary in March 20X4 to outside investors for ₹9,00,000. The parent still maintains a 60% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is ₹18,00,000 (including net assets of ₹16,00,000 & goodwill of ₹2,00,000).

Calculate gain or loss on sale of interest in subsidiary as on 31st March 20X4.

Solution:

As per Ind AS 110, a change in ownership that does not result in a loss of control. The identifiable net assets (including goodwill) remain unchanged and any difference between the amount by which the non-controlling interest is recorded (including the non-controlling interest portion of goodwill) and a fair value of the consideration received is recognized directly in equity and attributed to the controlling interest. For disposals that do not result in the loss of control, the change in the non-controlling interest is recorded at its proportionate interest of the carrying value of the subsidiary.

Gain on the sale of the investment of ₹ 5,00,000 in parent's separate financial statements calculated as follows:

	₹'000
Sale proceeds	900
Less: Cost of investment in subsidiary (₹ 10,00,000 X 40%)	(400)
Gain on sale in the parent's separate financial statement	<u>500</u>

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	<u>180</u>

The entry recognized in the consolidated accounts under Ind AS 110 is :

	₹'000	₹'000
Cash	Dr.	900
To Non-controlling interest (1,800 x 40%)		720
To Other Equity (Gain on sale of interest on subsidiary)		180

The difference between the gain in the parent's income statement and the increase reported in the

group's consolidated equity is ₹ 3,20,000. This difference represents the share of post- acquisition profits retained in the subsidiary ₹ 3,20,000 [(that is, 18,00,000 – 10,00,000) x 40%] that have been reported in the groups income statement upto the date of sale.

Illustration 50 - Reduction in interest in subsidiary

Entity A sells a 30% interest in its wholly-owned subsidiary to outside investors in an arm's length transaction for ₹ 500 crore in cash and retains a 70% controlling interest in the subsidiary. At the time of the sale, the carrying value of the subsidiary's net assets in the consolidated financial statements of Entity A is ₹ 1,300 crore, additionally, there is a goodwill of ₹ 200 crore that arose on the subsidiary's acquisition. Entity A initially accounted for NCI representing present ownership interests in the subsidiary at fair value and it recognises subsequent changes in NCI in the subsidiary at NCI's proportionate share in aggregate of net identifiable assets and associated goodwill. How should Entity A account for the transaction?

Solution:

As per paragraph 23 of Ind AS 110, changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners). Thus, changes in ownership interest that do not result in loss of control do not impact goodwill associated with the subsidiary or the statement of profit and loss.

Paragraph B96 of Ind AS 110 states that when the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Thus, at the time of sale of 30% of its equity interest, consolidated financial statements include an amount of ₹ 1,500 crore in respect of the subsidiary. Accordingly, in the present case, the accounting entry on the date of sale of the 30% interest would be as follows:

		₹ in crore	
	Dr.		Cr.
Cash		900	
Dr.			
To Non-controlling interest (1,500 x 30%)			450
To Other Equity (Gain on sale of interest in subsidiary)			50

Illustration 51 - 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

- 100% of the goodwill with 20% then being allocated to the non- controlling interest, or
- 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).

Illustration 52 – Chain Holding (Past Exam Nov'18, Nov'22) (MTP April'22)

Prepare the consolidated Balance Sheet as on 31st March, 20X2 of a group of companies comprising P Limited, S Limited and SS Limited. Their balance sheets on that date are given below:

(₹ in lakhs)

	P Ltd.	S Ltd.	SS Ltd.
Assets			
Non-Current Assets			
Property, Plant and Equipment	320	360	300
Investment :			
32 lakhs shares in S Ltd.	340		
24 Lakhs shares in SS Ltd.		280	
Current Assets			
Inventories	220	70	50
Financial Assets			
Trade Receivables	260	100	220
Bills Receivable	72	-	30
Cash in hand and at Bank	228	40	40
	1440	850	640
Equity and Liabilities			
Shareholder's Equity			
Share capital (₹ 10 per Share)	600	400	320
Other Equity			
Reserves	180	100	80
Retained earnings	160	50	60
Current Liabilities			
Financial Liabilities			
Trade Payables	470	230	180
Bills Payable			
P Ltd.		70	
SS Ltd.	30		
	1440	850	640

The following additional information is available :

- 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.
- 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.
- On 1st April, 20X1 the following balances stood in the books of S Limited and SS Limited.

(₹ in lakhs)

	S Limited	SS Limited
Reserves	80	60
Retained earnings	20	30

- (iv) ₹10 lakhs included in the inventory figure of S Limited, is inventory which has been purchased from SS Limited at cost plus 25%.
- (v) The parent company has adopted an accounting policy to measure non-controlling interest at fair value (quoted market price) applying IND AS 103. Assume market prices of S Limited and SS Limited are the same as respective face values. (16 Marks)

Solution:

Consolidated Balance Sheet of the Group as on 31st March, 20X2

Particulars	Note No.	(₹ in lakh)
ASSETS		
Non-current assets		
Property, plant and equipment	1	980
Current assets		
(a) Inventory	2	338
(b) Financial assets	3	580
Trade receivables Bills	4	2
receivable	5	308
Cash and cash equivalents		
Total assets		2,208
EQUITY & LIABILITIES		
Equity attributable to owners of the parent		
Share capital		600
Other Equity		
Reserves (W.N.5)		194
Retained Earnings (W.N.5)		179.8
Capital Reserve (W.N.3)		188
Non-controlling interests (W.N.4)		166.2
Total equity		1328
LIABILITIES		
Non-current liabilities		Nil
Current liabilities		
(a) Financial Liabilities		
(i) Trade payables	6	880
Total liabilities		880
Total equity and liabilities		2,208

Notes to Accounts

(₹ in lakh)

1.	Property Plant & Equipment		
	P Ltd.	320	
	S Ltd.	360	
	SS Ltd.	<u>300</u>	980
2.	Inventories		
	P Ltd.	220	
	S Ltd. (70-2)	68	
	SS Ltd.	<u>50</u>	338
3.	Trade Receivables		
	P Ltd.	260	
	S Ltd.	100	
	SS Ltd.	<u>220</u>	580
4.	Bills Receivable		
	P Ltd. (72-70)	2	
	SS Ltd. (30-30)	-	2
5.	Cash & Cash equivalents		
	P Ltd.	228	
	S Ltd.	40	
	SS Ltd.	<u>40</u>	308
6.	Trade Payables		
	P Ltd.	470	
	S Ltd.	230	
	SS Ltd.	<u>180</u>	880

Working Notes:**1. Analysis of Reserves and Surplus**

(₹ in lakh)

		S Ltd.	SS Ltd.
Reserves as on 31.3.20X1		80	60
Increase during the year 20X1-20X2	20	20	
Increase for the half year till 30.9.2017		<u>10</u>	<u>10</u>
Balance as on 30.9.20X1 (A)		90	70
Total balance as on 31.3.20X2		<u>100</u>	<u>80</u>
Post-acquisition balance		<u>10</u>	<u>10</u>

		S Ltd.	SS Ltd.
Retained Earnings as on 31.3.20X1		20	30
Increase during the year 20X1-20X2	30	30	
Increase for the half year till 30.9.20X1		<u>15</u>	<u>15</u>
Balance as on 30.9.20X1 (B)		35	45
Total balance as on 31.3.20X2		<u>50</u>	<u>60</u>
Post-acquisition balance		15	15
Less: Unrealised Gain on inventories (10 x 25%)		-	(2)
Post-acquisition balance for CFS		<u>15</u>	<u>13</u>
Total balance on the acquisition date i.e. 30.9.20X1 (A + B)		125	115

2. Calculation of Effective Interest of P Ltd. in SS Ltd.

Acquisition by P Ltd. in S Ltd. = 80%

Acquisition by S Ltd. in SS Ltd. = 75%

Acquisition by Group in SS Ltd. (80% x 75%) = 60% Non Controlling Interest = 40%

3. Calculation of Goodwill / Capital Reserve on the acquisition date

	S Ltd.	SS Ltd.
Investment or consideration	340	(280 × 80%) 224
Add: NCI at Fair value		
(400 × 20%)	80	
(320 × 40%)		128
	420	352
Less: Identifiable net assets (Share capital + Increase in the Reserves and Surplus till acquisition date)		
	(400+125) (525)	(320+115) (435)
Capital Reserve	105	83
Total Capital Reserve (105 + 83)	188	

4. Calculation of Non-Controlling Interest

	S Ltd.	SS Ltd.
At Fair Value (See Note 3)	80	128
Add: Post Acquisition Reserves (See Note 1)	(10 × 20%) 2	(10 × 40%) 4
Add: Post Acquisition Retained Earnings (See Note 1)	(15 × 20%) 3	(13 × 40%) 5.2
Less: NCI share of investment in SS Ltd.	(280 × 20%) (56)*	
	29	137.2
Total (29+ 137.2)	166.2	

*Note: The Non-controlling interest in S Ltd. will take its proportion in SS Ltd. so they have to bear their proportion in the investment by S Ltd. (in SS Ltd.) also.

5. Calculation of Consolidated Other Equity

	Reserves	Retained Earnings
P Ltd.	180	160
Add: Share in S Ltd.	(10 × 80%) 8	(15 × 80%) 12
Add: Share in SS Ltd.	(10 × 60%) 6	(13 × 60%) 7.8
	194	179.8

Note: It is assumed date the sale of goods by SS Ltd. is done after acquisition of shares by S Ltd. Alternatively, it may be assumed that the sale has either been done before acquisition of shares by S Ltd. in SS Ltd. or sale has been throughout the year. Accordingly, the treatment for unrealized gain may vary.

Illustration 53 - 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:

	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.

Illustration 54 - Calculation of gain on outright sale of subsidiary

A parent purchased an 80% interest in a subsidiary for ₹1,60,000 on 1 April 20X1 when the fair value of the subsidiary's net assets was ₹1,75,000. Goodwill of ₹20,000 arose on consolidation under the partial goodwill method. An impairment of goodwill of ₹8,000 was charged in the consolidated financial statements to 31 March 20X3. No other impairment charges have been recorded. The parent sold its investment in the subsidiary on 31 March 20X4 for ₹2,00,000. The book value of the subsidiary's net assets in the consolidated financial statements on the date of the sale was ₹2,25,000 (not including goodwill of ₹12,000). When the subsidiary met the criteria to be classified as held for sale under IND AS 105, no write down was required because the expected fair value less cost to sell (of 100% of the subsidiary) was greater than the carrying value.

The parent carried the investment in the subsidiary at cost, as permitted by IND AS 27.

Calculate gain or loss on disposal of subsidiary in parent's separate and consolidated financial statements as on 31st March 20X4.

Solution:

The parent's separate statement of profit and loss for 20X3-20X4 would show a gain on the sale of investment of ₹ 40,000 calculated as follow:

	₹ '000
Sale proceeds	200
Less: Cost of investment in subsidiary	(160)
Gain on sale in parent's account	40

However, the group's statement of profit & loss for 20X3-20X4 would show a gain on the sale of subsidiary of ₹ 8,000 calculated as follows:

	₹'000
Sale proceeds	200

Less: Share of net assets at date of disposal (₹ 2,25,000 X 80%)	(180)	
Goodwill on consolidation at date of sale (W.N 1)	(12)	(192)
Gain on sale in the group's account		8

Working Note

The goodwill on consolidation (assuming partial goodwill method) is calculated as follows:

	₹'000	₹'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 55 - 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 BT Ltd. whose net assets was ₹40,00,000. Therefore, goodwill is ₹10,00,000. The AT Ltd. sold 60% of its investment in BT Ltd. on 31st March 20X3 for ₹ 67,50,000, leaving the AT Ltd. with 40% and significant influence. At the date of disposal, the carrying value of net assets of BT Ltd., excluding goodwill is ₹80,00,000. Assume the fair value of the investment in associate BT Ltd. retained is proportionate to the fair value of the 60% sold, that is ₹45,00,000.

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as on 31st March 20X3.

Solution:

AT Ltd.'s statement for profit or loss of 20X2-20X3 would show a gain on the sale of investment of ₹ 37,50,000 calculated as follows:

₹' lakhs

Sale proceeds	67.5
Less: Cost on investment in subsidiary (₹ 50,00,000 X 60%)	(30.0)
Gain on sale in the parent's financial statement	37.5

In the consolidated financial statements, the group will calculate the gain or loss on disposal differently. The carrying amount of all of the assets including goodwill is derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

The gain on the disposal will, therefore, be calculated as follows:

₹' lakhs

Sale proceeds	67.5
Fair value of 40% interest retained	45.0
	112.5
Less: Net assets disposed, including goodwill (80,00,000+ 10,00,000)	(90.0)
Gain on sale in the group's financial statements	22.5

The gain on loss of control would be recorded in profit or loss. The gain or loss includes the gain of ₹ 13,50,000 [₹ 67,50,000 – (₹90,00,000 x 60%)] on the portion sold. However, it also includes a gain on remeasurement of the 40% retained interest of ₹ 9,00,000 (₹ 36,00,000* to ₹ 45,00,000). The entity will

need to disclose the portion of the gain that is attributable to remeasuring any remaining interest to fair value, that is, ₹ 9,00,000.

$$* 90,00,000 \times 40\% = 36,00,000$$

Illustration 56 - Partial disposal when 10% investment in former subsidiary is retained

The facts of this illustration are same as illustration 50, except that the group AT Ltd. disposes of a 90% interest for ₹85,50,000, leaving the AT Ltd. with a 10% investment. The fair value of the remaining interest is ₹9,50,000 (assumed for simplicity to be pro rata to the fair value of the 90% sold).

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as on 31st March 20X1.

Solution:

The parent's AT Ltd. income statement in its separate financial statements for 20X1 would show a gain on the sale of the investment of ₹ 40,50,000 calculated as follows:

	₹ in lakhs
Sale proceeds	85.5
Less: Cost on investment in subsidiary (₹ 50,00,000 X 90%)	(45.0)
Gain on sale in the parent's financial statement	<u>40.5</u>

In the consolidated financial statements, all of the assets, including goodwill are derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

	₹ in lakhs
Sale proceeds	85.5
Fair value of 10% interest retained	<u>9.5</u>
	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	<u>5.0</u>

The gain on loss of control would be recorded in profit or loss. The gain or loss includes the gain of ₹ 4,50,000 related to the 90% portion sold [₹ 85,50,000 – (₹ 90,00,000 X 90%)] as well as ₹ 50,000 related to the remeasurement to fair value of 10% retained interest (₹ 9,00,000 to ₹ 9,50,000)

Illustration 57 - 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	<u>1,80,000</u>	<u>(7,20,000)</u>
Gain to be recorded in profit or loss		<u>80,000</u>

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.

Illustration 58 - An entity ceases to be an investment entity

A Limited ceased to be an 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:

<u>Goodwill calculation:</u>		₹
Deemed consideration (i.e. fair value of subsidiary on the date of change in status)		4,00,000
Fair value of non-controlling interest		<u>1,00,000</u>
		5,00,000
Value of subsidiary's identifiable net assets as per Ind AS 103		<u>(4,50,000)</u>
Goodwill		<u>50,000</u>

<u>Journal entry</u>	₹	
	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

Illustration 59 - 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

Illustration 60

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?

Solution:-

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 loses 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.

Illustration 61

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?

Solution

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 ($40 \times 25\% \times 90\%$)	9	
Attributable to Non-controlling interest of N Limited ($50 \times 25\% \times 10\%$)	1	10

Illustration 62

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?

Solution

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 is calculated as follows:

	₹' lakhs
AB Limited's share in the consideration received by the associate for issue of shares ($800 \times 20\%$) (1)	160
Less: Carrying value of interest sold ($360 \times 1/3$)(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 ($30 \times 1/3$).
- (3) Gain of ₹ 40 lakhs will be recorded in the profit or loss.

Illustration 63 – (Past Exam – May 2018) + (MTP – March 2020)

DEF Ltd. acquired 100% ordinary shares of ₹ 100 each of XYZ Ltd. on 1st October 20X1. On March 31, 20X2 the summarised Balance Sheets of the two companies were as given below:

	DEF Ltd.	XYZ Ltd.
Assets		
Property Plant Equipment		
Land & Buildings	15,00,000	18,00,000
Plant & Machinery	24,00,000	13,50,000
Investment in XYZ Ltd.	34,00,000	-
Inventory	12,00,000	3,64,000
Financial Assets		
Trade Receivable	5,98,000	4,00,000
Cash	1,45,000	80,000

Total	92,43,000	39,94,000
Equities & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	50,00,000	20,00,000
Other Equity		
Other reserves	24,00,000	10,00,000
Retained Earnings	5,72,000	8,20,000
Financial Liabilities		
Bank Overdraft	8,00,000	-
Trade Payable	4,71,000	1,74,000
Total	92,43,000	39,94,000

The retained earnings of XYZ Ltd. showed a credit balance of ₹ 3,00,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; DEF Ltd. has recognised the dividend received to profit or loss account; Fair Value of P & M as on 1st October 20X1 was ₹ 20,00,000. The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with Book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	1,00,000	Land & Buildings	10,00,000
		Inventories	1,50,000

Note:

- 1) It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.
- 2) Also assume that the Other Reserves of both the companies as on 31st March 20X2 are the same as was on 1st April 20X1.
- 3) All fair value adjustments have not yet started impacting consolidated post-acquisition profits.

Prepare consolidated Balance Sheet as on March 31, 20X2.

15 Marks

Solution:

Consolidated Balance Sheet of DEF Ltd. and its subsidiary, XYZ Ltd. as on 31st March, 20X2

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	86,00,000
(2) Current Assets		
(i) Inventories	2	17,14,000
(ii) Financial Assets		
(a) Trade Receivables	3	9,98,000
(b) Cash & Cash equivalents	4	2,25,000
Total Assets		1,15,37,000
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	5	50,00,000
(ii) Other Equity	6	49,92,000
(2) Current Liabilities		
(i) Financial Liabilities		

(a) Trade Payables	7	7,45,000
(b) Short term borrowings	8	8,00,000
Total Equity & Liabilities		1,15,37,000

Notes to Accounts

			₹
1.	Property Plant & Equipment		
	Land & Building	43,00,000	
	Plant & Machinery	43,00,000	86,00,000
2.	Inventories		
	DEF Ltd.	12,00,000	
	XYZ Ltd.	5,14,000	17,14,000
3.	Trade Receivables		
	DEF Ltd.	5,98,000	
	XYZ Ltd.	4,00,000	9,98,000
4.	Cash & Cash equivalents		
	DEF Ltd.	1,45,000	
	XYZ Ltd.	80,000	2,25,000
7.	Trade payable		
	DEF Ltd.	4,71,000	
	XYZ Ltd.	2,74,000	7,45,000
8.	Shorter-term borrowings		
	Bank overdraft		8,00,000

Statement of Changes in Equity:

5. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
50,00,000	0	50,00,000

6. Other Equity

	Share application money pending allotment	Equity component of compound financial instrument	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning				0	24,00,000	24,00,000
Total comprehensive income for the year			0	5,72,000		5,72,000
Dividends			0	(2,00,000)		(2,00,000)
Total comprehensive income attributable to parent			0	3,35,000		3,35,000

Gain on Bargain purchase			18,85,000			18,85,000
Balance at the end of reporting period			18,85,000	7,07,000	24,00,000	49,92,000

It is assumed that there exists no clear evidence for classifying the acquisition of the subsidiary as a bargain purchase and, hence, the bargain purchase gain has been recognised directly in capital reserve. If, however, there exists such a clear evidence, the bargain purchase gain would be recognised in other comprehensive income and then accumulated in capital reserve. In both the cases, closing balance of capital reserve will be ₹ 18,85,000.

Working Notes:

1. Adjustments of Fair Value

The Plant & Machinery of XYZ Ltd. would stand in the books at ₹ 14,25,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 15,00,000 total depreciation being ₹ 1,50,000. The value put on the assets being ₹ 20,00,000 there is an appreciation to the extent of ₹ 5,75,000.

2. Acquisition date profits of XYZ Ltd.

Reserves on 1.4. 20X1	10,00,000
Profit & Loss Account Balance on 1.4. 20X1 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 2 nd 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 Profits for the year 20X1-20X2	(0)
Less: Elimination of intra-group dividend	5,72,000
Adjusted profit for the year	(2,00,000)
XYZ Ltd.	3,72,000
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.	<u>32,85,000</u>	<u>(52,85,000)</u>
Gain on Bargain Purchase		<u>18,85,000</u>

7. Value of Plant & Machinery

DEF Ltd.		24,00,000
XYZ Ltd.	13,50,000	
Add: Appreciation on 1.10. 20X1	<u>5,75,000</u>	
	19,25,000	
Add: Depreciation for 2nd half charged on pre-revalued value	75,000	
Less: Depreciation on ₹ 20,00,000 for 6 months	<u>(1,00,000)</u>	<u>19,00,000</u>
		<u>43,00,000</u>

8. Consolidated retained earnings

	DEF Ltd.	XYZ Ltd.	Total
As given	5,72,000	8,20,000	13,92,000
<i>Consolidation Adjustments:</i>			
(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:

- Investment in XYZ Ltd is carried at cost in the separate financial statements of DEF Ltd.
- Appreciation of ₹10 lakhs in land & buildings is entirely attributable to land element only.
- Depreciation on plant and machinery is on WDV method.
- 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.

Illustration 64 - (Past Exam May'19, MTP Oct'20, Nov'21) – 15 Marks

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	<u>29,000</u>	<u>16,000</u>
Total	<u>19,68,600</u>	<u>7,98,800</u>
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	<u>94,200</u>	<u>34,800</u>
Total	<u>19,68,600</u>	<u>7,98,800</u>

The Retained earnings of Krishan Ltd. showed a credit balance of ₹60,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; Ram Ltd. has credited the dividend received to its Retained earnings; Fair Value of P& M as on 1st October 20X1 was ₹4,00,000; The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	20,000	Land & Buildings	2,00,000
		Inventories	30,000

Note:

1. It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.
2. Also assume that the Other Reserves as on 31st March 20X2 are the same as was on 1st April 20X1.

Prepare consolidated Balance Sheet as on March 31, 20X2.

Solution:

Consolidated Balance Sheet of Ram Ltd. and its subsidiary, Krishan Ltd.

as on 31st March, 20X2

Particulars	Note No.	₹

I. Assets		
(1) Non-current assets		
(i) Property, Plant & Equipment	1	17,20,000
(ii) Goodwill	2	1,65,800
(2) Current Assets		
(i) Inventories	3	3,42,800
(ii) Financial Assets		
(a) Trade Receivables	4	1,99,600
(b) Cash & Cash equivalents	5	45,000
Total Assets		24,73,200
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	6	10,00,000
(ii) Other Equity	7	7,30,600
(2) Non-controlling Interest (WN 5)		4,33,600
(3) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	8	1,49,000
(b) Short term borrowings	9	1,60,000
Total Equity & Liabilities		24,73,200

Notes to accounts

			₹
1. Property Plant & Equipment			
Land & Building	8,60,000		
Plant & Machinery	8,60,000		17,20,000
2. Goodwill			1,65,800
3. Inventories			
Ram Ltd.	2,40,000		
Krishan Ltd.	1,02,800		3,42,800
4. Trade Receivables			
Ram Ltd.	1,19,600		
Krishan Ltd.	80,000		1,99,600
5. Cash & Cash equivalents			
Ram Ltd.	29,000		
Krishan Ltd.	16,000		45,000
8. Trade Payables			
Ram Ltd.	94,200		
Krishan Ltd.	54,800		1,49,000
9. Short-term borrowings			
Bank overdraft			1,60,000

Statement of Changes in Equity:**6. Equity share Capital**

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
10,00,000	0	10,00,000

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the						

beginning of the reporting period				0	6,00,000	6,00,000
Total comprehensive income for the year			0	1,14,400		1,14,400
Dividends			0	(24,000)		(24,000)
Total comprehensive income attributable to parent			0	40,200		40,200
Gain on Bargain purchase				0		0
Balance at the end of reporting period				1,30,600	6,00,000	7,30,600

Working Notes:**1. Adjustments of Fair Value**

The Plant & Machinery of Krishan Ltd. would stand in the books at ₹ 2,85,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 3,00,000 total depreciation being ₹ 30,000. The value put on the assets being ₹ 4,00,000 there is an appreciation to the extent of ₹ 1,15,000.

2. Acquisition date profits of Krishan Ltd.

Reserves on 1.4. 20X1	₹	2,00,000
Profit & Loss Account Balance on 1.4. 20X1	₹	60,000
Profit for 20X1-20X2: Total (₹ 1,64,000 less ₹ 20,000) x 6/12 i.e. ₹ 72,000; upto 1.10. 20X1		72,000
Total Appreciation		3,25,000
Total		6,57,000
Holding Co. Share (60%)		3,94,200

3. Post-acquisition profits of Krishan Ltd.

Profit after 1.10. 20X1 [1,64,000-20,000]x 6/12	72,000
Less: 10% depreciation on ₹ 4,00,000 for 6 months less depreciation already charged for 2 nd 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) 2/5	2,46,800
Post-acquisition profits [WN 4]	26,800
	4,33,600

5. Goodwill

Amount paid for 2,400 shares		8,00,000
Par value of shares	2,40,000	
Acquisition date profits share of Ram Ltd.	3,94,200	(6,34,200)
Goodwill		1,65,800

6. Value of Plant & Machinery

Ram Ltd.		4,80,000
Krishan Ltd.	2,70,000	
Add: appreciation on 1.10. 20X1	<u>1,15,000</u>	
	3,85,000	
Add: Depreciation for 2nd half charged on pre-revalued value	15,000	
Less: Depreciation on ₹ 4,00,000 for 6 months	<u>(20,000)</u>	
		<u>3,80,000</u>
		<u>8,60,000</u>

7. Profit & Loss account consolidated

Ram Ltd. (as given)	1,14,400	
Less: Dividend	<u>(24,000)</u>	90,400
Share of Ram Ltd. in post-acquisition profits		<u>40,200</u>
		<u>1,30,600</u>

Illustration 65

On 31st March 20X2, Blue Heavens Ltd. acquired 100% ordinary shares carrying voting rights of Orange County Ltd. for ₹6,000 lakh in cash and it controlled Orange County Ltd. from that date. The acquisition-date statements of financial position of Blue Heavens Ltd. and Orange County Ltd. and the fair values of the assets and liabilities recognised on Orange County Ltd. statement of financial position were:

	Blue Heavens Ltd.	Orange County Ltd.	
	Carrying Amount (₹ in lakh)	Carrying Amount (₹ in lakh)	Fair Value (₹ in lakh)
Assets			
Non-current assets			
Building and other PPE	7,000	3,000	3,300
Investment in Orange County Ltd.	6,000		
Current assets			
Inventories	700	500	600
Trade receivables	300	250	250
Cash	<u>1,500</u>	<u>700</u>	700
Total assets	<u>15,500</u>	<u>4,450</u>	
Equity and Liabilities			
Equity			
Share capital	5,000	2,000	
Retained earnings	10,200	2,300	
Current liabilities			
Trade payables	300	150	
Total liabilities and equity	<u>15,500</u>	<u>4,450</u>	

Prepare the Consolidated Balance Sheet as on March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.

Solution:

Blue Heavens Ltd. consolidated statement of financial position at 31 March 20X2 will be calculated as follows:

(in lakhs)

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			1,300 (WN 1)	1,300
Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	6,000		(6,000)	
Current assets				
Inventories	700	500	100	1,300
Financial Assets				
Trade receivables	300	250		550
Cash	1,500	700		2,200
Total assets	15,500	4,450		15,650
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	10,200	2,300	(2,300)	10,200
Trade payable	300	150		450
Total liabilities and equity	15,500	4,450		15,650

Consolidation involves:

- Adding the statement of financial position of the parent and its subsidiary together line by line.
- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased) and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary.

1. Working for goodwill:

	(₹ in lakhs)
Consideration paid	6,000
Less: Acquisition date fair value of Orange County Ltd. net assets	(4,700)
Goodwill	1,300

2. Working for the acquisition date fair value of Orange County Ltd. net assets:

Acquisition date fair value of acquiree (Orange County Ltd.) assets

Buildings and other PPE	3,300
Inventories	600
Trade receivables	250
Cash	700

Less: fair value of trade payables	(150)
Fair value of net assets acquired	4,700

Illustration 66

The facts are the same as in Question above. However, Blue Heavens Ltd. acquires only 75% of the ordinary shares, to which voting rights are attached of Orange County Ltd. Blue Heavens Ltd. pays ₹4,500 lakhs for the shares. Prepare the Consolidated Balance Sheet as on March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.

Solution:

Non-controlling interest

= 25 % × Orange County Ltd. identifiable net assets at fair value of ₹ 4,700

= ₹ 1,175.

Blue Heavens Ltd. consolidated statement of financial position at 31 March 20X2 will be calculated as follows:

(in lakhs)

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			975 (WN 1)	975
Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	4,500		(4,500)	
Current assets				
Inventories				
Financial Assets	700	500	100	1,300
Trade receivables	300	250		550
Cash	3,000	700		3,700
Total assets	15,500	4,450		16,825
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	10,200	2,300	(2,300)	10,200
Non-controlling interest			1,175	1,175
Current liabilities				
Financial Liabilities				
Trade payables	300	150		450
Total liabilities and equity	15,500	4,450		16,825

Note: In this question, Blue Heavens Ltd.'s (and consequently the group's) cash balance is ₹ 1,500 lakh higher than in Question above because, in this example, Blue Heavens Ltd. paid ₹ 1,500 less to acquire Orange County Ltd. (ie ₹ 6,000 less ₹ 4,500).

1. Working for goodwill:

	(₹ in lakhs)
Consideration paid	4,500
Non- controlling interest	1,175
Less: Acquisition date fair value of Orange County Ltd. net assets	4,700
Goodwill	975

(Goodwill recognised in the consolidated statement of financial position relates solely to the acquirer's proportion of the subsidiary; it does not include the non-controlling interest's share).

Illustration 67

Facts are same as in Question 65 & 66, 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	-
	<u>11,000</u>	<u>2,750</u>
Current assets		
Inventories	800	550
Financial Asset - Trade receivables	380	300
Cash	4,170	1,420
	<u>5,350</u>	<u>2,270</u>
Total assets	16,350	5,020
Equity and liabilities		
Equity		
Share capital	5,000	2,000
Retained earnings	11,000	2,850
	<u>16,000</u>	<u>4,850</u>
Current liabilities		
Financial Liabilities - Trade payables	350	170
	<u>350</u>	<u>170</u>
Total liabilities and equity	16,350	5,020

Statements of Profit and Loss for the year ended 31 March 20X3:

	<u>Blue Heavens Ltd.</u> Carrying Amount (₹ in lakh)	<u>Orange County Ltd.</u> 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 31st 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 31st March 20X2 was sold during 20X3.

Prepare the Consolidated Balance Sheet as on March 31, 20X3 of group of entities Blue Heavens Ltd. and Orange County Ltd.

Solution:

Alternative I for calculation of Non-controlling Interest:

The Non-controlling Interest proportion of Orange County Ltd. is 25 %.

At 31 March 20X3, the NCI in the consolidated statement of financial position would be calculated as:

₹ (lakh)

NCI at date of acquisition (31 March 20X2) (see solution to Question 4)	1,175
NCI's share of profit for the year ended 31 March 20X3, being 25% of ₹ 435 lakh (being ₹ 550 profit of Orange County Ltd. as per Orange County Ltd. financial statements, less ₹ 100 group inventory Fair value adjustment less ₹ 15 group depreciation on building fair value adjustment)*	109
NCI as at 31 March 20X3	1,284

*In calculating the NCI's share of profit for the year ended 31 March 20X3, no deduction is made for goodwill amortisation because, as explained above, the goodwill arising on consolidation relates solely to the acquirer's proportion of the subsidiary and does not include the non-controlling interest's share.

Alternative II for calculation of Non-controlling Interest:

As an alternative to the above three-step approach, at 31 March 20X3 the NCI in the consolidated statement of financial position is calculated as 25% (the NCI's proportion) of ₹ 5,135, which is ₹ 1,284. ₹ 5,135 is Orange County Ltd. net assets at 31 March 20X3 as shown in Orange County Ltd. statement of financial position (₹ 4,850, being ₹ 5,020 assets less ₹ 170 liabilities) plus the fair value adjustment to those assets as made in preparing the group statement of financial position (₹ 285, being the fair value adjustment in respect of Orange County Ltd. building, ₹ 300, less one year's depreciation of that adjustment, ₹ 15).

Blue Heavens Ltd. consolidated statement of comprehensive income for the year ended 31 March 20X3 will be computed as follows:

	Blue Heavens Ltd.	Orange County Ltd.	Consolidate adjustments	Consolidated
Revenue	3,000	1,900		4,900
Cost of sales	(1,800)	(1,000)	(100) (WN 1)	(2,900)
Profit for the year	1,200	900		2,000
Administrative expenses	(400)	(350)	(113) (WN 2)	(863)
Total comprehensive income for the year	800	550		1,137

Total comprehensive income attributable to:

Owners of the parent (75%)	1,028
Non-controlling interest (25%)	<u>109</u>
	<u>1,137</u>

Consolidation involves:

- Adding the statement of comprehensive income of the parent and its subsidiary together line by line
- Recognising the fair value adjustments and/ or amortisation thereof together with amortisation of the goodwill asset that arose on acquisition of the subsidiary.

Blue Heavens Ltd. consolidated statement of financial position at 31 March 20X3 will be computed as follows:

(₹ in lakh)

	Blue Heavens Ltd.	Orange County Ltd.	Consolidation adjustments	Consolidated Blue Heavens Ltd.
	Carrying amount	Carrying amount		
Assets				
Non-current assets				
Goodwill			975-98 (WN 3)	877
Buildings and other PPE	6,500	2,750	285 (WN 4)	9,535
Financial Assets				
Investment in Entity B	4,500		(4,500)	
Current assets				
Inventories	800	550		1,350
Financial Assets				
Trade receivables	380	300		680
Cash	4,170	1,420		5,590
Total assets	16,350	5,020		18,032
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	11,000	2,850	(2,622) (WN 5)	11,228
Non-controlling interest			1,284	1,284
Current liabilities				
Financial Liabilities				
Trade payables	350	170		520
Total liabilities and equity	16,350	5,020		18,032

Consolidation involves:

- Adding the statement of financial position of the parent and its subsidiary together line by line.

- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased), and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary as adjusted to reflect the first year post-acquisition
- Recognising the non-controlling interest in the net assets of Entity B.

Working Notes:**1) Cost of sales adjustment:**

₹ 100 = fair value adjustment in respect of inventories at 31 March 20X2.

2) Administrative expenses adjustment:

₹ 113 = Amortisation of goodwill ₹ 98 (WN 3) + additional depreciation on building ₹ 15 (WN 4).

For simplicity it is assumed that all the goodwill amortisation and the additional buildings depreciation is adjusted against administrative expenses.

3) Working for goodwill:

Goodwill at the acquisition date, ₹ 975, less accumulated amortisation, which this year is amortisation for one year, ₹ 98 approx. (ie ₹ 975 ÷ 10 years) = ₹ 877.

4) Working for building consolidation adjustment:

The fair value adjustment at 31 March 20X2 in respect of Orange County Ltd. building was ₹ 300, that is, the carrying amount at 31 March 20X2 was ₹ 300 lower than was recognised in the group's consolidated statement of financial position. The building is being depreciated over 20 years from 31 March 20X2. Thus at 31 March 20X3 the adjustment required on consolidation to the statement of financial position will be ₹ 285, being ₹ 300 × 19/20 years' estimated useful life remaining. The additional depreciation recognised in the consolidated statement of comprehensive income is ₹ 15 (being ₹ 300 × 1/20).

5) Reserves adjustment:

₹ 2,300 adjustment at the acquisition date (Illustration 66)

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.

Illustration 68

P Pvt. Ltd. has a number of wholly-owned subsidiaries including S Pvt. Ltd. at 31st March 20X2. P Pvt. Ltd. consolidated statement of financial position and the group carrying amount of S Pvt. Ltd. assets and liabilities (i.e. the amount included in that consolidated statement of financial position in respect of S Pvt. Ltd. assets and liabilities) at 31st March 20X2 are as follows:

Particulars	Consolidated (₹ in millions)	Group carrying amount of S Pvt. Ltd. asset and liabilities Ltd. (₹ in millions)
Assets		
Non-Current Assets		

Goodwill	380	180
Buildings	3,240	1,340
Current Assets		
Inventories	140	40
Trade Receivables	1,700	900
Cash	3,100	1,000
Total Assets	8,560	3,460
Equities & Liabilities		
Equity		
Share Capital	1600	
Other Equity		
Retained Earnings	4,260	
Current liabilities		
Trade Payables	2,700	900
Total Equity & Liabilities	8,560	900

Prepare consolidated Balance Sheet after disposal as on 31st March, 20X2 when P Pvt. Ltd. group sold 100% shares of S Pvt. Ltd. to independent party for ₹3,000 millions.

Solution:

When 100% shares sold to independent party

Consolidated Balance Sheet of P Pvt. Ltd. and its remaining subsidiaries as on 31st March, 20X2

Particulars	Note No.	(₹ in millions)
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	1,900
(ii) Goodwill	2	200
(2) Current Assets		
(i) Inventories	3	100
(ii) Financial Assets		
(a) Trade Receivables	4	800
(b) Cash & Cash equivalents	5	5,100
Total Assets		8,100
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	6	1,600
(ii) Other Equity	7	4,700
(2) Non-controlling Interest		
(3) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	8	1,800
Total Equity & Liabilities		8,100

Notes to accounts:

		(₹ in millions)
1.	Property Plant & Equipment	
	Land & Building	3,240

	Less: S. Pvt. Ltd.	(1,340)	1,900
2.	Goodwill	380	
	Less: S. Pvt. Ltd.	(180)	200
3.	Inventories		
	Group	140	
	Less: S. Pvt. Ltd.	(40)	100
4.	Trade Receivables		
	Group	1,700	
	Less: S. Pvt. Ltd.	(900)	800
5.	Cash & Cash equivalents		
	Group (WN 2)	5,100	5,100
8.	Trade Payables		
	Group	2,700	
	Less: S. Pvt. Ltd.	900	1,800

Statement of changes in Equity:**6. Equity share Capital**

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
1600	0	1600

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				4,260		4,260
Total comprehensive income for the year			0			
Dividends			0			
Total comprehensive income attributable to parent			0			
Gain on disposal of S. Pvt. Ltd.				440		440
Balance at the end of reporting period			0	4,700		4,700

Working Notes:

1. When sold, the carrying amount of all assets and liabilities attributable to S Pvt. Ltd. were eliminated from the consolidated 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

Illustration 69

Reliance Ltd. has a number of wholly-owned subsidiaries including Reliance Jio Infocomm Ltd. at 31st March, 20X2.

Reliance Ltd. consolidated statement of financial position and the group carrying amount of Reliance Jio Infocomm Ltd. assets and liabilities (i.e. the amount included in that consolidated statement of financial position in respect of Reliance Jio Infocomm Ltd. assets and liabilities) at 31st March 20X2 are as follows:

Particulars	Consolidated (₹ In '000)	Group carrying amount of Reliance Jio Infocomm Ltd. asset and liabilities Ltd. (₹ In '000)
Assets		
Non-current Assets		
Goodwill	190	90
Buildings	1,620	670
Current Assets		
Inventories	70	20
Financial Assets		
Trade Receivables	850	450
Cash	1,550	500
Total Assets	4,280	1,730
Equity & Liabilities		
Equity		
Share Capital	800	
Other Equity		
Retained Earnings	2,130	
	2,930	
Current liabilities		
Financial liabilities		
Trade Payables	1,350	450
Total Equity & Liabilities	4,280	450

Prepare consolidated Balance Sheet after disposal as on 31st March, 20X2 when Reliance Ltd. group sold 90% shares of Reliance Jio Infocomm Ltd. to independent party for ₹1000 thousand.

Solution:

When 90% shares sold to independent party

Consolidated Balance Sheet of Reliance Ltd. and its remaining subsidiaries as on 31st March, 20X2

Particulars	Note No.	(₹ In '000)
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	950
(ii) Goodwill	2	100
(iii) Financial Assets		
(a) Investments	3	128
(2) Current Assets		
(i) Inventories	4	50
(ii) Financial Assets		
(b) Trade Receivables	5	400
(c) Cash & Cash equivalents	6	<u>2,050</u>
Total Assets		<u>3,678</u>
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	<u>900</u>
Total Equity & Liabilities		<u>3,678</u>

Notes to accounts:

			(₹ In '000)
1.	Property Plant & Equipment Land & Building Less: Reliance Jio Infocomm Ltd.	1620 <u>(670)</u>	950
2.	Goodwill Less: Reliance Jio Infocomm Ltd.	190 <u>(90)</u>	100
3.	Investments Investment in Reliance Jio Infocomm Ltd. (WN 2)	<u>128</u>	128
4.	Inventories Group Less: Reliance Jio Infocomm Ltd.	70 <u>(20)</u>	50
5.	Trade Receivables Group Less: Reliance Jio Infocomm Ltd	850 <u>(450)</u>	400

8.	Cash & Cash equivalents Group (WN 3)	2050	2050
9.	Trade Payables Group Less: Reliance Jio Infocomm Ltd.	1,350 450	900

Statement of changes in Equity:**6. Equity share Capital**

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
800	0	800

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				2,130		2,130
Total comprehensive income for the year			0			
Dividends			0			
Total comprehensive income attributable to parent			0			
Loss on disposal of Reliance Jio Infocomm Ltd.				(152)		(152)
Balance at the end of reporting period			0	1,978		1,978

Working Notes:

- When 90% being sold, the carrying amount of all assets and liabilities attributable to Reliance Jio Infocomm Ltd. were eliminated from the consolidated statement of financial position and further financial asset is recognized for remaining 10%.

- Fair value of remaining investment

(in '000)

Net Assets of Reliance Ltd.	1,280
Less: 90% disposal	(1152)
Financial Asset	128

- 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

Illustration 70:

Airtel Telecommunications Ltd. owns 100% share capital of Airtel Infrastructures Pvt. Ltd. On 1st April 20X1 Airtel Telecommunications Ltd. acquired a building from Airtel Infrastructures Pvt. Ltd., for ₹11,00,000 that the group plans to use as its new headquarters office.

Airtel Infrastructures Pvt. Ltd. had purchased the building from a third party on 1st 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 1st 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.

Solution:

Journal Entries in Airtel Infrastructures Pvt. Ltd.

1.	Assets(Land) A/c	Dr.	10,25,000	
	To cash			10,25,000
2.	Depreciation (P/L) A/c	Dr.	25,000	
	To Asset (Land)			25,000
3.	Cash A/c	Dr.	11,00,000	
	To Asset (Land)			10,00,000
	To P/L			1,00,000

Journal Entries in Airtel Telecommunications Ltd.

1.	Asset (Land) A/c	Dr.	11,00,000	
	To Cash			11,00,000
2.	Depreciation (P/L) A/c	Dr.	37,500	
	To Assets (Land)			37,500

Journal entry for consolidation:

1. Gain on sale of asset (P/L)	Dr.	1,00,000	
	To Asset (Building) A/c		1,00,000
2. Asset (Land) A/c	Dr.	5,000 (WN 1)	
	To Consolidated P&L		5,000

Working Note:

To be depreciated on original value	(10,00,000-3,50,000)/20	32,500
Depreciation charged	(11,00,000-3,50,000)/20	37,500
Reversal of depreciation		<u>5,000</u>

Particulars	Consolidated financial statements	Individual Financial statements	
		Airtel Telecommunications Ltd.	Airtel Infrastructures Pvt. Ltd.
31 st March 20X1	10,00,000	0	10,00,000
1 st April 20X1 purchase sale	0	11,00,000	(10,00,000)
Depreciation	(32,500)	(37,500)	0
31 st March 20X2	<u>9,67,500</u>	<u>10,62,500</u>	0

Illustration 71

As at the beginning of its current financial year, AB Limited holds 90% equity interest in BC Limited. During the financial year, AB Limited sells 70% of its equity interest in BC Limited to PQR Limited for a total consideration of ₹ 56 crore and consequently loses control of BC Limited. At the date of disposal, fair value of the 20% interest retained by AB Limited is ₹ 16 crore and the net assets of BC Limited are fair valued at ₹ 60 crore.

These net assets include the following:

- Debt investments classified as fair value through other comprehensive income (FVOCI) of ₹ 12 crore and related FVOCI reserve of ₹ 6 crore.
- Net defined benefit liability of ₹ 6 crore that has resulted in a reserve relating to net measurement losses of ₹ 3 crore.
- Equity investments (considered not held for trading) of ₹ 10 crore for which irrevocable option of recognising the changes in fair value in FVOCI has been availed and related FVOCI reserve of ₹ 4 crore.
- 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?

Solution:

Paragraph 25 of Ind AS 110 states that if a parent loses control of a subsidiary, the parent:

- derecognises the assets and liabilities of the former subsidiary from the consolidated balance sheet.
- 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.
- recognises the gain or loss associated with the loss of control attributable to the former controlling interest."

Paragraph B98(c) of Ind AS 110 states that on loss of control over a subsidiary, a parent shall reclassify to profit or loss, or transfer directly to retained earnings if required by other Ind AS, the amounts recognised in other comprehensive income in relation to the subsidiary on the basis specified in paragraph B99.

As per paragraph B99, if a parent loses control of a subsidiary, the parent shall account for all amounts previously recognised in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.

Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. If a revaluation surplus previously recognised in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

In view of the basis in its consolidated financial statements, AB Limited shall:

- 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;
- 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.
- reclassify the cumulative gain on fair valuation of equity investment of ₹ 3.6 crore (90% of ₹ 4 crore) attributable to the owners of the same parent from OCI to retained earnings under equity as per paragraph B5.7.1 of Ind AS 109, Financial Instruments, which provides that in case an entity has made an irrevocable election to recognise the changes in the fair value of an investment in an equity instrument not held for trading in OCI, it may subsequently transfer the cumulative amount of gains or loss within equity. Remaining 10% (i.e., ₹ 0.4 crore) related to the NCI are derecognised along with the balance of NCI and not reclassified to profit and loss.
- reclassify the foreign currency translation reserve of ₹ 7.2 crore (90% × ₹ 8 crore) attributable to the owners of the parent to statement of profit or loss as per paragraph 48 of Ind AS 21, The Effects of Changes in Foreign Exchange Rates, which specifies that the cumulative amount of exchange differences relating to the foreign operation, recognised in OCI, shall be reclassified from equity to profit or loss on the disposal of foreign operation. This is reflected in the gain on disposal. Remaining 10% (i.e., ₹ 0.8 crore) relating to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss on the loss of control of subsidiary, but is not reclassified to profit or loss in pursuance of paragraph 48B of Ind AS 21, which provides that the cumulative

exchange differences relating to that foreign operation attributed to NCI shall be derecognised on disposal of the foreign operation, but shall not be reclassified to profit or loss.

The impact of loss of control over BC Limited on the consolidated financial statements of AB Limited is summarised below:

(Rupees in crore)

Particular	Amount (Dr)	Amount (Cr)	PL Impact	RE Impact
Gain / Loss on Disposal on Investments				
Bank	56			
Non-controlling interest (Derecognised)	6			
Investment at FV (20% Retained)	16			
Gain on Disposal (PL) balancing figure		18	18	
De-recognition of total net assets of subsidiary	60			
Reclassification of FVTOCI reserve on debt instruments to profit or loss				
FVTOCI reserve on debt instruments (6 cr. x 90%)	5.4			
To Profit and loss	5.4	5.4		
Reclassification of net measurement loss reserve to profit or loss				
Reserve and Surplus	2.7			-2.7
To Net measurement loss reserve (FVTOCI) [(3 cr. x 90%)]		2.7		
Reclassification of FVTOCI reserve on equity instruments to retained earnings				
FVTOCI reserve on equity instruments (4 cr. x 90%)	3.6			
To Reserve and Surplus		3.6		3.6
Foreign currency translation reserve reclassified to profit or loss				
Foreign currency translation reserve (FVOCI) [8 cr. x 90%]	7.2			
To Profit and loss		7.2	7.2	
Total			30.6	0.9

Illustration 73 – (RTP May 2020)

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.

Solution

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.

Question 1 (MTP - OCT 2019)

Tee Limited is carrying on the business of developing light weight and medium weight guns for the Indian defence industry. Tee Limited acquired 48% of shares in Kay Limited, a company engaged in advanced research in weapons. Tee Limited acquired shares in Kay Limited to substantiate their position in the industry.

The remaining 52% of shares are held by the key management personnel of the Company Kay Limited. The Kay management consists of eleven people who are experts in the fields of advanced weapons and the core of the Company.

Tee Limited has the option to purchase remaining 52% at any time by paying 6 times the market price of the share. But on purchase of the shares it is highly possible that the key management personnel will leave the company.

(A) State whether Tee Limited has control over Kay Limited.

(B) What will be your answer if Tee Limited had 51% of shares in Kay Limited and Kay Limited can start the research, development and production of weapon only with the stringent approval process of the defence ministry of the Central Government.

Solution

As per para 7 of Ind AS 110 / IFRS 10, an investor controls an investee if and only if the investor has all the following:

1. Power over the investee

Further, as per para 10 of the standard, an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, ie the activities that significantly affect the investee's returns.

2. Exposure, or rights, to variable returns from its involvement with the investee

As per para 15 of the standard, an investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance.

3. The ability to use its power over the investee to affect the amount of the investor's returns.

An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance. The investor's returns can be only positive, only negative or both positive and negative.

Based on the above guidance, following can be concluded:

(a) Tee limited has acquired 48% in Kay Limited. The purpose of acquiring the shares by Tee limited in it is to substantiate their position in the industry. Kay Limited is a specialist entity that is engaged in advanced research in weapons. Acquiring Kay Limited will help Tee limited to gain access to their research which would complement Tee limited's operations and business of developing light weight and medium weight guns.

The key management personnel who holds 52% shares of Kay Limited are key for running Kay Limited's business of advanced research and will help Tee limited to acquire the market through ground breaking advanced researches of Kay Limited. In case of acquisition of 52% stake of Kay Limited, the key management personnel may leave the organisation and in such a situation Tee limited will not enjoy any economic benefit or infact will lose the benefit of unique technical knowledge of those 11 experts.

Hence, Tee limited would not be able to use its power over Kay Limited to affect the amount of its returns which is one of the essential criteria to assess the control, so there is no control of Tee limited on Kay Limited.

(b) Even though Tee limited has acquired 51% stake in Kay Limited yet it does not have power over Kay Limited as it would not be able to exercise its existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the investee's returns. In other words, the relevant activity of Kay Limited is advance research in weapons which will help Tee limited to substantiate their position. However, the research, development and production will start only after stringent approval process of the defence ministry of the Central Government. Thus regulations prevent Tee limited to direct the relevant activity of Kay Limited which ultimately lead to prevent Tee Limited to have control.

Question 2 - (RTP - MAY 2018)

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 an 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?

Solution:

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

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	₹ in lakhs	₹ in lakhs
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 amount of the non controlling interest would be ₹ 80 ($₹ 400 \times 0.20$). The gain on the bargain purchase then would be ₹ 20 ($₹ 400 - (₹ 300 + ₹ 80)$)

Question 3 - (RTP - May 2019)

Angel Ltd. has adopted Ind AS with a transition date of 1st April, 2017. Prior to Ind AS adoption, it followed Accounting Standards notified under Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as "IGAAP").

It has made investments in equity shares of Pharma Ltd., a listed company engaged in the business of pharmaceuticals. The shareholding pattern of Pharma Ltd. is given below:

Shareholders (refer Note 1)	Percentage shareholding as on 1st April, 2017
Angel Ltd.	21%
Little Angel Ltd. (refer Note 2)	24%
Wealth Master Mutual Fund (refer Note 3)	3%
Individual public shareholders (refer Note 4)	52%

Notes:

- (1) None of the shareholders have entered into any shareholders' agreement.
- (2) Little Angel Ltd. is a subsidiary of Angel Ltd. (under Ind AS) in which Angel Ltd. holds 51% voting power.
- (3) Wealth Master Mutual Fund is not related party of either Little Angel Ltd. or Pharma Ltd.
- (4) Individual public shareholders represent 17,455 individuals. None of the individual shareholders hold more than 1% of voting power in Pharma Ltd.

All commercial decisions of Pharma Ltd. are taken by its directors who are appointed by a simple majority vote of the shareholders in the annual general meetings ("AGM"). The following table shows the voting pattern of past AGMs of Pharma Ltd.:

Shareholders	AGM for the financial year:		
	2013-14	2014-15	2015-16
Angel Ltd.	Attended and voted in favour of all the resolutions	Attended and voted in favour of all the resolutions	Attended and voted in favour of all the resolutions
Little Angel Ltd.	Attended and voted as per directions of Angel Ltd.	Attended and voted as per directions of Angel Ltd.	Attended and voted as per directions of Angel Ltd.
Wealth Master Mutual Fund	Attended and voted in favour of all the resolutions except for the reappointment of the retiring directors	Attended and voted in favour of all the resolutions except for the reappointment of the retiring directors	Attended and voted in favour of all the resolutions except for the reappointment of the retiring directors

Individuals	7% of the individual shareholders attended the AGM. All the individual shareholders voted in favour of all the resolutions, except that 50% of the individual Shareholders voted against the resolution to appoint the retiring directors.	8% of the individual shareholders attended the AGM. All the individual shareholders voted in favour of all the resolutions, except that 50% of the individual Shareholders voted against the Resolution to appoint the retiring directors.	6% of the individual shareholders attended the AGM. All the individual shareholders voted in favour of all the resolutions, except that 50% of the individual Shareholders voted against the resolution to appoint the retiring directors.

Pharma Ltd. has obtained substantial long term borrowings from a bank. The loan is payable in 20 years from 1st April, 2017. As per the terms of the borrowing, following actions by Pharma Ltd. will require prior approval of the bank:

- Payment of dividends to the shareholders in cash or kind;
- Buyback of its own equity shares;
- Issue of bonus equity shares;
- Amalgamation of Pharma Ltd. with any other entity; and
- Obtaining additional loans from any entity.

Recently, the Board of Directors of Pharma Ltd. proposed a dividend of ₹ 5 per share. However, when the CFO of Pharma Ltd. approached the bank for obtaining their approval, the bank rejected the proposal citing concerns over the short-term cash liquidity of Pharma Ltd. Having learned about the developments, the Directors of Angel Ltd. along with the Directors of Little Angel Ltd. approached the bank with a request to re-consider its decision. The Directors of Angel Ltd. and Little Angel Ltd. urged the bank to approve a reduced dividend of at least ₹ 2 per share. However, the bank categorically refused to approve any payout of dividend.

Under IGAAP, Angel Ltd. has classified Pharma Ltd. as its associate. As the CFO of Angel Ltd., you are required to comment on the correct classification of Pharma Ltd. on transition to Ind AS.

Solution

To determine whether Pharma Limited can be continued to be classified as an associate on transition to Ind AS, we will have to determine whether Angel Limited controls Pharma Limited as defined under Ind AS 110.

An investor controls an investee if and only if the investor has all the following:

- Power over investee
- Exposure, or rights, to variable returns from its involvement with the investee
- Ability to use power over the investee to affect the amount of the investor's returns.

Since Angel Ltd. does not have majority voting rights in Pharma Ltd. we will have to determine whether the existing voting rights of Angel Ltd. are sufficient to provide it power over Pharma Ltd.

Analysis of each of the three elements of the definition of control:

Elements / conditions	Analysis
Power over investee	Angel Limited along with its subsidiary Little Angel Limited (hereinafter referred to as "the Angel group") does not have majority voting rights in Pharma Limited. Therefore, in order to determine whether Angel group have power over Pharma Limited, we will

	need to analyse whether Angel group, by virtue of its non-majority voting power, have practical ability to unilaterally direct the relevant activities of Pharma Limited. In other words, we will need to analyse whether Angel group has de facto power over Pharma Limited. Following is the analysis of de facto power of Angel over Pharma Limited: - The public shareholding of Pharma Limited (that is, 52% represents thousands of shareholders none individually holding material shareholding, - The actual participation of Individual public shareholders in the general meetings is minimal (that is, in the range of 6% to 8%). - Even the public shareholders who attend the meeting do not consult with each other to vote. - Therefore, as per guidance of Ind AS 110, the public shareholders will not be able to outvote Angel group (who is the largest shareholder group) in any general meeting. Based on the above-mentioned analysis, we can conclude that Angel group has de facto power over Pharma Limited.
Exposure, or rights, to variable returns from its involvement with the investee	Angel group has exposure to variable returns from its involvement with Pharma Limited by virtue of its equity stake
Ability to use power over the investee to affect the amount of the investor's returns	Angel group has ability to use its power (in the capacity of a principal and not an agent) to affect the amount of returns from Pharma Limited because it is in the position to appoint directors of Pharma Limited who would take all the decisions regarding relevant activities of Pharma Limited. Here, it is worthwhile to evaluate whether certain rights held by the bank would prevent Angel Limited's ability to use the power over Pharma Limited to affect its returns. It is to be noted that, all the rights held by the bank in relation to Pharma Limited are protective in nature as they do not relate to the relevant activities (that is, activities that significantly affect the Pharma Limited's returns) of Pharma Limited. As per Ind AS 110, protective rights are the rights designed to protect the interest of the party holding those rights <u>without giving that party power over the entity to which those rights relate.</u> Therefore, the protective rights held by the bank should not be considered while evaluating whether or not Angel Group has control over Pharma Limited.

Conclusion: Since all the three elements of definition of control is present, it can be concluded that Angel Limited has control over Pharma Limited

Since it has been established that Angel Limited has control over Pharma Limited, upon transition to Ind AS, Angel Limited shall classify Pharma Limited as its subsidiary.

Question 4 (Past Exam Jan'21) (MTP Oct'21, March'22)

On 1st April 2017, A Limited acquired 80% of the share capital of S Limited. On acquisition date the share capital and reserves of S Ltd. stood at ₹ 5,00,000 and ₹ 1,25,000 respectively. A Limited paid initial cash consideration of ₹ 10,00,000. Additionally, A Limited issued 2,00,000 equity shares with a nominal value of ₹ 1 per share at current market value of ₹ 1.80 per share.

It was also agreed that A Limited would pay a further sum of ₹ 5,00,000 after three years. A Limited's cost of capital is 10%. The appropriate discount factor for ₹ 1 @ 10% receivable at the end of

1st year: 0.91

2nd year: 0.83

3rd year: 0.75

The shares and deferred consideration have not yet been recorded by A limited. Below are the Balance Sheet of A Limited and S Limited as at 31st March, 2019:

	A Limited (₹ 000)	S Limited (₹ 000)
Non-current assets:		
Property, plant & equipment	5,500	1,500
Investment in S Limited at cost	1,000	
Current assets:		
Inventory	550	100
Receivables	400	200
Cash	200	50
	<u>7,650</u>	<u>1,850</u>
Equity:		
Share capital	2,000	500
Retained earnings	<u>1,400</u>	<u>300</u>
	3,400	800
Non-current liabilities	3,000	400
Current liabilities	1,250	650
	<u>7,650</u>	<u>1,850</u>

Further information:

- On the date of acquisition the fair values of S Limited's plant exceeded its book value by ₹ 2,00,000. The plant had a remaining useful life of five years at this date;
 - The consolidated goodwill has been impaired by ₹ 2,58,000; and
 - The A Limited Group, values the non-controlling interest using the fair value method. At the date of acquisition, the fair value of the 20 % non-controlling interest was ₹ 3,80,000.
- You are required to prepare Consolidated Balance Sheet of A Limited as at 31st March, 2019. (Notes to Account on Consolidated Balance Sheet is not required).

(15 Marks)

SOLUTION

(a) Consolidated Balance Sheet of A Ltd. and its subsidiary, S Ltd. as at 31st March, 2019

Particulars	₹ in 000s

I. Assets	
(1) Non-current assets	
(i) Property Plant & Equipment (W.N.4)	7,120.00
(ii) Intangible asset – Goodwill (W.N.3)	1,032.00
(2) Current Assets	
(i) Inventories (550 + 100)	650.00
(ii) Financial Assets	
(a) Trade Receivables (400 + 200)	600.00
(b) Cash & Cash equivalents (200 + 50)	250.00
Total Assets	9,652.00
II. Equity and Liabilities	
(1) Equity	
(i) Equity Share Capital (2,000 + 200)	2,200.00
(ii) Other Equity	
(a) Retained Earnings (W.N.6)	1190.85
(b) Securities Premium	160.00
(2) Non-Controlling Interest (W.N.5)	347.40
(3) Non-Current Liabilities (3,000 + 400)	3,400.00
(4) Current Liabilities (W.N.8)	2,353.75
Total Equity & Liabilities	9,652.00

Notes:

- Since the question required not to prepare Notes to Account, the column of Note to Accounts had not been drawn.
- It is assumed that shares were issued during the year 2018-2019 and entries are yet to be made.

Working Notes:

- Calculation of purchase consideration at the acquisition date i.e. 1st April, 2017

	₹ in 000s
Payment made by A Ltd. to S Ltd.	
Cash	1,000.00
Equity shares (2,00,000 shares x ₹ 1.80)	360.00
Present value of deferred consideration (₹ 5,00,000 x 0.75)	<u>375.00</u>
Total consideration	<u>1,735.00</u>

- Calculation of net assets i.e. net worth at the acquisition date i.e. 1st April, 2017

	₹ in 000s
Share capital of S Ltd.	500.00
Reserves of S Ltd.	125.00
Fair value increase on Property, Plant and Equipment	<u>200.00</u>
Net worth on acquisition date	<u>825.00</u>

- Calculation of Goodwill at the acquisition date i.e. 1st April, 2017 and 31st March, 2019

	₹ in 000s
Purchase consideration (W.N.1)	1,735.00
Non-controlling interest at fair value (as given in the question)	<u>380.00</u>
	2,115.00

Less: Net worth (W.N.2)	<u>(825.00)</u>
Goodwill as on 1st April 2017	1,290.00
Less: Impairment (as given in the question)	<u>258.00</u>
Goodwill as on 31st March 2019	<u>1,032.00</u>

4. Calculation of Property, Plant and Equipment as on 31st March 2019

		₹ in 000s
A Ltd. S Ltd.	1,500.00	5,500.00
Add: Net fair value gain not recorded yet	200.00	
Less: Depreciation $[(200/5) \times 2]$	(80.00)	
	120.00	1,620.00
		<u>7,120.00</u>

5. Calculation of Post-acquisition gain (after adjustment of impairment on goodwill) and value of NCI as on 31st March 2019

	₹ in 000s	₹ in 000s
	NCI (20%)	A Ltd. (80%)
Acquisition date balance	380.00	Nil
Closing balance of Retained Earnings	300.00	
Less: Pre-acquisition balance	<u>(125.00)</u>	
Post-acquisition gain	175.00	
Less: Additional Depreciation on PPE $[(200/5) \times 2]$	<u>(80.00)</u>	
Share in post-acquisition gain	95.00	76.00
Less: Impairment on goodwill	<u>(51.60)</u>	<u>(206.40)</u>
	<u>347.40</u>	<u>(130.40)</u>

6. Consolidated Retained Earnings as on 31st March 2019

	₹ in 000s
A Ltd.	1,400.00
Add: Share of post-acquisition loss of S Ltd. (W.N.5)	(130.40)
Less: Finance cost on deferred consideration (37.5 + 41.25) (W.N.7)	<u>(78.75)</u>
Retained Earnings as on 31st March 2019	<u>1,190.85</u>

7. Calculation of value of deferred consideration as on 31st March 2019

	₹ in 000s
Value of deferred consideration as on 1st April 2017 (W.N.1)	375.00
Add: Finance cost for the year 2017-2018 $(375 \times 10\%)$	<u>37.50</u>
	<u>412.50</u>

Add: Finance cost for the year 2018-2019 (412.50 x 10%)	<u>41.25</u>
Deferred consideration as on 31st March 2019	<u>453.75</u>

8. Calculation of current Liability as on 31st March 2019

	₹ in 000s
A Ltd.	1,250.00
S Ltd.	650.00
Deferred consideration as on 31st March 2019 (W.N.7)	<u>453.75</u>
Current Liability as on 31st March 2019	<u>2,353.75</u>

Question 5 (Past Exam July'21) (MTP Nov'22)

Given below are the balance sheets of a group of companies comprising LX Limited, MX Limited and NX Limited as on 31st March 2021:

₹ in lakh

Particulars	LX Limited	MX Limited	NX Limited
Assets			
<u>Non-current Assets</u>			
Property, Plant and Equipment	1,500	1,600	1,400
Investment			
17.0 lakh share in MX Limited	2,620	-	-
9.6 lakh shares in NX Limited	-	1,350	-
<u>Current Assets</u>			
Inventories	1,230	730	1,180
Financial Assets			
Trade Receivables	1,415	270	620
Bills Receivables	650	60	-
Cash in hand and at Bank	<u>1,085</u>	<u>90</u>	<u>150</u>
	<u>8,500</u>	<u>4,100</u>	<u>3,350</u>
Equity and Liabilities			
Shareholders' Equity			
Share Capital (₹ 100 per share)	3,400	2,000	1,600
Other Equity			
Reserves	1,150	810	580
Retained earnings	1,030	600	310
<u>Current Liabilities</u>			
Financial Liabilities			
Trade Payables	2,920	690	805
Bills Payable	-	-	-
MX Limited	-	-	<u>55</u>
	<u>8,500</u>	<u>4,100</u>	<u>3,350</u>

LX Limited holds 85% shares in MX Limited, which were acquired on 1st April 2020 and MX Limited holds 60% shares in NX Limited, which were acquired on 30th September 2020.

The following balances stood in the books of MX Limited and NX Limited as on 1st April 2020:

	MX Limited	NX Limited
	₹ in lakh	₹ in lakh
Reserves	760	520
Retained earnings	480	150

The business activities of NX Limited are not seasonal in nature.

The parent company has adopted an accounting policy to measure non-controlling interest at fair value applying Ind AS 103. The fair value is to be determined at quoted market price. The given market price of MX Limited is ₹ 120 per share and NX Limited is ₹ 125 per share.

Prepare the consolidated Balance Sheet as on 31st March 2021 of the group of companies LX Limited, MX Limited and NX Limited. (15 Marks)

Solution:

Consolidated Balance Sheet of the Group as at 31st March, 2021

Particulars	Note No.	₹ in lakh
ASSETS		
Non-current assets		
Property, plant and equipment	1	4,500.00
Current assets		
(a) Inventories	2	3,140.00
(b) Financial assets		
Trade receivables	3	2,305.00
Bills receivables	4	655.00
Cash and cash equivalents	5	1,325.00
Total assets		11,925.00
EQUITY & LIABILITIES		
Equity attributable to owners of parent		
Share Capital		3,400.00
Other Equity	6	2,893.10
Non-controlling interests (W.N.4)		1,216.90
LIABILITIES		
Non-current liabilities		Nil
Current liabilities		
(a) Financial Liabilities		
Trade payables	7	4,415.00
Total equity and liabilities		11,925.00

Notes to Accounts

1.	Property Plant & Equipment		
	LX Ltd.	1,500	
	MX Ltd.	1,600	
	NX Ltd.	1,400	4,500
2.	Inventories		
	LX Ltd.	1,230	

	MX Ltd.	730	
	NX Ltd.	1,180	3,140
3.	Trade Receivables		
	LX Ltd.	1,415	
	MX Ltd.	270	
	NX Ltd.	620	2,305
4.	Bills Receivables		
	LX Ltd.	650	
	MX Ltd. (60-55)	5	655
5.	Cash & Cash equivalents		
	LX Ltd.	1,085	
	MX Ltd.	90	
	NX Ltd.	150	1,325
6.	Other Equity		
	Reserve (W.N.5)	1,207.80	
	Retained earnings (W.N.5)	1,172.80	
	Capital Reserve (W.N.3)	512.50	2,893.10
7.	Trade Payables		
	LX Ltd.	2,920	
	MX Ltd.	690	
	NX Ltd.	805	4,415

Working Notes:**1. Analysis of Reserves and Surplus**

(₹ in lakh)

	MX Ltd.		NX Ltd.
Reserves as on 1.4.2020	760		520
Increase during the year 2020-2021 (580 - 520)		60	
Increase for the half year till 30.9.2020			30
Balance on acquisition date (A)	760		550
Total balance as on 31.3.2021	810		580
Post-acquisition balance	50		30
Retained Earnings as on 1.4.2020	480		150
Increase during the year 2020-2021 (310 - 150)		160	
Increase for the half year till 30.9.2020			80
Balance on acquisition date (B)	480		230
Total balance as on 31.3.2021	600		310
Post-acquisition balance	120		80
Total balance on the acquisition date (A+B)	1,240		780

2. Calculation of Effective Interest of LX Ltd. in NX Ltd.

Acquisition by LX Ltd. in MX Ltd. = 85%

Acquisition by MX Ltd. in NX Ltd. = 60%

Acquisition by Group in NX Ltd. (85% x 60%) = 51%

Non-controlling Interest = 49%

3. Calculation of Goodwill / Capital Reserve on the acquisition

	MX Ltd.	NX Ltd.
Investment or consideration	2,620.00	(1,350 x 85%) 1,147.50
Add: NCI at Fair value		
[(2,000 / 100) x 120 x 15%]	360.00	
[(1,600 / 100) x 125 x 49%]	-	980.00
	2,980.00	2,127.50
Less: Identifiable net assets (Share Capital + Increase in the Reserves and Surplus till acquisition date)	(2,000+760+48 0) (3,240.00)	(1,600+550+23 0) (2,380.00)

Capital Reserve	260.00	252.50
Total Capital Reserve (260 + 252.50)	512.50	0

4. Calculation of Non-controlling Interest

	MX Ltd.	NX Ltd.
At Fair Value (See Note 3)	360.00	980.00
Add: Post Acquisition Reserves (W.N.1)	(50 x 15%) 7.50	(30 x 49%) 14.70
Add: Post Acquisition Retained Earnings (W.N.1)	(120 x 15%) 18.00	(80 x 49%) 39.20
Less: NCI share of investment in NX Ltd.	(1,350 x 15%) (202.50)*	-
	183.00	1,033.90
Total (183.00 + 1,033.90)		1,216.90

*Note: The non-controlling interest in MX Ltd. will take its proportion in NX Ltd. Therefore, they have to bear their proportion in the investment by MX Ltd. (in NX Ltd.) also.

5. Calculation of Consolidated Other Equity

	Reserves	Retained Earnings
LX Ltd.	1,150.00	1,030.00
Add: Share in MX Ltd.	(50 x 85%) 42.50	(120 x 85%) 102.00
Add: Share in NX Ltd.	(30 x 51%) 15.30	(80 x 51%) 40.80
	1,207.80	1,172.80

Question 6 - (RTP Dec 2021)

PP Ltd., a non-investment entity, is the parent of Praja Ltd. within the meaning of Ind AS 110 'Consolidated Financial Statements'. The investment in Praja Ltd. was carried in the separate financial statements of PP Ltd. at fair value with changes in fair value recognised in the other comprehensive income. On 1st April, 20X2, PP Ltd. qualifies as one that is an investment entity. Carrying amount of the investment on 1st April, 20X2 was ₹ 8,00,000. The fair value of its investment in Praja Ltd was ₹ 10,00,000 on that date. PP Ltd had recognised in OCI an amount of ₹ 1,00,000 as a previous fair value increase related to the investment in Praja Ltd.

How would PP Ltd account for the investment in Praja Ltd on the date of change of its classification/status as an investment entity, in its separate financial statements?

Solution

- (i) As per paragraph 11B(b) of Ind AS 27, on the date of change, ie, 1st April, 20X2, PP Ltd (the parent) becoming an investment entity, its investment in Praja Ltd (the subsidiary) shall be at fair value through profit and loss in accordance with Ind AS 109. Accordingly, the new carrying amount will be ₹ 10,00,000.
- (ii) The difference between the new carrying amount and the carrying amount of the investment on the date of change will be recognised in the profit and loss. Hence, PP Ltd will recognise an amount of ₹ 2,00,000 (₹ 10,00,000 – ₹ 8,00,000) in profit and loss as gain.
- (iii) Any fair value adjustments previously recognised in OCI in respect of subsidiary ie Praja Ltd. shall be treated as if the investment entity had disposed off the subsidiary at the date of change in status as per para 11B(b) of Ind AS 27.

Further, as per para B5.7.1 of Ind AS 109, amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity.

Therefore, the company shall not reclassify the fair value gains or losses to profit or loss on change in classification from FVTOCI to FVTPL. However, the company may transfer the fair value gains or losses from one component to the other within equity.

Moreover, Paragraph 11A(e) of Ind AS 107, requires disclosure of any transfers of the cumulative gain or loss within equity during the period and the reason for such transfers. Accordingly, PP Ltd. shall provide the disclosures if it transfers the cumulative gain or loss from one component to the other within equity.

Particulars	₹
Carrying amount of investment in Praja Ltd [as per (i) above]	10,00,000
Amounts recognised in profit and loss relating to investment in Praja Ltd [as per (ii) above]	2,00,000

Question 7 - (RTP Dec'21) (MTP May'23)

Solar Limited has an 80% interest in its subsidiary, Mars Limited. Solar Limited holds a direct interest of 25% in Venus Limited. Mars Limited also holds a 30% interest in Venus Limited. The decisions concerning relevant activities of Venus Limited require a simple majority of votes. How should Solar Limited account for its investment in Venus Limited in its consolidated financial statements?

(5 Marks)

Solution

In the present case, Solar Limited controls Mars Limited (since it holds 80% of its voting rights). Consequently, it also controls the voting rights associated with 30% equity interest held by Mars Limited in Venus Limited. Solar Limited also has 25% direct equity interest and related voting power in Venus Limited. Thus, Solar Limited controls 55% (30% + 25%) voting power of Venus Limited. As the decisions concerning relevant activities of Venus Limited require a simple majority of votes. Solar Limited controls Venus Limited and should therefore consolidate it in accordance with Ind AS 110.

Although, Solar Limited controls Venus Limited, its entitlement to the subsidiary's economic benefits is determined on the basis of its actual ownership interest. For the purposes of the consolidated financial statements, Solar Limited's share in Venus Limited is determined as 49% [25% + (80% × 30%)]. As a result, 51% of profit or loss, other comprehensive income and net assets of Venus Limited shall be attributed to the non-controlling interests in the consolidated financial statements (this comprises 6% attributable to holders of non-controlling interests in Mars Limited [reflecting 20% interest of non-controlling shareholders of Mars Limited in 30% of Venus Limited] and 45% to holders of non-controlling interests in Venus Limited).

Question 8 (MTP Nov'22)

High Speed Ltd. has entered into a Share Purchase Agreement ("SPA") with the shareholders of Fast Move Limited to purchase 30% stake in Fast Move Limited as at 1st June, 20X1 at a price of ₹ 30 per share. As per the terms of SPA, High Speed Ltd. has an option to purchase additional 25% stake in Fast Move Limited on or before 15th June, 20X1 at a price of ₹ 30 per share. Similarly, the selling shareholder has an option to sell additional 25% stake in Fast Move Limited on or before 15.6.20X1 to High Speed Ltd. at a price of ₹ 30 per share. The decisions on relevant activities of Fast Move Limited are made in Annual General Meeting / Extraordinary General Meeting (AGM / EGM). A resolution in AGM / EGM is passed when more than 50% votes are casted in favor of the resolution. An AGM / EGM can be called by giving atleast 21 days advance notice to all shareholders.

With respect to the SPA entered by High Speed Ltd., you are required to determine whether High Speed Ltd. has control over Fast Move Limited as at 1st June, 20X1. **(5 Marks)**

Solution

Paragraph 10 of Ind AS 110 'Consolidated Financial Statements', states that an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the investee's returns. As per the facts given in the question, High Speed Ltd. has 15 days to exercise the option to purchase 25% additional stake in Fast Move Ltd. which will give it majority voting rights of 55% (30% + 25%). This is a substantive potential voting rights which is currently exercisable. Further, the decisions on relevant activities of Fast Move Ltd. are made in AGM / EGM. An AGM/ EGM can be called by giving atleast 21 days advance notice. A resolution in AGM / EGM is passed when more than 50% votes are casted in favour of the resolution. Thus, the existing shareholders of Fast Move Ltd. are unable to change the existing policies over the relevant activities before the exercise of option by High Speed Ltd. High Speed Ltd. can exercise the option and get voting rights of more than 50% at the date of AGM/ EGM. Accordingly, the option contract gives High Speed Ltd. the current ability to direct the relevant activities even before the option contract is settled. Therefore, High Speed Ltd. controls Fast Move Ltd. as at 1st June, 20X1.

IND AS 111 – JOINT ARRANGEMENTS

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.

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?

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.

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 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.

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 give 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. 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 decision about relevant activities independently and they will entitled for 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	

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 requires 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.

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.

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.

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?

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.

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.

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 partnership firm with each party having 50% share in the net profits of the firm. 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:

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.

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.

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.

Illustration 19 - Assessing other facts and circumstances (MTP April'22)

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 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?

Will your conclusion change in case Entity A sells all its output to third parties instead of its owners?

(6 Marks)

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.

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.

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 in PQ. However, the contractual terms of the joint arrangement state that P has the rights to all of Machinery and the obligation to pay Bank Loan in PQ. P and Q have rights to all other assets in PQ, and obligations for all other liabilities in PQ in proportion to their capital share (i.e., 50%).

PQ's balance sheet is as follows:

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

What would you record in P's financial statements to account for its rights and obligations in PQ?

Solution:

Under Ind AS 111, we would record the following in P's financial statements, to account for its rights to the assets in PQ and its obligations for the liabilities in PQ. This may differ from the amounts recorded using proportionate consolidation.

Machinery	250,000
Cash	25,000
Capital	75,000
Bank Loan	75,000
Other Loan	37,500

Illustration 22 - Accounting of interest in joint operation (RTP - May 2020)

AB Limited and BC Limited establish a joint arrangement through a separate vehicle PQR, but the legal form of the separate vehicle does not confer separation between the parties and the separate vehicle itself. Thus, both the parties have rights to the assets and obligations for the liabilities of PQR. As neither the contractual terms nor the other facts and circumstances indicate otherwise, it is concluded that the arrangement is a joint operation and not a joint venture.

Both the parties own 50% each of the equity interest in PQR. However, the contractual terms of the joint arrangement state that AB Limited has the rights to all of Building No. 1 owned by PQR and the obligation to pay all of the debt owed by PQR to a lender XYZ. AB Limited and BC Limited have rights to all other assets in PQR, and obligations for all other liabilities of PQR in proportion of their equity interests (i.e. 50% each).

PQR's balance sheet is as follows (all amounts in INR):

Liabilities and equity	Amount	Assets	Amount
Debt owed to XYZ	240	Cash	40
Employee benefit plan obligation	100	Building 1	240
Equity	140	Building 2	200
Total	480	Total	480

How 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.

	₹
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

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].

The journal entry for the transaction would be as follows:

Bank	Dr.	₹ 32	
Loss on sale	Dr.	₹ 8	
To Asset			₹ 40

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

Illustration 25 – (RTP – Nov 18)

On 1st April 20X1 Alpha Ltd. commenced joint construction of a property with Gamma 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.

Solution

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 ($₹ 10,00,00,000 \times 10\% \times 6/12$).

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 ($₹ 40,50,00,000 \times 1/20 \times 6/12$). ₹ 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.

Question 1 - (Past Exam – Nov 2020)

Entity K is owned by three institutional investors - M Limited, N Limited and C Limited holding 40%, 40% and 20% equity interest respectively. A contractual arrangement between M Limited and N Limited gives them joint control over the relevant activities of Entity K. It is determined that Entity K is a joint operation (and not a joint venture). C Limited is not a party to the arrangement between M Limited and N Limited. However, like M Limited and N Limited, C Limited also has rights to the assets, and obligations for the liabilities, relating to the joint operation in proportion of its equity interest in Entity K.

Would the manner of accounting to be followed by M Limited and N Limited on the one hand and C Limited on the other in respect of their respective interests in Entity K be the same or different?

You are required to explain in light of the relevant provisions in the relevant standard in this regard.

Solution:**(4 Marks)**

Ind AS 111 states that a joint operator shall recognise in relation to its interest in a joint operation:

- (a) its assets, including its share of any assets held jointly;
- (b) its liabilities, including its share of any liabilities incurred jointly;
- (c) its revenue from the sale of its share of the output arising from the joint operation;
- (d) its share of the revenue from the sale of the output by the joint operation; and
- (e) its expenses, including its share of any expenses incurred jointly.

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 AS applicable to the particular assets, liabilities, revenues and expenses. Further, Ind AS 111 states that a party that participates in, but does not have joint control of a joint operation shall also account for its interest in the arrangement in accordance with above provisions of the standard, if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation.

In the given case, all three investors (M Limited, N Limited and C Limited) share in the assets and liabilities of the joint operation in proportion of their respective equity interest. Accordingly, both M Limited and N Limited (which have joint control) and C Limited (which does not have joint control but participates) shall recognise their interest in joint operation as per above guidance while accounting for their respective interests in Entity K in their respective separate financial statements as well as in the consolidated financial statements.

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

Identify the type of joint arrangements in each of the following scenarios:

- (i) X Ltd and Y Ltd, manufacturing similar type of mobile phones, form a joint arrangement to manufacture and sell mobile phones. Under the terms of the arrangement, both X Ltd and Y Ltd are to use their own assets to manufacture the mobile phones and both are responsible for liabilities related to their respective manufacture. The arrangement also lays down the distribution revenues from the sale of the mobile phones and expenses incurred thereof. X Ltd however has exclusive control over the marketing and distribution functions and does not require the consent of Y Ltd in this aspect. No separate entity is created for the arrangement.
- (ii) Continuing with (i) above, what would be the classification of the joint arrangement if X Ltd and Y Ltd both jointly control all the relevant activities of the Joint arrangement including the marketing and the distribution functions?
- (iii) What would be the classification of the joint arrangement if under the terms of the arrangement, a separate entity is created to manufacture the mobile phones.
- (iv) Continuing with (iii) above, the joint arrangement is a means of manufacturing mobile phones on a common platform but the output of the joint arrangement is purchased by both X Ltd and Y Ltd in the ratio of 50:50. The joint arrangement cannot sell output to third parties. The price of the output sold to

X Ltd and Y Ltd is set by both the parties to the arrangement to cover the production costs and other administrative costs of the joint arrangement entity.

- (v) Would your answer in (iv) above be different if X Ltd and Y Ltd sold their respective share of output to third parties?
- (vi) Assume that in (iv) above, the contractual terms of the arrangement were modified so that the joint arrangement entity is not obliged to sell the output to X Ltd and Y Ltd but was able to sell the output to third parties. **(7 Marks)**

Solution:

For a joint arrangement to be either a *joint operation* or *joint venture*, it depends on whether the parties to the joint arrangement have rights to the assets and obligations for liabilities (will be a joint operation) OR whether the parties to the joint arrangement have rights to the net assets of the arrangement (will be joint venture).

- (i) In order to fit into the definition of a joint arrangement, the parties to the joint arrangement should have joint control over the arrangement. In the given case, decisions relating to relevant activities, ie, marketing and distribution, are solely controlled by X Ltd and such decisions do not require the consent of Y Ltd. Hence, the joint control test is not satisfied in this arrangement and the arrangement does not fit into the definition of a joint arrangement in accordance with the Standard.
- (ii) Where X Ltd and Y Ltd both jointly control all the relevant activities of the arrangement and since no separate entity is formed for the arrangement, the joint arrangement is in the nature of a *joint operation*.
- (iii) Where under a joint arrangement, a separate vehicle is formed to give effect to the joint arrangement, then the joint arrangement can either be a *joint operation* or a *joint venture*. Hence in the given case, if:
 - (a) The contractual terms of the joint arrangement, give both X Ltd and Y Ltd rights to the assets and obligations for the liabilities relating to the arrangement, and the rights to the corresponding revenues and obligations for the corresponding expenses, *then the joint arrangement will be in the nature of a joint operation.*
 - (b) The contractual terms of the joint arrangement, give both X Ltd and Y Ltd. rights to the net assets of the arrangement, *then the joint arrangement will be in the nature of a joint venture.*
- (iv) Where the rights to assets and liabilities to obligations are not clear from the contractual arrangement, then other facts and circumstances also need to be considered to determine whether the joint arrangement is a joint operation or a joint venture.

When the provision of the activities of the joint venture is primarily to produce output and the output is available / distributed only to the parties to the joint arrangement in some pre-determined ratio, then this indicates that the parties have substantially all the economic benefits of the assets of the arrangement. The only source of cash flows to the joint arrangement is receipts from parties through their purchases of the output and the parties also have a liability to fund the settlement of liabilities of the separate entity. Such an arrangement indicates that the joint arrangement is in the nature of a joint operation.

In the given case, the output of the joint arrangement is exclusively used by X Ltd. and Y Ltd. and the joint arrangement is not allowed to sell the output to outside parties. Hence, the joint arrangement between X Ltd. and Y Ltd. is in the nature of a joint operation.

- (v) It makes no difference whether the output of the joint arrangement is exclusively for use by the parties to the joint arrangement or the parties to the arrangement sold their share of the output to third parties. Hence, even if X Ltd. and Y Ltd. sold their respective share of output to third parties, the fact still remains that the joint arrangement cannot sell output directly to third parties. Hence, the joint arrangement will still be deemed to be in the nature of a joint operation.
- (vi) Where the terms of the contractual arrangement enable the separate entity to sell the output to third parties, this would result in the separate entity assuming demand, inventory and credit risks. Such facts and circumstances would indicate that the arrangement is a joint venture.

IND AS 28 – INVESTMENT IN ASSOCIATES & JOINT VENTURES

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 influence 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.

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.

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.

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.

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 as well as to entity X's. Analyse.

Solution:

The secondment of the board member and a senior manager from entity X to entity Y gives entity X, a range of power over a new production process and may evidence that entity X has significant influence over entity Y. This assessment take into the account what are the key financial and operating policies of entity Y and the influence this gives entity X over those policies.

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 the 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.

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?

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.)

Illustration 8 - Accounting entries related investment in associate / joint venture (MTP May'23)

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. (4 Marks)

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%)]

4) Recording of dividend distributed by associate

Dividend Income A/c (P&L)	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%)]

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 through profit or loss as per Ind AS 109

Illustration 10 - Acquisition of interest in an associate (MTP Oct'21)

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. (8 Marks)

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 * 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

(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

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 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*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

Illustration 12 - Share in the consolidated financial statements of associate – (Past Exam Nov'20)

Entity A holds a 20% equity interest in Entity B (an associate) that in turn has a 100% equity interest in Entity C. Entity B recognised net assets relating to Entity C of ₹ 1,000 in its consolidated financial statements. Entity B sells 20% of its interest in Entity C to a third party (a non-controlling shareholder) for ₹ 300 and recognises this transaction as an equity transaction in accordance with paragraph 23 of Ind AS 110, resulting in a credit in Entity B's equity of ₹ 100.

The financial statements of Entity A and Entity B are summarised as follows before and after the transaction:

Before			
A's consolidated financial statements			
Assets	₹	Liabilities	₹
Investment in B	200	Equity	200
Total	200	Total	200
B's consolidated financial statements			
Assets	₹	Liabilities	₹
Assets (from C)	1000	Equity	1000
Total	1000	Total	1000

The financial statements of B after the transaction are summarised below:

After			
B's consolidated financial statements			
Assets	₹	Liabilities	₹
Assets (from C)	1000	Equity	1000

Cash	300	Equity transaction with non-controlling interest	100	
		Equity attributable to owners		1100
		Non-controlling interest		200
Total	1300	Total		1300

Although Entity A did not participate in the transaction, Entity A's share of net assets in Entity B increased as a result of the sale of B's 20% interest in C. Effectively, A's share in B's net assets is now ₹ 220 (20% of ₹ 1,100) i.e., ₹ 20 in addition to its previous share.

How is an equity transaction that is recognised in the financial statements of Entity B reflected in the consolidated financial statements of Entity A that uses the equity method to account for its investment in Entity B? (6 Marks)

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 as per paragraph 3 of Ind AS 28 and also faithfully reflects the investor's share of the associate's transaction as presented in the associate's consolidated financial statements.

Thus, in the given case, Entity A recognises ₹ 20 as change in other equity instead of in statement of profit and loss and maintains the same classification as of its associate, Entity B, i.e., a direct credit to equity as in its consolidated financial statements.

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 of 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 * 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 * 10%). Hence, M Ltd.'s share in such profit i.e. ₹ 16,000 (40,000 * 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		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.

[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 unrealised 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 ($6,00,000 \times 10\%$ 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 ($4,00,000 \times 10\%$). 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 ($40,000 \times 60\%$) is treated as realised profit. Balance profit of ₹ 16,000 ($40,000 \times 40\%$) 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.

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.

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. would have 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 $[(10,00,000 - 8,00,000) \times 50\%]$ 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

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.

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	(1,00,000)	17,00,000	(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 recognized loss to the extent of ₹ 1,50,000 at the end of year 2.

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.

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.

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.

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.

Illustration 18 – (RTP Nov'20, MTP Nov'22) (Past Exam Nov'22)

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. (5 to 8 Marks)

Solution

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)]	<u>(70,000)</u>	
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]		<u>(4,20,000)</u>
Closing balance of Investor Ltd.'s investment in XYZ Ltd.		<u>46,10,000</u>

Question 1 (MTP OCT'19)

Sumeru Limited holds 35% of total equity shares of Meru Limited, an associate company. The value of Investments in Meru Limited on March 31, 20X1 is Rs. 3 crores in the consolidated financial statements of Sumeru Limited.

Sumeru Limited sold goods worth Rs. 3,50,000 to Meru Limited. The cost of goods sold is Rs. 3,00,000. Out of these, goods costing Rs. 1,00,000 to Meru Limited were in the closing stock of Meru Limited.

During the year ended March 31, 20X2 the profit and loss statement of Meru Limited showed a loss of Rs. 1 crore.

(A) What is the value of investment in Meru Limited as on March 31, 20X2 in the consolidated financial statements of Sumeru Limited, if equity method is adopted for valuing the investments in associates?

(B) Will your answer be different if Meru Limited had earned a profit of Rs. 1.50 crores and declared a dividend of Rs. 75 lacs to the equity shareholders of the Company?

Solution

(a) Value of investment in Meru Ltd. as on 31st March, 20X2 as per equity method in the consolidated financial statements of Sumeru Ltd.

	Rs.
Cost of Investment	3,00,00,000
Less: Share in Post-acquisition Loss (1,00,00,000 x 35%)	(35,00,000)
Less: Unrealised gain on inventory left unsold with Meru Ltd.	
[(50,000/3,00,000) x 1,00,000] x 35%	(5,833)
Carrying value as per Equity method	2,64,94,167

(b) Value of investment in Meru Ltd. as on 31st March, 20X2 as per equity method in the consolidated financial statements of Sumeru Ltd.

	Rs.
Cost of Investment	3,00,00,000
Add: Share in Post-Acquisition Profit (1,50,00,000 x 35%)	52,50,000
Less: Unrealised gain on inventory left unsold with Meru Ltd.	
[(50,000/3,00,000) x 1,00,000] x 35%	(5,833)
Less: Dividend (75,00,000 x 35%)	(26,25,000)
Carrying value as per Equity method	3,26,19,167

Question 2 - (RTP - May 2020)

An entity P (parent) has two wholly-owned subsidiaries - X and Y, each of which has an ownership interest in an 'associate', entity Z. Subsidiary X is a venture capital organisation. Neither of the investments held in associate Z by subsidiaries X and Y is held for trading. Subsidiary X and Y account for their investment in associate Z at fair value through profit or loss in accordance with Ind AS 109 and using the equity method in accordance with Ind AS 28 respectively.

How should P account for the investment in associate Z in the following scenarios:

Scenario 1: Where both investments in the associate result in significant influence on a stand-alone basis - Subsidiary X and Y ownership interest in associate Z is 25% and 20% respectively.

Scenario 2: When neither of the investments in the associate results in significant influence on a stand-alone basis, but do provide the parent with significant influence on a combined basis - Subsidiary X and Y ownership interest in associate Z is 10% each.

Scenario 3: When one of the investments in the associate results in significant influence on a stand-alone basis and the other investment in the associate does not result in significant influence on a stand-alone basis - Subsidiary X and Y ownership interest in associate Z is 30% and 10% respectively.

Assume there is significant influence if the entity has 20% or more voting rights.

Solution

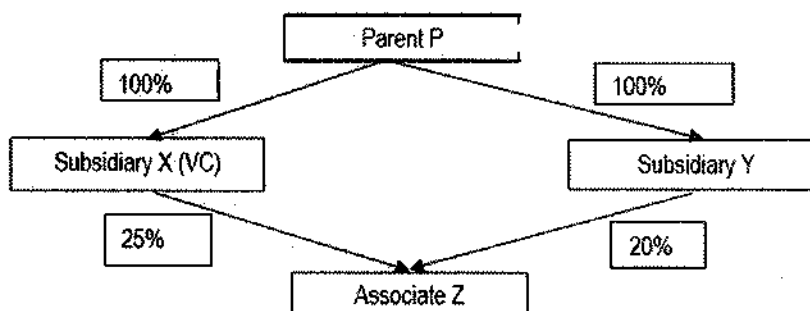
Paragraph 18 of Ind AS 28 states that, "when an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with Ind AS 109. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture."

Paragraph 19 of Ind AS 28 provides that, "when an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with Ind AS 109 regardless of whether the venture capital organisation has significant influence over that portion of the investment."

If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organisation".

Therefore, fair value exemption can be applied partially in such cases.

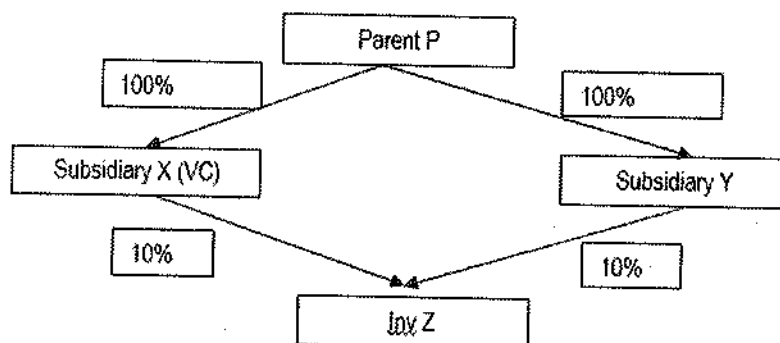
Scenario 1: Where both investments in the associate result in significant influence on a stand-alone basis.



In the present case, in accordance with paragraph 19 of Ind AS 28, P must follow equity method of accounting for its 20% interest held by Y.

Under the partial use of fair value exemption, P may elect to measure the 25% interest held by X at fair value through profit or loss.

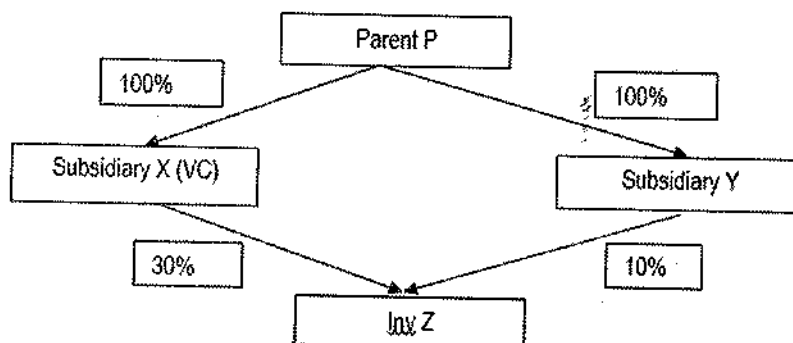
Scenario 2: When neither of the investments in the associate results in significant influence on a stand-alone basis, but do provide the parent with significant influence on a combined basis.



In the present case in accordance with the paragraph 19 of Ind AS 28, P must follow equity method of accounting for its 10% interest held by Y, even though Y would not have significant influence on a stand-alone basis.

Under the partial use of fair value exemption, P may elect to measure the 10% interest held by X at fair value through profit or loss.

Scenario 3: When one of the investments in the associate results in significant influence on a stand-alone basis and the other investment in the associate does not result in significant influence on a stand-alone basis



In the present case, in accordance with paragraph 19 of Ind AS 28, P must follow equity method of accounting for its 10% interest held by Y, even though Y would not have significant influence on a stand-alone basis.

Under the partial use of fair value exemption, the P may elect to measure the 30% interest held by X at fair value through profit or loss.

Question 3 - (RTP - Nov 2020)

On 1st April 2019, Big Limited acquired a 35 interest in Dig Limited and achieved a significant influence. The cost of the investment was ₹ 3,00,000. Dig Limited has net assets of ₹ 5,50,000 as on 1st April 2019. The fair value of those net assets is ₹ 6,50,000, since the fair value of property, plant and equipment is ₹ 1,00,000 higher than its book value. This property, plant and equipment have a remaining useful life of 8 years. For the financial year 2019-2020, Dig Limited earned a profit (after tax) of ₹ 1,00,000 and paid a dividend of ₹ 11,000 out of these profits. Dig Ltd. has also recognized the loss of ₹ 15,000, that arose from re-measurement of defined benefit directly in 'Other Comprehensive Income'. Calculate Big Ltd.'s interest in Dig Ltd. as at the year ended 31 st March 2020 under the relevant method.

Solution:

(5 Marks)

Calculation of Big Ltd.'s interest in Dig Ltd at the year ended 31 st March, 2020 as per Equity method:

	Amount (₹)

Cost of investment (35%)	3,00,000
Share in profit after adjustment (Refer Working Note)	30,625
Dividend received by Big Ltd from Dig Ltd (35% x ₹ 11,000)	(3,850)
Big Ltd.'s share of loss in OCI w.r.t Dig Ltd.'s loss from remeasurement of defined benefit liability (35% x ₹ 15,000)	<u>(5,250)</u>
Big Ltd.'s interest in Dig Ltd at the end of the year	<u>3,21,525</u>

Working Note:**Computation of Share in profit after adjustment**

	Amount (₹)
Big Ltd.'s share of Dig Ltd.'s after tax profit (35% x ₹ 1,00,000)	35,000
Less: Big Ltd.'s share of depreciation based on fair value (35% x ₹ 12,500)	<u>(4,375)</u>
Share in profit after adjustment	<u>30,625</u>

IND AS 32, 109, 107 – ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS

UNIT 1 – Scope & Definitions

Illustration 1 - Trade receivables

A Ltd. makes sale of goods to customers on credit of 45 days. the customers are entitled to earn a cash discount @ 2% per annum if payment is made before 45 days and an interest @ 10% per annum is charged for any payments made after 45 days. Company does not have a policy of selling its debtors and holds them to collect contractual cash flows.

Evaluate 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.

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 / bank at the end of contract period between the dealer and the Company.

Hence they meet the definition of financial assets.

Illustration 3 - Perpetual debt instruments

A Ltd. issues a bond at principal amount of CU 1000 per bond. The terms of bond require annual payments in perpetuity at a stated interest rate of 8 per cent applied to the principal amount of CU 1000. Assuming 8 per cent to be the market rate of interest for the instrument when it was issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition.

Evaluate the financial instrument in the hands of both the holder and the issuer.

Solution:

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. Hence, it will be classified as a financial liability.

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 – (MTP – April, 2021)

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.

(4 Marks)

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 [$10,00,000 \times 1.12 \times 1.12$ (Interest for 5th & 6th year in default plus principal amount)]
- One time settlement = INR 13,00,000
- Additional amount payable = ₹ 45,600

The above represents a contractual obligation to pay cash against settlement of a financial liability under conditions that are unfavorable to A Ltd. (owing to additional amount payable in comparison to amount that would have been paid without one time settlement). Hence, the rescheduled arrangement meets definition of 'financial liability'.

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.

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, i.e., 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 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 tantamount to use of equity shares as 'currency' and hence, this contract meets definition of financial liability in books of Target Ltd.

UNIT 2 - CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Illustration 9

An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs.

The entity performs credit risk management activities with the objective of minimising credit losses. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.

Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.

Evaluate the business model.

Solution

- Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows.

- Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy. Infrequent sales resulting from unanticipated funding needs (eg in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.

Hence, the business model of the company is to collect contractual cash flows and not realisation from sale of financial assets.

Illustration 10

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 11

Entity B sells goods to customers on credit. Entity B typically offers customers up to 60 days following the delivery of goods to make payment in full. Entity B collects cash in accordance with the contractual cash flows of trade receivables and has no intention to dispose of the receivables.

Evaluate the business model.

Solution

Entity's B objective is to collect contractual cash flows from trade receivables and therefore, trade receivables meet the business model test for the purpose of classifying the financial assets at amortised cost.

Illustration 12

An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period.

The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.

Evaluate the business model.

Solution

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk). The objective of this contrasting business model is to hold financial assets to collect contractual cash flows.

Illustration 13

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 14

A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (eg, a run on the bank's deposits). The entity does not anticipate selling these assets except in such scenarios. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised.

However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.

Evaluate the business model.

Solution

The objective of the entity's business model is to hold the financial assets to collect contractual cash flows. The analysis would not change –

- If during a previous stress case scenario the entity had sales that were significant in value in order to meet its liquidity needs; or
- Recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows; or
- If the entity is required by its regulator to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's business model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.

In contrast, if an entity holds financial assets to meet its everyday liquidity needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows.

Illustration 15

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 16

Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer. Analyse the nature of cash flows.

Solution

The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement; ie the return is linked to the value of the equity of the issuer.

Illustration 17

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 18

Instrument D is loan with recourse and is secured by collateral. Does the collateral affect the nature of contractual cash flows?

Solution

The fact that a loan is collateralised (since with recourse) does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The collateral is only a security to recover dues.

Illustration 19

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.

Illustration 20 - 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 21 - 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 22 - 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?

Solution

Yes. The terms for the repayment of the principal amount of the loan on demand satisfies the criterion of SPPI.

Illustration 23 - 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 on demand satisfies the criterion of SPPI.

Illustration 24 - 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 25 - 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.

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 amortized cost.

Illustration 26 - 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.

Illustration 27 - '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.

Illustration 28 – (MTP – April 2021)

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? (4 Marks)

Solution

The loans from ABC Bank carry interest @ 10% and 12% for 5 year term and 3 year term respectively. Additionally, there is a processing fee payable @ 1% on the principal amount on date of transaction. It is assumed that ABC Bank charges all customers in a similar manner and hence, this is representative of the market rate of interest.

Amortised cost is computed by discounting all future cash flows at market rate of interest. Further, any transaction fees that are an integral part of the transaction are adjusted in the effective interest rate and recognised over the term of the instrument.

Hence, loan processing fees shall be reduced from the principal amount to arrive the value on day 1 upon initial recognition.

Fair value (5 year term loan) = $10,00,000 - 10,000 (1\% \times 10,00,000) = 9,90,000$

Fair value (3 year term loan) = $8,00,000 - 8,000 (1\% \times 8,00,000) = 7,92,000$.

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.

Illustration 29 - Deposits carrying off-market rate of interest

Containers Ltd provides containers for use by customers for multiple purposes. The containers are returnable at the end of the service contract period (3 years) between Containers Ltd and its customers. In addition to the monthly charge, there is a security deposit that each customer makes with Containers Ltd for ₹ 10,000 per container and such deposit is refundable when the service contract terminates. Deposits do not carry any interest. Analyse the fair value upon initial recognition in books of customers leasing containers. Market rate of interest for 3 year loan is 7% per annum.

Solution

In the above case, lessee (ie, customers leasing the containers) make interest free deposits, which are refundable at the end of 3 years. Now, this money if it was to lent to a third party would fetch interest @ 7% per annum.

Hence, discounting all future cash flows (ie, ₹ 10,000)

Fair value on initial recognition = $10,000 / (1+0.07)^3 = 8,163$.

Differential on day 1 = $10,000 - 8,163 = 1,837$

The differential on day 1 shall be treated as follows:

- **Scenario 1** – If fair valuation is determined using level 1 inputs or other observable inputs, difference on day 1 recognised in profit or loss
- **Scenario 2** – If fair valuation is determined using other inputs, difference on day 1 shall be recognised in profit or loss unless it meets definition of an asset or liability.

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 P&L in a straight lined manner as depreciation as per Ind AS 16.

Illustration 30 - Accounting for transaction costs on initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income

An entity acquires a financial asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. How would transaction costs be accounted in books of the entity?

Solution

- On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income.
- If the financial asset is measured at fair value through other comprehensive income in accordance with Ind AS 109, the transaction costs are amortised to profit or loss using the effective interest method.

Illustration 31 - Determining fair value upon initial measurement

The shareholders of Company C provide C with financing in the form of loan notes to enable it to acquire investments in subsidiaries. The loan notes will be redeemed solely out of dividends received from these

subsidiaries and become redeemable only when C has sufficient funds to do so. In this context, 'sufficient funds' refers only to dividend receipts from subsidiaries. Analyse the initial measurement of loan notes.

Solution

In this case –

Loan notes are repayable only then C earns returns in form of dividends from subsidiaries. Hence, C cannot be forced to obtain additional external financing or to liquidate its investments to redeem the shareholder loans. Consequently, the loan notes are not considered payable on demand.

Accordingly –

- Loan notes shall be initially measured at their fair value (plus transaction costs), being the present value of the expected future cash flows, discounted using a market-related rate. The amount and timing of the expected future cash flows should be determined on the basis of the expected dividend flow from the subsidiaries. Also, the valuation would need to take into account possible early repayments of principal and corresponding reductions in interest expense.

- Since the loan notes are interest-free or bear lower-than-market interest, there will be a difference between the nominal value of the loan notes - i.e. the amount granted - and their fair value on initial recognition. Because the financing is provided by shareholders, acting in the capacity of shareholders, the resulting credit should be reflected in equity as a shareholder contribution in C's balance sheet. Conversely, in books of shareholders, the difference between amount invested and its fair value shall be recorded as 'investment in C Ltd' being representative of the underlying relationship between shareholders and C Ltd.

Illustration 32 - Use of cost v/s fair value determination for equity instruments

Silver Ltd. has made an investment in optionally convertible preference shares (OCPS) of a Company – Bronze Ltd. at ₹ 100 per share (face value ₹ 100 per share). Silver Ltd. has an option to convert these OCPS into equity shares in the ratio of 1:1 and if such option not exercised till end of 9 years, then the shares shall be redeemable at the end of 10 years at a premium of 20%.

Analyse the measurement of this investment in books of Silver Ltd.

Solution

The classification assessment for a financial asset is done based on two characteristics:

- i) Whether the contractual cash flows comprise cash flows that are solely payments of principal and interest on the principal outstanding
- ii) Entity's business model (BM) for managing financial assets – Whether the Company's BM is to collect cash flows; or a BM that involves realisation of both contractual cash flows & sale of financial assets;

In all other cases, the financial assets are measured at fair value through profit or loss.

In the above case, the Holder can realise return either through conversion or redemption at the end of 10 years, hence it does not indicate contractual cash flows that are solely payments of principal and interest. Therefore, such investment shall be carried at fair value through profit or loss. Accordingly, the investment shall be measured at fair value periodically with gain/ loss recorded in profit or loss.

Illustration 33 - Accounting for assets at amortised cost (Past Exam – Dec 2021)

A Ltd has made a security deposit whose details are described below. 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

Determine, how above financial asset should be measured and briefly explain measurement determined as such. Make necessary journal entries for accounting of the security deposit in the first and last year. (5 Marks)

Solution

The above security deposit is an interest free deposit redeemable at the end of lease term for ₹ 10,00,000. Hence, this involves collection of contractual cash flows and shall be accounted at amortised cost.

Upon initial measurement –

Particulars	Details
Security deposit (A)	10,00,000
Total Lease Period (Years)	5
Discount rate	12.00%
Present value annuity factor	0.56743
Present value of deposit at beginning (B)	5,67,427
Prepaid lease payment at beginning (A-B)	4,32,573

Journal Entries

Year – 1 beginning

Particulars		Amount	Amount
Security deposit A/c	Dr.	5,67,427	
Prepaid lease expenses (ROU ASSET)	Dr.	4,32,573	
To Bank A/c			10,00,000

Subsequently, every annual reporting year, interest income shall be accrued @ 12% per annum and prepaid expenses shall be amortised on straight line basis over the lease term.

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
Depreciation (4,32,573 / 5 years)	Dr.	86,515	
To Prepaid lease expenses (ROU Asset)			86,515

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

Depreciation (4,32,573 / 5 years)	Dr.	86,515	
To Prepaid lease expenses (ROU Asset)			86,515
Bank A/c	Dr.	10,00,000	
To Security deposit A/c			10,00,000

Illustration 34 - Accounting for assets at FVTPL

A Ltd. invested in equity shares of C Ltd. on 15th March for ₹10,000. Transaction costs were ₹500 in addition to the basic cost of ₹ 10,000. On 31 March, the fair value of the equity shares was ₹11,200 and market rate of interest is 10% per annum for a 10 year loan. Pass necessary journal entries. Analyse the measurement principle and pass necessary journal entries.

Solution

The above investment is in equity shares of C Ltd and hence, does not involve any contractual cash flows that are solely payments of principal and interest. Hence, these equity shares shall be measured at fair value through profit or loss. Also, an irrecoverable option exists to designate such investment as fair value through other comprehensive income.

Journal Entries

Particulars		Amount	Amount
Upon initial recognition –			
Investment in equity shares of C Ltd.	Dr.	10,000	
Transaction cost	Dr.	500	
To Bank A/c			10,500
(Being investment recognized at fair value plus transaction costs upon initial recognition)			
Profit and Loss A/c	Dr.	500	
To Transaction cost			500
(Being transaction cost incurred on assets measured at FVTPL transferred to P&L A/c)			

Subsequently –			
Investment in equity shares of C Ltd.	Dr.	1,200	
To Fair value gain on financial instruments			1,200
(Being fair value gain recognized at year end in P&L)			
Fair value gain on financial instruments	Dr.	1,200	
To Profit and Loss A/c			1,200
(Being fair value gain transferred to P&L A/c)			

Illustration 35 - Accounting for assets at FVOCI

Metallics Ltd. has made an investment in equity instrument of a company – Castor Ltd. for 19% equity stake. Significant influence not exercised. The investment was made for ₹ 5,00,000 for 10,000 equity shares on 01

April 20X1. On 30 June 20X1 the fair value per equity share is ₹45. The Company has taken an irrevocable option to measure such investment at fair value through other comprehensive income.

Solution

The Company has made an irrecoverable option to carry its investment at fair value through other comprehensive income. Accordingly, the investment shall be initially recognised at fair value and all subsequent fair value gains/ losses shall be recognised in other comprehensive income (OCI).

Journal Entries

Particulars		Amount	Amount
Upon initial recognition –			
Investment in equity shares of C Ltd.	Dr.	5,00,000	
To Bank a/c			5,00,000
(Being investment recognized at fair value plus transaction costs upon initial recognition)			
Subsequently –			
Fair value loss on financial instruments	Dr.	50,000	
To Investment in equity shares of C Ltd.			50,000
(Being fair value loss recognised)			
Fair value reserve in OCI	Dr.	50,000	
To Fair value loss on financial instruments			50,000
(Being fair value loss recognized in other comprehensive income)			

Illustration 36 - Accounting for assets at FVOCI – (Past Exam – Dec 2021)

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 Ind AS financial statements of XYZ, ABC and consolidated financial statements of the group?

Consider the following scenarios:

- The loan is repayable on demand.
- 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.
- The loan is repayable when ABC has funds to repay the loan.

Briefly, analyse the above scenarios. Also pass Journal Entries in the books of Ram Limited and Balram Limited in case of Scenario (a) and (b). (12 Marks)

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.

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
1	On the date of loan Loan to ABC Ltd (Subsidiary) Dr. Deemed Investment (Capital Contribution) in ABC Ltd Dr. To Bank (Being the loan is given to ABC Ltd and recognised at fair value)	7,51,315 2,48,685	10,00,000
2	Accrual of Interest income Loan to ABC Ltd Dr. To Interest income (Being interest income accrued) – Year 1	75,131	75,131
3	Loan to ABC Ltd Dr. To Interest income (Being interest income accrued) – Year 2	82,645	82,645
4	Loan to ABC Ltd Dr. To Interest income (Being interest income accrued) – Year 3 On repayment of loan	90,909	90,909
5	Bank Dr. To Loan to ABC Ltd (Subsidiary)	10,00,000	10,00,000

Accounting in the books of ABC Ltd (Subsidiary)

S. No.	Particulars	Amount	Amount
1	On the date of loan Bank Dr. To Loan from XYZ Ltd (Payable) To Equity (Deemed Capital Contribution from ABC Ltd) (Being the loan is given to ABC Ltd and recognised at Fair value)	10,00,000	751,315 2,48,685
2	Accrual of Interest Interest expense Dr. To Loan from XYZ Ltd (Payable) (Being interest expense recognised) – Year I	75,131	75,131
3	Interest expense Dr. To Loan from XYZ Ltd (Payable) (Being interest expense recognised) – Year II	82,645	82,645
4	Interest expense Dr. To Loan from XYZ Ltd (Payable) (Being interest expense recognised) – Year III On repayment of loan	90,909	90,909
5	Loan from XYZ Ltd (Payable) Dr. To Bank	10,00,000	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 1

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%
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 knocked-off 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.

Illustration 37

A Company purchases its raw materials from a vendor at a fixed price of ₹ 1,000 per tonne of steel. The payment terms provide for 45 days of credit period, after which an interest of 18% per annum shall be charged. How would the creditors be classified in books of the Company?

Solution

In the above case, creditors for purchase of steel shall be carried at amortised cost, ie, fair value of amount payable upon initial recognition plus interest (if payment is delayed). Here, fair value upon initial recognition shall be the price per tonne, since the transaction is at market terms between two knowledgeable parties in an arms-length transaction and hence, the transaction price is representative of fair value.

Illustration 38

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).

Illustration 39 - 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 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	-

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:

Year end	Opening balance	Repayment/Cash flows	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 40 - : Issue of borrowings with fixed rate of interest – (Past Exam – May'22)

A Ltd has made a borrowing from RBC Bank for ₹10,000 at a fixed interest of 12% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable 4 half-yearly installments of ₹ 2,500 each. Details are as follows:

Particulars	Details
Loan amount	₹ 10,000
Date of loan (Starting Date)	1-Apr-20X1
Date of loan (Finishing Date)	31-March-20X3
Description of repayment	Repayment of loan starts from 30-Sept-20X1 (To be paid half yearly)
Installment amount	₹ 2,500
Interest rate	12.00%
Interest charge	Interest to be charged quarterly
Upfront fees	₹ 500

How would loan be accounted in books of A Ltd. Compute the interest to be charged to the statement of profit & loss every quarter over the period of loan?

Consider IRR is 16.60% p.a.

(5 Marks)

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 Calculation	Revised Interest computed	Loan Balance

1-Apr-20X1	10,000	-	500	-	-	9,500	-	-
30-Jun-20X1	-	-	-	300	90	(300)	389	9,589
30-Sep-20X1	-	2500	-	300	92	(2,800)	401	7,190
31-Dec-20X1	-	-	-	225	92	(225)	301	7,266
31-Mar-20X2	-	2500	-	225	90	(2,725)	297	4,838
30-Jun-20X2	-	-	-	150	91	(150)	200	4,888
30-Sep-20X2	-	2500	-	150	92	(2,650)	204	2,442
31-Dec-20X2	-	-	-	75	92	(75)	102	2,473
31-Mar-20X3	-	2500	-	75	91	(2,575)	102	0
					IRR	16.60%		

Illustration 41 - 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?

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 42 - Accounting treatment of prepayment premium and processing fees for obtaining new loan to repay 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.

(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/renewal 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 43 - 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.

Illustration 44 - Amortised cost to FVTPL

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

Illustration 45 - Amortised cost to FVOCI

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

Illustration 46 - FVTPL to Amortised cost

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

Illustration 47 - FVTPL to FVOCI

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

Illustration 48 - FVOCI to Amortised cost

Bonds for ₹100,000 reclassified as Amortised cost. Fair value on reclassification is ₹90,000 and ₹10,000 loss was recognised in OCI till date of reclassification. Pass required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	10,000	
	To OCI - Loss on reclassification		10,000
[Being loss recognized in OCI now reversed prior to reclassification]			
Bonds (Amortised cost)	Dr.	100,000	
	To Bonds at FVOCI		100,000
[Being bonds reclassified from FVOCI to Amortised cost]			

Illustration 49 - FVOCI to FVTPL

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 FVOCI			10,000
Bonds at FVTPL	Dr.	90,000	
To Bonds at FVOCI			90,000

Illustration 50 - 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 51 - 12 month expected credit loss – Loss rate approach

Bank A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. 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 CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU300, for a total gross carrying amount of CU 300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees. Calculate loss rate when

Group	Historic per annum average defaults	Present value of observed loss assumed
X	4	CU 600
Y	2	CU 450

Solution

- Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans.
- In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss assumed	Loss rate
Group	A	B	$C = A \times B$	D	$E = B \times D$	F	$G = F \div C$
X	1,000	CU200	CU2,00,000	4	CU800	CU600	0.3%
Y	1,000	CU300	CU3,00,000	2	CU600	CU450	0.15%

Illustration 52 - Life time expected credit losses (Past Exam Nov'22)

Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with Ind AS 115. In accordance with paragraph 5.5.15 of Ind AS 109 the loss allowance for such trade receivables is always measured at an amount equal to lifetime expected credit losses.

Please use the following information of debtors outstanding:

	Gross carrying amount
Current	CU 15,000,000
1–30 days past due	CU 7,500,000
31–60 days past due	CU 4,000,000
61–90 days past due	CU 2,500,000
More than 90 days past due	CU 1,000,000
	CU 30,000,000

Company M uses following default rates for making provisions:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

Determine the expected credit losses for the portfolio.

(5 Marks)

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

Unit 3 - FINANCIAL INSTRUMENTS: EQUITY AND FINANCIAL LIABILITIES

Illustration 53 - 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.

Illustration 54 - 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.

Illustration 55 - 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 56 - Restriction on the ability of an entity to satisfy a contractual obligation

Does the lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, will lead to contractual obligation?

Solution

Lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

Illustration 57 - 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 58 - 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.

Illustration 59 - 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.

Illustration 60 - 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.

Illustration 61 - 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.

Illustration 62 - 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.

Illustration 63 - 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.

Illustration 64 - Issue of variable number of shares against issue of CCPS

A Ltd. issued compulsorily convertible preference shares (CCPS) at ₹100 each (₹10 face value + ₹90 premium per share) for ₹10,00,000. These are convertible into equity shares at the end of 10 years, where the number of equity shares to be issued shall be determined based on fair value per equity share to be determined at the time of conversion.

Evaluate if this is financial liability or equity? What if the conversion ratio was fixed at the time of issue of such preference shares?

Solution

- i. As per Ind AS 109, non-derivative contracts which will be settled against issue of variable number of own equity shares meet the definition of financial liability.

In this case, A Ltd. has issued CCPS which are convertible into variable number of shares. Hence, it is akin to use of own equity shares as currency for settlement of the liability of CCPS issued. Accordingly, it meets the definition of financial liability.

Measurement –

Initial measurement – This shall be measured at fair value on date of transaction. Since A Ltd shall give shares worth Rs. 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. As Per Ind AS 109, a non-derivative contract that involves issue of fixed number of equity shares shall be classified as equity.

In this case, if the conversion of CCPS was into a fixed number of equity shares at the end of 10 years, then it meets the definition of equity and hence, shall be classified as 'equity instrument'.

An equity instrument is carried at cost and no further adjustments made to its carrying value after initial recognition.

Illustration 65 – (This Illustration has been deleted by ICAI)

On 1 January 20X1, Entity X writes a put option over 1,00,000 of its own equity shares for which it receives a premium of ₹ 5,00,000. Under the terms of the option, Entity X may be obliged to take delivery of 1,00,000 of its own shares in one year's time and to pay the option exercise price of ₹ 22,000,000. The option can only be settled through physical delivery of the shares (gross physical settlement). Examine the nature of the financial instrument and how it will be accounted.

Solution

This derivative involves Entity X taking delivery of a fixed number of equity shares for a fixed amount of cash. Even though the obligation for Entity X to purchase its own equity shares for ₹22,000,000 is conditional on the holder of the option exercising the option, Entity X has an obligation to deliver cash which it cannot avoid.

The accounting for financial instrument in the above illustration is as below (Ind AS 32):

- The financial liability is recognised initially at the present value of the redemption amount, and is reclassified from equity – In the illustration above, this would imply that a financial liability for an amount of present value of ₹ 22,000,000, say ₹ 20,000,000 will be recognised through a debit to equity. The initial premium received (₹ 500,000) is credited to equity.
- Subsequently, the financial liability is measured in accordance with Ind AS 109. While a subsequent paragraph will deal with measurement of financial liabilities, the financial liability of ₹ 20,000,000 in the aforementioned illustration will be measured at amortised cost and finance cost of ₹ 2,000,000 will be recognised over the exercise period.
- If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. This means, in case of illustration above, an amount of ₹ 22,000,000 will be reclassified from financial liability to equity.

Illustration 66 - (This Illustration has been deleted by ICAI)

Parent P holds a 70% controlling interest in Subsidiary S. The remaining 30% is held by Entity Z. On 1 January 20X1, P writes an option to Z which grants Z the right to sell its shares to Parent P on 31 December 20X2 for ₹ 1,000. Parent P receives a payment of ₹ 100 for the option. The applicable discount rate for the

put liability is determined to be 12%. State by which amount the financial instrument will be recognised and under which category.

Solution

On 1 January 20X1, the present value of the (estimated) exercise price is ₹ 797 (₹ 1,000 discounted over 2 years at 12%).

Accordingly, P will recognise a financial liability of ₹ 797 and the difference between cash received i.e. ₹ 1000 and the financial liability of ₹ 797 will be debited to equity.

Illustration 67 - 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:

$$\frac{100 \text{ crores} \times (1 + 10\%)^5}{\text{Fair value on date of conversion}}$$

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 68 - Conversion into a fixed number of equity instruments

DF Ltd. issues convertible debentures to JL Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of ₹ 10 each.

Examine the nature of the financial instrument.

Solution

This contract is an equity instrument because changes in the fair value of equity shares arising from market related factors do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered.

Illustration 69 - Written option for a fixed or variable number of equity instruments

ST Ltd. purchases an option from AT Ltd. entitling the holder to subscribe to equity shares of issuer at a fixed exercise price of ₹ 50 per share at any time during a period of 3 months. Holder paid an initial premium of ₹ 2 per option. Examine whether the financial instrument will be classified as equity.

Solution

For the issuer AT Ltd., this option is an equity instrument as it will be settled by the exchange of a fixed amount of cash for a fixed number of its own equity instruments.

If, on the other hand, if the exercise price of the option was variable, say benchmarked to an index or a variable, other than the market price of equity shares of AT Ltd., the written option will be classified as a "financial liability" in the books of the issuer, AT Ltd.

Illustration 70 - 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 71 - 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. The share swap ratio is agreed as 1:5 i.e. 1 equity share of Acquirer Ltd. for every 5 equity shares held in Target Ltd. Examine whether the financial instrument will be classified as equity.

Solution

Such arrangements will not meet the condition for classification as "equity instrument" since the contract will be settled by delivery of fixed number of Acquirer Ltd.'s own equity instruments against a variable amount of cash i.e. market value of Target Ltd.'s equity shares.

Such a contract will likely result in a derivative liability or asset for both the parties.

Illustration 72 - 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 73 - 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 74 - Conversion ratio changes if issuer subsequently issues shares to others at a lower price

On 1 January 20X1, PG Ltd. subscribes to convertible preference shares of BG Ltd. at ₹ 100 per preference share. The preference shares are convertible in the ratio of 10:1 i.e. 10 equity shares for each preference share held. On a fully diluted basis, PG Ltd. is entitled to 30% stake in BG Ltd.

If subsequent to the issuance of these convertible preference shares, BG Ltd. issues any equity instruments at a price lower than ₹10 per share, conversion ratio will be changed to compensate PG Ltd. for dilution in its stake below the expected dilution at a price of ₹10 per share. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, BG Ltd. The variability in the conversion ratio underwrites the return on preference shares and not just protects the rights of convertible instrument holders vis-à-vis equity shareholders.

Illustration 75 - 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 76 - Instrument convertible only at the option of issuer

XYZ Ltd. issues optionally convertible debentures with the following terms:

The debentures carry interest at the rate of 7% p.a.

Issuer has option to either:

Convert the instrument into a fixed number of its own shares at any time, or redeem the instrument in cash at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted.

The holder has no conversion or redemption options.

Debentures have a tenor of 12 years and, if not converted or redeemed earlier, will be repaid in cash at maturity, including accrued interest, if any.

Examine the nature of the financial instrument.

Solution

The issuer has the ability to convert the debentures into a fixed number of its own shares at any time. The issuer, therefore, has the ability to avoid making a cash payment or settling the debentures in a variable number of its own shares. Therefore, such a financial instrument is likely to be classified as equity.

However, it must be noted that mere existence of a right to avoid payment of cash is not conclusive. The instrument is to be accounted for as per its substance and hence it needs to be seen whether the conversion option is substantive.

In this particular situation, the issuer will need to determine whether it is favourable to exercise the conversion option or redemption option. In case of latter, the instrument will be classified as a financial liability (a hybrid instrument, whose measurement is dealt with in a subsequent section).

Practical situations do arise wherein the issuer has an option or obligation to issue own equity instruments only in particular circumstances i.e. the instrument is contingently convertible.

Illustration 77 - Conversion ratio changes under independent scenarios

On 1 January 20X1, STAL Ltd. subscribes to convertible preference shares of ATAL Ltd. The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests in the issuer within one year
Convertible 1.5:1: If an IPO is successfully completed within 2 years

Convertible 2:1: if a binding agreement for sale of majority stake by equity shareholders is entered into within 3 years

Convertible 3:1: if none of these events occur in 3 years' time.

Examine whether the financial instrument will be classified as equity.

Solution

In this case the four events can be viewed as discrete because the achievement of each one of these can occur independently of the other (as they relate to different periods). The arrangement can therefore be considered to be economically equivalent to four separate contracts. The price per share and the amount of shares to be issued is fixed in each of these discrete periods, with each event relating to a different year and therefore a separate risk. The "fixed for fixed" test is therefore met.

The instrument is therefore classified as "equity instrument".

Illustration 78 - 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.

Illustration 79 - 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.

Illustration 80 - 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 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 81 - 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.

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 82 - 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.

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”.

Illustration 83 - Perpetual loan with mandatory interest (continued from Illustration 56)

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 84 - Optionally convertible redeemable preference shares (continued from Illustration 82)

On 1 July 20X1, D Ltd. issues preference shares to G Ltd. for a consideration of ₹10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a fixed coupon of 6% p.a. The prevailing market rate for similar preference shares, without the conversion feature, is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 9% for 3 years)
= ₹ 772,183

Present value of interest payable in arrears for 3 years (₹ 60,000 discounted at 9% for each of 3 years) = ₹ 151,878

Total financial liability = ₹ 924,061

Therefore, equity component = fair value of compound instrument, say, ₹ 1,000,000 less financial liability component i.e. ₹ 924,061 = ₹ 75,939.

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument.

Illustration 85

D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a coupon of RBI base rate plus 1% p.a.

The prevailing market rate for similar preference shares, without the conversion feature or issuer's redemption option, is RBI base rate plus 4% p.a. On the date of contract, RBI base rate is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 13% for 3 years)

= ₹ 6,93,050

Present value of interest payable in arrears for 3 years (₹ 100,000 discounted at 13% for each of 3 years)

= ₹ 2,36,115

Paragraph AG 31 of Ind AS 32 states that a common form of compound financial instruments is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivatives features.

The liability component = Present value of principal + Present value of Interest

= Rs. 6,93,050 + Rs. 2,36,115 = Rs. 9,29,165

Equity Component = Rs. 10,00,000 – Rs. 9,29,165 = Rs. 70,835

Illustration 86 - Optionally convertible redeemable preference shares (continued from Illustration 84)

The amortisation schedule of the instrument is set out below:

Dates	Cash flows	Finance cost at effective interest rate	Liability	Equity
1 July 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. Calculate the value of the liability and equity components. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%. Calculate the value of the liability and equity components.

Solution

Ind AS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

The split will be made as below:

Particulars	Amount (₹)

Present value of principal payable at 30 June 20X4 in one year's time (₹10 lakhs discounted at 5% for one year)	9,52,381
Present value of interest payable (₹ 60,000 discounted at 5% for one year)	<u>57,142</u>
Total liability component	10,09,523
Consideration paid	<u>11,00,000</u>
Residual – equity component	90,477

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is debited to equity.

UNIT 4 - DERIVATIVES AND EMBEDDED DERIVATIVES

Illustration 87 - Prepaid interest rate swap (fixed rate payment obligation prepaid at inception)

Entity S enters into a ₹100 crores notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C.

- The interest rate of the variable part of the swap is reset on a quarterly basis to three-month Mumbai Interbank Offer Rate (MIBOR).
- The interest rate of the fixed part of the swap is 10% p.a.
- Entity S prepays its fixed obligation under the swap of ₹50 crores (₹100 crores × 10% × 5 years) at inception, discounted using market interest rates
- Entity S retains the right to receive interest payments on the ₹100 crores reset quarterly based on three-month MIBOR over the life of the swap.

Analyse.

Solution

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond.

Therefore, the contract fulfils the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'.

Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Illustration 88 - Prepaid pay-variable, receive-fixed interest rate swap

- Entity S enters into a ₹100 crores notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C.
- The variable leg of the swap is reset on a quarterly basis to three-month MIBOR.
- The fixed interest payments under the swap are calculated as 10% of the swap's notional amount, i.e. ₹10 crores p.a.
- Entity S prepays its obligation under the variable leg of the swap at inception at current market rates. Say, that amount is ₹ 36 crores.
- It retains the right to receive fixed interest payments of 10% on ₹ 100 crores every year.

Analyse.

Solution

In effect, this contract results in an initial net investment of ₹ 36 crores which yields a cash inflow of ₹ 10 crores every year, for five years. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions.

For this reason, the instrument fails the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'. Therefore, the contract is not accounted for as a derivative contract.

Illustration 89 - 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.

Illustration 90

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 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 91

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.

Illustration 92 (Past Exam – Jan 2021)

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.

(5 Marks)

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'.

As per Ind AS 109 – A derivative financial liability shall be carried at fair value through profit or loss.

Illustration 93 - Derivative contract:

Entity – B Ltd writes an option contract for sale of shares of Target Ltd. at a fixed price of ₹100 per share to C Ltd. This option is exercisable anytime for a period of 90 days ('American option'). Evaluate this under definition of financial instrument.

Solution

In the above case – B Ltd has written an option, which if exercised by C Ltd. will result in B Ltd. selling equity shares of Target Ltd. for fixed cash of ₹100 per share. Such option will be exercised by C Ltd. only if the market price of shares of Target Ltd. increases beyond ₹100, thereby resulting in contractual obligation over B Ltd. to settle the contract under potential unfavorable terms.

In the above case, if the market price is already ₹120 which means that if option is exercised by C Ltd; then B Ltd shall buy shares from the market at ₹120 per share and sell at ₹100, thereby resulting in a loss or exchange at unfavorable terms to B Ltd. Hence, it meets the definition of financial liability in books of B Ltd.

The additional question that arises here is the nature of this financial liability and if it meets the definition of derivative. A derivative is a financial instrument that meets following conditions –

- (a) Its value changes in response to change in specified variable like interest rate, equity index, commodity price, etc. If the variable is non-financial, it is not specific to party to the contract
- (b) It requires no or little initial net investment
- (c) It is settled at a future date.

Evaluating the above instrument, B Ltd. has written an option whose value changes based on change in market price of equity share, it requires no initial net investment and is settled at a future date (anytime in 90 days). Hence, it meets definition of derivative financial liability in books of B Ltd.

Illustration 94 - Derivative contract to be settled in own equity instruments

A Ltd. issues warrants to all existing shareholders entitling them to purchase additional equity shares of A Ltd. (with face value of ₹100 per share) at an issue price of ₹150 per share. Evaluate whether this constitutes an equity instrument or a financial liability?

Solution

In this case, Company A Ltd. has issued warrants entitling the shareholders to purchase equity shares of the Company at a fixed price. Hence, it constitutes a contractual arrangement for issuance of fixed number of shares against fixed amount of cash.

Now, evaluating this contract under definition of derivative –

- (i) The value of warrant changes in response to change in value of underlying equity shares;
- (ii) This involves no initial net investment
- (iii) It shall be settled at a future date.

Hence, this warrant meets the definition of derivative.

Applying definition of equity under Ind AS 32, a derivative contract that will be settled by exchange of fixed number of equity shares for fixed amount of cash meets definition of equity instrument. The above contract is derivative contract that will be settled by issue of fixed number of own equity instruments by A Ltd. for fixed amount of cash and hence, meets definition of equity instrument.

Illustration 95

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.

Illustration 96 - 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 97 - 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?

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 98 - 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.

Illustration 99 - 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	<u>59.88</u>	<u>11.10</u>	-
		<u>104.22</u>	<u>67.78</u>	

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).

Illustration 100 - Purchase contract settled in a foreign currency

On 1 January 20X1, ABG Pvt. Ltd., a company incorporated in India enters into a contract to buy solar panels from A&A Associates, a firm domiciled in UAE, for which delivery is due after 6 months i.e. on 30 June 20X1

The purchase price for solar panels is US\$ 50 million.

The functional currency of ABG is Indian Rupees (INR) and of A&A is Dirhams.

The obligation to settle the contract in US Dollars has been evaluated to be an embedded derivative which is not closely related to the host purchase contract.

Exchange rates:

1. Spot rate on 1 January 20X1: USD 1 = INR 60
2. Six-month forward rate on 1 January 20X1: USD 1 = INR 65
3. Spot rate on 30 June 20X1: USD 1 = INR 66

Analyse.

Solution

This contract comprises of two components:

- Host contract to purchase solar panels denominated in INR i.e. a notional payment in INR at 6-month forward rate (INR 3,250 million or INR 325 crores)
- Forward contract to pay US Dollars and receive INR i.e. a notional receipt in INR. In other words, a forward contract to sell US Dollars at INR 65 per US Dollar

It may be noted that the notional INR payment in respect of host contract and the notional INR receipt in respect of embedded derivative create an offsetting position.

Subsequently, the host contract is not accounted for until delivery. The embedded derivative is recorded at fair value through profit or loss. This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery ABG records the inventory at the amount of the host contract (INR 325 crores). The embedded derivative is considered to expire. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial liability that arises on delivery.

In this case the carrying value of the currency forward at 30 June 20X1 on maturity is INR 50 million $\times$ (66 minus 65) = INR 5 crores (liability/loss). The loss arises because ABG has agreed to sell US Dollars at ₹ 65 per US Dollar whereas in the open market, US Dollar can be sold at ₹ 66 per US Dollar.

No accounting entries are passed on the date of entering into purchase contract. On that date, the forward contract has a fair value of zero (refer section "option and non-option based derivatives" below)

Subsequently, say at 30 June 20X1, the accounting entries are as follows (all in INR crores):

1. Loss on derivative contract 5
 To Derivative liability 5
 (Being loss on currency forward)
2. Inventory 325
 To Trade payables (financial liability) 325
 (Being inventory recorded at forward exchange rate determined on date of contract)
3. Derivative liability 5
 To Trade payables (financial liability) 5
 (Being reclassification of derivative liability to trade payables upon settlement)

The effect is that the financial liability at the date of delivery is INR 330 crores (= INR 325 crores + INR 5 crores); equivalent to US\$ 50 million at the spot rate on 30 June 20X1.

Going forward, the financial liability is a US\$ denominated financial instrument. It is retranslated at the dollar spot rate in the normal way, until it is settled.

Illustration 101 - 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

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 102 - 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.

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 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	3,00,000	

31-Dec-X1	Derivative asset (company B) Dr. [(67.8-67.5) x 10,00,000] To Profit or loss		3,00,000
	Fair value change in forward contract	5,00,000	
31-Dec-X1	Forward contract asset (company B) Dr. [(67.8-67) x 10,00,000] - 3,00,000 To Profit or loss		5,00,000
	Recognition of machinery acquired and on settlement	6,78,00,000	
	Property, plant and equipment Dr. (at forward rate) To Forward contract asset (company B)		8,00,000
	To Creditor (company B) / Bank		6,70,00,000

UNIT 5 - RECOGNITION AND DERECOGNITION OF FINANCIAL INSTRUMENTS

Illustration 103 - 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 104 - Regular way contracts: option contracts

NKT Ltd. purchases a call option in a public market permitting it to purchase 100 shares of VT Ltd. at any time over the next one month at a price of ₹ 1,000 per share. If NKT Ltd. exercises its option, it has 7 days to settle the transaction according to regulation or convention in the options market. VT Ltd.'s shares are traded in an active public market that requires two-day settlement.

Solution

In this case, the options contract is a regular way transaction as the settlement of the option is governed by regulation or convention in the marketplace for options. Fair value changes between the trade date and settlement date are recognised in other comprehensive income if share of VT Ltd. are equity instruments and not held for trading by NKT Ltd.

Illustration 105 - 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.

Illustration 106 – De-recognition of Part of a financial asset

State whether the derecognition principles will be applied or not.

- Interest strip of an interest-bearing financial asset i.e. the part entitles its holder to interest cash flows of a financial asset
- Dividend strip of an equity share i.e. the part entitles its holder to only dividends arising from an equity share
- 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:

- 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
- 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.
- The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).
For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, derecognition principles are applied to 90 per cent of those interest cash flows.

The example of a part of a financial asset at (iii) in Illustration 106 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).

Illustration 107 - 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.

Illustration 108 - 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.

Illustration 109 - Repurchase agreements

A financial asset is sold under repurchase agreement. The repurchase price as per that agreement is (a) fixed price or (b) sale price plus a lender's return. Let's look at three alternate scenarios:

- i. Repurchase agreement is for the same financial asset.
- ii. Repurchase agreement is for substantially the same asset
- iii. Repurchase agreement provides the transferee a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date.

State whether the derecognition principles will be applied or not.

Solution

In each of these scenarios, the transferred financial asset is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

Let's look at another scenario:

Repurchase agreement provides the transferor only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it

In this scenario, the transferred financial asset is derecognised because the transferor has transferred substantially all the risks and rewards of ownership.

Illustration 110 - 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 111 - 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.

In the third scenario, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control.

Illustration 112 - 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.

Illustration 113 - 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.

Illustration 114 A - Debt factoring with recourse – continuing involvement asset

Entity C agrees with factoring company D to enter into a debt factoring arrangement. Under the terms of the arrangement, the factoring company B agrees to pay ₹ 91.5 crores, less a servicing charge of ₹ 1.5 crores (net proceeds of ₹ 90 crores), in exchange for 100% of the cash flows from short-term receivables.

The receivables have a face value of ₹ 100 crores and carrying amount of ₹ 95 crores.

The customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses upto ₹5 crores, over and above the expected credit losses of ₹5 crores and losses of up to ₹15 crores are considered reasonably possible. The guarantee is estimated to have a fair value of ₹ 0.5 crores. Comment.

Solution

In this situation, the “continuing involvement asset” will be recognised at ₹ 5 crores i.e. lower of:

- the amount of the asset – ₹ 95 crores
- the guarantee amount – ₹ 5 crores

Illustration 114 B - Debt factoring with recourse – associated liability

Continuing illustration 114A, calculate the amount of associated liability:

Solution:

The associated liability is recognised at ₹ 5.5 crores, as below:

- the guarantee amount (i.e. ₹5 crores) plus
- the fair value of the guarantee (i.e. ₹0.5 crores). Comment

Illustration 114 C – Debt factoring with recourse – gain or loss on derecognition

Continuing illustration 114A & 114B, 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.

Illustration 115 – 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 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 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.

Unit 8 – COMPREHENSIVE ILLUSTRATIONS**Illustration 116 – (Past Exam – May 2018)**

A Ltd. issued redeemable preference shares to a Holding Company – Z Ltd. The terms of the instrument have been summarized below. Account for this in the books of Z Ltd.

Nature	Non-cumulative redeemable preference shares
Repayment:	Redeemable after 5 years
Date of Allotment:	1-Apr-20X1
Date of repayment:	31-Mar-20X6
Total period:	5.00 years
Value of preference shares issued:	100,000,000
Dividend rate	0.0001%
Market rate of interest	12% per annum
Present value factor	0.56743

Solution:

Applying the guidance in Ind AS 109, a 'financial asset' shall be recorded at its fair value upon initial recognition. Fair value is normally the transaction price. However, sometimes certain type of instruments may be exchanged at off market terms (ie, different from market terms for a similar instrument if exchanged between market participants).

For example, a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. In such cases where part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

In the above case, since A Ltd has issued preference shares to its Holding Company – Z Ltd, the relationship between the parties indicates that the difference in transaction price and fair value is akin to investment made by Z Ltd. in its subsidiary.

Following is the table summarising the computations on initial recognition:

Market rate of interest	12%
Present value factor	0.56743
Present value	56,742,686
Loan component	56,742,686
Investment in subsidiary	43,257,314

Subsequently, such preference shares shall be carried at amortised cost at each reporting date. The computation of amortised cost at each reporting date has been done as follows:

Year	Date	Opening Asset	Days	Interest @ 12%	Closing balance
	1-Apr-20X1				56,742,686
1	31-Mar-20X2	56,742,686	365	6,809,122	63,551,808
2	31-Mar-20X3	63,533,153	365	76,26,217	71,178,025
3	31-Mar-20X4	71,157,131	365	85,41,363	79,719,388
4	31-Mar-20X5	79,695,987	365	95,66,327	89,285,707
5	31-Mar-20X6	89,285,707	365	10,714,285	100,000,000

JOURNAL ENTRIES TO BE DONE AT EVERY REPORTING DATE

Particulars		Amount	Amount
Date of transaction			
Investment - Equity portion	Dr.	43,257,314	
Loan receivable	Dr.	56,742,686	
To Bank			100,000,000
Interest income - March 31, 20X2			
Loan receivable	Dr.	6,809,122	
To Interest income			6,809,122
Interest income - March 31, 20X3			
Loan receivable	Dr.	76,26,217	
To Interest income			76,26,217
Interest income - March 31, 20X4			
Loan receivable	Dr.	85,41,363	
To Interest income			85,41,363
Interest income - March 31, 20X5			
Loan receivable	Dr.	95,66,327	
To Interest income			95,66,327
Interest income - March 31, 20X6			

Loan receivable	Dr.	10,714,285	
To Interest income			10,714,285
Settlement of transaction			
Bank	Dr.	100,000,000	
To Loan receivable			100,000,000

Illustration 117 – (Past Exam - Nov 2018, May 2022)

A Limited issues INR 1 crore convertible bonds on 1 July 20X1. The bonds have a life of eight years and a face value of INR 10 each, and they offer interest, payable at the end of each financial year, at a rate of 6 per cent annum. The bonds are issued at their face value and each bond can be converted into one ordinary share in A Limited at any time in the next eight years. Companies of a similar risk profile have recently issued debt with similar terms, without the option for conversion, at a rate of 8 per cent per annum.

Required:

- Provide the appropriate accounting entries for initial recognition.
- Calculate the stream of interest expenses across the eight years of the life of the bonds.
- 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. **(14 Marks)**

Solution:

- Applying the guidance for compound instruments, the present value of the bond is computed to identify the liability component and then difference between the present value of these bonds & the issue price of INR 1 crore shall be allocated to the equity component. In determining the present value, the rate of 8 per cent will be used, which is the interest rate paid on debt of a similar nature and risk that does not provide an option to convert the liability to ordinary shares.

Present value of bonds at the market rate of debt

Present value of principal to be received in eight years discounted at 8%

$(10,000,000 \times 0.5403)$

Present value of interest stream discounted at 8% for 8 years = 5,403,000

$(6,00,000 \times 5.7466) = 3,447,960$

Total present value = 8,850,960

Equity component = 1,149,040

Total face value of convertible bonds = 10,000,000

The accounting entries will be as follows

	Dr. Amount (INR)	Cr. Amount (INR)
1 July 20X1		
Cash Dr.	10,000,000	
To Convertible bonds (liability)		8,850,960
To Convertible bonds (equity component)		1,149,040
(Being entry to record the convertible bonds and the recognition of the liability and equity components)		
30 June 20X2		
Interest expense Dr.	708,077	
To Cash		600,000
To Convertible bonds (liability)		108,077

(Being entry to record the interest expense, where the expense equals the present value of the opening liability multiplied by the market rate of interest).

- (b) The stream of interest expense is summarised below, where interest for a given year is calculated by multiplying the present value of the liability at the beginning of the period by the market rate of interest, this is being 8 per cent.

Date	Payment	Interest expense at 8%	Increase in bond liability	Total bond liability
01 July 20X1				8,850,960
30 June 20X2	600,000	708,077	108,077	8,959,037
30 June 20X3	600,000	716,723	116,723	9,075,760
30 June 20X4	600,000	726,061	126,061	9,201,821
30 June 20X5	600,000	736,146	136,146	9,337,967
30 June 20X6	600,000	747,037	147,037	9,485,004
30 June 20X7	600,000	758,800	158,800	9,643,804
30 June 20X8	600,000	771,504	171,504	9,815,308
30 June 20X9	600,000	784,692*	184,692	10,000,000

*difference is due to rounding off

- (c) If the holders of the bonds elect to convert the bonds to ordinary shares at the end of the third year (after receiving their interest payments), the entries in the third year would be:

	Dr. Amount (INR)	Cr. Amount (INR)
30 June 20X4		
Interest expense Dr.	726,061	
To Cash		600,000
To Convertible bonds (liability)		126,061
(Being entry to record interest expense for the period)		
30 June 20X4		
Convertible bonds (liability) Dr.	9,201,821	
Convertible bonds (equity component) Dr.	1,149,040	
To Ordinary share capital A/c		10,350,861
(Being entry to record the conversion of bonds into shares of A Limited)		

Illustration 118 – (Past Exam – May 2018)

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. Sam Co 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

Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:

- the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate;
- 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;
- 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. To derivative financial liability (Being mark to market loss on forward contract recorded)	25,000	25,000

(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. To Profit and loss A/c (being partial reversal of mark to market loss on forward contract recorded)	10,000	10,000

(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. Derivative financial asset A/c Dr. To Profit and loss A/c (being gain on mark to market of forward contract booked as derivative financial asset and reversal of derivative financial liability)	15,000 12,000	27,000

(vi) Accounting on 31st December 20X1:

The settlement of the derivative forward contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash (USD Account) @ 20,000 * 66 Dr.	13,20,000	
Profit and loss A/c Dr.	52,000	
To Cash @ 20,000 x 68		13,60,000
To Derivative financial asset A/c		12,000
(being loss on settlement of forward contract booked on actual purchase of USD)		

Illustration 119

Entity A (an INR functional currency entity) enters into a USD 1,000,000 sale contract on 1 January 20X1 with Entity B (an INR functional currency entity) to sell equipment on 30 June 20X1.

Spot rate on 1st January 20X1: INR/USD	45
Spot rate on 31 March 20X1: INR/USD	57
Three-month forward rate on 31 March 20X1: INR/USD	45
Six-month forward rate on 1 January 20X1: INR/USD	55
Spot rate on 30 June 20X1: INR/USD	60

Assume that this contract has an embedded derivative that is not closely related and requires separation. Please provide detailed journal entries in the books of Entity A for accounting of such embedded derivative until sale is actually made.

Solution:

The contract should be separated using the 6 month USD/INR forward exchange rate, as at the date of the contract (INR/USD = 55). The two components of the contract are therefore:

- A sale contract for INR 55 Million
- A six-month currency forward to purchase USD 1 Million at 55
- This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery

1. Entity A records the sales at the amount of the host contract = INR 55 Million
2. The embedded derivative is considered to expire.
3. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial asset on delivery.
4. In this case the carrying value of the currency forward at 30 June 20X1 on maturity is = INR (1,000,000 x 60 – 55 x 1,000,000) = ₹ 5,000,000 (profit/asset)

The table summarising the computation of gain/ loss to be recorded at every period end –

Date	Transaction	Sales	Debtors	Derivative Asset (Liability)	(Profit) Loss
1-Jan- 20X1	Embedded Derivative	INR	INR	INR	INR
		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. To Derivative financial liability A/c (being loss on mark to market of embedded derivative booked)	10,000,000	10,000,000

c. 30 June 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial asset A/c Dr. Derivative financial liability A/c Dr. To Profit and loss A/c (being gain on embedded derivative based on spot rate at the date of settlement booked)	5,000,000 10,000,000	15,000,000

d. 30 June 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Trade receivable A/c Dr. To Sales A/c (being sale booked at forward rate on the date of transaction)	55,000,000	55,000,000

e. 30 June 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Trade receivable A/c Dr. To Derivative financial asset A/c (being derivative asset re-classified as a part of trade receivables, bringing it to spot rate on the date of sale)	5,000,000	5,000,000

Illustration 120

On 1st January 20X1, Sam Co. 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. Sam Co. Ltd. did not receive any amount upon entering into the contract. Sam Co 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

Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:

- the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.
- 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.
- 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. To derivative financial liability (Being mark to market loss on the put option contract recorded)	25,000	25,000

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. To Profit and loss A/c (Being partial reversal of mark to market loss on the put option contract recorded)	10,000	10,000

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. To Profit and loss A/c (Being gain on mark to market of put option contract booked to make the value the derivative liability as zero)	15,000	15,000

vi) Accounting on 31st December 20X1

The settlement of the derivative put option contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. upon exercise by JT Corp. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash (USD Account) (20,000 x 66) Dr. Profit and loss A/c Dr. To Cash @ 20,000 x 68 (being loss on settlement of put option contract booked on actual purchase of USD)	13,20,000 40,000	13,60,000

Illustration 121 – (Past Exam May'19, MTP Oct'21) (MTP May'23)

ABC Company issued 10,000 compulsory cumulative convertible preference shares (CCCPS) as on 1 April 20X1 @ Rs 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.

(12 Marks)

Solution:

This is a compound financial instrument with two components – liability representing present value of future cash outflows and balance represents equity component.

i) 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

ii) 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

iii) Accounting for liability at amortised cost:

- Initial accounting = Present value of cash outflows less transaction costs
- Subsequent accounting = At amortised cost, ie, initial fair value adjusted for interest and repayments of the liability.

Assume the effective interest rate is 15.86%

	Opening Financial Liability A	Interest B	Cash Flow C	Closing Financial Liability A+B-C
01-Apr-20X1	492,767	-	-	4,92,767
31-Mar-20X2	492,767	78,153	150,000	4,20,920
31-Mar-20X3	420,920	66,758	150,000	3,37,678
31-Mar-20X4	337,678	53,556	150,000	2,41,234
31-Mar-20X5	241,234	38,260	150,000	1,29,494
31-Mar-20X6	129,494	20,506	150,000	-

iv) Journal Entries to be recorded for entire term of arrangement are as follows:

Date	Particulars	Debit	Credit
01-Apr-20X1	Bank A/c Dr.	1,470,000	
	To Preference Shares A/c		492,767
	To Equity Component of Preference shares A/c		977,233
	(Being compulsorily convertible preference shares issued. The same are divided into equity component and liability component as per the calculation)		
31-Mar-20X2	Preference shares A/c Dr.	150,000	
	To Bank A/c		150,000

	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X2	Finance cost A/c Dr.	78,153	
	To Preference Shares A/c		78,153
	(Being interest as per EIR method recorded)		
31-Mar-20X3	Preference shares A/c Dr.	150,000	
	To Bank A/c		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 A/c		66,758
	(Being interest as per EIR method recorded)		
31-Mar-20X4	Preference shares A/c Dr.	150,000	
	To Bank A/c		150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X4	Finance cost A/c Dr.	53,556	
	To Preference Shares A/c		53,556
	(Being interest as per EIR method recorded)		
31-Mar-20X5	Preference shares A/c Dr.	150,000	
	To Bank A/c		150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X5	Finance cost A/c Dr.	38,260	
	To Preference Shares A/c		38,260
	(Being interest as per EIR method recorded)		
31-Mar-20X6	Preference shares A/c Dr.	150,000	
	To Bank A/c		150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X6	Finance cost A/c Dr.	20,506	
	To Preference Shares 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)		

Illustration 122

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

Solution:

i) Calculation of initial recognition amount of loan to its employees:

Year end	Cash flow		Total	PV factor	Present value
	Principal	Interest @ 5%			
20X1	320,000	80,000	400,000	.909	363,600
20X2	320,000	64,000	384,000	.827	317,568
20X3	320,000	48,000	368,000	.751	276,368
20X4	320,000	32,000	352,000	.683	240,416
20X5	320,000	16,000	336,000	.620	208,320
					1,406,272

ii) Calculation of amortised cost of loan to employees

Year end	Amortised cost (opening balance)	Interest to be recognised	Repayment (including interest)	Amortised cost (closing balance)
20X1	1,406,272	140,627	400,000	1,146,899
20X2	1,146,899	114,690	384,000	877,589
20X3	877,589	87,759	368,000	597,348
20X4	597,348	59,735	352,000	305,083
20X5	305,083	30,917*	336,000	

*305,083 * 10% = 30,508. Difference of ₹ 409 is due to approximation in computation.

iii) Journal Entries to be recorded of Y Ltd. for the year ended 31 December 20X1

Date	Particulars	Debit	Credit
1 Jan 20X1	Staff loan A/c Dr.	14,06,272	
	Prepaid staff cost A/c*	1,93,728	
	To Bank A/c		14,06,272
	(Being disbursement of loans to staff)		
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 interest accrued on loans to staff)

* Where the difference between the amount given by the Company to its employees and its fair value represents another asset, then such asset shall be recognised. Accordingly, such difference is recognised as prepaid employee cost and amortised over the period of loan.

Illustration 123 – (Past Exam Jan'21, July'21) (MTP Nov'22)

Wheel Co. Limited has a policy of providing subsidized loans to its employees for the purpose of buying or building houses. Mr. X, who's executive assistant to the CEO of Wheel Co. Limited, took a loan from the Company on the following terms:

- Principal amount: 1,000,000
- Interest rate: 4% for the first 400,000 and 7% for the next 600,000
- Start date: 1 January 20X1
- Tenure: 5 years
- Pre-payment: Full or partial pre-payment at the option of the employee
- The principal amount of loan shall be recovered in 5 equal annual instalments and will be first applied to 7% interest bearing principal.
- The accrued interest shall be paid on an annual basis
- Mr. X must remain in service till the term of the loan ends

The market rate of a comparable loan available to Mr. X, is 12% per annum.

Following table shows the contractually expected cash flows from the loan given to Mr. X:

(amount in ₹)

Date	Outflows	Inflows			Principal outstanding
		Principal	Interest income 7%	Interest income 4%	
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 ₹)

Date	Outflows	Inflows			Principal outstanding
		Principal	Interest income 7%	Interest income 4%	
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.

Solution:

(14 Marks)

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:

Date	Inflows				Discount factor @12%	PV
	Principal	Interest 7%	Income	Interest 4%		
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	
31-Dec-20X2	525,600	244,000	101,265
31-Dec-20X3	358,672	230,000	82,457
31-Dec-20X4	185,713	216,000	63,072
31-Dec-20X5	(0)	208,000	43,041
			22,287*

* Difference is due to approximation.

Journal Entries to be recorded at every period end:

i) 1 January 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Loan to employee A/c Dr.		
Pre-paid employee cost A/c Dr	843,879	
To Cash A/c	156,121	
(Being loan asset recorded at initial fair value)		1,000,000

ii) 31 December 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)

Cash A/c Dr. To Interest income (profit and loss) @12% A/c To loan to employee A/c (Being first instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)	258,000	101,265 156,735
Employee benefit (profit and loss) A/c Dr. To Pre-paid employee cost A/c (Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)	31,224	31,224

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:

iii) 31 December 20X2 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr. To Interest income (profit and loss) @12% A/c To loan to employee A/c (Being second instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)	244,000	82,457 161,543
Employee benefit (profit and loss) A/c Dr. To Pre-paid employee cost A/c (Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)	31,224	31,224

Computation of new carrying value of loan to employee:

Date	Inflows				Discount factor @12%	PV
	Principal	Interest 7%	income	Interest 4%		
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.

iv) 31 December 20X2 prepayment–

Particulars	Dr. Amount (₹)	Cr. Amount (₹)

Cash 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	
31-Dec-20X3	30,300	30,300	33,072
31-Dec-20X4	-	30,300	

v) 31 December 20X3 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr.	216,000	
To Interest income (profit and loss) @12% A/c		43,041
To loan to employee A/c		172,959
(Being third instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)		
Employee benefit (profit and loss) A/c Dr	30,300	
To Pre-paid employee cost A/c		30,300
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)		

vi) 31 December 20X4 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr	208,000	
To Interest income (profit and loss) @12% A/c		22,286
To loan to employee A/c		185,714
(Being last instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)		
Employee benefit (profit and loss) A/c Dr	30,300	
To Pre-paid employee cost A/c		30,300
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)		

Illustration 124 (Past Exam Dec'21) (MTP March'22, May'23)

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:

***Note:** Before approaching bank, Wheel Ltd. made the interest payment on 31st Dec, 20X2

- 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.

(*That note was mentioned when the question was asked in exam)

(12 Marks)

Solution:

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

i) 1 January 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr. To Loan from bank A/c (Being loan recorded at its fair value less transaction costs on the initial recognition date)	494,129,904	494,129,904

ii) 31 December 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)

Loan from bank A/c Dr.	98,175,061	
Interest expense (profit and loss) Dr.	56,824,939	
To Cash A/c		
(Being first instalment of loan and payment of interest accounted for as an adjustment to the amortised cost of loan)		155,000,000

iii) 31 December 20X2 – Before Wheel Co. Limited approached the bank –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Interest expense (profit and loss) Dr.		
To Loan from bank A/c To cash A/c	45,534,807	
(Being loan payment of interest recorded by the Company before it approached the Bank for deferment of principal)		1,534,807
		44,000,000

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 @15%	outflow	Discount factor	PV of cash flows
31-Dec-20X2	(400,000,000)				
31-Dec-20X3	40,000,000	60,000,000		0.8969	89,686,099
31-Dec-20X4	40,000,000	54,000,000		0.8044	75,609,805
31-Dec-20X5	40,000,000	48,000,000		0.7214	63,483,092
31-Dec-20X6	40,000,000	42,000,000		0.6470	53,053,542
31-Dec-20X7	40,000,000	36,000,000		0.5803	44,100,068
31-Dec-20X8	40,000,000	30,000,000		0.5204	36,429,133
31-Dec-20X9	40,000,000	24,000,000		0.4667	29,871,422
31-Dec-20Y0	40,000,000	18,000,000		0.4186	24,278,903
31-Dec-20Y1	40,000,000	12,000,000		0.3754	19,522,235
31-Dec-20Y3	40,000,000	6,000,000		0.3367	15,488,493
PV of new contractual cash flows discounted at 11.50%					451,522,791
Carrying amount of loan					397,489,650
Difference					54,033,141
Percentage of carrying amount					13.59%

Note: Calculation above done on full decimal, though in the table discount factor is limited to 4 decimals.

Considering a more than 10% change in PV of cash flows compared to the carrying value of the loan, the existing loan shall be considered to have been extinguished and the new loan shall be accounted for as a separate financial liability. The accounting entries for the same are included below

iv) 31 December 20X2 – accounting for extinguishment

Particulars	Dr. Amount (₹)	Cr. Amount (₹)

Loan from bank (old) A/c Dr	397,489,650	
Finance cost (profit and loss) Dr	2,510,350	
To Loan from bank (new) A/c		
(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)		400,000,000

v) 31 December 20X3

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Loan from bank A/c Dr.	40,000,000	
Interest expense (profit and loss) Dr.	60,000,000	
To cash A/c		
(Being first instalment of the new loan and payment of interest accounted for as an adjustment to the amortised cost of loan)		100,000,000

Illustration 125

K Ltd. issued 500,000, 6% convertible debentures @ ₹ 10 each on 01 April 20X1. The debentures are due for redemption on 31 March 20X5 at a premium of 10%, convertible into equity shares to the extent of 50% and balance to be settled in cash to the debenture holders. The interest rate on equivalent debentures without conversion rights was 10%.

You are required to separate the debt and equity components at the time of issue and show the accounting entries in Company's books at initial recognition. The following present values of Re 1 at 6% and at 10% are provided:

Interest rate	Year 1	Year 2	Year 3	Year 4
6%	0.94	0.89	0.84	0.79
10%	0.91	0.83	0.75	0.68

Solution

Computation of debt component of convertible debentures on 01 April 20X1

Particulars	Amount
Present value of principal amount repayable after 4 years	
(A) $5,000,000 \times 50\% \times 1.10 \times 0.68$ (10% discount factor)	1,870,000
(B) Present value of interest $[300,000 \times 3.17]$ (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)		

Illustration 126 – (MTP May'23)

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 present the above loan notes in the financial statements for the year ended 31 March 20X2?
(8 Marks)

Solution:

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 ($6,00,000 \times 8\%$)

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
Year 4	20X5	648,000	0.68	1,19,583
Amount to be recognised as a liability				4,40,640
Initial proceeds				5,60,223
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. $6,00,000 \times 8\%$ 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 ($5,60,000 \times 10\%$)	₹ 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. To Debt component A/c (Being interest recorded for difference between amount recorded earlier and that to be recorded per Ind AS 32)	8,000	8,000

Illustration 127 - (RTP May'21) (MTP Oct'21, Nov'22) (Past Exam Nov'22)

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. (10 to 12 Marks)

Solution**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 Rs. 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.

Question 1 – (MTP AUG'18, Oct'20) (Past Exam July'21) (RTP Dec'21)

On 1 April 2019, Shelter Ltd. issued 5,000, 8% debentures maturing on 31 March 2024. The debentures are convertible at the option of the holder into equity shares of Shelter Ltd. at a conversion price of ₹ 105 per share or redeemable at face value of Rs. 100 each. Interest is payable annually in cash. At the date of issue, Shelter Ltd. could have issued non-convertible debt with a 5 year term bearing a coupon interest rate of 12%. On 1 April 2022, the convertible debentures have a fair value of ₹ 5,25,000. Shelter Ltd. makes a tender offer to debenture holders to repurchase the debentures for ₹ 5,25,000, which the holders accepted. At the date of repurchase, Shelter Ltd. could have issued non-convertible debt with a 2 year term bearing a coupon interest rate of 9%.

Show accounting entries in the books of Shelter Ltd. for recording of equity and liability component:

- (1) At the time of initial recognition and
- (2) At the time of repurchase of the convertible debentures.

The following present values of Re. 1 at 8%, 9% & 12% are supplied to you:

Interest Rate	Year 1	Year 2	Year 3	Year 4	Year 5
8%	0.926	0.857	0.794	0.735	0.681
9%	0.917	0.842	0.772	0.708	0.650
12%	0.893	0.797	0.712	0.636	0.567

(5 Marks)

SOLUTION:**(1) At the time of initial recognition**

	Rs.
Liability component	
Present value of 5 yearly interest payments of Rs. 40,000, discounted at 12% annuity (40,000 x 3.605)	1,44,200
Present value of Rs. 5,00,000 due at the end of 5 years, discounted at 12%, compounded yearly (5,00,000 x 0.567)	2,83,500
Equity component	4,27,700
(Rs. 5,00,000 – Rs. 4,27,700)	72,300
Total proceeds	5,00,000

Note: Since Rs. 105 is the conversion price of debentures into equity shares and not the redemption price, the liability component is calculated @ Rs. 100 each only.

Journal Entry

	Rs.	Rs.
Bank	Dr.	
To 8% Debentures (Liability component)	5,00,000	
To 8% Debentures (Equity component)		4,27,700
(Being Debentures are initially recorded a fair value)		72,300

(2) At the time of repurchase of convertible debentures

The repurchase price is allocated as follows:

	Carrying Value @ 12%	Fair Value @ 9%	Difference
	Rs.	Rs.	Rs.
Liability component			
Present value of 2 remaining yearly interest payments of Rs. 40,000, discounted at 12% and 9%, respectively	67,600	70,360	
Present value of Rs. 5,00,000 due in 2 years, discounted at 12% and 9%, compounded yearly, respectively	<u>3,98,500</u>	<u>4,21,000</u>	
Liability component	4,66,100	4,91,360	(25,260)
Equity component (5,25,000 - 4,91,360)	<u>72,300</u>	<u>33,640*</u>	<u>38,660</u>
Total	<u>5,38,400</u>	<u>5,25,000</u>	<u>13,400</u>

*(5,25,000 – 4,91,360) = 33,64

Journal Entries

	Rs.	Rs.
8% Debentures (Liability component) Dr.	4,66,100	
Profit and loss A/c (Debt settlement expense) Dr.	25,260	
To Bank A/c		4,91,360
(Being the repurchase of the liability component recognised)		
8% Debentures (Equity component) Dr.	72,300	
To Bank A/c		33,640
To Reserves and Surplus A/c		38,660
(Being the cash paid for the equity component recognised)		

Question 2 - (MTP - March 2019)

QA Ltd. issued 10,00,000 of 8% Long Term bond-A Series of Rs. 1 each on 1st April, 2016. The bond tenure is 3 years. Interest is payable annually on 1st April each year. The investors expect an effective interest rate on the loan at 10%. QA Ltd. wants you to suggest the suitable accounting entries for the issue of these bonds as per applicable Ind AS. Consider the discounting factor 3 years, 10% discounting factor is 0.751315 and 3 years cumulative discounting factor is 2.48685.

- What is the principal value of the bond at the initial recognition at the time of issue of bond as per applicable Ind AS?
- What is the present value of the interest payment to be recognised as part of the sale price of the bond as per applicable Ind AS?
- What are the proceeds of the sale of the bond to be recognized at the time of initial recognition as per applicable Ind AS?
- What is the accounting entry to be passed at the time of accounting for payment of interest for the first year?

SOLUTION:

- Rs. 7,51,315
- Rs. 1,98,948
- Rs. 9,50,263

(iv) Bond Interest Expenses A/c Dr. Rs. 95,026

To Discount on Bond A/s Rs. 15,026

To Cash/Bank A/c Rs. 80,000

Workings for the above

Since the Effective interest rate on the loan is 10% while the Bond has been issued at 8%, the financial liability will be recognized at fair value determined as follows:

Calculation of initial recognition amount of 8% Long term Loan Bond A Series

Particulars	Rs.
Present value of the principal repayable after 3 years $(10,00,000 \times .751315)$	7,51,315
Present value of Interest $[(10,00,000 \times 8\%) \times 2.48685]$	1,98,948
Total Present Value of Long term Loan Bond	9,50,263

Interest for the first year recognized in the books as per effective interest rate method

$$= \text{Rs. } 9,50,263 \times 10\% = \text{Rs. } 95,026$$

However, interest paid is @ 8% i.e. $\text{Rs. } 10,00,000 \times 8\% = \text{Rs. } 80,000$

Question 3 - (MTP - March 2019)

QA Ltd. has also issued 10,00,000 of 8% Long Term Bond-B Series of Rs. 1 each on 1st April, 2016. The bond tenure is 3 years. Interest is payable annually on 1st April each year. However, the bond holders of this series are entitled to convert the bonds to shares of Rs. 1 each on the date of maturity, instead of receiving the principal repayment. Interest rate on the similar bond without conversion option is 10%. QA Ltd. has requested you to suggest the following for this type of instrument:

- What is entry to be passed at the date of issuance of the bond as per applicable Ind AS?
- What is entry to be passed at the date of conversion of the bond as per applicable Ind AS?

SOLUTION:

- (a) Cash/Bank A/c Rs. 10,00,000
- To 8% LT Bond Series B A/c Rs. 9,50,263
- To Share Option A/c Rs. 49,737

Workings for the above

It is a compound instrument.

Calculation of initial recognition amount of 8% Long term Loan Bond B Series liability and equity component

Particulars	Rs.

Present value of the principal repayable after 3 years $(10,00,000 \times .751315)$	7,51,315
Present value of Interest $[(10,00,000 \times 8\%) \times 2.48685]$	<u>1,98,948</u>
Total Present Value of Long term Loan Bond B I	
Issue proceeds from convertible bond II	9,50,263
Value of equity component (II – I)	<u>10,00,000</u>
	<u>49,737</u>

(b)	8% LT Bond Series B A/c	Rs. 10,00,000
	Share Option A/c	Rs. 49,737
	To Share Capital A/c	Rs. 10,00,000
	To Share Premium A/c	Rs. 49,737

Reasoning:

As per para AG32 of Ind AS 32, on conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The 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.

Question 4 - (MTP March'19, April'22) (Past Exam Nov'20)

On 1st April, 20X1, Star Limited has advanced a housing loan of ₹ 15 lakh 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 lakh. 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 lakh).

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 31st March, 20X2. Ignore defer tax impact (12 Marks)

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:

Date	Outstanding loan	Principal	Interest income @ 6%	Total inflow	Discount factor @ 10%	PV
31st March 20X2	15,00,000	3,00,000	90,000	3,90,000	0.909	3,54,510
31st March 20X3	12,00,000	3,00,000	72,000	3,72,000	0.826	3,07,272
31st March 20X4	9,00,000	3,00,000	54,000	3,54,000	0.751	2,65,854
31st March 20X5	6,00,000	3,00,000	36,000	3,36,000	0.683	2,29,488
31st March 20X6	3,00,000	3,00,000	18,000	3,18,000	0.621	1,97,478
Fair value of the loan						<u>13,54,602</u>

As per Ind AS 19, employee benefits are all forms of consideration given by an entity in exchange for services 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 31st 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	-

* $2,88,663 \times 10\% = ₹ 28,866$. Difference of ₹ 471 (29,337 – 28,866) is due to approximation in computation.

Journal Entries to be recorded at every period end

1. On 1st 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 31st 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 31st March, 20X2

Non-current asset	
<i>Financial asset</i>	
Loan to employee (11,00,062 – 3,72,000 + 1,10,006)	8,38,068
<i>Other non-current asset</i>	
Prepaid employee cost	87,238
Current asset	
<i>Financial asset</i>	
Loan to employee (3,72,000-1,10,006)	2,61,994
<i>Other current asset</i>	
Prepaid employee cost	29,080

Question 5 - (MTP - OCT 2019)

Croton Limited is engaged in the business of trading commodities. The company's main asset are investments in equity shares, preference shares, bonds, non-convertible debenture (NCD) and mutual funds.

The Company collects the periodical income (i.e. interest, dividend, etc.) from the investments and regularly sells the investment in case of favourable market conditions. Such investments have been classified as non-current investments in the financial statements.

Also, the company buys and sells equity shares of companies for earning short term profits from the stock market.

The CFO of company classified all the non-current investments as Fair Value Through Other Comprehensive Income (FVTOCI) and all the current investment as Fair value Through Profit and Loss (FVTPL).

Croton Limited raised the following queries:

(a) Can the Company classify the equity shares previously held under current investment as FVTOCI if the company decides to hold them for more than one-year (i.e. classify it as non-current)?

(b) The Company had classified NCDs with a maturity period of less than twelve months from the reporting period as current. This has been classified as FVTPL by the CFO of the company. The Company wants to know whether these NCDs can be recognized as FVTOCI?

SOLUTION

(a) It seems that the equity shares are acquired for the purpose of selling it in the near term and therefore are held for trading. Such investments have been appropriately classified as subsequently measured at fair value through profit or loss. Such investments in equity shares cannot be classified as subsequently measured at fair value through other comprehensive income. The option to measure investment in equity shares at fair value through other comprehensive income has to be made at initial recognition. Therefore,

equity shares that were held for trading previously cannot be reclassified to fair value through other comprehensive income due to change in business model to not held for trading.

(b) In absence of contractual terms of NCDs, it is assumed that the contractual terms give rise on specified dates to cash flows that are solely payment of principal and interest on the principal outstanding. The business model also includes sales of these instruments on a regular basis. Hence, these instruments will be classified as FVTOCI. Therefore, such NCD investments shall be classified as subsequently measured at Fair Value through Other Comprehensive Income. The classification does not change based on whether the investment is current or non-current as the end of the reporting period. It seems the company has previously classified these investments at fair value through profit or loss. The company must rectify this by reclassifying as FVTOCI.

Question 6 - (MTP - May 2020)

Blueberry Ltd entered into the following transactions during the year ended 31st March, 20X2:

- Entered into a speculative interest rate option costing Rs. 10,000 on 1st April, 20X0 to borrow Rs. 6,000,000 from Exon Bank commencing 30th June, 20X2 for 6 months at 4%. The value of the option at 31st March, 20X2 was Rs. 15,250.
- Purchased 6% debentures in Fox Ltd on 1st April, 20X1 (their issue date) for Rs. 150,000 as an investment. Blueberry Ltd. intends to hold the debentures, until their redemption at a premium, in 5 years' time. The effective rate of interest of the bond is 8%.
- Purchased 50,000 shares in Cox Ltd on 1st October, 20X2 for Rs. 3.50 each as an investment. The share price on 31st March, 20X2 was Rs. 3.75.

Show the accounting treatment and relevant extracts from the financial statements for the year ended 31st March, 20X2 of transactions related to financial instruments. Blueberry Ltd designates financial assets at fair value through Profit or loss only when this is unavoidable.

(10 Marks)

Solution:

Balance Sheet as at 31st March, 20X2 (Extracts)

Financial Assets:	Rs.
Interest rate option (W.N.1)	15,250
6% Debentures in Fox Ltd. (W.N.2)	1,53,000
Shares in Cox Ltd. (W.N.3)	1,87,500
Statement of Profit and Loss (Extracts)	
Finance Income:	
Gain on interest rate option (W.N.1)	5,250
Effective interest on 6% Debentures (W.N.2)	12,000

Working Notes:

1. Interest rate option

This is a derivative and so it must be treated as at fair value through profit or loss

Particulars	Rs.	Rs.
Initial measurement (at cost)		
Financial Asset Dr.	10,000	

To Cash A/c		10,000

At 31st March, 20X2

Particulars	Rs.	Rs.
(Re-measured to fair value)		
Financial Asset (Rs. 15,250 - Rs.10,000) Dr.	5,250	
To Profit and loss A/c		5,250

Financial Assets (Rs.10,000 + Rs.5,250) = **Rs. 15,250 (Balance Sheet)**

Gain on Interest option = **Rs. 5,250 (Statement of Profit and Loss)**

2. Debentures

On the basis of information provided, this can be treated as a held-to-maturity investment

Particulars	Rs.	Rs.
Initial measurement (at cost) Financial Asset Dr.	1,50,000	
To Cash A/c		1,50,000

At 31st March, 20X2 (Amortized cost)

Particulars	Rs.	Rs.
Financial Asset (Rs.1,50,000 x 8%) Dr.	12,000	
To Finance Income		12,000

Cash (Rs. 1,50,000 x 6%) Dr.	9,000	
To Financial asset		9,000

Amortized cost at 31st March, 20X2

(Rs. 150,000 + Rs. 12,000 – Rs. 9,000) = **Rs. 153,000 (Balance Sheet)**

Effective interest on 6% debenture = **Rs. 12,000 (Statement of Profit and Loss)**

3. Shares in Cox Ltd.

These are treated as an available for sale financial asset (shares cannot normally be held to maturity and they are clearly not loans or receivables)

Particulars	Rs.	Rs.
Initial measurement (at cost)		
Financial Asset (Rs. 50,000 x Rs.3.50) Dr.	1,75,000	
To Cash A/c		1,75,000

At 31st March, 20X2 (Re-measured at fair value)

Particulars	Rs.	Rs.
Financial Asset [(Rs. 50,000 x 3.75) – 1,75,000] Dr.	12,500	

To Equity A/c

12,500

Shares in Cox Ltd (Rs. 1,75,000 + Rs. 12,500) = Rs. 1,87,500 (Balance Sheet)

Question 7 - (RTP - November 2018)

On 1st April 2017, A Ltd. lent ₹ 2 crores to a supplier in order to assist them with their expansion plans. The arrangement of the loan cost the company ₹ 10 lakhs. The company has agreed not to charge interest on this loan to help the supplier's short-term cash flow but expected the supplier to repay ₹ 2.40 crores on 31st March 2019. As calculated by the finance team of the company, the effective annual rate of interest on this loan is 6.9% On

28th February 2018, the company received the information that poor economic climate has caused the supplier significant problems and in order to help them, the company agreed to reduce the amount repayable by them on 31st March 2019 to ₹ 2.20 crores. Suggest the accounting entries as per applicable Ind AS.

Solution

The loan to the supplier would be regarded as a financial asset. The relevant accounting standard Ind AS 109 provides that financial assets are normally measured at fair value.

If the financial asset in which the only expected future cash inflows are the receipts of principal and interest and the investor intends to collect these inflows rather than dispose of the asset to a third party, then Ind AS 109 allows the asset to be measured at amortised cost using the effective interest method.

If this method is adopted, the costs of issuing the loan are included in its initial carrying value rather than being taken to profit or loss as an immediate expense. This makes the initial carrying value ₹ 2,10,00,000.

Under the effective interest method, part of the finance income is recognised in the current period rather than all in the following period when repayment is due. The income recognised in the current period is ₹ 14,49,000 ($₹ 2,10,00,000 \times 6.9\%$)

In the absence of information regarding the financial difficulties of the supplier the financial asset at 31st March, 2018 would have been measured at ₹ 2,24,49,000 ($₹ 2,10,00,000 + 14,49,000$). The information regarding financial difficulty of the supplier is objective evidence that the financial asset suffered impairment at 31st March 2018.

The asset is re-measured at the present value of the revised estimated future cash inflows, using the original effective interest rate. Under the revised estimates the closing carrying amount of the asset would be ₹ 2,05,79,981 ($₹ 2,20,00,000 / 1.069$). The reduction in carrying value of ₹ 18,69,019 ($₹ 2,24,49,000 - 2,05,79,981$) would be charged to profit or loss in the current period as an impairment of a financial asset.

Therefore, the net charge to profit or loss in respect of the current period would be ₹ 4,20,019 ($18,69,019 - 14,49,000$).

Question 8 - (RTP - May 2019) (MTP - Oct 2020)

KK Ltd. has granted an interest free loan of 10,00,000 to its wholly owned Indian Subsidiary YK Ltd. There is no transaction cost attached to the said loan. The Company has not finalised any terms and conditions including the applicable interest rates on such loans. The Board of Directors of the Company are evaluating various options and has requested your firm to provide your views under Ind AS in following situations:

- The Loan given by KK Ltd. to its whollyowned subsidiary YK Ltd. is interest free and such loan is repayable on demand.
- The said Loan is interest free and will be repayable after 3 years from the date of granting such loan. The current market rate of interest for similar loan is 10%. Considering the same, the fair value of the loan at initial recognition is 8,10,150.

(iii) The said loan is interest free and will be repaid as and when the YK Ltd. has funds to repay the Loan amount.

Based on the same, KK Ltd. has requested you to suggest the accounting treatment of the above loan in the stand-alone financial statements of KK Ltd. and YK Ltd. and also in the consolidated financial statements of the group. Consider interest for only one year for the above loan.

Further the Company is also planning to grant interest free loan from YK Ltd. to KK Ltd. in the subsequent period. What will be the accounting treatment of the same under applicable Ind AS? (8 Marks)

Solution

Scenario (i)

Since the loan is repayable on demand, it has fair value equal to cash consideration given. KK Ltd. and YK Ltd. should recognize financial asset and liability, respectively, at the amount of loan given (assuming that loan is repayable within a year). Upon, repayment, both the entities should reverse the entries that were made at the origination.

Journal entries in the books of KK Ltd.

At origination			
Loan to YK Ltd. A/c	Dr.	10,00,000	
To Bank A/c			10,00,000
On repayment			
Bank A/c	Dr.	10,00,000	
To Loan to YK Ltd. A/c			10,00,000

Journal entries in the books of YK Ltd.

At origination			
Bank A/c	Dr.	₹ 10,00,000	
To Loan from KK Ltd. A/c			₹ 10,00,000
On repayment			
Loan from KK Ltd. A/c	Dr.	₹ 10,00,000	
To Bank A/c			₹ 10,00,000

In the consolidated financial statements, there will be no entry in this regard since loan receivable and loan payable will get set off.

Scenario (ii)

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).

If a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. 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. The difference in fair value and transaction cost will be treated as investment in Subsidiary YK Ltd.

Both KK Ltd. and YK Ltd. should recognise financial asset and liability, respectively, at fair value on initial recognition, i.e., the present value of ₹ 10,00,000 payable at the end of 3 years using discounting factor of 10%. Since the question mentions fair value of the loan at initial recognition as ₹ 8,10,150, the same has

been considered. The difference between the loan amount and its fair value is treated as an equity contribution to the subsidiary. This represents a further investment by the parent in the subsidiary

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

At origination			
Loan to YK Ltd. A/c	Dr.	8,10,150	
Investment in YK Ltd. A/c	Dr.	1,89,850	
To Bank A/c			10,00,000
During periods to repayment- to recognise interest			
Year 1 – Charging of Interest			
Loan to YK Ltd. A/c	Dr.	81,015	
To Interest income A/c			81,015
Transferring of interest to Profit and Loss			
Interest income A/c	Dr.	81,015	
To Profit and Loss A/c			81,015
On repayment			
Bank A/c	Dr.	10,00,000	
To Loan to YK Ltd. A/c			10,00,000
Note- Interest needs to be recognised in statement of profit and loss. The same cannot be adjusted against capital contribution recognised at origination.			

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

At origination			
Bank A/c	Dr.	10,00,000	
To Loan from KK Ltd. A/c			8,10,150
To Equity Contribution in KK Ltd. A/c			1,89,850
During periods to repayment- to recognise interest			
Year 1			
Interest expense A/c	Dr.	81,015	
To Loan from KK Ltd. A/c			81,015
On repayment			
Loan from KKLtd.A/c	Dr.	10,00,000	
To Bank A/c			10,00,000

In the consolidated financial statements, there will be no entry in this regard since loan and interest income/expense will get set off.

Scenario (iii)

Generally, a loan which is repayable when funds are available, cannot be stated as loan repayable on demand. Rather the entity needs to estimate the repayment date and determine its measurement accordingly by applying the concept prescribed in Scenario (ii). In the consolidated financial statements, there will be no entry in this regard since loan and interest income/expense will get set off.

In case the subsidiary YK Ltd. is planning to grant interest free loan to KK Ltd., then the difference between the fair value of the loan on initial recognition and its nominal value should be treated as dividend distribution by YK Ltd. and dividend income by the parent KK Ltd.

Question 9 - (RTP - Nov 2019), (MTP – March 2021)

An entity purchases a debt instrument with a fair value of ₹ 1,000 on 15th March, 20X1 and measures the debt instrument at fair value through other comprehensive income. The instrument has an interest rate of 5% over the contractual term of 10 years, and has a 5% effective interest rate. At initial recognition, the entity determines that the asset is not a purchased or original credit-impaired asset.

On 31st March 20X1 (the reporting date), the fair value of the debt instrument has decreased to ₹ 950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that ECL should be measured at an amount equal to 12 month ECL, which amounts to ₹ 30.

On 1st April 20X1, the entity decides to sell the debt instrument for ₹ 950, which is its fair value at that date.

Pass journal entries for recognition, impairment and sale of debt instruments as per Ind AS 109. Entries relating to interest income are not to be provided. (5 Marks)

Solution

On Initial recognition

	Debit (₹)	Credit (₹)
Financial asset-FVOCI Dr.	1,000	
To Cash		1,000

On Impairment of debt instrument

	Debit (₹)	Credit (₹)
Impairment expense (P&L) Dr.	30	
Other comprehensive income Dr.	20	
To Financial asset-FVOCI		50

The cumulative loss in other comprehensive income at the reporting date was ₹ 20. That amount consists of the total fair value change of ₹ 50 (that is, ₹ 1,000-₹ 950) offset by the change in the accumulated impairment amount representing 12-month ECL, that was recognized (₹ 30).

On Sale of debt instrument

	Debit (₹)	Credit (₹)
Cash	950	
To Financial asset –FVOCI		950
Loss on sale (P&L)	20	
To Other comprehensive income		20

Question 10 - (RTP - May 2020) + (MTP – March 2021)

XYZ issued ₹ 4,80,000 4% redeemable preference shares on 1st April 20X5 at par. Interest is paid annually in arrears, the first payment of interest amounting ₹ 19,200 was made on 31st March 20X6 and it is debited directly to retained earnings by accountant. The preference shares are redeemable for a cash amount of ₹ 7,20,000 on 31st March 20X8. The effective rate of interest on the redeemable preference shares is 18% per annum. The proceeds of the issue have been recorded within equity by accountant as this reflects the legal nature of the shares. Board of directors intends to issue new equity shares over the next two years to build up cash resources to redeem the preference shares.

Mukesh, Accounts manager of XYZ has been told to review the accounting of aforesaid issue. CFO has asked from Mukesh the closing balance of preference shares at the year end. If you were Mukesh, then how much balance you would have shown to CFO on analysis of the stated issue. Prepare necessary adjusting journal entry in the books of account, if required. (5 Marks)

Solution

The preference shares provide the holder with the right to receive a predetermined amount of annual dividend out of profits of the company, together with a fixed amount on redemption.

Whilst the legal form is equity, the shares are in substance debt. The fixed level of dividend is interest and the redemption amount is equivalent to the repayment of a loan.

Under Ind AS 32 'Financial Instruments: Presentation' these instruments should be classified as financial liabilities because there is a contractual obligation to deliver cash. The preference shares should be accounted for at amortised cost using the effective interest rate of 18%.

Year	1 April, 20X5 ₹	Interest @18% ₹	Paid at 4% ₹	31 March, 20X6 ₹
20X5-20X6	480,000	86,400	(19,200)	547,200

Accordingly, the closing balance of Preference shares at year end i.e. 31 st March, 20X6 would be ₹ 5,47,200.

Accountant has inadvertently debited interest of ₹ 19,200 in the profit and loss. However, the interest of ₹ 86,400 should have been debited to profit and loss as finance charge.

Similarly, amount of ₹ 5,47,200 should be included in borrowings (non-current liabilities) and consequently, Equity should be reduced by ₹ 480,000 proceeds of issue and ₹ 67,200 (86,400 – 19,200) i.e. total by 5,47,200.

Necessary adjusting journal entry to rectify the books of accounts will be:

		₹	₹
Preference share capital (equity) (Balance sheet)	Dr.	4,80,000	
Finance costs (Profit and loss)	Dr.	86,400	
To Equity – Retained earnings (Balance sheet)			19,200
To Preference shares (Long-term Borrowings) (Balance sheet)			5,47,200

Question 11 - (RTP Nov'20, MTP Nov'22)

An Indian entity, whose functional currency is rupees, purchases USD dominated bond at its fair value of USD 1,000. The bond carries stated interest @ 4.7% p.a. on its face value. The said interest is received at the year end. The bond has maturity period of 5 years and is redeemable at its face value of USD 1,250. The fair value of the bond at the end of year 1 is USD 1,060. The exchange rate on the date of transaction and at the end of year 1 are USD 1 = ₹ 40 and USD 1 = ₹ 45, respectively. The weighted average exchange rate for the year is 1 USD = ₹ 42.

The entity has determined that it is holding the bond as part of an investment portfolio whose objective is met both by holding the asset to collect contractual cash flows and selling the asset. The purchased USD bond is to be classified under the FVTOCI category.

The bond results in effective interest rate (EIR) of 10% p.a.

Calculate gain or loss to be recognised in Profit & Loss and Other Comprehensive Income for year 1. Also pass journal entry to recognise gain or loss on above. (Round off the figures to nearest rupees) (8 Marks)

Solution:

Computation of amounts to be recognized in the P&L and OCI:

Particulars	USD	Exchange rate	₹
Cost of the bond	1,000	40	40,000
Interest accrued @ 10% p.a.	100	42	4,200
Interest received (USD 1,250 x 4.7%)	(59)	45	(2,655)
Amortized cost at year-end	1,041	45	46,845

Fair value at year end	1,060	45	47,700
Interest income to be recognized in P & L			4,200
Exchange gain on the principal amount [1,000 x (45 - 40)]			5,000
Exchange gain on interest accrual [100 x (45 - 42)]			300
Total exchange gain/loss to be recognized in P&L			5,300
Fair value gain to be recognized in OCI [45 x (1,060 - 1,041)]			855

Journal entry to recognize gain/loss

Bond (₹ 47,700 – ₹ 40,000) Dr.	7,700	
Bank (Interest received) Dr.	2,655	
To Interest Income (P & L)		4,200
To Exchange gain (P & L)		5,300
To OCI (fair value gain)		855

Question 12 - (Past Exam - Nov 2018)

NAV Limited granted a loan of ₹ 120 lakh to OLD Limited for 5 years @ 10% p.a. which is Treasury bond yield of equivalent maturity. But the incremental borrowing rate of OLD Limited is 12%. In this case, the loan is granted to OLD Limited at below market rate of interest. Ind AS 109 requires that a financial asset or financial liability is to be measured at fair value at the initial recognition. Should the transaction price be treated as fair value? If not, find out the fair value. What is the accounting treatment of the difference between the transaction price and the fair value on initial recognition in the book of NAV Ltd.?

Present value factors at 12%:

Year	1	2	3	4	5
PVF	0.892	0.797	0.712	0.636	0.567

Solution

Since the loan is granted to OLD Ltd at 10% i.e below market rate of 12%. It will be considered as loan given at off market terms. Hence the Fair value of the transaction will be lower from its transaction price & not the transaction price.

Calculation of fair value

Year	Future cash flow (in lakh)	Discounting factor @ 12%	Present value (in lakh)
1	12	0.892	10.704
2	12	0.797	9.564
3	12	0.712	8.544
4	12	0.636	7.632
5	120+12=132	0.567	74.844
			111.288

The fair value of the transaction be ₹ 111.288 lakh.

Since fair value is based on level 1 input or valuation technique that uses only data from observable markets, difference between fair value and transaction price will be recognized in Profit and Loss as fair value loss i.e ₹ 120 lakh – ₹ 111.288 lakh = ₹ 8.712 lakh.

Note: One may also calculate the above fair value by the way of annuity on interest amount rather than separate calculation.

Question 13 - (Past Exam Nov'20)

Note: Same question is there in module (Illustration 126 of our book) but have still included this question as the way of presenting the solution is different

On 1 April 2019, 8% convertible loan with a nominal value of ₹ 12,00,000 was issued at par by Cargo Ltd. It is redeemable on 31 March 2023 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 ₹ 96,000 has already been paid and included as a finance cost.

Present Value (PV) rates are as follows:

Year End	@ 8%	@ 10%
1	0.93	0.91
2	0.86	0.83
3	0.79	0.75
4	0.73	0.68

How will the Company present the above loan notes in the financial statements for the year ended 31 March 2020?

(6 Marks)

Solution:

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	2020	96,000	0.91	87,360
Year 2	2021	96,000	0.83	79,680
Year 3	2022	96,000	0.75	72,000
Year 4	2023	12,96,000*	0.68	8,81,280
Amount to be recognised as a liability				11,20,320
Initial proceeds				(12,00,000)
Amount to be recognised as equity				79,680

* In year 4, the loan note will be redeemed; therefore, the cash outflow would be ₹ 12,96,000 (₹ 12,00,000 + ₹ 96,000).

Presentation in the Financial Statements:

In Statement of Profit and Loss for the year ended on 31 March 2020

Finance cost to be recognised in the Statement of Profit and Loss (11,20,320 x 10%)	₹ 1,12,032
Less: Already charged to the income statement	(₹ 96,000)
Additional finance charge required to be recognised in the Statement of Profit and Loss	₹ 16,032

In Balance Sheet as at 31 March 2020

Equity and Liabilities	
Equity	
Other Equity (8% convertible loan)	79,680
Non-current liability	
Financial liability [8% convertible loan – [(11,20,320 + 1,12,032 – 96,000)]]	11,36,352

Question 14 - (MTP – April 2021)

Besides construction activity, Buildings & Co. Limited is also engaged in the trading of Copper. On 1st April, 20X1, it had 100 kg of copper costing Rs. 70 per kg - totalling Rs. 7000. The Company has a scheduled delivery of these 100 kgs of copper to its customer on 30th September, 20X1 at the rate of USD 100 on that date. To protect itself from decline in currency exchange rate (USD to Rs.), the entity hedges its position by entering into currency futures contract for equivalent currency units at Rs. 76 / USD. The future contract mature on 30th September, 20X1. The management performed an assessment of hedge effectiveness and concluded that the hedging relationship qualifies for cash flow hedge accounting. The entity determines and documents that changes in fair value of the currency futures contract will be highly effective in offsetting variability in cash flow of currency exchange. On 30th September, 20X1, the entity closes out its currency futures contract. On the same day, it also sells its inventory of copper at USD 100 when the spot rate is Rs. 72 / USD.

You are required to prepare detailed working and pass necessary journal entries for the sale of copper and the corresponding hedge instrument taken by the company. Pass the journal entries as on the initial date (i.e. 1st April 20X1), first quarter end reporting (i.e. 30th June 20X1) and date of sale of copper and settlement of forward contract (i.e. 30th September 20X1).

Assume the exchange rates as follows and yield @ 6% per annum.

Date	Future price for 30th September 20X1 delivery (Rs. / USD)
1st April, 20X1	76
30th June, 20X1	74
30th September, 20X1	71

(10 Marks)

Solution:

Calculation of discounting factor based on yield @ 6% p.a.

Date	Spot rate at indicated date	Forward rate for 30th September 20X1	Discount factor @ 6% p.a. on quarter basis
1st April, 20X1		76	0.971
30th June 20X1		74	0.985
30th September, 20X1	72	71	1

Determination of fair value change

X		1st April, 20X1	30th June, 20X1	30th September, 20X1
a	Nominal value in Rs. @ Rs. 76 / USD	7,600	7,600	7,600
b	Nominal value in USD (100 kg for USD 100)	100	100	100
c	Forward rate for 30th September, 20X1	76	74	71
d	Value in Rs. (b x c)	7,600	7,400	7,100
e	Difference (a-d)	0	200	500

f	Discount factor (as calculated in the above table)	0.971	0.985	1
g	Fair value (e x f)	0	197	500
h	Fair value change for the period	0	197	303*

* 500 – 197 = 303

Journal Entries

Date	Particulars	Dr.	Cr.
1st April, 20X1	No entry as initial fair value is zero		
30th June, 20X1	Future Contract Dr. To Cash Flow Hedge Reserve (Other Equity)- OCI (Being Change in Fair Value of Hedging Instrument recognised in OCI accumulated in a separate component in Equity)	197	197
30th September, 20X1	Future Contract Dr. To Cash Flow Hedge Reserve (Other Equity) - OCI (Being change in fair value of the hedging instrument recognised in OCI)	303	303
30th September, 20X1	Bank/Trade Receivable Dr. To Revenue from Contracts With Customer (Being sale of 100 kgs. of copper for USD 100 recognised at spot rate of Rs. 72 for USD 1)	7,200	7200
30th September, 20X1	Cash Flow Hedge Reserve (Other Equity) - OCI Dr. To Revenue from Contracts with Customers (Being fair value change in forward contract reclassified to profit and loss and recognised in the line item affected by the hedge item)	500	500
30th September, 20X1	Bank / Cash Dr. To Future Contract	500	500

Question 15 - (MTP Oct'21)

Which of the following would meet and not meet the definition of financial instruments and fall outside the scope of Ind AS 32?

- (1) Cash deposited in banks
- (2) Gold deposited in banks
- (3) Trade receivables
- (4) Investments in debt instruments
- (5) Investments in equity instruments
- (6) Prepaid expenses
- (7) Inter-corporate loans and deposits
- (8) Deferred revenue
- (9) Tax liability
- (10) Provision for estimated litigation losses.

(4 Marks)

Solution

Table showing classification of various items:

S. No.	Item	Classification
(1)	Cash deposited in banks	Financial Instrument
(2)	Gold deposited in banks	Not a financial instrument
(3)	Trade receivables	Financial Instrument
(4)	Investments in debt instruments	Financial Instrument
(5)	Investments in equity instruments	Financial Instrument
(6)	Prepaid expenses	Not a financial instrument

(7)	Inter-corporate loans and deposits	Financial Instrument
(8)	Deferred revenue	Not a financial instrument
(9)	Tax liability	Not a financial instrument
(10)	Provision for estimated litigation losses	Not a financial instrument

Question 16 (RTP May'22)

On 1st April, 2X01, Entity X issued a 10% convertible debenture with a face value of ₹ 1,000 maturing on 31st March, 2X11. The debenture is convertible into ordinary shares of Entity X at a conversion price of ₹ 50 per share. Interest is payable yearly in cash. On 1st April, 2X02, to induce the holder to convert the convertible debenture promptly, Entity X reduces the conversion price to ₹ 40 if the debenture is converted before 1st June, 2X02 (ie, within 60 days). The market price of Entity X's ordinary shares on the date the terms are amended is ₹ 80 per share. How will the revised terms be accounted?

Solution:

The fair value of the incremental consideration paid by Entity X is calculated as follows:

Number of ordinary shares to be issued to debenture holders under amended terms		
Particulars		
Face value		₹ 1,000
New conversion price		₹ 40 per share
Number of ordinary shares to be issued to debenture holders under amended terms	1,000 / ₹ 40	25 Shares
Number of ordinary shares to be issued to debenture holders under original terms		
Face value		₹ 1,000
Original conversion price		₹ 50 per share
Number of ordinary shares to be issued to debenture holders under original terms		20 Shares
Number of additional shares to be issued to debenture holders under amended terms	1,000 / ₹ 50	5 Shares
Value of additional shares upon conversion (to be recognised as loss in P&L)		
5 shares x ₹ 80 per share		₹ 400

Question 17 (RTP May'22)

ABC Ltd. issues 4% 1,00,000 OCPS at a face value of ₹ 100 per share on 1st April, 20X1 and these are redeemable after 5 years, ie, on 31st March, 20X6. Dividend is non-cumulative. Each preference shares entitles the holders to 10 equity shares and the preference shares are optionally convertible by the holder at any time until maturity.

How will the preference shares be classified at initial recognition assuming that a comparable instrument carries a market interest rate of 7%? Provide journal entries for year 1. Will this classification be changed subsequently in case there is likelihood that OCPS will be encashed at the end of the maturity period?

Solution:

The OCPS is redeemable at the end of the 5th year. Hence, the preference share contains a liability component. Further the dividend payable on the preference shares is non-cumulative. The holder may also be able to convert the preference shares at his option any time until maturity.

Paragraph AG 37 of Ind AS 32, Financial Instruments: Presentation states that non-cumulative dividends paid at the discretion of the issuer entity is part of equity element.

Paragraph 29 of Ind AS 32, Financial Instruments: Presentation, requires separate recognition of components of a financial instrument that (a) creates a financial liability of the entity; and (b) grants an option to the holder of the instrument to convert it into fixed number of equity instruments of the entity.

From the above paragraphs it is clear that OCPS issued by ABC Ltd. has a financial liability component as well as an equity component, making it a compound financial instrument.

As per paragraph 32, in case of compound financial instruments, the issuer first determines the carrying amount of the financial liability component by measuring the fair value of a similar liability that does not have an associated equity component. The carrying amount of the equity represented by (a) non-cumulative dividend feature and

(b) option to convert the preference shares for fixed number of pre-determined ordinary shares is then determined by deducting the fair value of the financial liability component from the fair value of the compound financial instrument as a whole.

Measurement and recognition (Calculations have been done at full scale):

At 7% market rate of interest, the fair value of the financial liability component of the OCPS is ₹ 71,29,862 $[100,000 \text{ OCPS} \times ₹ 100 \times (1/(1+7\%))^5]$

The fair value of the equity component is (residual value) ₹ 28,70,138 $[₹ 1,00,00,000 - ₹ 71,29,862]$

Journal Entries

1st April, 20X1	On Initial recognition			
	Bank	Dr.	1,00,00,000	
	To OCPS (Financial liability)			71,29,862
	To OCPS (Equity)			28,70,138
	(Being OCPS issued and recognised)			
31st March, 20X2	Interest expense – unwinding of discount			
	Interest expense @ 7% (Refer W.N.)	Dr.	4,99,090	
	To OCPS (Financial liability)			4,99,090
	(Being interest recorded as per EIR)			
	Interest entry will be passed every year till conversion option is not exercised			
	Whenever the option is exercised by the holder to convert to equity shares			
	OCPS (Financial liability)	Dr.	Balance on date exercise of	
	To OCPS (Equity)		of the option	

As per paragraph 30, in case of a convertible financial instrument, the classification of the liability and equity components is not revised as a result of change in the likelihood that a conversion option will be exercised.

In other words, the amount attributable to equity component on initial recognition shall remain in equity and will not be reclassified even if the OCPS are ultimately redeemed in cash by the issuer.

31st March, 20X6	If redeemed in cash on maturity			
	OCPS (financial liability) (Refer W.N.)	Dr.	1,00,00,000	
	To Bank			1,00,00,000
	(Being OCPS redeemed on maturity)			

Working Note:

Calculation of the amortised cost of the financial liability (at full scale):

Year	Opening Balance (₹)	Interest @ 7%	Repayment	Closing Balance (₹)
1	71,29,862	4,99,090	-	76,28,952
2	76,28,952	5,34,027	-	81,62,979
3	81,62,979	5,71,409	-	87,34,388
4	87,34,388	6,11,407	-	93,45,795
5	93,45,795	6,54,206	10,00,000	-

Question 18 (MTP March'22)

A Company invested in Equity shares of another entity on 15 th March for ₹ 20,000. Transaction Cost = ₹ 400 (not included in ₹ 20,000)

Fair Value on Balance Sheet date i.e. 31st March, 20X1 = ₹ 24,000. Pass necessary Journal Entries when Financial Asset is accounted as FVTPL (4 Marks)

Solution:

Date	Particulars	(₹)	(₹)
15/3/20X1	Investment A/c Dr. Transaction Cost A/c Dr. To Bank	20,000 400	20,400
31/3/20X1	Investment A/c Dr. To Fair Value Gain A/c	4,000	4,000
31/3/20X1	P&L A/c Dr. To Transaction	400	400
31/3/20X1	Fair Value Gain A/c Dr. To P&L	4,000	4,000

Question 19 (RTP Nov'22)

On 1st April, 20X1 an entity granted an interest-free loan of ₹ 5,00,000 to an employee for a period of three years. The market rate of interest for similar loans is 5% per year. On 31st March, 20X3, because of financial difficulties, the employee asked to extend the interest-free loan for further three years. The entity agreed. Under the restructured terms, repayment will take place on 31st March, 20X7. However, the entity only expects to receive a payment of ₹ 2,50,000, given the financial difficulty of the employee.

Explain the accounting treatment on initial recognition of loan and after giving effect of the changes in the terms of the loan as per Ind AS 109. Support your answer with Journal entries and amortised cost calculation, as on the date of initial recognition and on the date of change in terms of loan.

Solution:

As the loan is not at a market interest rate, hence it is not recorded at the transaction price of ₹ 5,00,000. Instead, the entity measures the loan receivable at the present value of the future cash inflows discounted at a market rate of interest available for a similar loan.

The present value of the loan receivable (financial asset) discounted at 5% per year is $₹ 5,00,000 \div (1.05)^3 = ₹ 4,32,000$. Therefore, ₹ 4,32,000 is recorded on initial measurement of the loan receivable. This amount will accrete to ₹ 5,00,000 over the three-year term using the effective interest method.

The difference between ₹ 5,00,000 and ₹ 4,32,000 i.e., ₹ 68,000 is accounted for as prepaid employee cost in accordance with Ind AS 19 'Employee Benefits', which will be deferred and amortised over the period of loan on straight line basis.

The journal entries on initial recognition are:

	₹	₹
Loan receivable (financial asset) Dr.	4,32,000	
Prepaid employee cost (asset) Dr.	68,000	
To Cash / Bank (financial asset)		5,00,000
<i>(Being loan granted to the employee recognised)</i>		

The amortised cost calculation at 1st April, 20X1 is as follows:

Period	Carrying amount at 1st April	Interest at 5%	Cash inflow	Carrying amount at 31st March
20X1-20X2	4,32,000	21,600	—	4,53,600
20X2-20X3	4,53,600	22,680	—	4,76,280
20X3-20X4	4,76,280	23,720*	(5,00,000)	—

*Difference of ₹ 94 (₹ 23,814 – ₹ 23,720) is due to approximation.

On 31st March, 20X3, the carrying amount of the loan receivable is ₹ 4,76,280.

As a result of that modification, on 31st March, 20X3, the present value of estimated cash flows is recalculated to be ₹ 2,05,750 using the asset's original effective interest rate of 5% ($₹ 2,50,000 \div (1.05)^4$).

An impairment loss of ₹ 2,70,530 (₹ 4,76,280 – ₹ 2,05,750) is recognised in profit or loss in the year 20X2-20X3.

The carrying amount of the loan receivable may be reduced directly, as follows:

	₹	₹
Profit or loss - impairment loss Dr.	2,70,530	
To Loan receivable		2,70,530
<i>(Being impairment loss recognised)</i>		

In this case, the loan receivable will be measured at ₹ 2,05,750 at 31st March, 20X3. The revised amortised cost calculation at 1st April, 20X3 is as follows:

Period	Carrying amount at 1st April	Interest at 5% (the original effective interest rate)	Cash inflow	Carrying amount at 31st March
20X3-20X4	2,05,750	10,288	—	2,16,038
20X4-20X5	2,16,038	10,802	—	2,26,840
20X5-20X6	2,26,840	11,342	—	2,38,182
20X6-20X7	2,38,182	11,818	(2,50,000)	—

SOLVED EXAMPLE

Example 1 - Extinguishment accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 10,00,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 10,00,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- the term is extended to 31 December 20Y1;
- interest payments are reduced to 5% p.a.;
- the bonds are redeemable on 31 December 20Y1 for ₹ 15,00,000; and
- legal and other fees of ₹ 1,00,000 are incurred.

XYZ Ltd. determines that the market interest rate on 1 January 20X5 for borrowings on similar terms is 11%.

The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(100,000)	10,00,000
31 December 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

- cash flows under the new terms – i.e. ₹ 15,00,000 payable on 31 December 20Y1 and ₹ 50,000 payable for each of the 7 years ending 31 December 20Y1.
- any fee paid (net of any fee received) – i.e. ₹ 1,00,000 using the original effective interest rate of 10%.

The total of these amounts to ₹ 11,13,158 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 11.32% i.e. by more than 10%. Hence, extinguishment accounting applies.

The next step is to estimate the fair value of the modified liability. This is determined as the present value of the future cash flows (interest and principal), using an interest rate of 11% (the market rate at which XYZ Ltd. could issue new bonds with similar terms). The estimated fair value on this basis is ₹ 958,097 (Refer Working Note). A gain or loss on modification is then determined as:

Gain (loss) = carrying value of existing liability - fair value of modified liability - fees and costs incurred i.e. ₹ 10,00,000 – ₹ 9,58,097 – ₹ 1,00,000 = Loss of ₹ 58,097

Working Note:

Year	Discount factor @ 10%	Discount factor @ 11%
1	0.909091	0.900901
2	0.826446	0.811622
3	0.751315	0.731191
4	0.683013	0.658731
5	0.620921	0.593451
6	0.564474	0.534641
7	<u>0.513158</u>	<u>0.481658</u>
Annuity	<u>4.868419</u>	<u>4.712196</u>

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	5.868419	2,43,421	4.712196	2,35,610
PV of original cash flows @ original EIR		11,13,158		9,58,097
Difference		(10,00,000)		
Difference %		1,13,158		
		11.32%		

Modification accounting

Ind AS 109 is not clear as to the accounting treatment if the 10% test is failed. Two alternate approaches are therefore possible:

Approach 1: Recognition of gain or loss on date of modification

Under this approach, the difference between:

- discounted present value of the remaining cash flows of the original financial liability, and
- discounted present value of the remaining cash flows of the new financial liability

both computed using original effective interest rate, is recognized in profit or loss. In addition, any fees or costs incurred will also be recognized in profit or loss.

Approach 2: Amortisation of gain or loss on date of modification

Under this approach,

- the fees or costs incurred are netted against the existing liability;
- the effective interest rate is recalculated. This is the rate which discounts the future cash flows as per modified contractual terms to the adjusted carrying amount mentioned above
- the adjusted effective interest rate is used to determine the amortised cost and interest expense in future periods

Example 2 - Modification accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 1,000,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 1,000,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- no further interest payments are made
- the bonds are redeemed on the original due date (31 December 20X9) for ₹ 1,600,000;
- legal and other fees of ₹ 50,000 are incurred.

The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X5	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

- cash flows under the new terms – i.e. ₹ 16,00,000 payable on 31 December 20X9
- 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:

- 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;
- 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%
- 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

Example 3 - Extinguishment of part of a financial liability through issue of equity instruments

JK Ltd. has an outstanding unsecured loan of ₹ 90 crores to a bank. The effective interest rate (EIR) of this loan is 10%. Owing to financial difficulties, JK Ltd. is unable to service the debt and approaches the bank for a settlement.

The bank offers the following terms which are accepted by JK Ltd.:

- 2/3rd of the debt is unsustainable and hence will be converted into 70% equity interest in JK Ltd. The fair value of net assets of JK Ltd. is ₹ 80 crores.
- 1/3rd of the debt is sustainable and the bank agrees to certain moratorium period and decrease in interest rate in initial periods. The present value of cash flows as per these revised terms calculated using original EIR is ₹ 25 crores. The fair value of the cash flows as per these revised terms is ₹ 28 crores.

Fair value of the consideration paid is ₹ 56 crores (70% of ₹ 80 crores) plus ₹ 28 crores i.e. ₹ 84 crores.

Accordingly, 2/3rd of the original financial liability is extinguished through issue of equity shares and terms of 1/3rd of the original financial liability have been modified. JK Ltd. will need to evaluate if this modification tantamount to "substantial modification" or not.

Applying the guidance contained in Appendix D to Ind AS 109:

- Difference between the fair value of equity instruments (₹ 56 crores) and 2/3rd of the original financial liability (2/3rd of ₹ 90 crores = ₹ 60 crores) i.e. ₹ 4 crores will be recognised as a gain in the statement of profit 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.

PROFESSIONAL & ETHICAL DUTY OF A CA

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
₹ 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.

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.

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 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.

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 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.

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.

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 be higher than the depreciation 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.

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 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-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.

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 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.

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:

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 nonfinancial 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 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 nonfinancial 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.

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 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 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.

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:

- Discuss the accounting treatment which Mitra Ltd. should adopt to address the issue above for the financial statements.
- Discuss the ethical issues which may arise in the above scenario, including any actions which Mitra Ltd. and Mr. X should take.

Solution

- 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.

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 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 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.

Illustration 10

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.

Solution:

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;
- 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 managing 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 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.

ACCOUNTING & TECHNOLOGY

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:

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.
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.
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.

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, 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.
- ✓ 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.
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.

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 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.

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 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.

Illustration 5

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'?

Answers

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.

Illustration 6

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.
- (ii) Establish rules to link relevant transactions to specific contracts and assign unique identifiers to each contract

Required

Advise the steps to automate the process to perform the above tasks on behalf of New Way Ltd.

Answers

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.

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.

Example 1: Using RPA (Robotic Process Automation) 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.

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.

Examples 3 – 5 : Using Blockchain**Example 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.

Example 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.

Example 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.

Examples: 6 – 9 : Using Artificial Intelligence in Financial Reporting**Example 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.

Example 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.

Example 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. 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.

Example 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.

FINAL EXAMINATION: MAY, 2023

QUESTIONS

Ind AS 110

1. 'High Speed Limited' manufactures and sells cars. The Company wants to foray into the two-wheeler business and therefore it acquires 30% interest in Quick Bikes Limited for ₹ 5,00,000 as at 1st November, 20X1 and an additional 25% stake as at 1st January, 20X2 for ₹ 5,00,000 at its fair value.

Following is the Balance Sheet of Quick Bikes Limited as at 1st January, 20X2:

Liabilities	Carrying value	Fair value	Assets	Carrying value	Fair value
Share capital	1,00,000		Plant and equipment	3,50,000	7,50,000
Reserves	5,50,000		Investment in bonds	4,00,000	5,00,000
Trade payables	1,50,000	1,50,000	Trade Receivables	50,000	50,000
Total	8,00,000		Total	8,00,000	

Quick Bikes Limited sells the motorcycles under the brand name 'Super Start' which has a fair value of ₹ 3,50,000 as at 1st January, 20X2. This is a self-generated brand therefore Quick Bikes Limited has not recognized the brand in its books of accounts. Following is the separate balance sheet of High Speed Limited as at 1st January, 20X2:

Liabilities	Amount	Assets	Amount
Share capital	5,00,000	Plant and equipment	13,50,000
Reserves	15,00,000	Investment in Quick Bike	10,00,000
Short term loans	4,00,000	Trade Receivables	80,000
Trade payables	3,00,000	Cash and bank balances	5,20,000
Other liabilities	2,50,000		
Total	29,50,000	Total	29,50,000

In relation to the acquisition of Quick Bikes Limited, you are required to:

- (i) Pass the necessary journal entries to give effect of business combination in accordance with Ind AS 103 as at acquisition date 1st January, 20X2. NCI is

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measured by the entity at fair value. Provide working notes, Ignore deferred tax implication; and

- (ii) Prepare a consolidated balance sheet of High Speed Limited as at 1st January, 20X2.

Ind AS 2

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

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

Applying the retail method, compute the following:

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

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

Ind AS 19

3. From the following particulars, compute the net defined benefit liability and expense to be recognized in Profit and Loss account.

(₹ in lakhs)

Particulars	Defined benefit obligation		Plan Assets	
	31 st Dec. 20X2	31 st Dec. 20X1	31 st Dec. 20X2	31 st Dec. 20X1
Balance at the beginning of the year	63.25	47.08	21.80	14.65
Current service cost	5.84	4.97	-	-
Interest cost	4.27	3.56	-	-
Changes in demographic assumptions	0.62	1.86	-	-
Changes in financial assumptions	3.58	1.93	-	-

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Experience variance	(2.49)	4.46	-	-
Benefits paid	-	(0.61)	-	(0.61)
Investment income	-	-	1.47	1.12
Employers' contribution	-	-	8.00	7.00
Return on plan assets	-	-	2.12	(0.35)

Ind AS 102

4. Entity A runs a copper-mining business. Entity A has a year-end of 31st March. Dividends declared on the shares accrue to the employees during the three-year period. If the condition is met, the employees will receive the shares together with the dividends that have been declared on those shares during the three years upto 31st March, 20X3.

The entity estimates that on 1st April, 20X0 its shares are valued at ₹ 10 each. The grant date fair amount of each share is ₹ 10.

Entity A prepares annual financial statements for the year ended 31st March and:

- ♦ on 1st April, 20X0 it estimates that 800 shares will vest;
- ♦ at the end of the first year (31st March, 20X1) it has revised this estimate to 780;
- ♦ at 31st March, 20X2 it has further revised this estimate to 750; and
- ♦ 750 shares vest on 31st March, 20X3 based on the number of employees still employed on that date.

On 1st April, 20X0 as part of a long-term incentive scheme, Entity A provisionally awards its sales employees 1,000 Entity A's shares receivable on 31st March, 20X3. Explain the accounting treatment for the above share-based awards based on satisfaction of the condition that the sales employees must remain in employment until 31st March, 20X3. The requirement to remain in employment is a service condition and would not be reflected in the fair value of the share awards.

Ind AS 101

5. ABC Ltd., a public limited company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India. It operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. The company was following Accounting Standards as notified under the Companies (Accounting Standards) Rules until 31st March, 20X1. However, it has adopted Indian Accounting Standards (Ind AS) with effect from 1st April, 20X1.

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The goodwill recognised in accordance with AS 21 and AS 27 was due to corporate structure and the line-by-line consolidation of subsidiaries'/proportionate consolidation of jointly controlled entities' financial statements which was prepared on historical costs convention. ABC Ltd. has not taken into consideration the valuation of underlying oil and gas reserves for which excess amount (i.e. goodwill calculated as per the relevant AS requirements) has been paid by the company at the time of acquisition. The company further considered that in oil and gas companies, the goodwill generated on acquisition of mineral rights either through jointly controlled entities or subsidiaries, inherently derives its value from the underlying mineral rights and, accordingly, value of such goodwill depletes as the underlying mineral resources are extracted.

Therefore, taking a prudent approach and considering the above substance, the company amortised the goodwill in respect of its subsidiaries / jointly controlled assets over the life of the underlying mineral rights using Unit of Production method. This allowed the company to utilise the value of goodwill over the life of mineral rights and completely charging off the goodwill over the life of the reserves.

For financial year 20X0-20X1, the company has availed transition exemption under Ind AS 101 and has not applied the principles of Ind AS 103.

ABC Ltd. considering the substance over form of the goodwill to be in the nature of 'acquisition costs' intends to continue amortisation of the goodwill recognised under AS in respect of its subsidiaries / joint ventures (jointly controlled entities under AS) over the life of the underlying mineral rights using Unit of Production method, under Ind AS also post transition date.

Comment on appropriateness of the accounting treatment, under Ind AS, for amortisation of the goodwill by the company and state whether the accounting treatment in respect of amortisation of goodwill is correct or not.

Ind AS 23

6. LT Ltd. is in the process of constructing a building. The construction process is expected to take about 18 months from 1st January 20X1 to 30th June 20X2. The building meets the definition of a qualifying asset. LT Ltd. incurs the following expenditure for the construction:

1 st January, 20X1	₹ 5 crores
30 th June, 20X1	₹ 20 crores
31 st March, 20X2	₹ 20 crores
30 th June, 20X2	₹ 5 crores

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On 1st July 20X1, LT Ltd. issued 10% Redeemable Debentures of ₹ 50 crores. The proceeds from the debentures form part of the company's general borrowings, which it uses to finance the construction of the qualifying asset, ie, the building. LT Ltd. had no borrowings (general or specific) before 1st July 20X1 and did not incur any borrowing costs before that date. LT Ltd. incurred ₹ 25 crores of construction costs before obtaining general borrowings on 1st July 20X1 (pre-borrowing expenditure) and ₹ 25 crores after obtaining the general borrowings (post-borrowing expenditure).

For each of the financial years ended 31st March 20X1, 20X2 and 20X3, calculate the borrowing cost that LT Ltd. is permitted to capitalize as a part of the building cost.

Ind AS 115

7. 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 Ind AS 115 because it obtains control of the air conditioners before they are transferred to the customer. The customer obtains control of the air conditioners when they are delivered to the hospital premises.

Company X uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation.

As at 31st March, 20X1, other costs incurred excluding the air conditioners are ₹ 6,00,000.

Whether Company X should include cost of the air conditioners in measure of its progress of performance obligation? How should revenue be recognized for the year ended 31st March, 20X1?

Ind AS 16

8. Company X built a new plant that was brought into use on 1st April, 20X1. The cost to construct the plant was ₹ 1.5 crore. The estimated useful life of the plant is 20 years and Company X accounts for the plant using the cost model.

The initial carrying amount of the plant included an amount of ₹ 10 lakh for decommissioning, which was determined using a discount rate of 10%. On 31st March, 20X2, Company X remeasures the provision for decommissioning to ₹ 13 lakh.

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Provide necessary journal entries at the end of the year i.e. 31st March, 20X2 for recording of depreciation and decommissioning provision.

Ind AS 20

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. How should A Ltd. present such grant related to income in its financial statements?

Ind AS 116

10. How will Entity Y account for the incentive in the following scenarios:

Scenario A:

Entity Y (lessor) enters into an operating lease of property with Entity X (lessee) for a five-year term at a monthly rental of ₹ 1,10,000. In order to induce Entity X to enter into the lease, Entity Y provides ₹ 6,00,000 to Entity X at lease commencement for lessee improvements (i.e., lessee's assets).

Scenario B:

Entity Y (lessor) enters into an operating lease of property with Entity X (lessee) for a five-year term at a monthly rental of ₹ 1,10,000. At lease commencement, Entity Y provides ₹ 6,00,000 to Entity X for leasehold improvements which will be owned by Entity Y (i.e., lessor's assets). The estimated useful life of leasehold improvements is 5 years

Ind AS 103

11. In October 20X1, IHL acquired 75% of Very Relevant Limited by paying cash consideration of ₹ 0.80 million. The fair value of non-controlling interest on the date of acquisition is ₹ 0.20 million. The value of Very Relevant Limited's identifiable net assets as per Ind AS 103 is ₹ 1.10 million.

With respect to acquisition of Very Relevant Limited, determine the value of gain on bargain purchases, when NCI is measured as per:

- (a) Fair value method
- (b) Proportionate share of net identifiable assets method.

Ind AS 41

12. Fisheries Ltd. practices pisciculture in sweet waters (ponds, tanks and dams). The fishing activity of Fisheries Ltd. in such sweet waters consists only of catching the fishes. Comment whether such fishing activity will be covered within the scope of Ind AS 41?

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Ind AS 32

13. State whether the following items meet the definition of Financial Asset or Financial Liability for an entity:
- (i) A bank advances an entity a five-year loan. The bank also provides the entity with an overdraft facility for a number of years.
 - (ii) Entity A owns preference shares in Entity B. The preference shares entitle Entity A to dividends, but not to any voting rights.
 - (iii) An entity has a present obligation in respect of income tax due for the prior year.
 - (iv) In a lawsuit brought against an entity, a group of people is seeking compensation for damage to their health as a result of land contamination believed to be caused by waste from the entity's production process. It is unclear whether the entity is the source of the contamination since many entities operate in the same area and produce similar waste.

Ind AS 33

14. Company P has both ordinary shares and equity-classified preference shares in issue. The reconciliation of the number of shares during Year 1 is set out below:

Number of shares

Dates in Year 1	Transaction	Ordinary shares	Treasury shares	Preference shares
1 st April	Balance	30,00,000	(5,00,000)	5,00,000
15 th April	Bonus issue – 5% (no corresponding changes in resources)	1,50,000	(25,000)	-
1 st May	Repurchase of shares for cash	-	(2,00,000)	-
1 st November	Shares issued for cash	4,00,000	-	-
31 st March	Balance	35,50,000	(7,25,000)	5,00,000

The following additional information is relevant for Year 1.

- Company P's net profit for the year is ₹ 46,00,000.
- On 15th February, non-cumulative preference dividends of ₹ 1.20 per share were declared. The dividends were paid on 15th March. Preference shares do not participate in additional dividends with ordinary shares.
- Dividends on non-cumulative preference shares are deductible for tax purposes. The applicable income tax rate is 30%.

The financial year of Company P ends on 31st March.

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Determine the Basic EPS of the Company P for Year 1. Use the number of months or part of months, rather than the number of days in the calculation of EPS.

Ind AS 8

15. 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 was not discoverable by reasonable or customary inspection). As a result of the latent defect, the entity incurred ₹ 1,00,000 in 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 financial statements of 20X2-20X3 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 Ind AS 8.

Ind AS 109

16. In an arm's length transaction, Entity X buys 10,000 convertible preference shares in Company Z for cash payments of ₹ 40,000, with ₹ 25,000 payable immediately and ₹ 15,000 payable in two years. The market rate of annual interest for a two-year loan to the entity would be 6%.

Explain the accounting treatment for the said transaction.

Ind AS 24 / Ind AS 109

17. SEL has applied for a term loan from a bank for business purposes. As per the loan agreement, the loan required a personal guarantee of one of the directors of SEL to be executed. In case of default by SEL, the director will be required to compensate for the loss that bank incurs. Mr. Pure Joy, one of the directors had given guarantee to the bank pursuant to which the loan was sanctioned to SEL. SEL does not pay premium or fees to its director for providing this financial guarantee.

Whether SEL is required to account for the financial guarantee received from its director? Will there be any disclosures under Ind AS 24?

Ind AS 38 / Ind AS 103

18. An entity acquired two trade secrets (secret recipes) in a business combination. Recipe A is patented. Recipe B is not legally protected.

FINAL EXAMINATION: MAY, 2023

How the acquisition of Recipe A and Recipe B would be accounted for by the entity as per relevant Ind AS.

Ind AS 34

19. 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.

Ind AS 105

20. On 1st January, 20X1, the carrying amounts of the relevant assets of the division of an entity, Star Ltd. were as follows:
- Purchased goodwill ₹ 1.2 lakhs;
 - Property, plant and equipment (average remaining estimated useful life two years) ₹ 4 lakhs;
 - Inventories ₹ 2 lakhs.

From 1st January, 20X1, Star Ltd. began to actively market the division and has received a number of serious enquiries.

On 1st January, 20X1, the directors estimated that they would receive ₹ 6.4 lakhs from the sale of the division. Since 1st January, 20X1, market conditions have improved and on 30th April, 20X1, Star Ltd. received and accepted a firm offer to purchase the division for ₹ 6.6 lakhs. The sale is expected to be completed on 30th June, 20X1.

₹ 6.6 lakhs can be assumed to be a reasonable estimate of the value of the division on 31st March, 20X1.

During the period from 1st January 20X1 to 31st March, 20X1, inventories of the division costing ₹ 1.6 lakhs were sold for ₹ 2.4 lakhs. At 31st March, 20X1, the total cost of the inventories of the division was ₹ 1.8 lakhs. All of these inventories have an estimated net realizable value that is in excess of their cost.

Explain the disclosure requirement related to sale of division and provide the accounting treatment of property held for sale and discontinued operations.

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ANSWERS

1. (i)

Journal Entry

		₹	₹
Plant and Equipment	Dr.	7,50,000	
Investment in bonds	Dr.	5,00,000	
Trade Receivables	Dr.	50,000	
Brand	Dr.	3,50,000	
Goodwill (balancing figure)	Dr.	5,00,000	
	To Investment in Quick Bikes		10,00,000
	To Profit or loss A/c (W.N.1)		1,00,000
	To Trade Payables		1,50,000
	To NCI (W.N.3)		9,00,000
(Being assets and liabilities acquired at fair value and previous investment considered at fair value on the acquisition date)			

Working Notes:

1. Calculation of fair value of shares on the acquisition date 1st January, 20X2

25% Shares purchase on 1 st January, 20X2 (fair value)	₹ 5,00,000
30% Shares purchase on 1 st November, 20X1 at ₹ 5,00,000	
Fair value = [(5,00,000 / 25%) x 30%]	₹ 6,00,000
Total consideration at fair value on acquisition date	₹ 11,00,000
Less: Cost of investment (5,00,000 + 5,00,000)	(₹ 10,00,000)
Gain recognised to Profit or Loss/OCI (as appropriate)	₹ 1,00,000

2. Computation of Net Identifiable Assets at fair value

	₹
Plant and Equipment	7,50,000
Investment in bonds	5,00,000
Trade Receivables	50,000
Self-generated Brand	3,50,000
	16,50,000

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Less: Trade Payables	(1,50,000)
Net Identifiable Assets at fair value	<u>15,00,000</u>

3. Measurement of Non-controlling Interest (on fair value basis)

Share of NCI (100- 30-25)	45%
Taking fair value of shares on 1 st January, 20X2 as a base [(11,00,000/ 55%) x 45%]	₹ 9,00,000

(ii) Consolidated Balance Sheet of High Speed Limited as at 1st January, 20X2

	Note No.	₹
Assets		
Non-current assets		
(a) Property, plant and equipment	1	21,00,000
(b) Intangible asset	2	8,50,000
(c) Investment in bonds		5,00,000
Current Assets		
(a) Financial assets		
(i) Trade receivables	3	1,30,000
(ii) Cash and cash equivalents	4	<u>5,20,000</u>
		<u>41,00,000</u>
Equity and Liabilities		
Equity		
(a) Equity share capital		5,00,000
(b) Other Equity	5	16,00,000
Non-controlling Interest (W.N.3)		9,00,000
Current Liabilities		
(a) Financial liabilities		
(i) Borrowings	6	4,00,000
(ii) Trade Payables	7	4,50,000
(b) Other Current Liabilities	8	<u>2,50,000</u>
		<u>41,00,000</u>

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Notes to Accounts

S. No.		₹	₹
1.	Property, plant and equipment		
	High Speed Ltd.	13,50,000	
	Quick Bikes Ltd.	<u>7,50,000</u>	21,00,000
2.	Intangible asset		
	Goodwill	5,00,000	
	Brand value of Quick Bikes Ltd.	<u>3,50,000</u>	8,50,000
3.	Trade Receivables		
	High Speed Ltd.	80,000	
	Quick Bikes Ltd.	<u>50,000</u>	1,30,000
4.	Cash and cash equivalents		
	Quick Bikes Ltd.		5,20,000
5.	Other Equity - Reserves		
	High Speed Ltd.	15,00,000	
	Add: Gain on investment in Quick Bikes Ltd.	<u>1,00,000</u>	16,00,000
6.	Borrowings		
	Short term loans of High Speed Ltd.		4,00,000
7.	Trade Payables		
	High Speed Ltd.	3,00,000	
	Quick Bikes Ltd.	<u>1,50,000</u>	4,50,000
8.	Other Current Liabilities		
	High Speed Ltd.		2,50,000

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

S. No.	Particulars		₹
	Cost price of goods	6,250 + 19,500	25,750
	Retail price of goods	8,000 + 34,000	42,000
(a)	Cost percentage of retail price	25,750 / 42,000	61%
(b)	Closing inventory (at cost)	23,000 x 61%	14,030

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(c)	Cost of sales for the period	$[(6,250 + 19,500) - 14,030]$	11,720
	Sales for the period		19,000
(d)	Profit earned on sale of goods during the year	$19,000 - 11,720$	7,280

3. Computation of defined benefit liability and expenses to be charged to Statement of Profit and Loss:

	Defined benefit obligation (₹ in lakhs)		Plan Assets (₹ in lakhs)	
	31 st Dec 20X2	31 st Dec 20X1	31 st Dec 20X2	31 st Dec 20X1
Balance at the beginning of year	63.25	47.08	21.80*	14.65
Current service cost	5.84	4.97	-	-
Interest cost	4.27	3.56	-	-
Changes in demographic assumptions	0.62	1.86	-	-
Changes in financial assumptions	3.58	1.93	-	-
Experience variance	(2.49)	4.46	-	-
Benefits paid	-	(0.61)	-	(0.61)
Investment income	-	-	1.47	1.12
Employers' contribution	-	-	8.00	7.00
Return on plan assets	-	-	2.12	(0.35)
Balance at the end of year	<u>75.07</u>	<u>63.25</u>	<u>33.39</u>	<u>21.81*</u>

*Difference is due to approximation.

In the BALANCE SHEET, the following will be recognised:

Net defined liability to be recognised for the period ending 31st December, 20X1:

$$= ₹ 41.44 \text{ lakhs } (₹ 63.25 \text{ lakhs} - ₹ 21.81 \text{ lakhs})$$

Net defined liability to be recognised for the period ending 31st December, 20X2:

$$= ₹ 41.68 \text{ lakhs } (₹ 75.07 \text{ lakhs} - ₹ 33.39 \text{ lakhs})$$

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In the STATEMENT OF PROFIT AND LOSS, the following will be recognised:

	Defined benefit obligation (₹ in lakhs)		Plan Assets (₹ in lakhs)	
	31 st Dec., 20X2	31 st Dec., 20X1	31 st Dec., 20X2	31 st Dec., 20X1
Current service cost	5.84	4.97	-	-
Interest cost	4.27	3.56	-	-
Investment income	-	-	(1.47)	(1.12)
Total	10.11	8.53	(1.47)	(1.12)

Expense to be recognised in the Statement of Profit and Loss for the period ending 31st December, 20X1 = ₹ 7.41 lakhs (₹ 8.53 lakhs - ₹ 1.12 lakhs)

Expense to be recognised in the Statement of Profit and Loss for the period ending 31st December, 20X2 = ₹ 8.64 lakhs (₹ 10.11 lakhs - ₹ 1.47 lakhs).

4. The grant date fair value amount would be recognised as an expense over the three year service period adjusted by the number of shares expected to vest. Consequently, for each period, Entity A estimates how many eligible employees are expected to be employed on 31st March, 20X3 and this forms the basis for that adjustment. The journal entries would be:

Year 1 (Year ended 31st March, 20X1)

Employee benefit expenses A/c	Dr. ₹ 2,600	
To Share-based payment reserve		₹ 2,600
(To recognise the receipt of employee services in exchange for shares)		

Year 2 (Year ended 31st March, 20X2)

Employee benefit expenses A/c	Dr. ₹ 2,400	
To Share-based payment reserve		₹ 2,400
(To recognise the receipt of employee services in exchange for shares)		

Year 3 (Year ended 31st March, 20X3)

Employee benefit expenses A/c	Dr. ₹ 2,500	
To Share-based payment reserve		₹ 2,500
(To recognise the receipt of employee services in exchange for shares)		

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Working Notes:

1. Year 1

780 shares expected to vest $\times$ ₹ 10 grant date fair value of each share $\times$ 1/3 of vesting period elapsed = ₹ 2,600 recognised in Year 1.

2. Year 2

(750 shares expected to vest $\times$ ₹ 10 grant date fair value of each share $\times$ 2/3 of vesting period elapsed) less ₹ 2,600 recognised in Year 1 = ₹ 2,400 recognised in Year 2.

3. Year 3

(750 shares $\times$ ₹ 10 grant date fair value of each share) less ₹ 5,000 recognised in Years 1 and 2 = ₹ 2,500 recognised in Year 3.

5. Point (g) of para C4 of Ind AS 101 states that the carrying amount of goodwill or capital reserve in the opening Ind AS Balance Sheet shall be its carrying amount in accordance with previous GAAP at the date of transition to Ind AS after the two adjustments. One of the adjustment states that the standard requires the first-time adopter to recognise an intangible asset that was subsumed in recognised goodwill or capital reserve in accordance with previous GAAP, the first-time adopter shall decrease the carrying amount of goodwill or increase the carrying amount of capital reserve accordingly (and, if applicable, adjust deferred tax and non-controlling interests)

As per the facts given, the entity paid excess amount to avail the rights to use the underlying oil and gas reserves. However, since the rights was not recorded in the books at that time, the value of goodwill subsumed the value of that intangible asset which should be separately identified in the books. Hence, value of goodwill will be reduced accordingly and intangible asset for rights for using mine should be recognised.

Further, regardless of whether there is any indication that the goodwill may be impaired, the first-time adopter shall apply Ind AS 36 in testing the goodwill for impairment at the date of transition to Ind AS and in recognising any resulting impairment loss in retained earnings (or, if so required by Ind AS 36, in revaluation surplus). The impairment test shall be based on conditions at the date of transition to Ind AS. No other adjustments (eg- previous amortisation of goodwill) shall be made to the carrying amount of goodwill / capital reserve at the date of transition to Ind AS.

However, once goodwill is recognised in the opening transition date balance sheet, the entity has to follow the provisions of Ind AS, which states that goodwill is not amortised

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but rather tested for impairment annually. Accordingly, the amortization of goodwill based on 'Unit of Production' method is not correct after implementation of Ind AS.

6. Applying paragraph 17 of Ind AS 23 to the fact pattern, the entity would not begin capitalising borrowing costs until it incurs borrowing costs (i.e. from 1st July, 20X1)

In determining the expenditures on a qualifying asset to which an entity applies the capitalisation rate (paragraph 14 of Ind AS 23), the entity does not disregard expenditures on the qualifying asset incurred before the entity obtains the general borrowings. Once the entity incurs borrowing costs and therefore satisfies all three conditions in para 17 of Ind AS 23, it then applies paragraph 14 of Ind AS 23 to determine the expenditures on the qualifying asset to which it applies the capitalisation rate.

Calculation of borrowing cost for financial year 20X0-20X1

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1 st January 20X1	₹ 5 crore	0/3	Nil

Borrowing Costs eligible for capitalisation = NIL. LT Ltd. cannot capitalise borrowing costs before 1st July, 20X1 (the day it starts to incur borrowing costs).

Calculation of borrowing cost for financial year 20X1-20X2

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1 st January, 20X1	₹ 5 crore	9/12*	₹ 3.75 crore
30 th June, 20X1	₹ 20 crore	9/12	₹ 15 crore
31 st March, 20X2	₹ 20 crore	0/12	Nil
Total			₹ 18.75 crore

Borrowing Costs eligible for capitalisation = 18.75 cr. x 10% = ₹ 1.875 cr.

*LT Ltd. cannot capitalise borrowing costs before 1st July, 20X1 (the day it starts to incur borrowing costs). Accordingly, this calculation uses a capitalization period from 1st July, 20X1 to 31st March, 20X2 for this expenditure.

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Calculation of borrowing cost for financial year 20X2-20X3

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1 st January, 20X1	₹ 5 crore	3/12	₹ 1.25 crore
30 th June, 20X1	₹ 20 crore	3/12	₹ 5 crore
31 st March, 20X2	₹ 20 crore	3/12	₹ 5 crore
31 st March, 20X2	₹ 1.875 crore	3/12	₹ 0.47 crore
30 th June, 20X2	₹ 5 crore	0/12	Nil
Total			₹ 11.72 crore

Borrowing costs eligible for capitalisation = ₹ 11.72 cr. x 10% = ₹ 1.172 cr.

7. Paragraph B19 of Ind AS 115 inter alia, states that, "an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 39, do not depict the entity's performance in transferring control of goods or services to the customer".

In accordance with the above, Company X assesses whether the costs incurred to procure the air conditioners are proportionate to the entity's progress in satisfying the performance obligation. The costs incurred to procure the air conditioners i.e ₹ 10,00,000 are significantly relative to the total costs to completely satisfy the performance obligation i.e. ₹ 40,00,000. Also, Company X is not involved in manufacturing or designing of air conditioners.

Company X concludes that including the costs to procure the air conditioners in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph B19 of Ind AS 115, the entity adjusts its measure of progress to exclude the costs to procure the air conditioners from the measure of costs incurred and from the transaction price. The entity recognises revenue for the transfer of the air conditioners at an amount equal to the costs to procure the air conditioners (i.e., at a zero margin). Accordingly, the total revenue on account of renovation would be ₹ 50,00,000 - ₹ 10,00,000 = ₹ 40,00,000.

Company X assesses that as at 31st March, 20X1, the performance is 20% complete (i.e., ₹ 6,00,000 / ₹ 30,00,000).

Total revenue from renovation work would be

$$= ₹ 50,00,000 - ₹ 10,00,000 = ₹ 40,00,000.$$

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Consequently, as at 31st March, 20X1, Company X recognises the following:

		₹
Revenue	[(₹ 40,00,000 x 20%) + ₹ 10,00,000]	18,00,000
Less: Cost of goods sold	(₹ 6,00,000 of costs incurred + ₹ 10,00,000 costs of air conditioners)	(16,00,000)
Profit		<u>2,00,000</u>

8. **Journal Entries in the books of Company X
for the year ending ended 31st March, 20X2**

	₹ in lakh	₹ in lakh
Depreciation (profit or loss) Dr. To Accumulated depreciation (plant) (Being depreciation on plant recognised under straight-line method (1,50,00,000 x 1/20))	7.5	7.5
Interest expense (profit or loss) Dr. To Provision for decommissioning (Being unwinding of decommissioning provision @10% recognised in the books)	1.0	1.0
Plant Dr. To Provision for decommissioning (Being increase in decommissioning provision recognised [13,00,000 - (10,00,000 + 1,00,000)] at the end of the year)	2.0	2.0

9. As per paragraph 29 of Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance', 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 would be 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".

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This method considered on the contention that it would be inappropriate to present income and expense items on a net basis and that separation of the grant from the expense would facilitate 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).

This method is considered based on the contention that the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting the grant might 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.

10. Para 70 of Ind AS 116 state that at the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:
- (a) fixed payments (including in-substance fixed payments as described in para B42), less any lease incentives payable;
 - (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
 - (c) 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;
 - (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in para B37); and
 - (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

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Further para 71 of the standard states that 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 from the use of the underlying asset is diminished.”

Scenario A

In accordance with above, in the given case, at lease commencement, Entity Y accounts for the incentive as follows:

To account for the lease incentive

Deferred lease incentive	Dr. ₹ 6,00,000	
To Cash		₹ 6,00,000

Recurring monthly journal entries in Years 1 – 5

To record cash received on account of lease rental and amortisation of lease incentive over the lease term

Cash	Dr. ₹ 1,10,000	
To Lease income		₹ 1,00,000
To Deferred lease incentive		₹ 10,000*

* This is calculated as ₹ 6,00,000 ÷ 60 months.

Scenario B

Entity Y has provided lease incentive amounting to ₹ 6,00,000 to Entity X for leasehold improvements in the premises. As Entity Y has the ownership of the leasehold improvements carried out by the lessee, it shall account for the same as property, plant and equipment and shall depreciate the same over its useful life.

In accordance with above, in the given case, at lease commencement, Entity Y accounts for the incentive as follows:

To record the lease incentive

Property, plant & Equipment	Dr. ₹ 6,00,000	
To Cash		₹ 6,00,000

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Recurring monthly journal entries in Years 1 – 5

To record cash received on account of lease rental over the lease term

Cash	Dr. ₹ 1,10,000	
To Lease income		₹ 1,10,000

To record depreciation on PPE over the lease term using straight line method

Depreciation	Dr. ₹ 10,000	
To Accumulated Depreciation		₹ 10,000

11. (a) When NCI is measured as per fair value method

	₹ in million
Fair value of consideration transferred	0.80
Fair value of non-controlling interest	<u>0.20</u>
	1.00
Value of Very Relevant Limited's identifiable net assets as per Ind AS 103	<u>(1.10)</u>
Gain on bargain purchase	<u>0.10</u>

(b) When NCI is measured as per proportionate share method

	₹ in million
Fair value of consideration transferred	0.80
Proportional share of non-controlling interest in the net identifiable assets of acquiree (1.10 x 25%)	<u>0.275</u>
	1.075
Value of Very Relevant Limited's identifiable net assets as per Ind AS 103	<u>(1.10)</u>
Gain on bargain purchase	<u>0.025</u>

12. Paragraph 5 of Ind AS 41, defines agricultural activity as follows:

"Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets."

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For fishing to qualify as agricultural activity, it must satisfy both of the below mentioned conditions:

- a) management of biological transformation of a biological asset; **and**
- b) harvesting of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

Therefore, when fishing involves managed activity to grow and procreate fishes in designated areas, such fishing is an agricultural activity as per the above definition. Managing the growth of fish for subsequent sale is an agricultural activity as per Ind AS 41.

In the aforementioned scenario, only fish harvesting is managed by Fisheries Ltd. Therefore, mere fish harvesting without management of biological transformation cannot be termed as an agricultural activity as per Ind AS 41.

Hence, fishing in sweet waters (pond, tanks and dams) where only fishing (harvesting) is carried out without any management of biological transformation is outside the scope of Ind AS 41.

13. (i) The entity has two financial liabilities namely (a) the obligation to repay the five-year loan and (b) the obligation to repay the bank overdraft to the extent that it has borrowed using the overdraft facility. Both the loan and the overdraft result in contractual obligations for the entity to pay cash to the bank for the interest incurred and for the return of the principal.
- (ii) For Entity B: The preference shares may be equity instruments or financial liabilities of Entity B, depending on their terms and conditions.
- For Entity A: Irrespective of Entity B's treatment, the preference shares are a financial asset because the investment satisfies the definition of a financial asset.
- (iii) An income tax liability is created as a result of statutory requirements imposed by the government. The rights and obligations are not created by a contract. Hence, the liability for income-tax dues is not a financial liability.
- (iv) The fact that a lawsuit may result in the payment of cash does not create a financial liability for the entity because there is no contract between the entity and the affected group. The entity will need to consider providing for the payment as per Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

14. Determination of numerator for calculation of Basic EPS

The first step in the basic EPS calculation is to determine the profit or loss that is attributable to ordinary shareholders of Company P for the period.

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Non-cumulative dividends paid on equity-classified preference shares are not deducted in arriving at net profit or loss for the period, but they are not returns to ordinary shareholders. Accordingly, these dividends are deducted from net profit or loss for the period in arriving at the numerator.

		(₹)
Net profit		46,00,000
Preference dividends (5,00,000 shares x 1.2)	(6,00,000)	
Related tax (₹ 6,00,000 x 30%)	<u>1,80,000</u>	<u>(4,20,000)</u>
Profit or loss attributable to P's ordinary shareholders		<u>41,80,000</u>
Accordingly, the numerator for calculation of Basic EPS is ₹ 41,80,000		

Determination of denominator for calculation of Basic EPS

The second step in the basic EPS calculation is to determine the weighted-average number of ordinary shares outstanding for the reporting period.

Number of shares	Time weighting	Weight	Weighted average number of shares
1 st April - opening balance (30,00,000 - 5,00,000)	25,00,000	1	
15 th April - bonus issue (1,50,000 - 25,000)	<u>1,25,000</u>		
1 st April to 30 th April	26,25,000	1/12	2,18,750
1 st May - repurchase of shares	<u>(2,00,000)</u>		
1 st May to 31 st October	24,25,000	6/12	12,12,500
1 st November - new shares issued	<u>4,00,000</u>		
1 st November to 31 st March	<u>28,25,000</u>	5/12	<u>11,77,083</u>
Weighted average number of shares for the year			<u>26,08,333</u>

The denominator for calculation of Basic EPS is 26,08,333 shares.

Basic EPS = ₹ 41,80,000 / 26,08,333 shares = ₹ 1.60 per share (approx.).

15. The defect was neither known nor reasonably possible to detect at 31st March, 20X3 or before the financial statements were approved for issue, hence ₹ 1,00,000 understatement of the warranty provision and ₹ 2,000 [refer Working Note] overstatement of inventory in the 31st March, 20X3 financial statements is not a prior

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period error. 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 31st March, 20X3 financial statements 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 taken into account in the preparation and presentation of those financial statements. Consequently, the additional costs will be expensed in calculating profit or loss for 20X3-20X4.

Working Note:

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

16. Since payment of ₹ 15,000 is deferred for two years, the fair value of the consideration given for the shares is equal to ₹ 25,000 plus the present value of ₹ 15,000. The present value of ₹ 15,000 deferred payment is ₹ 13,350 ($₹ 15,000 \div 1.06^2$).

Entity X will initially measure the shares purchased at ₹ 38,350 (i.e., ₹ 25,000 + ₹ 13,350).

Since this transaction took place at an arm's length, this is considered to be fair value for initial recognition in the absence of evidence to the contrary.

The difference between the ₹ 40,000 cash paid out and the ₹ 38,350, i.e. ₹ 1,650, will be recognised as interest expense in profit or loss over the two year period of deferred payment.

17. Ind AS 109 'Financial Instruments', defines a financial guarantee contract as 'a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.'

Based on this definition, an evaluation is required to be done to ascertain whether the contract between director and Bank qualifies as a financial guarantee contract as defined in Appendix A to Ind AS 109. In the given case, it does qualify as a financial guarantee contract as:

- the reference obligation is a debt instrument (term loan);
- the holder i.e. Bank is compensated only for a loss that it incurs (arising on account of non-repayment); and
- the holder is not compensated for more than the actual loss incurred.

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Ind AS 109 provides principles for accounting by the issuer of the guarantee. However, it does not specifically address the accounting for financial guarantees by the beneficiary. In an arm's length transaction between unrelated parties, the beneficiary of the financial guarantee would recognise the guarantee fee or premium paid as an expense.

It is also pertinent to note that the entity needs to exercise judgment in assessing the substance of the transaction taking into consideration relevant facts and circumstances, for example, whether the director is being compensated otherwise for providing guarantee. Based on such an assessment, an appropriate accounting treatment based on the principles of Ind AS should be followed.

In the given case, SEL is the beneficiary of the financial guarantee and it does not pay a premium or fees to its director for providing this financial guarantee. Accordingly, SEL will not be required to account for such financial guarantee in its financial statements considering the unit of account as being the guaranteed loan, in which case the fair value would be expected to be the face value of the loan proceeds that SEL received.

In the given case based on the limited facts provided, SEL will be required to make necessary disclosures of such financial guarantee in accordance with Ind AS 24 as follows:

- (a) the amount of the transactions;
 - (b) the amount of outstanding balances, including commitments, and:
 - (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
 - (ii) details of any guarantees given or received;
 - (c) provisions for doubtful debts related to the amount of outstanding balances; and
 - (d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.
18. Para 11 and 12 of Ind AS 38 states that the definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements.

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Further, an asset is identifiable if it either:

- (a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
- (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

In the given case, Recipe A meets the contractual-legal criterion for identification as an intangible asset because it is protected by a patent. This recipe is identified and recognised separately from goodwill while accounting the business combination.

Since Recipe B is not protected by a patent, it does not meet the contractual-legal criterion for identification as an intangible asset. However, Recipe B is identified as a separate intangible asset because it meets the separability criterion. Such recipes can be, and often are, exchanged, licensed or leased to others. Therefore, the unpatented Recipe B should be accounted for as a separate intangible asset acquired in the business combination.

19. 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 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.

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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	30 th September 20X1	31 st March 20X1	-	-
Statement of profit and loss for	3 months ended 30 th September 20X1	3 months ended 30 th September 20X0	6 months ended 30 th September 20X1	6 months ended 30 th September 20X0
Statement of changes in equity for	6 months ended 30 th September 20X1	6 months ended 30 th September 20X0		
Statement of cash flows for	6 months ended 30 th September 20X1	6 months ended 30 th 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	30 th September, 20X1	31 st March, 20X1
Statement of profit and loss for	6 months ending 30 th September, 20X1	6 months ending 30 th September, 20X0
Statement of changes in equity for	6 months ending 30 th September 20X1	6 months ending 30 th September 20X0
Statement of cash flows for	6 months ending 30 th September 20X1	6 months ending 30 th September 20X0

20. The decision to offer the division for sale on 1st January, 20X1 means that from that date the division is classified as held for sale. The division available for immediate sale, is being actively marketed at a reasonable price, and the sale is expected to be completed within one year.

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The consequence of this classification is that the assets of the division will be measured at the lower of their existing carrying amounts (₹ 7.20 lakhs i.e. Goodwill ₹ 1.2 lakh + PPE ₹ 4 lakhs + Inventory ₹ 2 lakhs) and their fair value less costs to sell (₹ 6.40 lakhs). This implies that the assets of the division will be measured at ₹ 6.40 lakhs on 1st January, 20X1.

The reduction in carrying value of the assets of ₹ 0.80 lakhs (₹ 7.20 lakhs - ₹ 6.40 lakhs) will be treated as an impairment loss and allocated to goodwill, leaving a carrying amount for goodwill of ₹ 0.40 lakhs (₹ 1.20 lakhs - ₹ 0.80 lakhs).

The increased expectation of the selling price of ₹ 0.20 lakhs (₹ 6.60 lakhs - ₹ 6.40 lakhs) will be treated as a reversal of an impairment loss. However, since this reversal relates to goodwill, it cannot be recognised.

The assets of the division need to be presented separately from other assets in the balance sheet. Their major classes of assets classified as held for sale should be separately disclosed, either in the balance sheet or in the notes.

The property, plant and equipment should not be depreciated after 1st January, 20X1, so its carrying value at 31st March, 20X1 will be ₹ 4 lakhs. The inventories of the division will be shown at their year-end cost of ₹ 1.80 lakhs.

The division will be regarded as a discontinued operation for the year ended 31st March, 20X1. It will represent a separate line of business and will be held for sale at the year end.

The statement of profit and loss should disclose, as a single amount, the post-tax profit or loss of the division and the impairment loss arising on the re-measurement of the division on classification as held for sale. Further analysis of this single amount may be presented in the notes or in the statement of profit and loss. If it is presented in the statement of profit and loss it shall be presented in a section identified as relating to discontinued operations, i.e. separately from continuing operations.