<u>Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 5</u>

'Ind AS Transition Facilitation Group' (ITFG) of Ind AS (IFRS) Implementation Committee has been constituted for providing clarifications on timely basis on various issues related to the applicability and/or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015, raised by preparers, users and other stakeholders.

At the 5th meeting of Ind AS Transition Facilitation Group (ITFG) held on September 19, 2016 at Mumbai, certain issues received from members were discussed. The Group after due deliberations decided to issue clarifications[1] on the issues considered at the meeting:

However, at 8th and 9th meetings of Ind AS Transition Facilitation Group (ITFG) held on April 01, 2017 and April 08, 2017 respectively at Mumbai, the Group reconsidered certain issues of Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 5 on the basis of representations received from stakeholders and decided to withdraw the Issue No. 2 and to revise Issue No. 4 and Issue No 5 of the said Bulletin.

In accordance with the above, the revised Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 5 is as follows:

Issue 1

ABC Ltd. is a listed company. The net worth of ABC Ltd. as on 31st March 2014 was Rs. 200 crores.

ABC Ltd. had a subsidiary, namely, XYZ Ltd. as at 31st March, 2015 whose net worth, consisting only of share capital as at that date, was Rs. 600 crores. XYZ Ltd. was incorporated in January, 2015. It was incorporated only for the purposes of its divestment. The financial statements of XYZ Ltd. were not consolidated with that of ABC Ltd. as at 31st March, 2015 in view of requirements of Paragraph 11 of Accounting Standard (AS) 21, *Consolidated Financial Statements.*

ABC Ltd. entered into agreement with a proposed acquirer of the subsidiary, i.e., PQR Ltd., in September, 2015. The entire ownership of XYZ Ltd. was finally transferred to the said acquirer in the first fortnight of April, 2016.

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[1]Clarifications given or views expressed by the ITFG represent the views of the members of the Ind AS Transition Facilitation Group (ITFG) and are not necessarily the views of the Ind AS (IFRS) Implementation Committee or the Council of the Institute. The clarifications/views are based on the accounting principles as on the date the Group finalises the particular clarification. The date of finalisation of each clarification is indicated along with the clarification. The clarification must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of clarifications by the Group.

In the given case, whether the ABC Ltd. is required to comply with Ind AS from the financial year 2016-17?

Response

Rule 4(1)(ii) of the Companies (Indian Accounting Standards) Rules, 2015, states as under:

"......

(ii) the following companies shall comply with the Indian Accounting Standards (Ind AS) for the accounting periods beginning on or after 1st April, 2016, with the comparatives for the periods ending on 31st March, 2016, or thereafter, namely:-

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

(b) companies other than those covered by sub-clause (a) of clause (ii) of sub-rule (1) and having net worth of rupees five hundred crore or more;

(c) holding, subsidiary, joint venture or associate companies of companies covered by sub-clause (a) of clause (ii) of sub-rule (1) and sub-clause (b) of clause (ii) of sub- rule (1) as the case may be; and".

In accordance with the above, it may be noted that holding, subsidiary, joint venture, associate companies of companies falling under any of threshold specified Rule 4(1)(ii) are required to comply with Ind AS from financial year 2016-17.

Further, Rule 4(2)(b) of the Companies (Indian Accounting Standards) Rules, 2015, states as under:

"

(2) For the purposes of calculation of net worth of companies under sub-rule (1), the

following principles shall apply, namely:-

………

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

*Explanation- **For the purposes of sub-clause (b), the companies meeting the specified thresholds given in sub-rule (1) for the first time at the end of an accounting year shall apply Indian Accounting Standards (Ind AS) from the immediate next accounting year in the manner specified in sub-rule (1).***

Illustration - (i) The companies meeting threshold for the first time as on 31st March, 2017 shall apply Ind AS for the financial year 2017-18 onwards.

(ii) The companies meeting threshold for the first time as on 31st March, 2018 shall apply Ind AS for the financial year 2018-19 onwards and so on.

On a combined reading of Rule 4(1) and (2) of the Companies (Indian Accounting Standards) Rules, 2015, if an existing company meets the net worth criteria before mandatory applicability dates laid down in the roadmap, the company would be required to follow Ind AS as per the dates for implementation of Ind AS prescribed in the roadmap, i.e., 2016-17 or 2017-18, as the case may be.

In the given case, Ind AS will be mandatorily applicable to XYZ Ltd. from financial year, 2016-17 since its net worth as on 31st March, 2015 is more than Rs. 500 crores.

As already clarified in ITFG Clarification Bulletin 3 as Issue No. 5, consistent approach would be followed to consider the definitions given in Ind AS both for the purpose of preparing financial statements and determining the relationship with another entity (i.e. subsidiary, associate, joint venture etc.) for the purpose of applicability of Ind AS. Therefore, the relationship between ABC Ltd. and XYZ Ltd. should be determined in accordance with Indian Accounting Standards (Ind AS). Hence, it is irrelevant to consider the fact that XYZ Ltd. was not a subsidiary company of ABC Ltd. as per the previous GAAP.

In view of the above ITFG clarification, whether ABC Ltd. is a holding company of XYZ Ltd. or not shall be determined as per Ind AS 110, *Consolidated Financial Statements*, i.e., evaluating whether ABC Ltd. Controls XYZ Ltd. or not.

If ABC Ltd. was a holding company of XYZ Ltd. in accordance with Ind AS 110 as at 31st March, 2015, then ABC Ltd. should comply with Ind AS from the financial year 2016-17, since Ind AS are applicable to XYZ Ltd. from financial year 2016-17.

Issue 2

~~An electricity distribution company collects security deposit at the time of issue of electricity connection, which is refundable when the connection is surrendered. The entity expects that most of the customers will not surrender their connection. Whether such a security deposit shall be classified as a‘current liability’ or a ‘non-current liability’ in the books of the electricity company~~?

Stands withdrawn

Since the concept of current and non-current classification of assets and liabilities already existed under previous GAAP and is already explained in the 'General Instructions For Preparation Of Balance Sheet' pursuant to the requirements of Division II- Schedule III to the Companies Act, 2013, the issue does not pertain to transition from previous GAAP to Ind AS. In view of this, the above issue is being withdrawn. The companies should apply the principles of current and non-current classification based on the respective definition in the Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules, 2015 and Schedule III to the Companies Act, 2013.

Issue 3

Ind AS has given the option to consider previous GAAP carrying value of property, plant and equipment (PPE) as deemed cost for assets acquired before the transition date. Whether an entity has the option of fair valuing few items of PPE and taking carrying amounts of the remaining items of PPE as the deemed cost on the date of transition?

Response

No. In accordance with paragraph D7AA of Ind AS 101, *The First-time Adoption of Indian Accounting Standards*, where there is no change in its functional currency on the date of transition to Ind AS, a first-time adopter of Ind AS has the option to elect to continue with the carrying value of *all* of its property, plant and equipment as at the date of transition measured as per the previous GAAP and use that as its deemed cost at the date of transition after making necessary adjustments in accordance with paragraph D21 and D21A of Ind AS 101. If a first time adopter chooses this option, then the option of applying this on selective basis to some of the items of property, plant and equipment and using fair value for others is not available.

Issue 4

PQR Ltd. had obtained a loan prior to April 1, 2015. The processing fees on the loan were capitalised as part of the relevant fixed assets as per the previous GAAP. PQR Ltd. is required to adopt Ind AS from financial year 2016-17. It has chosen to avail deemed cost exemption provided in paragraph D7AA of Ind AS 101, i.e., to continue with carrying value of property, plant and equipment as per the previous GAAP. The loan needs to be accounted for as per amortised cost method in accordance with Ind AS 109, *Financial Instruments.*

Whether PQR Ltd. is required to adjust the carrying amount of fixed assets as per the previous GAAP to reflect accounting treatment of processing fees as per Ind AS 109?

Response

Paragraph D7AA of Ind AS 101, *First-time Adoption of Indian Accounting Standards*, states as under:

> *"Where there is no change in its functional currency on the date of transition to Ind ASs, a first-time adopter to Ind ASs may elect to continue with the carrying value for all of its property, plant and equipment as recognised in the financial statements as at the date of transition to Ind ASs, measured as per the previous GAAP and use that as its deemed cost as at the date of transition after making necessary adjustments in accordance with paragraph D21 and D21A, of this Ind AS. For this purpose, if the financial statements are consolidated financial statements, the previous GAAP amount of the subsidiary shall be that amount used in preparing and presenting consolidated financial statements. Where a subsidiary was not consolidated under previous GAAP, the amount required to be reported by the subsidiary as per previous GAAP in its individual financial statements shall be the previous GAAP amount.* ***If an entity avails the option under this paragraph, no further adjustments to the deemed cost of the property, plant and equipment so determined in the opening balance sheet shall be made for transition adjustments that might arise from the application of other Ind ASs.*** *This option can also be availed for intangible assets covered by Ind AS 38, Intangible Assets and investment property covered by Ind AS 40, Investment Property."*

In accordance with the above, when the option of deemed cost exemption is availed for property, plant and equipment under paragraph D7AA of Ind AS 101, no further adjustments to the deemed cost of the property, plant and equipment shall be made for transition adjustments that might arise from the application of other Ind AS.

However paragraph 10 of Ind AS 101, inter alia, provides that Ind AS will be applied in measuring all recognised assets and liabilities except for mandatory exceptions and voluntary exemptions from other Ind AS as prescribed under Ind AS 101.

In absence of any other mandatory exception or voluntary exemption applicable in this case, the carrying amount of loan is required to be restated to its amortised cost in accordance with the requirements of Ind AS 109 as at the date of the transition. Accordingly, the unamortised amount of processing cost as at the date of the transition should be adjusted from the carrying amount of loan to arrive at its amortised cost. In the current case, the Company has already capitalised the processing cost as a part of the cost of the fixed assets. As a consequence, to restate the carrying amount of loan in accordance with paragraph 10 of Ind AS 101, the carrying amount of fixed assets as at the date of the transition should also be reduced by the amount of processing cost (net of cumulative depreciation impact). The difference between the adjustments to the carrying amount of loan and to fixed assets, respectively should be recognised in the retained earnings as at the date of the transition. This treatment would reflect the correct economic reality and result in faithful representation of the effects of these transactions on transition in accordance with the requirements of Ind AS. Since the adjustment to fixed assets is only consequential and arising because of applying the transition requirements of Ind AS 101, it would not be construed as an adjustment to the deemed cost of property, plant and equipment as envisaged under paragraph D7AA of Ind AS.

Issue 5

ABC Ltd. is a first-time adopter of Ind AS from the financial year 2016-17. It had received government grant from the Central Government during the financial year 2012-13 to purchase a fixed asset. The grant received from the Government was deducted from the carrying amount of fixed asset as permitted under previous GAAP, i.e. AS 12, *Accounting for Government Grants.* ABC Ltd. has chosen to continue with carrying value of property, plant and equipment as per the previous GAAP as provided in paragraph D7AA of Ind AS 101. As per Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, such a grant is required to be accounted by setting up the grant as deferred income on the date of transition and deducting the grant in arriving at the carrying amount of the asset is not allowed.

In this situation, whether ABC Ltd. is required to adjust the carrying amount of fixed assets as per previous GAAP to reflect accounting treatment of the government grant as per Ind AS 20?

Response

Paragraph D7AA of Ind AS 101, *First-time Adoption of Indian Accounting Standards,* states as under:

> *"Where there is no change in its functional currency on the date of transition to Ind ASs, a first-time adopter to Ind ASs may elect to continue with the carrying value for all of its property, plant and equipment as recognised in the financial statements as at the date of transition to Ind ASs, measured as per the previous GAAP and use that as its deemed cost as at the date of transition after making necessary adjustments in accordance with paragraph D21 and D21A, of this Ind AS. For this purpose, if the financial statements are consolidated financial statements, the previous GAAP amount of the subsidiary shall be that amount used in preparing and presenting consolidated financial statements. Where a subsidiary was not consolidated under previous GAAP, the amount required to be reported by the subsidiary as per previous GAAP in its individual financial statements shall be the previous GAAP amount.* ***If an entity avails the option under this paragraph, no further adjustments to the deemed cost of the property, plant and equipment so determined in the opening balance sheet shall be made for transition adjustments that might arise from the application of other Ind ASs.*** *This option can also be availed for*

intangible assets covered by Ind AS 38, Intangible Assets and investment property covered by Ind AS 40, Investment Property."

In accordance with the above, when the option of deemed cost exemption is availed for property, plant and equipment under paragraph D7AA of Ind AS 101, no further adjustments to the deemed cost of the property, plant and equipment shall be made for transition adjustments that might arise from the application of other Ind AS.

However paragraph 10 of Ind AS 101, inter alia, provides that Ind AS will be applied in measuring all recognised assets and liabilities except for mandatory exceptions and voluntary exemptions from other Ind AS as prescribed under Ind AS 101.

In absence of any other mandatory exception or voluntary exemption applicable in this case, the company shall recognise the asset related government grants outstanding on the transition date as deferred income in accordance with the requirements of Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance.* In the current case, the company has already deducted the amount of grant from the cost of the fixed assets. As a consequence, to recognise the amount of unamortised deferred income as at the date of the transition in accordance with paragraph 10 of Ind AS 101, the corresponding adjustment should be made to the carrying amount of property, plant and equipment (net of cumulative depreciation impact) and retained earnings, respectively, as the grant is directly linked to the property, plant and equipment. This treatment would reflect the correct economic reality and result in faithful representation of the effects of these transactions on transition in accordance with the requirements of Ind AS. Since the adjustment to the property, plant and equipment is only consequential and arising because of applying the transition requirements of Ind AS 101, it would not be construed as an adjustment to the deemed cost of property, plant and equipment as envisaged under paragraph D7AA of Ind AS.

Issue 6

XYZ Ltd. is covered under Ind AS roadmap and needs to comply Ind AS from financial year 2016-17. It has recorded certain spare parts in its previous GAAP financial statements as a part of inventory. As per paragraph 8 of Ind AS 16, these items meet the definition of 'property, plant and equipment' and required to be capitalised as PPE on the date of transition to Ind AS. In this regard, clarify the issues given below:

(i) At what amount such spare parts should be recognised in the first Ind AS financial statements? Whether depreciation should be charged from the date when the same became available for use or date of actual use?

(ii) Explain the words 'more than one period' used in definition of property, plant and equipment.

Response

(i) As per Ind AS 16,*Property, Plant and Equipment*, 'property, plant and equipment', are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

Further paragraph 7 of Ind AS 16, states as under:

"The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

(a) it is probable that future economic benefits associated with the item will flow to the entity; and

(b) the cost of the item can be measured reliably."

As per paragraph 8 of Ind AS 16, *Property, Plant and Equipment*, items such as spare parts are to be recognised as property, plant and equipment in accordance with Ind AS 16, when they meet the definition of 'property, plant and equipment'. Otherwise such items are classified as inventory.

Therefore, if an item of spare part meets the definition of 'property, plant and equipment' as mentioned above and satisfies the recognition criteria as per paragraph 7 of Ind AS 16, such an item of spare has to be recognised as property, plant and equipment. If that spare part does not meet the definition and recognition criteria as cited above that spare is to be recognised as inventory [Refer - Issue 9 of ITFG Clarification Bulletin 3].

As per paragraph 10 of Ind AS 101, except for the mandatory exceptions and voluntary exemptions provided in Ind AS 101, an entity shall, in its opening Ind AS Balance Sheet:

(a) recognise all assets and liabilities whose recognition is required by Ind ASs;
(b) not recognise items as assets or liabilities if Ind ASs do not permit such recognition;

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind ASs; and

(d) apply Ind ASs in measuring all recognised assets and liabilities.

Paragraphs D5 to D8B provide various deemed cost exemptions that an entity may elect to use on the date of transition. In this regard, it is pertinent to note that paragraph D7AA of Ind AS 101 provides an option to continue the carrying values for all of its property, plant and equipment as recognised in the financial statements as at the date of transition to Ind ASs, measured as per the previous GAAP and use that as its deemed cost as at the date of transition if there is no change in its functional currency. However, the above exemption cannot be used for such spare parts in the given case since the same were not recognised as fixed assets, i.e., PPE, in the previous GAAP.

Moreover, paragraph D7AA does not prevent a company to recognise an asset as PPE whose recognition is required by Ind AS on the date of transition [Refer Issue 9 of ITFG Clarification Bulletin 3].

In view of the above, the entity should apply applicable Ind AS i.e. Ind AS 16 retrospectively to measure the amount that will be recognised for such spare parts on the date of transition to Ind AS.

With regard to deprecation, paragraph 50 of Ind AS 16 provides that the depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

As per paragraph 6 of Ind AS 16, ***Useful life*** is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

Paragraph 55 of Ind AS 16, *inter alia*, provides that depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Spare parts are generally available for use from the date of its purchase. Accordingly, spare parts recognised as property, plant and equipment shall be depreciated when the same are available for use.

(ii) As per Ind AS 16, ‘property, plant and equipment’, are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

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

The term ‘more than one period’ is not defined in Ind AS. Ordinarily, the accounting policies are determined for preparing and presenting financial statements on annual basis. Accordingly, the term ‘period’, should ordinarily be construed to be the annual period.

Issue 7

ABC Ltd. has entered into an operating lease agreement for taking a building on lease. The rent agreement is for 5 years with escalation of lease rent at the rate of 15% p.a. The general inflation in the country expected for the aforesaid period is around 6%.

Shall the lease payments be straight-lined or not as per Ind AS 17? If yes, should the entire 15% p.a. escalation in lease rent be straight-lined over a period of 5 years or only the difference which exceeds the expected inflation rate will be straight-lined?

Response

Paragraph 33 of Ind AS 17, *Leases,* states as follows:

“Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless either:

(a) another systematic basis is more representative of the time pattern of the user’s benefit even if the payments to the lessors are not on that basis; or

(b) the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor’s expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition is not met.”

As per paragraph 33 of Ind AS 17, lease payments shall be straight-lined over the period of lease unless, *inter alia,* the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor’s expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then lease payments shall be straight-lined.

Judgement would be required to be made as per the facts and circumstances of each case to determine whether the payments to the lessor are structured to increase in line with expected general inflation. Therefore, it is required to evaluate the lease agreement to ascertain the real intention and attributes of escalation in lease payments, i.e., whether the intention of such escalation is to compensate for expected general inflation or any other factors.

It is not necessary that the rate of the escalation of lease payments should exactly be equal to the expected general inflation. If the actual increase or decrease in the rate of inflation is not materially different as compared to he expected rate of inflation under the lease agreement, it is not required to straight-line the lease payments. However, the purpose of such escalation should only be to compensate the expected general inflation rate.

In the given case, the increase of 15% p.a. in lease rentals does not appear to have any link with general inflation which is expected to be 6%. Accordingly, the entire lease payments should be straight-lined since the increase is not a compensation for inflation.

Issue 8

Company A Ltd. has equity investment in a Limited Liability Partnership (LLP). Company A Ltd. has joint control over the LLP and assessed that investment in LLP is a joint venture. How investment in LLP be accounted for in the separate financial statements of Company A Ltd? Whether profit share from LLP will be adjusted to the carrying amount of the investment in LLP in the separate financial statements of Company A Ltd.?

Response

Paragraph 26 of Ind AS 111, *Joint Arrangements*, prescribes the accounting treatment for investment in joint arrangements in separate financial statement of joint operator or joint venture as follows:

> **"26 In its separate financial statements, a joint operator or joint venturer shall account for its interest in:**
>
> **(a) a joint operation in accordance with paragraph 20-22;**
>
> **(b) a joint venture in accordance with paragraph 10 of Ind AS 27, *Separate Financial Statements.*"**

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:

(a) at cost, or

(b) in accordance with Ind AS 109.

In the given case, Company A Ltd. has joint control over the LLP and has assessed that investment in LLP is a joint venture. Accordingly, the entity shall account for its investment in the joint venture in its separate financial statements as per paragraph 10 of Ind AS 27, i.e. at cost or in accordance with Ind AS 109. Therefore, adjustment of profit share from LLP to the carrying amount of the investment in LLP in its separate financial statements is not permitted.

The accounting of return on investment (i.e. profit share from LLP) will depend on the terms of contract between Company A Ltd. and LLP. The share in profit in LLP shall be recognised as income in the statement of profit and loss as and when the right to receive its profit share is established.