Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 14

'Ind AS Transition Facilitation Group' (ITFG) of Ind AS 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. Ind AS Transition Facilitation Group (ITFG) considered some issues received from members and decided to issue following clarifications[1] *on February 1, 2018:*

Issue 1: As per Ind AS 23, *Borrowing Costs,* an entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

When the loans are specifically borrowed for the purpose of a qualifying asset and the processing charges incurred thereon have been incurred by the company, then whether the entire processing charges needs to be capitalised to the cost of the qualifying asset or the processing charges to the extent amortised up to the period of capitalisation needs to be capitalised?

Response: As per paragraph 6 of Ind AS 23, *Borrowing Costs,* borrowing costs includes interest expense calculated using the effective interest method as described in Ind AS 109, *Financial Instruments*.

Appendix A of Ind AS 109, *Financial Instruments*, defines 'Effective interest method' as, the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3),transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments)."

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[1] Clarifications given or views expressed by the Ind AS Transition Facilitation Group (ITFG) represent the views of the members of the ITFG and are not necessarily the views of the Ind AS 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

Paragraph B5.4.1 of Ind AS 109, *Financial Instruments*, states as follows:

"*In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised*."

Further, paragraph B5.4.2 of Ind AS 109, *inter-alia*, states that, "*fees that are an integral part of the effective interest rate of a financial instrument include:*

(c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services."

In accordance with the above, the 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. Accordingly, the processing charges to the extent amortised only up to the period of capitalisation of the qualifying asset can be capitalised.

Issue 2: A company is using a leasehold land for its business purposes. As per the lease terms, the company is under an obligation to restore the land to its original condition at the end of the lease tenure. What should be the accounting treatment of restoration costs in case of a leasehold land?

Response: The company will be required to first evaluate whether the lease is a finance lease or an operating lease, in accordance with the principles of Ind AS 17, *Leases*.

<u>If it is determined that the lease is a finance lease</u>, then as per paragraph 16(c) of Ind AS 16, *Property, Plant and Equipment*, the cost of an item of property, plant and equipment comprises the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets* contains requirements on how to measure decommissioning, restoration and similar liabilities. Further, Appendix A to Ind AS 16 also provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.

Paragraph 8 of Appendix A of Ind AS 16 states that the periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. Capitalisation under Ind AS 23 is not permitted.

In accordance with the above, all site restoration costs need to be estimated and capitalised at initial recognition, in order that such costs can be recovered over the life of the item of property, plant and equipment, even if the expenditure will only be incurred at the end of the item's life. Where an obligation exists to restore a site to its former condition at the end of its useful life, the present value of the related future payments is capitalised along with the cost of acquisition or construction upon completion and a corresponding liability is recognised.

Thereafter, the asset comprising the decommissioning cost is depreciated over its useful life, while the discounted provision is progressively unwound, with the unwinding charge shown as a finance cost in accordance with paragraph 8 of Appendix A of Ind AS 16 as stated above.

Alternatively, if it is determined that the lease is an operating lease and the entity incurs amount to construct the asset/ structure on land which it is required to remove those on expiration of the lease, it should account for the removal obligation as it has a present obligation under the lease to remove the improvements at the end of the lease term. In such situations, the entity will capitalise leasehold building/improvements and amortise them over the term of the lease. The removal obligation arises when the entity completes the construction, which is the past event. The present value of expected outflow should be recognised as a liability when the construction is completed. An asset of the same amount should be recognised and amortised over the remaining lease term.

Issue 3: On entering into contracts to supply goods and services, an entity requires advance payments from its customers. The period and effective interest rate between the date of receipt of the advance payment and the date that the entity transfers the risks and rewards of the goods and services to the customer are considered significant.

Whether the entity is required to adjust such advance payments received from a customer for goods or services to be provided over a long term for the effect of time value of money in accordance with Ind AS?

Response: Assuming that the contract established between the customer and the supplier does not contain a lease under Appendix C *Determining Whether an Arrangement contains a Lease* to Ind AS 17, and is not within the scope of Appendix C *Transfers of Assets from Customers* to Ind AS 18. Furthermore, the contract does not meet the definition of a derivative under Ind AS 109, *Financial Instruments.*

Paragraph 9 of Ind AS 18, *Revenue* requires entities to measure revenue 'at the fair value of the consideration received or receivable'.

Further, paragraph 11 of Ind AS 18, *inter-alia* provides that, 'In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest-free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.'

An analogy may be drawn from the above paragraph and accordingly, when the entity has received advance payments from the customer for providing promised goods or services, then it must evaluate whether the payment terms provide it with a significant benefit of financing. While making such an evaluation judgement is to be exercised and consideration be given to factors such as whether, the arrangement has been entered in the normal course of business, the advance payment is per typical payment terms within industry and having a primary purpose other than financing, it is a security for a future supply of limited goods or services or other relevant factors depending on facts and circumstances of each *case* [emphasis added]. If it is concluded that the arrangement does effectively constitute a significant financing component, i.e., a loan provided by the customer to the supplier for providing the promised goods, then the entity should adjust the consideration (including advance payments) for the effect of time value of money.

Issue 4: Entity A and B are fellow subsidiaries (entities under common control) and filed a scheme of arrangement in April 2017 for merger of Entity B into Entity A. Both the entities are covered under phase I of Ind AS. Entity B filed auditor's certificate with NCLT pursuant to Section 230(7) of Companies Act, 2013 which states that the accounting treatment proposed in the scheme of compromise or arrangement is in conformity with the Ind AS.

Entity B gets approval from NCLT in April 2018, which is after the year-end 31st March, 2018 but before the approval (by the Board of Directors) of the financial statements for the year ended 31st March 2018. As per the scheme, the appointed date is 1st April 2017.

Whether the business combination of Entity B shall be incorporated in the Entity A's standalone financial statements for the year ended 31st March 2018?

Response: Paragraph 3 of Ind AS 10, *Events After the Reporting Period* states as follows:

"Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue. Two types of events can be identified:

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period)."

It may be noted that although paragraph 22(a) of Ind AS 10 states that a major business combination after the reporting period is a non-adjusting event. However, where the court order approves a scheme with retrospective effect subsequent to the balance sheet date but before the approval of financial statements, the effective date for accounting is prior to the balance sheet date, wherein the courts' approval is an event that provide additional evidence to assist the estimation of amounts of assets and liabilities that existed at the balance sheet date. As such, an adjusting event has occurred which requires adjustment to the assets and liabilities of the transferor company which are being transferred.

In the given case, since the company has applied for the scheme of amalgamation and only the order of the court is pending then this indicates that conditions existed at the end of the reporting period and hence this shall be treated as an adjusting event. Accordingly, the effect of business combination of Entity B in Entity A shall be incorporated in the standalone financial statements of Entity A for the year ending 31st March 2018.

Issue 5: 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. The company is covered under Phase II of Ind AS roadmap. What will be the accounting treatment of such shares held as stock-in trade in accordance with Ind AS?

Response: Paragraph 2 of Ind AS 2, *Inventories,* inter-*alia, states* that this Standard applies to all inventories, except financial instruments (Ind AS 32, *Financial Instruments: Presentation* and Ind AS 109, *Financial Instruments).*

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Ind AS 109 applies to all types of financial instruments with certain exceptions as envisaged in paragraph 2 of Ind AS 109.

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 about them are in 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 unless otherwise exempted under Ind AS 101.

Issue 6: PQR Ltd. is under Phase II of Ind AS roadmap. On the date of transition i.e. 1.4.2016, it has elected not to use deemed cost exemption given under Ind AS 101, *First-time Adoption of Indian Accounting Standards* for measuring its property, plant and equipment. It has opted to retrospectively apply the requirements of Ind AS 16, *Property, Plant and Equipment* to all items of property, plant and equipment and has opted for revaluation model of Ind AS 16 for subsequent measurement. PQR Ltd. has been applying revaluation model under previous Indian GAAP.

What will be the accounting treatment of the following revaluation surplus in the Ind AS financial statements of PQR Ltd:

a) **Revaluation surplus as per previous GAAP on transition date;**
b) **Revaluation gain arising after transition date.**

Would the answer be different if the company would have opted for deemed cost exemption under paragraph D5 of Ind AS 101.

Response: Paragraph 39 of Ind AS 16, *Property, Plant and Equipment* states as follows:

> *39 If an asset's carrying amount is* ***increased as a result of a revaluation****, the increase shall be* ***recognised in other comprehensive income*** *and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.*

Further, as per Ind AS 1, *Presentation of Financial Statements,* other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Ind ASs. The components of other comprehensive income includes changes in revaluation surplus (see Ind AS 16, *Property, Plant and Equipment* and Ind AS 38, *Intangible Assets)*;

In accordance with the above, as per Ind AS 16, revaluation increase should be recognised in other comprehensive income.

(a) In the given case, the company has not elected deemed cost exemption given under Ind AS 101 and has chosen to apply the requirements of Ind AS 16 retrospectively. Assuming the other requirements of Ind AS 16 are met, the company would apply revaluation model of Ind AS 16 to its PPE and the revaluation reserve on transition date determined in accordance with the requirements of Ind AS 16 (carried from previous GAAP) will be recognised as revaluation surplus in equity. The opening balance of revaluation surplus as per previous GAAP should be transferred to retained earnings or if appropriate, another category of equity

(b) Any revaluation gains arising on subsequent recognition, i.e. after the date of transition, will be recognised in the Other Comprehensive Income.

If the company would have opted exemption under paragraph D5 of Ind AS 101 at the date of transition then the opening balance of revaluation surplus as per previous GAAP should be transferred to retained earnings or if appropriate, another category of equity disclosing the description of the nature and purpose of such amount in accordance with the requirements of paragraph 79(b), Ind AS 1, *Presentation of Financial Statements*.

This aspect has also been clarified in ITFG Clarification bulletin 8 (Issue 7).

Accordingly, at the date of transition if a company opts for deemed costs under Ind AS 101, then all revaluations under the Previous GAAP up to the date of transition i.e. opening balance of revaluation reserve will be transferred to retained earnings (or, if appropriate another category of equity) and changes in revaluations after the date of transition (i.e. subsequent recognition) will be recognised through OCI. *It may be noted that if the company has chosen to use revaluation model for subsequent measurement then it has to apply the same policy for all the periods (including transition date) presented in the first Ind AS financial statements*.

Issue 7: A holding company H Ltd., which is covered under phase II of Ind AS has a subsidiary S Ltd. H Ltd. is holding 57% of equity in S Ltd. The subsidiary S Ltd., has issued 1.5% optionally convertible preference shares to its holding company, which are non-cumulative. All preference shares are issued to holding company. The subsidiary company has the option to convert or redeem the stated preference shares. H Limited does not have any right for the redemption of such preference shares. How will these instruments be accounted for in the following financial statements:

(i) Standalone financial statements of S Ltd;

(ii) Standalone financial statements of H Ltd; and

(iii) Consolidated financial statements of the Group.

Response: It has been assumed that S Ltd. has an option to convert the instrument into a fixed number of its own shares and dividend payment is discretionary.

Paragraph 16 of Ind AS 32, *Financial Instruments: Presentation, inter alia,* states that, *"When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.*

(a) The instrument includes no contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Apart from the aforesaid, 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. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments."

(i) Provided the conversion feature is considered substantive, the instrument can be viewed as an equity instrument, because the issuer has the ability to convert the instrument 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 instrument in a variable number of its own shares. Any feature that might have been considered to be an embedded derivative would not meet the definition of a derivative on a stand-alone basis, given the ability to avoid payment. Hence, the issuer's conversion and redemption options would not be separated, and the entire instrument would be classified as equity in the separate financial statements of S Ltd.

(ii) In the separate financial statements of H Limited, the investment should be considered to be an investment in subsidiary and therefore would be excluded from the scope of Ind As 109 unless H Ltd has elected otherwise.

Paragraph 10 of Ind AS 27, *Separate Financial Statements*, states 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 view of the above assuming that the company H Ltd. has not elected to account for its investment in accordance with Ind AS 109, it would account for it at cost.

(iii) In the consolidated financial statements of the Group, these transactions will be eliminated, being intra-group transactions in accordance with Ind AS 110.

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