

Ind AS Technical Facilitation Group Clarification Bulletin 20

Ind AS Technical Facilitation Group (ITFG) of Ind AS Implementation Group 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, and other amendments finalised and notified till March 2019, raised by preparers, users and other stakeholders. Ind AS Technical Facilitation Group (ITFG) considered some issues received from members and decided to issue following clarifications¹ on June 27, 2019:

Issue 1: P Limited, with INR as its functional currency, holds an investment in debentures denominated in a foreign currency. The investment is not designated as a hedging instrument in a cash flow hedge of an exposure to changes in foreign currency rates. The investment is measured at fair value through profit or loss in the financial statements of P Limited in accordance with Ind AS 109, *Financial Instruments*. The change in fair value of the investment during a period measured in terms of INR also includes the effect of the change in foreign exchange rate during the period (i.e., foreign exchange difference).

Whether the foreign exchange difference is required to be presented separately from other fair value changes in statement of profit and loss?

Response:

Paragraph 5.7.1 of Ind AS 109 requires a gain or loss on a financial asset that is measured at fair value to be recognised in profit or loss – though there are some exceptions to this general requirement, these are not applicable in the case under discussion.

In the case of a financial asset denominated in a foreign currency and measured at fair value through profit or loss, the fair value is first determined in the relevant foreign currency and it is then translated into the functional currency in accordance with the requirements of Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*. Thus, change in fair value of such a financial asset during a period arises due to two factors: change in fair value expressed in terms of foreign currency and change in exchange rate.

Ind AS 109 does not contain any requirement for separation of change in fair value of a foreign-currency denominated financial asset measured at fair value through profit or loss into the aforesaid two constituent parts.

¹ Clarifications given or views expressed by the Ind AS Technical Facilitation Group (ITFG) represent the views of the ITFG and are not necessarily the views of the Ind AS Implementation Group 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 this Bulletin is June 26, 2019. The clarification must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of clarifications by the ITFG. The clarifications given are only for the accounting purpose. The commercial substance of the transaction and other legal and regulatory aspects has not been considered and may have to be evaluated on case to case basis.

As per paragraph 52 of Ind AS 21:

“52 An entity shall disclose:

- (a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with Ind AS 109; [Emphasis added]*

.....”

Thus, paragraph 52 of Ind AS 21 specifically excludes financial instruments measured at fair value through profit or loss from its requirement of disclosure of the amount of exchange differences recognised in profit or loss.

In view of the above, in the given case, P Limited is not required to present change in fair value of the investment in debentures on account of change in relevant foreign exchange rate separately from other changes in the fair value of the investment.

Issue 2: At the beginning of Year 1, A Limited obtains equity funds from several overseas investors with the express purpose of providing those investor(s) with investment management services. A Limited uses these funds to acquire controlling equity stake in several start-up companies (not related parties of A Limited).

A Limited incorporates a wholly-owned subsidiary, S Limited which acquires infrastructure like office space, office furniture, IT equipment and specialised software and hires skilled employees to provide investment management services to the investors as well as to third parties. S Limited is funded by equity contribution from A Limited.

Other than the above, A Limited has no other assets or liabilities or activities.

A Limited concludes that it meets all the conditions for classification as an investment entity within the meaning of Ind AS 110, *Consolidated Financial Statements*, including exit strategies for each of its investments in the start-up companies. A Limited does not have any exit strategy in place for its investment in S Limited. In its consolidated financial statements, it values the investments in start-up subsidiaries at fair value through profit or loss and consolidates S Limited as per Ind AS 110.

The above position continues in Year 2.

At the beginning of Year 3, A Limited transfers investments in start-up companies to a newly formed wholly-owned subsidiary, B Limited. It also transfers to B Limited its investment in S Limited. Consideration for the transfer is in the form of issue of equity shares by B Limited. Except for the above, there is no change, e.g. in the objectives or activities. Post transfer, A Limited’s only asset is its investment in B Limited and it has no liabilities.

A Limited does not have any exit strategy in place for its investment in B Limited, but the exit strategies for each of the investments in start-up companies continue to be in place.

The following accounting issues arise:

- (a) In the post-restructuring scenario, is A Limited still an investment entity?**
- (b) Whether B Limited qualifies to be an investment entity?**
- (c) Post-restructuring, is A Limited required to prepare consolidated financial statements? If yes, will it consolidate its direct investment in B Limited or its indirect investment in S Limited and the start-up companies and what would be the valuation basis?**

Response:

As per paragraph 27 of Ind AS 110, *Consolidated Financial Statements*:

“An investment entity is an entity that:

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

As per paragraphs 31, 32 and 33 of Ind AS 110, *Consolidated Financial Statements*:

“ 31 Except as described in paragraph 32, an investment entity shall not consolidate its subsidiaries or apply Ind AS 103 when it obtains control of another entity. Instead, an investment entity shall measure an investment in a subsidiary at fair value through profit or loss in accordance with Ind AS 109.

32 Notwithstanding the requirement in paragraph 31, if an investment entity has a subsidiary that provides services that relate to the investment entity’s investment, it shall consolidate that subsidiary and apply the requirements of Ind AS 103 to the acquisition of any such subsidiary.”

33 A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.”

Determining whether an entity satisfies the definition of an ‘investment entity’ requires assessment of specific facts and circumstances. As per the facts of the case, it has been

evaluated by A Limited prior to the restructuring that it satisfies all the three conditions laid down in paragraph 27 of Ind AS 110, *Consolidated Financial Statements*, for classification as an investment entity (including measurement and evaluation of performance of substantially all of its investments on a fair value basis). For the purpose of this analysis, it is assumed that this evaluation is correct. Accordingly, as per paragraphs 31 and 32 of Ind AS 110, prior to the restructuring, A Limited is required to consolidate S Limited (refer paragraph 32 of Ind AS 110) and measure the investments in the start-up companies (which qualify as its subsidiaries) at fair value through profit or loss. As per the facts of the case, prior to the restructuring, accounting by A Limited is along the above lines.

In the context of the restructuring undertaken by A Limited., the following further requirements/guidance contained in paragraph B85H of Ind AS 110 may be noted:

“An investment entity may have an investment in another investment entity that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the investment entity investor need not have an exit strategy for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.”

In the post-restructuring scenario, A Limited holds the investments in subsidiaries indirectly through B Limited. As per the facts of the case, the restructuring does not result in any change in objectives pursued or activities carried out prior to the restructuring. Thus, the change seems to be merely in form – in place of A Limited directly controlling and evaluating the performance of its subsidiaries (including the start-up companies), it does so now through B Limited. Assuming that this is indeed so, B Limited satisfies all the three conditions laid down in paragraph 27 of Ind AS 110 for classification as an investment entity.

While A Limited has no exit strategy in place for its investment in B Limited, exit strategies for each of the investments in start-up companies are still in place. As per paragraph B85H of Ind AS 110 quoted above, even if A Limited does not have an exit strategy in respect of B Limited, it still qualifies as an investment entity since B Limited has exit strategies in place in respect of start-up companies and satisfies the other conditions for classification as an investment entity.

In the post-restructuring scenario, in terms of requirements of paragraphs 31 and 32 of Ind AS 110, B Limited is required to consolidate S Limited and measure the investments in start-up companies at fair value through profit or loss.

A Limited is an investment entity in the post-restructuring scenario too. The start-up companies and S Limited are still its subsidiaries (albeit held and controlled indirectly). Accordingly, A Limited needs to still apply paragraphs 31 and 32 of Ind AS 110. This means that as in the pre-restructuring scenario, A Limited should consolidate S Limited and measure investments in start-up companies at fair value through profit or loss. As per the facts of the case, A Limited does not hold any assets other than its investment in B Limited and also has no liabilities. Hence, the consolidated financial statements of A Limited would be identical to the consolidated financial statements of B Limited..

Accordingly, in the given case:

- (a) A Limited is an investment entity in the post-restructuring scenario also.
- (b) B Limited qualifies to be an investment entity.
- (c) Post-restructuring too, A Limited is required to prepare consolidated financial statements in which it should consolidate S Limited and measure investments in start-up companies at fair value through profit or loss.

Issue 3: Company P has been making losses in the past years and hence did not pay dividend to its cumulative preference shareholders. Prior to transition to Ind ASs, the Company was showing the accumulated arrears of cumulative preference dividend as ‘contingent liability’ in the notes to its financial statements. On transition to Ind ASs, the cumulative preference shares are assessed to meet the requirements for classification as a financial liability in their entirety under Ind AS 32 *Financial Instruments: Presentation*.

- (i) **Whether the accumulated arrears of preference dividend, earlier shown as ‘contingent liability’, be recognised in the books of account as interest expense by applying the effective interest method?**
- (ii) **If yes, then whether the entire amount needs to be amortized or recognised as interest expense in the first Ind AS reporting period?**

Response:

Ind AS 32, *Financial Instruments: Presentation*, establishes, *inter alia*, principles for presentation of financial instruments as liabilities or equity. The application of these principles may result in a financial instrument being classified as a financial liability in entirety (e.g. a typical redeemable debenture that carries a periodic coupon rate and is redeemable at a fixed date for a fixed amount), or as equity in entirety (e.g. a typical equity share of an entity), or partly as a financial liability and partly as equity (e.g. a typical optionally convertible debenture that is convertible into a fixed number of equity shares).

As per the facts of the case, the preference shares under reference are assessed to meet the requirements for classification as a financial liability in entirety. This implies, *inter alia*, that the covenants of the terms of issue of preference shares relating to dividends represent a contractual obligation of the issuer (Company P) to pay such dividends. In this regard, the following paragraphs AG 25 and AG 26 of Ind AS 32 are noted:

“AG 25 Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability

because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

AG26 When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

- (a) a history of making distributions;*
- (b) an intention to make distributions in the future;*
- (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);*
- (d) the amount of the issuer's reserves;*
- (e) an issuer's expectation of a profit or loss for a period; or*
- (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period."*

Preference shares that are classified in entirety as a financial liability are accounted for under Ind AS 109 in the same manner as a redeemable debenture or a typical loan. This implies, inter alia, that the dividends on the preference shares are accrued in the same manner as interest on debentures or loans.

Paragraph 4.2.1 of Ind AS 109, *Financial Instruments*, provides that an entity shall classify all financial liabilities as subsequently measured at amortised cost, barring certain specified exceptions. Therefore, unless any of the specified exceptions given under paragraph 4.2.1(a) to (e) of Ind AS 109 applies (which, from the tenor of the query, does not appear to be the case), the preference shares under reference are required to be measured at amortised cost, using the effective interest method. In determining the amortised cost using the effective interest method, any dividends that have accrued but have not been paid will be reflected in the carrying amount of the liability.

Ind AS 101, *First-time Adoption of Indian Accounting Standards*, contains certain mandatory exceptions and certain optional exemptions from retrospective application of Ind ASs for an entity that is preparing its first Ind AS financial statements. None of these exceptions or exemptions applies in the case under discussion. Accordingly, the entity is required to apply

the amortised cost method to the preference shares under discussion retrospectively from the date of their issue and determine their amortised cost in accordance with Ind AS 109 as at the date of transition to Ind ASs. As indicated earlier, the amortised cost using the effective interest method as at the date of transition would include any preference dividends accrued for the period up to the date of transition but remaining unpaid at that date.

As regards the treatment of any difference between such amortised cost and the carrying amount of the preference shares as per the previous GAAP as at the date of transition, paragraph 11 of Ind AS 101 notes that:

“The accounting policies that an entity uses in its opening Ind AS balance sheet may differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to Ind ASs. Therefore, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to Ind ASs.”

Dividend for periods after the date of transition to Ind ASs would be accrued in each period in the same manner as interest and, if unpaid, would get reflected in the amortised cost as at the end of a period.

Issue 4: A Limited and B Limited, both operating companies are undertaking a transaction whereby one or more of the business divisions of A Limited (demerged company) will be demerged and vested in B Limited (resultant company).

All the three companies prepare their financial statements in accordance with Indian Accounting Standards (Ind ASs).

Both A Limited and B Limited have a common investor, X Limited. Both A Limited and B Limited are ‘associates’ of X Limited within the meaning of Ind ASs. Company A and Company B are not entities under common control within the meaning of Ind AS 103, Business Combinations.

X Limited carries its investments in associates at cost in its separate financial statements.

As part of the proposed transaction, A Limited will demerge an identified business undertaking (representing one or more of its business divisions) into B Limited.

As a result, A Limited as a legal entity shall continue to survive (with some of its other business divisions), while fresh shares of B Limited shall be issued to shareholders of A Limited (including to X Limited) as consideration for the demerger of the identified business undertaking. The consideration for the demerger would be determined on the basis of fair value of the underlying businesses.

What is the accounting treatment to be followed by X Limited in its separate financial statements in relation to the demerger transaction, i.e., accounting treatment for the receipt of additional shares of B Limited pursuant to the demerger and the potential reduction in value of shares held by it in A Limited due to the transfer of its business divisions from A Limited to B Limited?

Response:

(In the following analysis, it is noted that A Ltd. and B Ltd. are independent, unrelated parties except to the limited extent of both being associates of X Ltd.)

The query relates to accounting treatment of a demerger in the stand-alone financial statements of an investor which has opted to measure investments in associates at cost in such financial statements in accordance with Ind AS 27, *Separate Financial Statements*. The following discussion is in this context only.

The term ‘demerger’ is used in the commercial world to refer to a wide range of arrangements such as the following:

- An entity (the ‘transferor’) transfers one (or more) of its business divisions to a newly-formed entity (the ‘transferee’) which has no economic substance prior to the demerger. The transferee issues its equity shares to the transferor. Post-demerger, the transferee is a wholly-owned subsidiary of the transferor.
- An entity (the ‘transferor’) transfers one (or more) of its business divisions to a newly-formed entity (the ‘transferee’) which has no economic substance prior to the demerger. The transferee issues its equity shares to the equity shareholders of the transferor in the ratio of their equity shareholding in the transferor.
- An entity (the ‘transferor’) transfers one (or more) of its business divisions to an existing entity (the ‘transferee’) which has economic substance even prior to the demerger. The transferee issues its equity shares to the equity shareholders of the transferor in the ratio of their equity shareholding in the transferor.

Each of the above illustrative scenarios has different accounting implications from the perspective of stand-alone financial statements of an equity shareholder of the transferor. For example:

- In the first scenario, the said shareholder’s investment even post-demerger is in transferor company only. Therefore, the demerger per se does not require any accounting treatment by a shareholder of the transferor.
- In the second and the third scenarios, post-demerger, the shareholder holds investments in both the transferor and the transferee as against its holding in transferor only prior to the demerger. Therefore, the shareholder needs to account for the demerger to reflect the change in its investment. However, the two scenarios may have different economic effects on the investor which need to be carefully evaluated to determine the appropriate accounting treatment under each of these scenarios.

As the above discussion highlights, the specific facts of each scheme of demerger need to be considered to determine the accounting treatment that best reflects the substance and economic reality of the particular demerger from the perspective of an investor. Accordingly, the following discussion should not be extended by analogy to other types of demergers.

The two principal issues to be determined in the present case are: what amount should be derecognised, and what amount should be recognised, by X Limited to give accounting effect to transfer of business undertaking from A Limited to B Limited and receipt of additional shares in B Limited.

Amount to be derecognised

X Limited is not paying any explicit consideration for the shares in B Limited being allotted to it as part of the demerger scheme. However, prior to the demerger, its investment in A Limited represents its interest in both the demerged business undertaking as well as other businesses of A Limited whereas post-demerger, X Limited's investment in A Limited only represents its interest in businesses retained by A Limited. Thus, to the extent of reduction of its interest in A Limited, the shares of B Limited received by X Limited under the demerger scheme have an implicit cost associated with them. Neither Ind AS 27 nor any other standard under Ind ASs deals specifically with the issue as to how the amount to be derecognised should be determined in the kind of situation under discussion. However, paragraphs 10-12 of Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, state as below:

“10 In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:

- (a) relevant to the economic decision-making needs of users; and*
- (b) reliable, in that the financial statements:*
 - (i) represent faithfully the financial position, financial performance and cash flows of the entity;*
 - (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;*
 - (iii) are neutral, ie free from bias;*
 - (iv) are prudent; and*
 - (v) are complete in all material respects.*

11 In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

- (a) the requirements in Ind ASs dealing with similar and related issues; and*
- (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.*

12 In making the judgement described in paragraph 10, management may also first consider the most recent pronouncements of International Accounting Standards

Board and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11.”

In view of the above, analogy may be drawn from the paragraph 2(b) of Ind AS 103, *Business Combinations*, which states that-

“This Ind AS applies to a transaction or other event that meets the definition of a business combination. This Ind AS does not apply to:

(a)

(b) 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.”

A similar guidance is provided in Ind AS 115, *Revenue from Contracts with Customers*, which requires the use of relative stand-alone selling prices in allocating the transaction price to each performance obligation identified in a customer contract.

In accordance with the above, the carrying amount of X Limited’s investment in A Limited may be split between the demerged business undertaking and businesses retained by A Limited on the basis of the relative fair values of the two, with the portion of carrying amount allocated to the former being derecognised.

Amount to be recognised

As per paragraph 10 of Ind AS 27, *Separate Financial Statements*, 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 present case, X Limited has adopted the accounting policy of recognising investment in associates at ‘cost’.

Ind AS 27 does not define what is meant by ‘cost’ except in the specific circumstances of certain types of group reorganisations (which differ from the nature of the transaction under discussion).

The issue in the present case is whether the ‘cost’ of the additional shares in B Limited received by X Limited is represented by

- their fair value, or
- by the (allocated) carrying amount of the investment in A Limited, that is derecognised by X Limited.

The answer to the above issue depends on whether these additional shares represent a new or different investment acquired in exchange for a part of investment in A Limited or whether they represent the continuance of the pre-existing investment (though in a different name)

Drawing analogy to paragraphs 24-26 of Ind AS 16, *Property, Plant and Equipment*, and paragraphs 45-47 of Ind AS 38, *Intangible Assets*, regarding determination of cost of an item of property, plant and equipment or an intangible asset acquired in exchange for a non-monetary asset, it can be argued that these additional shares in B Limited may be said to represent a new or different investment acquired in exchange for a part of investment in A Limited, if the demerger results in a more than insignificant change in -

- (a) the risks and rewards associated with the business undertaking transferred from A Ltd. to B Ltd. or those associated with the other businesses carried on by B Ltd. or A Ltd; and/or
- (b) in the extent of X Ltd.'s exposure to aforesaid risks and rewards.

It may be noted that whether the change is 'significant' or 'insignificant' is a matter of judgement.

As per guidance provided in paragraphs 24-26 of Ind AS 16 and paragraphs 45-47 of Ind AS 38, if additional shares in B Limited received by X Limited represent a new or different investment acquired in exchange for a part of investment in A Limited, they would be measured initially at their fair value, with consequent recognition of gain or loss on derecognition of part of investment in A Limited.

In the present case, however, there is no 'exchange' of investments. X Limited continues to hold the same number and proportion of equity shares in A Limited after the demerger as it did before the demerger. Accordingly, in the given facts of the case, it would be an appropriate view to take that the 'cost' of the additional shares is represented by the amount derecognised by X Limited in respect of its investment in A Limited while accounting for the demerger.

Issue 5: Entity L applies Ind ASs in preparing its annual financial statements. During the year, Entity L has purchased investment in an overseas entity, Entity M. Entity M is associate of Entity L as per Ind ASs.

Entity M prepares its annual financial statements by following local GAAP and laws. There are following differences between Entity L's accounting policies/estimates as per Ind ASs and the corresponding accounting policies followed/estimates used by Entity M in its annual financial statements:

Particulars	Entity L	Entity M
(a) Business combinations	Common control business combinations – pooling of interests method as per Ind AS 103 Appendix C Other business combinations – ‘acquisition method’ as per Ind AS 103	Pooling of interests method (see Note)
(b) Depreciation method	Method used shall reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity as per paragraph 60 of Ind AS 16	Straight-line method for all assets to comply with local taxation and corporate laws
(c) Useful lives of items of PPE (or their significant parts)	Determined on the basis of factors (e.g. expected usage, expected physical wear and tear etc.) prescribed in paragraph 56 of Ind AS 16	Useful life prescribed by local taxation and corporate laws

Note: Entity M has effected two business combinations after acquisition of investment by Entity L. One of them qualifies as a common control business combination as per Ind AS 103. However, both business combinations have been accounted for by applying the pooling of interest methods as ordered by the local corporate regulator. No business combination was effected by Entity M in the past.

The management of Entity L is of the view that in applying equity method, it cannot change accounting policies of Entity M for (a) and (b) given above as, it is a well-established principle that accounting standards do not override local laws. Accounting policies followed by Entity M in preparing annual financial statements are in accordance with its local laws and therefore to change them in applying the equity method by Entity L is against this well-established principle.

Regarding matter (c), the management of Entity L is of the view that the useful lives used by Entity M are in accordance with local laws and they are accounting estimates and not accounting policies. Ind AS 28 does not require that accounting estimates should be uniform in applying the equity method.

How should the specific accounting policies/estimates referred to in the query be dealt with in application of equity method by Entity L?

Response:

Ind AS 28, *Investments in Associates and Joint Ventures*, requires an entity to account for its investment in an associate using the equity method except when that investment qualifies for exemption in accordance with paragraphs 17–19 of the Standard. It is implicit in the facts of the case that as per the querist’s evaluation, the exemption from application of equity method is not applicable in the given case. For the purposes of this analysis, it is assumed that the querist’s evaluation is correct.

Paragraphs 35 and 36 of Ind AS 28 state as follows:

“35 The entity’s financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances unless, in case of an associate, it is impracticable to do so.

36 If an associate or a joint venture uses accounting policies other than those of the entity for like transactions and events in similar circumstances, adjustments shall be made to make the associate’s or joint venture’s accounting policies conform to those of the entity when the associate’s or joint venture’s financial statements are used by the entity in applying the equity method.”

In the case of an overseas associate, application of the above requirements means that except to the extent the exception relating to impracticability applies, for the purpose of applying the equity method, the associate’s financial statements would need to be redrawn on the basis of Ind ASs. The financial statements so drawn are special-purpose financial statements, meant for the limited purpose of application of equity method by the investor. These special-purpose financial statements do not replace general purpose financial statements prepared and presented by the associate in accordance with its local laws and the preparation of these special-purpose financial statements by the investor (or by the associate at the investor’s behest) cannot be said to tantamount to breach or non-compliance of the local laws applicable to the associate.

Except to the extent the exception relating to impracticability applies, the treatment of the specific items mentioned in the query by Entity L in applying the equity method would be as follows:

Business combinations

A transaction that meets the definition of a common control business combination from the perspective of the associate should be accounted for as per Appendix C of Ind AS 103 (i.e., as per the pooling of interests method).

A transaction that meets the definition of a business combination, but not a common control business combination, from the perspective of the associate should be accounted for as per the requirements of Ind AS 103 (i.e., as per the acquisition method).

Depreciation method(s)

Ind AS 16, *Property Plant and Equipment*, states the following with regard to selection of depreciation method:

“60 The depreciation method used shall reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity

61 The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8.

62 A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset’s residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.”

As per the above, the depreciation method to be applied in respect of an item of property, plant and equipment (or part of an item of PPE that needs to be depreciated separately as per paragraphs 43 and 45 of Ind AS 16) is the one that reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Thus, under Ind AS 16, depreciation method is a matter of an accounting estimate, and not an accounting policy. In drawing up the financial statements of the associate as per Ind ASs, the requirements of Ind AS 16 need to be considered in determining an appropriate depreciation method for each item of property, plant and equipment (or significant part). The resultant method for an item of property, plant and equipment (or significant part) may be different from the method applied by the associate in preparing and presenting its financial statements to comply with its local laws.

Useful lives

Ind AS 16 defines the term ‘useful life’ as follows:

“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.”*

Ind AS 16 contains detailed guidance regarding the factors to be considered in determining the useful life of an item of property, plant and equipment (or significant part). In drawing up the financial statements of the associate as per Ind ASs, the useful life of each item of property, plant and equipment (or significant part) needs to be estimated in line with the definition of this term and related guidance provided in Ind AS 16. The useful life so

determined in respect of an item of property, plant and equipment (or significant part) may be different from the useful life taken by the associate in preparing and presenting its financial statements to comply with its local laws.
