IFRS Notes

Ind AS Transition Facilitation Group (ITFG) issues Clarifications Bulletin 5

13 October 2016

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Introduction

The ITFG held its fifth meeting on 19 September 2016, and issued its bulletin (Bulletin 5) on 1 October 2016 to provide clarifications on eight issues in relation to the application of Ind AS, as considered in its meeting.

Background

With Indian Accounting Standards (Ind AS) being applicable to large corporates from 1 April 2016, the Institute of Chartered Accountants of India (ICAI), on 11 January 2016 announced the formation of the Ind AS Transition Facilitation Group (ITFG) in order to provide clarifications on issues arising due to applicability and/or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015 (Rules 2015).

Earlier this year, ITFG issued four bulletins to provide guidance on issues relating to the application of Ind AS.

This issue of IFRS Notes provides an overview of the clarifications issued by the ITFG through its Bulletin 5.

"While the latest ITFG bulletin provides clarifications on several issues that are expected to reduce diversity in practice, there are some areas which may require further consideration. These include clarifications on measurement of capital spares on the transition date and the recognition of government grants that may have been deducted from fixed assets under previous GAAP and its resultant impact on net worth. Further, the clarification that companies need to assess the applicability of the Ind AS road map using the definitions in the Ind AS standards may prove to be quite onerous for some companies."

Sai Venkateshwaran
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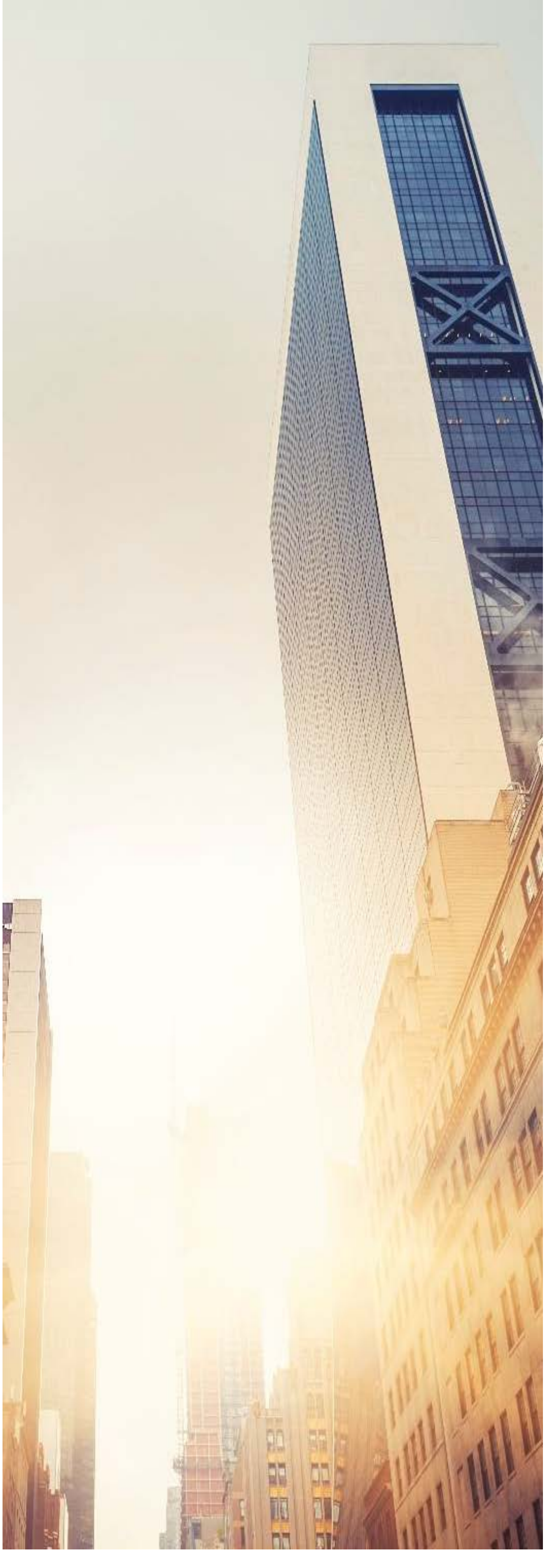


Overview of the clarifications in ITFG's Bulletin 5

The interpretations arising from ITFG's responses are summarised below:

1. **Application of Ind AS on meeting net worth criteria:** A company existing before the mandatory application date of Ind AS (i.e. before 1 April 2016 or 1 April 2017, as the case may be) that meets the net worth criteria (i.e. has net worth greater than INR500 crore or INR250 crore, respectively) would be required to follow Ind AS from the implementation dates prescribed in the road map i.e. 1 April 2016 or 1 April 2017 respectively.

   Further, as stated earlier in Clarification Bulletin 3 by the ITFG, a consistent approach should be followed while considering 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.

   In this context, the ITFG considered a situation where a parent entity incorporated a subsidiary only for the purposes of divestment. The subsidiary's net worth exceeded INR500 crore on 31 March 2015 and it was therefore required to implement Ind AS. The financial statements of the subsidiary were not consolidated by the parent under the previous generally accepted accounting principles in India (previous GAAP) since the subsidiary was held with a view to its subsequent disposal in the near future. The ITFG considered whether the parent entity of this subsidiary would also be required to adopt Ind AS in this scenario.

   The ITFG clarified that the relationship between a company that is mandatorily required to implement Ind AS and its holding/subsidiary/joint venture/associate company should be determined in accordance with the applicable Ind AS (being Ind AS 110, *Consolidated Financial Statements*), to assess if the related entity is also required to implement Ind AS. This is irrespective of the position taken under previous GAAP. Therefore, in the scenario above, the parent entity would also be required to adopt Ind AS from the financial year 2016-17 onwards.

2. **Classification of a liability as current/non-current:** As per paragraph 69 of Ind AS 1, *Presentation of Financial Statements*, if an entity does not have an unconditional right to defer the settlement of a liability then it should be classified as current liability. Accordingly, a refundable deposit (collected by a utility company from its customers) that is refundable on demand when the customer discontinues the service offered by an entity, would be classified as a current liability. This is because the timing of the refund (even if not expected to occur within 12 months) is not within the control of the entity.

3. **Property, plant and equipment - application of deemed cost exemption:** The ITFG has provided the following guidance on four application issues relating to Property, Plant and Equipment (PPE):

   a) Paragraph D7AA of Ind AS 101, *First-time Adoption of Indian Accounting Standards*, provides an option to a first-time adopter at the date of transition to continue with the carrying value of *all* PPE measured as per the previous GAAP, and use it as its deemed cost without making any further adjustments based on application of other Ind AS.

      Alternatively, Ind AS 101 also permits a first-time adopter to elect to measure an item of PPE at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost on transition.

      The ITFG has clarified that an entity cannot continue with the previous GAAP carrying value as deemed cost on a selective basis for some of the items of PPE and use a fair value as deemed cost approach for the remaining items.

   b) The ITFG has analysed a situation where loan processing fees have been capitalised as part of the relevant fixed asset as per previous GAAP. Further, the company has adopted the deemed cost exemption on the date of transition to Ind AS to continue with the previous GAAP carrying value for PPE. The ITFG has considered the following relevant guidance:

      - As per paragraph D7AA of Ind AS 101, if an entity avails the deemed cost exemption, *no further adjustments* to the deemed cost of the PPE so determined in the opening balance sheet should be made for transition adjustments that might arise from the application of other Ind AS.

Overview of the clarifications in ITFG's Bulletin 5 (cont.)

- Additionally, paragraph 10 of Ind AS 101 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.

Accordingly, in the given case ITFG has clarified that the entity needs to apply the requirements of Ind AS 109, *Financial Instruments,* retrospectively for loans outstanding on the date of transition to Ind AS that are measured at amortised cost and the adjustments related to bringing them in conformity with Ind AS 109 should be recognised in the retained earnings on the date of transition. Hence, the loan processing fees would form part of the amortised cost measurement of the loan liability. However, the carrying value of PPE as per previous GAAP cannot be adjusted to reflect the Ind AS accounting treatment for loan processing fees.

c) A similar situation involving a government grant was analysed by the ITFG, where the receiving company had deducted the grant from the carrying amount of the related fixed asset under previous GAAP. The entity has now elected to apply the deemed cost exemption and continue with previous GAAP carrying value for its PPE.

The ITFG opined that Ind AS 101 does not provide an exemption from retrospective application of the provisions of Ind AS 20, *Accounting for Government Grants and Disclosures of Government Assistance* in relation to government grants. Accordingly, the entity shall recognise the asset related government grants outstanding on the date of transition as deferred income in accordance with the requirements of Ind AS 20 with a corresponding adjustment to retained earnings and should not adjust the carrying value of PPE due to the application of other Ind AS.

d) A company that has recorded spares as part of inventory in its previous GAAP financial statements is required to recognise them as a part of PPE if they meet the criteria under Ind AS 16, *Property, Plant and Equipment.*

The ITFG has clarified that Ind AS 16 should be applied retrospectively to determine the amount at which such spare parts would be recognised in the first Ind AS financial statements. Further, depreciation on such spares should be provided when they are available for use.

The ITFG has also clarified that the exemption provided by paragraph D7AA of Ind AS 101 to continue the previous GAAP carrying values of all PPE at the date of transition as deemed cost under Ind AS cannot be used for spare parts that were not recognised as fixed assets, i.e. PPE, under the previous GAAP. While paragraph D7AA does not permit any further adjustments to be made to the previous GAAP carrying value on transition, it does not prevent recognition of an additional asset as PPE if so required by another Ind AS.

Therefore, spares that meet the definition of PPE should be capitalised on transition by retrospectively applying Ind AS 16.

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.

Since the accounting policies are determined for preparing and presenting financial statements on an annual basis, the term 'more than one period' used in the above definition should be generally construed to mean the annual period as per the ITFG. This is relevant in assessing whether spare parts meet the definition of PPE.

4. **Straight-lining of lease payments:** Paragraph 33 of Ind AS 17, *Leases,* requires operating lease payments to be expensed on a straight-line basis over the period of lease unless 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. However, if payments to the lessor vary because of factors other than general inflation, then lease payments shall be straight-lined.

The ITFG considered a situation where an entity entered into an operating lease agreement for five years with escalation of lease rent being fixed at 15 per cent per annum. The expected rate of general inflation in the country for the same period

Overview of the clarifications in ITFG's Bulletin 5 (cont.)

was around 6 per cent.

In this context, the ITFG clarified that careful evaluation of lease agreements is required to ascertain the real intention and attributes of escalation in lease payments. Further, in situations where a lease agreement specifies a fixed escalation rate for lease rentals, the ITFG stated that if the actual increase or decrease in the rate of inflation is not materially different as compared to the expected rate of inflation/escalation rate under the lease agreement, the lease payments are not required to be straight-lined. However, in such a case the purpose of such escalation should be only to compensate for the expected general inflation rate.

In the situation described in the ITFG bulletin 5, the fixed escalation rate for lease rentals did not appear to have any link with general inflation and accordingly the ITFG stated that the entire lease payments should be straight-lined. This indicates that the entity would also not be able to strip out a component of the escalation that is inflation-linked and would have to recognise the entire lease rental including the escalation on a straight-line basis.

5. **Accounting of share in profit in case of joint venture:** A company having joint control over a Limited Liability Partnership (LLP) shall account for its investment in the joint venture in its separate financial statements as per paragraph 10 of Ind AS 27, *Separate Financial Statements* i.e. either at cost or in accordance with Ind AS 109.

   Accordingly, the ITFG clarified that the amount of profit share from such LLP will not be adjusted to the carrying amount of the investment in the separate financial statements of a company having joint control over the LLP. Rather, it should be recognised as income in the statement of profit and loss as and when the right to receive the profit share is established.

Our comments

The ITFG clarifications are aimed at resolving various implementation challenges faced by the companies while transitioning to Ind AS. The companies should consider the interpretations provided by the ITFG in their implementation efforts.

However, further consideration may be required on the following issues.

a) The ITFG requires the relationship between entities (as holding/subsidiary/joint venture/associate company) to be assessed on the basis of the relevant Ind AS, regardless of the status of such entities under previous GAAP, to determine the applicability of Ind AS to a group of companies.

   An entity that falls within the Ind AS road map would be required to perform a detailed and careful assessment, based on its interests in/relationships with other entities. These interests may be in the form of investments in equity instruments, representation on the board of directors, interests in unstructured or special purpose entities, participative rights held under shareholders' agreements, etc. This exercise may involve significant time and efforts for some companies.

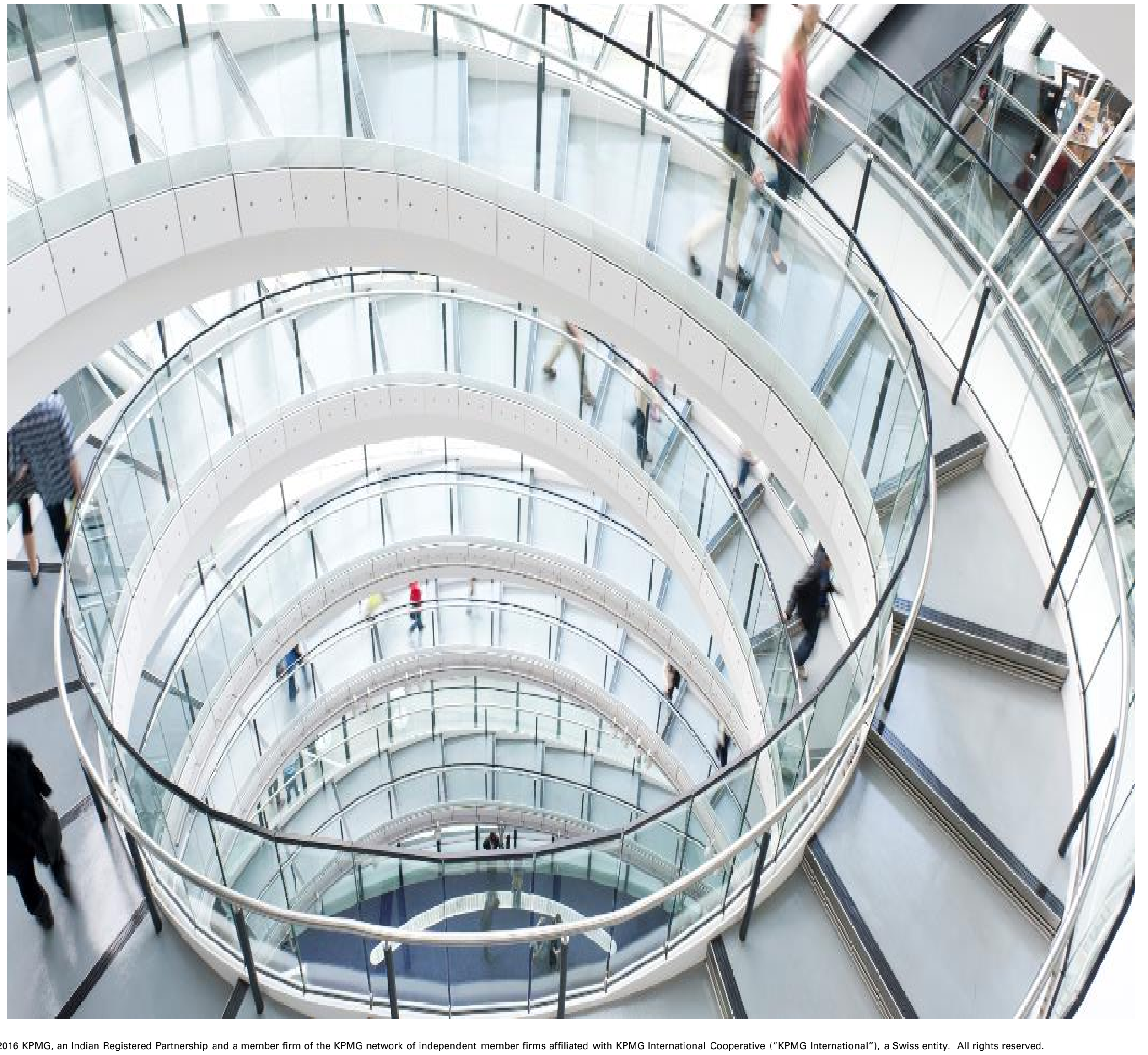
b) ITFG has stated that items such as loan processing fees or government grants that were adjusted in the measurement of related fixed assets under previous GAAP, should be accounted in accordance with the relevant Ind AS. However, the carrying value of PPE under previous GAAP that is used as deemed cost on transition should not be adjusted for such items. Although the accounting treatment may seem asymmetrical for such items, this view is consistent with the principle that 'deemed cost' is a surrogate for measuring cost on transition to Ind AS and first-time adopters should not 'look through' to the components of such deemed cost to make any further adjustments.

Our comments (cont.)

In addition, this view is consistent with the principles enunciated in the Educational Material on Ind AS 101 issued by the ICAI. In this, the ICAI considered whether the deemed cost of PPE (previous GAAP carrying value) should be adjusted for foreign exchange fluctuations capitalised under previous GAAP if the entity had not continued its policy of capitalising these exchange differences under Ind AS. The ICAI provided a view that both accounting policies were independent of each other and that deemed cost should not be adjusted further for previously capitalised exchange fluctuations. Further, the company should recognise the foreign exchange differences on long term borrowings in profit or loss.

c) According to ITFG's view, items such as security deposits accepted by utility companies would be classified as 'current liabilities' since the company does not have the unconditional right to defer their repayment for a period of twelve months after the reporting date. This is regardless of whether a company expects to settle such deposits within this time frame.

This view is consistent with the view provided in the Educational Material on Ind AS 1 issued by the ICAI. However, previously, under the Revised Schedule VI of the Companies Act, 1956 companies were permitted in specific cases based on commercial practice (such as in the case of utility companies) to classify security deposits collected as non-current. Therefore, companies that have followed a different practice prior to Ind AS implementation may see a significant increase in the quantum of their current liabilities. Such companies should consider the impact on key liquidity ratios and related debt covenants, if any.



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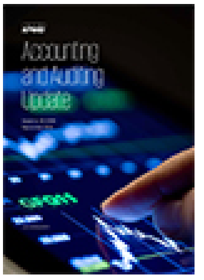
KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

Special session on revised Income Computation and Disclosure Standards (ICDS)

In our recent call, on 7 October 2016, we provided an overview of the key changes to the ICDS and their likely impact on companies in India.

Missed an issue of our Accounting and Auditing Update or First Notes



Issue no. 2 | September 2016

This month the Accounting and Auditing Update focusses on the emerging new trends and approaches in the field of accounting and auditing.

This month's edition provides an introduction to Data and Analytics (D&A). D&A has ushered in a virtual revolution in many organisations which are investing significant time, resources and capital to achieve desired business and controlling results. D&A is also acting as a significant disrupter in the way auditors are likely to perform audits in future. Therefore, from this month we begin a series of articles that will discuss how D&A is expected to affect audit, insights that could be provided to companies and how D&A tools are expected to change the conventional audit process.

Our article on Ind AS 102, *Share-based Payment* summarises the new concepts that companies should focus while accounting for share-based payments under Ind AS.

Financial instruments accounting can be complex as companies in India that enter into foreign currency transactions to purchase or sell machinery, inventory, etc. and such transaction are affected by the guidance under Ind AS 109, *Financial Instruments*. Companies that invest in financial assets are also impacted by the guidance in Ind AS 109. This publication analyses two such issues: foreign currency embedded derivatives and classification of investments in preference shares.

We also cast our lens on guidelines on presentation of non-GAAP measures and unconsolidated structured entities.

RBI issues NBFCs Auditor's Report Directions, 2016

12 October 2016

On 29 September 2016, RBI issued NBFCs Auditor's Report Directions, 2016 (Auditor's Report Directions, 2016) to every auditor of an NBFC for submission of an additional report to the Board of Directors (Board). These directions replace the previous circular and shall come into force with immediate effect.

This issue of First Notes provides a summary of the Auditor's report directions, 2016.

Previous editions are available to download from: www.kpmg.com/in