IFRS Notes

Ind AS Transition Facilitation Group (ITFG) issues Clarification Bulletin 8

16 May 2017

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Introduction

The ITFG held its meeting and issued its clarifications' bulletin (Bulletin 8) on 8 May 2017. The Bulletin provides clarifications on nine issues in relation to the application of Indian Accounting Standards (Ind AS).

Background

With 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.

Over the past year, ITFG issued seven 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 8.

Overview of the clarifications in ITFG's Bulletin 8

The following issues relating to the application of Ind AS have been clarified in this Bulletin.

Provision for unspent CSR expenditure under Ind AS

As per Section 135(5) of the Companies Act, 2013 (2013 Act), every company having net worth of INR500 crore or more, or turnover of INR1,000 crore or more or a net profit of INR5 crore or more during any Financial Year (FY) should contribute at least two per cent of its average net profits (made during the three immediately preceding FYs) towards Corporate Social Responsibility (CSR). However, in case a company fails to spend the amount earmarked for CSR, then the reasons for not spending the amount is required to be reported in the board's report.

The query raised to the ITFG was to clarify whether a provision for unspent CSR expenditure is required to be made under Ind AS.

The ITFG considered the principles mentioned in Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets.* Under Ind AS 37, a provision would be recognised when all of the following conditions are satisfied:

a) An entity has a present obligation (legal or constructive) as a result of a past event

b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation

c) A reliable estimate can be made of the amount of the obligation.

No provision is required to be made in case the above mentioned conditions are not met.

Considering the requirements of the 2013 Act (Section 135(5)) and Ind AS 37, the ITFG clarified that the provision for any shortfall in the amount that was expected to be spent on the CSR activities as per the 2013 Act on CSR activities and the amount actually spent at the end of a reporting period, may not be required in the Ind AS financial statements.

However, if a company has already undertaken certain a CSR activity for which an obligation has been created, for example, by entering into a contractual obligation, or either a constructive obligation has arisen during the year, then in accordance with Ind AS 37, a provision for the amount of such CSR obligation, should be recognised in the Ind AS financial statements.

Disclosure of impact of Ind AS 115 in Ind AS financial statements

Paragraph 30 of Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* requires following disclosures in case an entity has not applied a new Ind AS that has been issued but is not yet effective:

a) The fact that the issued Ind AS (not yet effective) has not been applied and

b) Known or reasonably estimable information relevant to assessing the possible impact that application of the new Ind AS will have on the entity's financial statements in the period of initial application.

The ITFG clarified that in accordance with paragraph 30 of Ind AS 8, an entity is required to disclose the impact of Ind AS which has been issued but is not yet effective. Ind AS 115, *Revenue from Contracts with Customers* was notified under the Ind AS Rules dated 16 February 2015 but was later withdrawn under the Companies (Indian Accounting Standards) (Amendments) Rules, 2016 dated 30 March 2016.

Therefore, an entity is not required to disclose the impact of Ind AS 115 for the FY ended 31 March 2017 as Ind AS 115 has been omitted from the Ind AS Rules.

Overview of the clarifications in ITFG's Bulletin 8 (cont.)

Date of transition for presentation of balance sheet

In the Bulletin, the ITFG considered a situation where the date of transition of a company is 1 April 2016. The issue raised relates to whether the company is required to prepare its balance sheet on the date of transition at the end of the day or the start of the day (i.e. balance sheet should be prepared at the close of 1 April or start of day of 1 April (i.e. closing of 31 March)).

As per paragraph 6 of Ind AS 101, *First-time Adoption of Indian Accounting Standards*, an entity is required prepare and present an opening Ind AS balance sheet at the date of transition to Ind AS. This is the starting point for its accounting in accordance with Ind AS subject to the requirements of paragraphs D13AA and D22 of Ind AS 101.

The above principle is explained with the help of an example. In this example, an entity with a year end as at 31 March 2017 decided to present comparative information in those financial statements for one year only. Therefore, as per the example, the date of transition to Ind AS is the beginning of business on 1 April 2015 (or, equivalently, close of business on 31 March 2015). Accordingly, the entity presented financial statements in accordance with its previous GAAP annually up to 31 March each year up to, and including, 31 March 2016.

Based on the above mentioned guidance given under Ind AS 101, the ITFG has clarified that the balance sheet of a company (with transition date as 1 April 2016) will be prepared as on date of transition to Ind AS i.e., the beginning of business on 1 April 2016 (or, equivalently, close of business on 31 March 2016).

Property, Plant and Equipment (PPE)

The ITFG has provided following guidance on various issues relating to PPE in the Bulletin:

- **Capitalisation of an item of PPE not falling under the definition of an asset**: In the Bulletin, the ITFG considered a situation where a first-time adopter of Ind AS who has opted for deemed cost exemption as per paragraph D7AA of Ind AS 101 i.e. to recognise PPE at carrying value as per the previous GAAP. In this case, the entity has capitalised an item of PPE under previous GAAP even though it did not meet the definition of an asset.

  Based on the guidance given in D7AA of Ind AS 101, the ITFG clarified that the option of deemed cost exemption could be availed for PPE measured as per previous GAAP. However, such exemption cannot be availed for those items that do not meet the definition of asset as per previous GAAP and the definition of PPE as per Ind AS 16.

  Further, as per the principles laid down in paragraph 26 of Ind AS 101 'if an entity becomes aware of errors made under previous GAAP, then following reconciliations required by paragraph 24(a) and 24(b) of Ind AS 101 (in an entity's first financial statements) should distinguish the correction of those errors from changes in accounting policies.

  a) Reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with Ind AS for both of the following dates:
     i. The date of transition to Ind AS and
     ii. The end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP.

  b) A reconciliation to its total comprehensive income in accordance with Ind AS for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.'

  Therefore, based on the above mentioned guidance, the ITFG clarified that the incorrect capitalisation of an asset which does not meet the definition of tangible asset will be covered under paragraph 26 of Ind AS 101 being an error, and the disclosure of the same should be done as per paragraph 24 of Ind AS 101.

- **Reversal of impairment**: The ITFG has considered a situation where an entity elected to measure its PPE at deemed cost measured as per paragraph D6 of Ind AS 101, i.e. at its previous GAAP revaluation amount measured before the date of transition (assuming the revaluation is broadly comparable to cost in accordance with Ind AS). The issue relates to whether the entity is allowed to reverse the impairment provision recognised in its books as at the date of transition.

  The ITFG reiterated that an entity may elect to measure its PPE at its deemed cost measured as per previous GAAP revaluation on or before the date of transition, if the revaluation was broadly comparable to fair value or cost or depreciated cost in accordance with Ind AS.

Overview of the clarifications in ITFG's Bulletin 8 (cont.)

The amount so elected as deemed cost is the cost and any accumulated depreciation and provision for impairment under previous GAAP have no relevance. Accordingly, provision for impairment provided before the date of such measurement as per previous GAAP cannot be reversed in later years.

Similar guidance was issued by the Accounting Standards Board of ICAI in the form of Frequently Asked Question (FAQ) on deemed cost of PPE under Ind AS 101 dated 24 June 2016. It, *inter alia*, provided that from the date of transition, the deemed cost, i.e., carrying values of PPE as per the previous GAAP is the cost and any accumulated depreciation and provision for impairment under previous GAAP have no relevance. The accounting treatment would be similar as if fair value were to be taken as deemed cost as per paragraph D5 of Ind AS 101.

The ITFG further explained that from the deemed cost determination date to the date of transition, the entity should apply appropriate Ind AS accounting policies and depreciation policies to that asset. The depreciation policy applied during the intervening period from the deemed cost determination date to the date of transition would have to be in accordance with the requirements of applicable Ind AS. Accordingly, the impairment loss for the period between the deemed cost determination date to the date of transition can be reversed, if permitted as per the principles of Ind AS 36, *Impairment of Assets.*

However, if the entity does not opt for the deemed cost exemption given under Ind AS 101 but elects to apply Ind AS 16 retrospectively, then impairment loss can be reversed, if permitted as per the principles of Ind AS 36.

- **Revalued amount of PPE considered as deemed cost:** The ITFG considered a situation wherein an entity had in the past revalued its PPE and had elected to continue with the revised carrying value of its PPE as at the date of transition to Ind AS and use that as its deemed cost as on that date. It also elected to apply the cost model (i.e. to carry the PPE at cost less accumulated depreciation and impairment losses) for the subsequent measurement of the PPE.

  ITFG clarified that since the entity had deemed the revalued amount of PPE as its cost on the date of transition to Ind AS, it would not be permitted to carry a revaluation reserve under Ind AS. Further, since the entity had elected to apply the cost model approach for the PPE in its opening balance sheet under Ind AS opposed to the application of the revaluation model on the same date as per its previous Indian GAAP, the adjustments are resulting on account of transition to Ind AS. Therefore, the balance outstanding in the revaluation reserve would be transferred to retained earnings or if appropriate, another category of equity. Accordingly, the entity would be required to disclose the details of this adjustment in the financial statements and provide a description of the nature and purpose of such an amount.

  Additionally, since the PPE had been revalued, there was a difference between its carrying value in the financial statements and the tax base, hence a deferred tax would be recognised on the PPE to the extent of this difference.

  The ITFG also pointed out that the requirements of the 2013 Act for declaration of dividend should be evaluated separately.

Accounting for accumulated losses of subsidiaries

While following AS 21, *Consolidated Financial Statements,* in its Consolidated Financial Statements (CFS), an entity may have incurred losses. Such losses may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses.

Under Ind AS 110, *Consolidated Financial Statements,* entities are required to attribute the total comprehensive income of their subsidiaries to the owners of the parent and to the Non-Controlling Interest (NCI), even if this results in the NCI having a deficit balance.

In this context, the ITFG considered a situation where an entity had multiple subsidiaries which had a negative net worth as on 31 March 2015. The issue under consideration was on how to deal with the accumulated losses of the subsidiaries where:

- **Past business combinations not restated**: In this case, the ITFG clarified that the entity will be required to attribute the total profit or loss and each component of other comprehensive income to the owners of the parent and to the NCI prospectively from the date of transition.
- **Past business combinations restated:** The ITFG clarified, that in this case, the entity should attribute the accumulated losses of the subsidiaries, to the owners of the parent and

Overview of the clarifications in ITFG's Bulletin 8 (cont.)

to the non-controlling interest from the date of application of Ind AS 103, *Business Combinations* in its CFS, on the date of transition.

Recognition of deferred taxes on capitalised exchange differences

According to the previous Indian GAAP, an entity was permitted by paragraph 46/46A of AS 11, *The Effects of Changes in Foreign Exchange Rates,* to capitalise foreign exchange gains or losses on long-term foreign currency monetary items. On availing of this option, such exchange gains/losses would be capitalised into the cost of a related item of PPE or accumulated in a reserve (Foreign Currency Monetary Item Translation Difference Account (FCMITDA)).

Paragraph D13AA of Ind AS 101, permits an entity that is transitioning to Ind AS to continue to apply the above mentioned accounting treatment to exchange differences arising on long-term foreign currency monetary items that have been recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period, i.e. 1 April 2016 for companies transitioning to Ind AS corporate road map (phase 1).

The ITFG considered a situation where a company had availed the option to capitalise exchange differences under AS 11 to a foreign currency loan that was taken for the construction of PPE. However, such exchange differences may not be allowed to be capitalised as part of the cost of an asset as per the Income-tax Act, 1961 (IT Act), including Income Computation and Disclosure Standards (ICDS).

The issue under consideration was whether the company should recognise deferred taxes on differences arising from the adjustment of exchange differences to the cost of the asset.

Also whether the company would be able to avail the benefit under paragraph 15(b) of Ind AS 12, *Income Taxes*, which stated that no deferred tax liability would be recognised on the initial recognition of an asset or a liability in a transaction, which was not a business combination and at the time of the transaction, neither affected the accounting profit nor the taxable profit.

The ITFG clarified that capitalisation of exchange differences represents subsequent measurement of the foreign currency loan liability which has been adjusted to the cost of the asset- i.e. it does not arise on initial recognition of an asset or liability.
Hence, the initial recognition exemption under paragraph 15(b) of Ind AS 12 will not be available and deferred tax is required to be recognised on temporary differences arising from capitalised exchange differences.

Recognition of dividend income on an investment in debt instrument

The ITFG clarified that dividend income on an investment in debt instrument would be recognised in the form of 'interest income' by an investor. However, the manner in which the income would be computed and recognised would depend on whether the debt instrument is classified as subsequently measured at amortised cost, Fair Value Through Other Comprehensive Income (FVOCI) or Fair Value Through Profit or Loss (FVTPL).

Interest income where debt instrument is subsequently measured at amortised cost: Where the debt instrument is measured at amortised cost, the interest revenue would be calculated using the Effective Interest Rate (EIR) method. The interest would be computed as below:

- Where the debt instrument is not credit impaired, the interest income should be computed by applying the EIR to its gross carrying amount
- Where the debt instrument is a purchased or originated credit-impaired financial asset, the entity should apply the credit adjusted EIR to the amortised cost of the financial asset from initial recognition to compute the interest income
- Where the debt instrument is not a purchased or originated credit impaired financial asset, but subsequently has become credit-impaired, the entity should apply the EIR to the amortised cost of the financial asset in subsequent reporting periods. Where the credit risk on the financial instrument improves so that the financial asset is no longer credit-impaired, the interest revenue is computed by applying the EIR to the gross carrying amount of the debt instrument. The improvement should be related objectively to an event occurring after the requirements in Ind AS 109 (para 5.4.1(b)) have been applied.

Interest income where debt instrument is classified and measured at FVOCI: Where a debt instrument is classified and measured at FVOCI, the interest revenue thereon is recognised in the statement of profit and loss in accordance with the EIR method, as explained above.

Overview of the clarifications in ITFG's Bulletin 8 (cont.)

Interest income where debt instrument is classified and measured at FVTPL: Where a debt instrument is classified and measured at FVTPL, the interest income thereon is recognised in the statement of profit and loss as under:

- The interest income may form part of the fair value gains or losses arising from changes in fair value of the instrument, or
- The interest income is presented separately.

The entity is required to adopt its accounting policy for recognition of the interest income, considering whether any statute or regulatory authority governing the entity prescribes the manner of presentation.

Our comments

The ITFG clarifications are expected to resolve various practical implementation issues faced by the companies transitioning to Ind AS. The companies should consider the interpretations provided by the ITFG in their implementation efforts. However, it should be noted that some of the issues are quite judgemental and would require consideration of facts and circumstances while analysing each individual situation.

Key matters for consideration are as follows:

- **Disclosure of impact of new standards on Ind AS financial statements:** Though ITFG has clarified that companies in India do not need to disclose the impact of Ind AS 115 as it is not yet notified by MCA. New IFRS standards e.g. on revenue and leases are likely to be applicable soon internationally. These standards would eventually be applicable to Indian companies as well. Therefore, the companies should start the process to assess the impact of these standards on their financial position, performance and cash flows.
- **Date of presentation of opening balance sheet**: The principle explained in the ITFG bulletin 8 that opening balance sheet on the date of transition of a company is equivalent to the closing balance sheet at the end of the previous year. The same principle will also apply when an accounting effect has to be given to the opening balance sheet of the earliest period presented e.g. accounting for common control business combinations, changes in accounting policy, etc.
- **Implication on deferred taxes when revalued PPE**: The ITFG has clarified that deferred tax liability would be recognised on temporary differences arising due to new accounting carrying value (e.g. deemed cost as revalued amount). This principle is equally relevant to companies that have chosen fair value as deemed cost for certain items of PPE e.g. freehold land. In its Bulletin 7, the ITFG had considered an issue of deferred tax in the case of freehold land that an entity expects to sell in a slump sale. In this case, the ITFG clarified that the company would be required to exercise judgement to determine whether the freehold land will be sold through a slump sale. If so, then the tax base of the land would be the same as its carrying amount as an indexation benefit is not available in case of slump sale under the Income Tax Act, 1961. Therefore, there would be no temporary difference and no deferred tax asset would be recognised.

  However, if the carrying amount of freehold land under Ind AS is the revalued amount under previous Indian GAAP, then it is likely to result in a temporary difference even in the situations where an entity expects to sell the freehold land under a slump sale. Therefore, entities should carefully evaluate the deferred tax impact on their transition to Ind AS.

  Further, entities that have brought forward losses should also evaluate whether recognition of deferred tax liability due to revalued amount of PPE (as the new accounting carrying value on transition to Ind AS) would have any corresponding impact on recognition of deferred tax asset on such brought forward losses.
- **Implication of deferred tax on capitalised exchange differences**: The ITFG has pointed out that exchange differences permitted to be capitalied to PPE under paragraph 46/46A of AS 11 may not be allowed as part of cost of an asset under the IT Act including ICDS. It has clarified that when an entity transitions to Ind AS it would not be able to take the benefit of initial recognition exemption under Ind AS 12. Therefore, entities should evaluate the impact of the deferred taxes due to capitalisation of foreign exchange differences. In certain cases, the impact could be quite substantial.

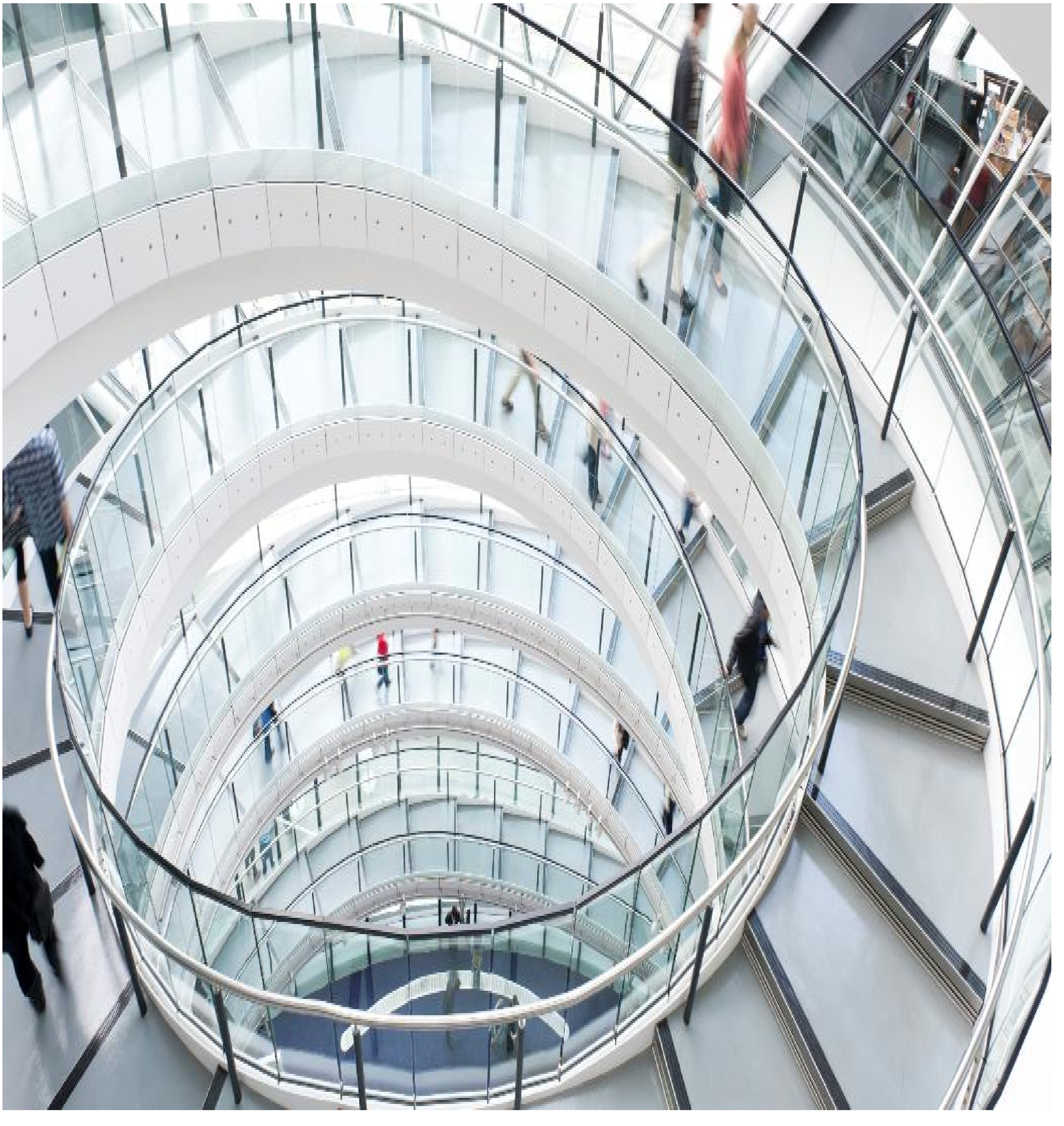
  Further, if paragraph 46/46A of AS 11 is followed as an accounting policy post transition to Ind AS then such adjustment would lead to temporary differences and recognition of deferred taxes through

Our comments (cont.)

statement of profit and loss. Such adjustments are likely to bring volatility to the statement of profit and loss.

Further, entities that have brought forward losses should also evaluate whether deferred tax liability due to temporary differences arising from capitalisation of foreign exchange differences due to para 46/46A of AS 11 would have any corresponding impact on recognition of deferred tax asset on such brought forward losses.

- **Accumulated losses of subsidiaries**: In case an entity does not restate its past business combinations and the accumulated losses of the subsidiaries have been attributed the owners of the parent on transition to Ind AS, then if the subsidiary subsequently reports profits, all such profits would not be allocated to the owners of the parent entity. Under Ind AS, such profits would be attributed to both owners of the parent entity and NCI. While under AS 21, if a subsidiary subsequently reports profits, all such profits would be allocated to the owners of the parent entity until the NCI's share of losses previously absorbed by the owners of the parent entity have been recovered.



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Voices on Reporting

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.

In our recent call held on 5 April 2017, we covered key financial reporting and regulatory matters that are expected to be relevant for stakeholders for the quarter ended 31 March 2017.

Our call included updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), etc.

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

Issue no. 9/2017 – April 2017

This edition of Accounting and Auditing Update (AAU) covers an article on accounting of prior period errors and explains the guidance with the help of illustrative examples. Ind AS 8, *Accounting policies, Changes in Accounting Estimates and Errors* covers guidance on accounting for accounting of changes in accounting policies, estimates and prior period errors. The guidance on accounting of errors under Ind AS is wider than current Indian GAAP (Accounting Standards) and requires an entity to adjust material prior period errors retrospectively by restating the comparative amounts and opening retained earnings at the beginning of the earliest period presented in the balance sheet.

In this edition of AAU, we explain the accounting treatment of FCTR in various scenarios e.g. on first-time adoption of Ind AS, disposal, impairment, restructuring, etc. of a foreign operation.

Under the Companies Act, 2013 section of AAU, we highlight the regulatory requirements with regard to acceptance of deposits. This article captures the amendments and updates on the topic 'acceptance of deposits' by the Ministry of Corporate Affairs.

The IASB proposed certain amendments to IFRS 8. Our article summarises the amendments proposed by the IASB.

As is the case each month, we also cover a regular round-up of some recent regulatory updates in India.

CBDT issues draft ICDS on real estate transactions

15 May 2017

The Finance Minister constituted a Committee (the Committee) comprising of experts from accounting, departmental officers and representatives from the Institute of Chartered Accountants of India (ICAI) to recommend the areas in respect of which further ICDS may be notified under the IT Act.

The Committee vide a press release dated 11 May 2017 has issued the draft ICDS on real estate transactions (draft ICDS). The draft ICDS is based on the Guidance Note issued on *Real Estate Transactions* (ICAI GN) issued by ICAI in 2012. For the purposes of providing uniformity, certainty and harmonising the same with provisions of the IT Act, the Committee suggested certain changes in draft ICDS in comparison to the ICAI GN.

The draft ICDS is open for comments from stakeholders till 26 May 2017.

This issue of First Notes provides an overview of the draft ICDS issued by the MoF.

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