IFRS Notes

Ind AS Transition Facilitation Group (ITFG) issues Clarifications Bulletin 14

20 February 2018

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Introduction

The Ind AS Transition Facilitation Group (ITFG) in its meeting considered certain issues received from the members of the Institute of Chartered Accountants of India (ICAI), and issued its Clarifications' Bulletin 14 on 1 February 2018 to provide clarifications on seven application issues relating to Indian Accounting Standards (Ind AS).

Background

With Ind AS being applicable to corporates in a phased manner from 1 April 2016, ICAI, on 11 January 2016 announced the formation of the ITFG in order to provide clarifications on issues raised by preparers, users and other stakeholders, related to the applicability and/or implementation of Ind AS under the Companies (Indian Accounting Standards) Rules, 2015 (Ind AS Rules).

Since then, ITFG issued 13 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 ITFG through its Bulletin 14.

Overview of the clarifications in ITFG's Bulletin 14

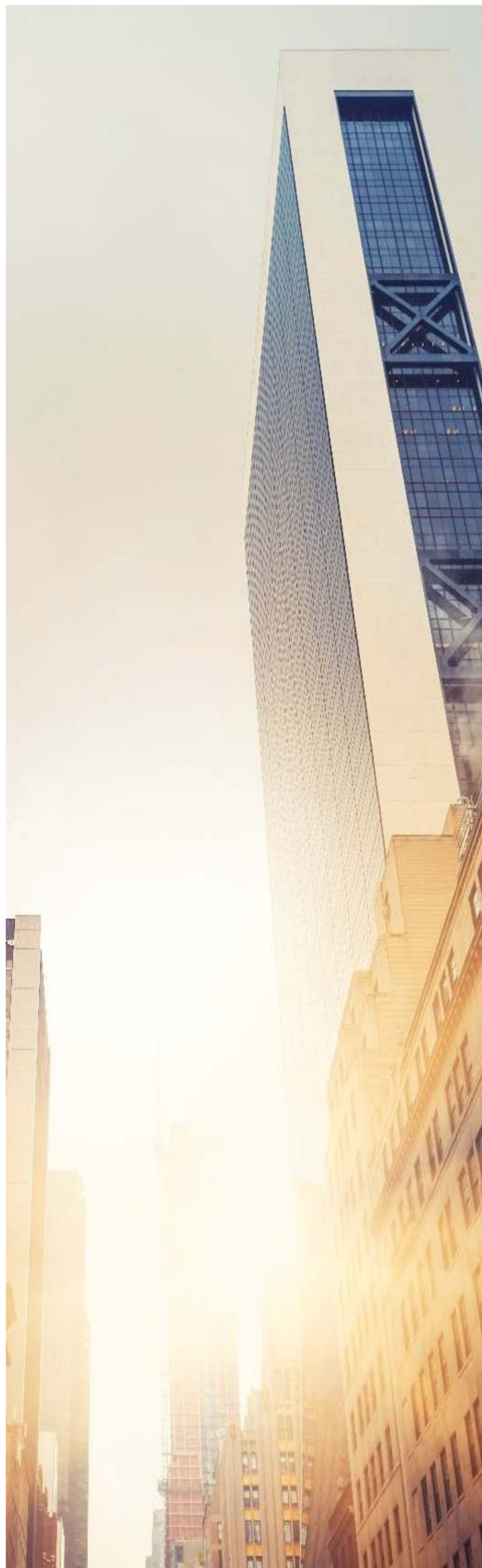
The following issues relating to the application of Ind AS have been clarified in this Bulletin:

- **Capitalisation of processing charges on a loan taken for acquiring/constructing a qualifying asset (Issue 1):** The ITFG considered a situation where a company has taken a loan specifically for the purpose of a qualifying asset and incurred processing charges thereon. The issue raised relates to whether the entire processing charges should be capitalised to the cost of the qualifying asset or the processing charges to the extent amortised up to the period of capitalisation should be capitalised.

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

  Appendix A of Ind AS 109 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.

  It further provides that, while calculating an effective interest rate, an entity should estimate the expected cash flows by considering all the contractual terms of a financial instrument (for example, prepayment, extension, call and similar options), except expected credit losses.



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Overview of the clarifications in ITFG's Bulletin 14 (cont.)

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, transaction costs, and all other premiums or discounts.

Further, paragraph B5.4.1 of Ind AS 109 provides that while 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. Such fees, inter alia, include origination fees paid on issuing financial liabilities measured at amortised cost.

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. However, in cases, where a financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss, the fees are recognised as revenue or expense when the instrument is initially recognised.

Based on the guidance given above, ITFG in the given case clarified that the processing fee is an integral part of the effective interest rate of a financial instrument that is measured at amortised cost, and should 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 to the cost of the related qualifying asset.

- **Accounting for restoration cost in case of a leasehold land (Issue 2):** As per paragraph 16(c) of Ind AS 16, *Property, Plant and Equipment*, the cost of an item of PPE comprises the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. This obligation is incurred by an entity 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.

  There could a situation where a company using a leasehold land (for business purposes) is under an obligation to restore the land to its original condition at the end of the lease period.

  In order to determine the accounting treatment for restoration costs on such land, the company would be required to evaluate whether the lease is a finance lease or an operating lease, in accordance with the principles of Ind AS 17, *Leases*. Accordingly, in case it is determined that the:

  – **Lease is a finance lease:** All site restoration costs would have to be estimated and capitalised at initial recognition of Property, Plant and Equipment (PPE). This should be done in such a manner that the restoration costs can be recovered over the life of the item of PPE, even if the expenditure will only be incurred at the end of the item's life (i.e. at the end of the lease period).

  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.

  Further, the asset comprising the decommissioning cost is depreciated over its useful life and the discounted provision is progressively unwound, with the unwinding charge shown as a finance cost in the statement of profit and loss, in accordance with paragraph 8 of Appendix A of Ind AS 16.

  – **Lease is an operating lease:** In this case, if an entity incurs an amount to construct an asset/structure on land which is required to be removed on expiration of the lease, then 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.

  The entity should capitalise leasehold building/improvements and amortise them over the term of the lease.

  The removal obligation arises when an entity completes the construction, which is a past event. Accordingly, the present value of expected outflow should be recognised as a liability when the construction has been completed. Further, an asset of the same amount should be recognised and amortised over the remaining lease term.

- **Advance payments received under contract to supply goods and services (Issue 3):** The ITFG considered a situation, wherein an entity requires an advance payment from its customers on entering into contracts to supply goods or services to them. The period and effective interest rate between the date of receipt of the advance payments and the date that the entity transferred the risks and rewards of the goods and services to the customer is considered significant. The issue under consideration was, whether the entity was required to adjust the advance payment received for the time value of money in accordance with Ind AS 18, *Revenue*.

  As per Ind AS 18 entities are required to measure revenue at the fair value of the consideration received or receivable.

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Overview of the clarifications in ITFG's Bulletin 14 (cont.)

In most cases, the consideration is in the form of cash or cash equivalents. Hence, 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.

The ITFG drew analogy from the above guidance and clarified that when an entity receives advance payments from its customers for providing promised goods or services, then it must exercise judgement, and consider the following factors to evaluate whether the contractual terms of payment provide a significant benefit of financing:

- Whether the arrangement is in the normal course of business
- Whether the advance payment is as per typical payment terms within the industry, and has a primary purpose other than financing
- Whether the advance payment is a security for a future supply of limited goods or services or
- Other relevant factors, depending on facts and circumstances of each case.

If the entity concludes that the arrangement does effectively constitute a significant financing component, then the advance payment is considered as a loan provided by the customer to the supplier for providing the promised goods or services. Accordingly, the entity is required to adjust the consideration (including the advance payment) for the effect of time value of money.

- **Approval of a scheme of arrangement post balance sheet date (Issue 4):** The ITFG considered an issue where two entities under common control (A and B) had filed a scheme of arrangement for merger of B into A prior to the balance sheet date (April 2017). They had also filed the auditor's certificate, confirming that the accounting treatment was in accordance with the respective Ind AS, with the National Company Law Tribunal (NCLT) (in accordance with Companies Act, 2013). The NCLT approved the scheme post the balance sheet date (31 March 2018), but before the date of approval of financial statements by the Board of Directors (April 2018). The appointed date as per the scheme was the beginning of the financial year under consideration (1 April 2017). The ITFG considered whether the merger should be incorporated in entity A's separate financial statements for the year ended 31 March 2018.

  As per Ind AS 10, *Events After the Reporting Period*, two types of favourable or unfavourable events may occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors of a company, these are:

  - **Adjusting events:** Events which provide evidence of conditions which existed at the reporting date
  - **Non-adjusting events:** These events are a result of conditions that arose after the reporting date.

  The ITFG clarified that since the company had applied to NCLT for approval in the case of the scheme of arrangement prior to the balance sheet date, only NCLT order was pending on the balance sheet date. Although the scheme was approved by NCLT subsequent to the balance sheet date, it was approved with a retrospective effect, before the financial statements were approved by the Board of Directors. Hence, the approval of the scheme was considered as an adjusting event as it provides an additional evidence to assist the estimation of amounts of assets and liabilities that exist at the balance sheet date. Accordingly, the effect of the business combination should be incorporated in the financial statements of A for the year ending 31 March 2018.

- **Accounting for shares held as stock-in-trade (Issue 5):** The ITFG considered the accounting treatment for shares held as stock-in-trade by a broking company dealing in sale/purchase of shares on its own account.

  Ind AS 32, *Financial Instruments: Presentation* defines a financial instrument as a contract that gives rise to a financial asset of one entity and a financial liability or an equity instrument of another entity. Ind AS 109 applies to all types of financial instruments, with certain exceptions.

  'Investments in shares of other entities' meet the definition of financial instruments, accordingly, these would be recognised and measured in accordance with Ind AS 109, presented as per the requirements of Ind AS 32 and disclosed as per the principles enunciated in Ind AS 107, *Financial Instruments: Disclosures*.

  The ITFG clarified that shares held by a broking company for trading on its own account (as stock-in-trade) are financial instruments, and are specifically excluded from the scope of Ind AS 2, *Inventories*. Accordingly, these shares would be accounted for and disclosed in accordance with the requirements of Ind AS 32, 109 and 107.

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Overview of the clarifications in ITFG's Bulletin 14 (cont.)

- **Accounting for revaluation surplus under Ind AS (Issue 6):** While accounting for PPE, on transition to Ind AS, entities are required to apply the provisions of Ind AS 16 retrospectively to all the PPE. However, paragraphs D7AA and D5 of Ind AS 101, *First-time Adoption of Indian Accounting Standards* provide entities with a deemed cost exemption, wherein they may elect to recognise either the carrying value of the PPE under Indian GAAP or the fair value of PPE as on the date of transition as the deemed cost of PPE under Ind AS on the same date (provided other conditions are fulfilled).

  In this context, ITFG considered a situation, wherein, on the date of transition to Ind AS, a company (PQR) elected not to use the deemed cost exemption given under Ind AS 101, and instead opted to retrospectively apply the requirements of Ind AS 16. It further opted for the revaluation model in Ind AS 16 for subsequent measurement. PQR had been applying the revaluation model previously under the Indian GAAP.

  The ITFG clarified that the accounting treatment for the revaluation surplus in the Ind AS financial statements, would be as follows, if:

  – **An entity applied Ind AS 16 retrospectively**: In this case, assuming that other requirements of Ind AS 16 were met, the entity would be able to apply the revaluation model to its PPE. Accordingly, the increase in the PPE's carrying amount as a result of revaluation would be determined as on the date of transition in accordance with Ind AS 16, and the revaluation reserve (carried from previous GAAP) to that extent would be accumulated in equity under the heading of revaluation surplus. The balance portion of revaluation surplus per the previous GAAP would be transferred to retained earnings or if appropriate, another category of equity, in accordance with Ind AS 101. Subsequent to the date of transition, revaluation gains arising would be recognised in other comprehensive income as permitted by Ind AS 1, *Presentation of Financial Statements*.

  – **An entity had opted for the deemed cost exemption under Ind AS 101**: Where PQR opted to consider the fair value of the PPE as its deemed cost on transition to Ind AS in accordance with paragraph D5 of Ind AS 101, the opening balance of revaluation surplus as per previous GAAP would be transferred to retained earnings or if appropriate, another category of equity. Appropriate disclosures would be required to be made with respect to the nature and purpose of such amounts, in accordance with Ind AS 1. This aspect has been explained in detail in ITFG Clarification Bulletin 8 (Issue 7).

  The ITFG reiterated that if entities choose to use the revaluation model for subsequent measurement, then they have to apply the same policy for all periods (including transition date) presented in the first Ind AS financial statements.

- **Debt-equity classification of optionally convertible preference shares (Issue 7):** The ITFG considered a situation, wherein a company (S) had issued non-cumulative, optionally convertible preference shares to its holding company (H). As per the terms of issue, S had the option to convert or redeem the stated preference shares. The issue considered was the classification of the preference shares either as a financial liability, an equity instrument, or a compound financial instrument in the separate financial statements of S and the corresponding accounting treatment in the financial statements of H as well as the consolidated group.

  As per Ind AS 32, financial instruments or their components are classified as a financial liability or equity in accordance with the substance of the contractual arrangement. Instruments are classified as a financial liability if they include a contractual obligation to deliver cash or other financial assets. Equity instruments on the other hand, evidence a residual interest in the assets of the entity after deducting all its liabilities. Financial instruments or their components that are in the nature of derivatives that may be settled in the issuer's own equity instruments, would be classified as equity, only if the terms of the instrument require an exchange of a fixed amount of cash or other financial assets for a fixed number of the issuer's own equity instruments (known as the 'fixed for fixed' criterion).

  The ITFG clarified, that the primary factor determining the classification of a financial instrument either as a financial liability or equity, was whether the issuer of the instrument had a contractual obligation to make payments (either principal, interest/dividend or both) or had an unconditional right to avoid making such payment. Assuming that S has an option to convert the preference shares into a fixed number of its own shares, and dividend payment is

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Overview of the clarifications in ITFG's Bulletin 14 (cont.)

discretionary, the accounting for the instrument will be as follows:

- **In the separate financial statements of S**: While assessing the classification of the preference shares in its separate financial statements, S assesses that:
  - The terms of the instrument provide the entity has substantive rights to avoid making cash payment (of the dividend as well as of the principal), and convert the instrument into a fixed number of its own shares at any time
  - The conversion option is already considered in determining the classification of the entire instrument, and hence is not accounted for separately as an embedded derivative, and
  - Discretionary payment features (such as discretionary dividend) on equity instruments are considered as an integral component of the instrument.

  Considering these facts, the entire instrument would be classified as an equity instrument in the separate financial statements of S.
- **In the separate financial statements of H**: Ind AS 27, *Separate Financial Statements*, provides entities with an accounting policy choice to account for their investments in subsidiaries, joint ventures and associates in their separate financial statements, either at cost or in accordance with Ind AS 109. Assuming that H has not chosen to account for its investment in accordance with Ind AS 109, it would account for it at cost.
- **In the consolidated financial statements:** These transactions, being intra-group transactions, would be eliminated in accordance with Ind AS 110.

Our comments

The ITFG clarifications are expected to resolve various practical implementation issues faced by companies that report their financial results under Ind AS or are transitioning to Ind AS. Companies should consider these interpretations when preparing their financial information. However, it should be noted that some of the issues require the exercise of judgement based on a consideration of specific facts and circumstances.

Specifically, companies may consider the following aspects:

- **Restoration cost**: In issue 2, ITFG has considered a situation where the obligation to restore the leasehold land arises on initial construction of the asset by the entity. However, there may be situations where the restoration obligation arises subsequent to initial recognition of the asset. In these cases, we consider that entities should apply the same principles as those applicable to changes in estimates of existing obligations. Therefore, related costs should be added to or deducted from the cost of the related asset in the period in which they arise. However, the amount deducted from the cost of the asset cannot exceed its carrying amount, and any excess is recognised in profit or loss.

- **Approval of a scheme of arrangement post balance sheet date**: Through its clarification in issue 4, ITFG provided greater clarity on the concepts in Ind AS 10, which provides examples of adjusting and non-adjusting events. As per para 22(a), a major business combination after the reporting period would be considered a non-adjusting event and generally require disclosure. However, ITFG clarification indicates that this would only apply to situations where the approval for the combination is received after the end of the reporting period, with an effective date which has a retrospective impact.

- **Debt-equity classification**: When classifying a financial instrument as either a financial liability or equity, entities need to assess the contractual rights associated with the instrument. In doing so, it is imperative to determine whether these rights are substantive. This determination is required when initially assessing the classification of the instrument. In certain cases, the contractual right of the issuer to settle the instrument by delivering a fixed number of shares may not be substantive, resulting in the establishment of a contractual obligation to deliver a variable number of shares/make cash payments indirectly through its terms and conditions. For example, if on initial recognition of the instrument, S determines that the market value of its shares substantially exceeds the amount of cash payment, although S does not have an explicit contractual obligation to settle in cash, the value of the share settlement option may be so high, that S may always settle in cash.

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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.

The new revenue standard (Ind AS 115, *Revenue from Contracts with Customers*) is expected to be applicable to Indian companies following the Ind AS road map framework from 1 April 2018.

Starting from January 2018, the Voices on Reporting presents a series of special sessions to discuss insights on Ind AS 115.

In the first session of Ind AS 115 series held on 17 January 2018, we discussed the key requirements of Ind AS 115, transition and key impact areas.

Our quarterly update publication (for the quarter ended 31 December 2017) provides summary of key updates from MCA, SEBI and ICAI.

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

Issue no. 18/2018 – January 2018

The Companies Act, 2013 (2013 Act) has been operationalised by the Ministry of Corporate Affairs (MCA) from 1 April 2014. Over the past three years, MCA has issued a number of amendments and clarifications to various sections and rules of the 2013 Act.

On 3 January 2018, the Companies (Amendment) Act, 2017 received the assent of the President of India. The Companies (Amendment) Act, 2017 makes significant changes to the 2013 Act which aim at ease of doing business, better corporate governance and enforcement of stringent penal provisions for defaulting companies.

The Companies (Amendment) Act, 2017 will come into effect on such date as the Central Government (CG) may, by notification in the Official Gazette, appoint. Different dates may be appointed for different provisions of the 2013 Act and any reference in any provision to the commencement of the 2013 Act should be construed as a reference to the coming into force of that provision.

This month's issue of the Accounting and Auditing Update (AAU) contains an updated compilation of our articles over the last year on the key aspects of the 2013 Act.

These articles include clarifications and implementation related insights that have been gained as companies have sought to apply in practice this legislation, including changes made by the Companies (Amendment) Act, 2017. Our publication also carries a regular synopsis of some recent regulatory updates in India and internationally.

SEBI relaxes norms governing schemes of arrangements by listed entities

18 January 2018

The listed entities that desire to undertake a scheme of arrangement or are involved in a scheme of arrangement need to follow the regulations laid down by the Securities and Exchange Board of India (SEBI). On 10 March 2017, SEBI issued a circular number CFD/DIL3/CIR/2017/21 which laid down a revised regulatory framework for schemes of arrangements by listed entities and relaxation under Rule 19(7) of the Securities Contract (Regulation) Rules, 1957.

The SEBI received representations to improve the existing framework governing schemes of arrangements.

Additionally, SEBI wanted to expedite the processing of draft schemes and prevent misuse of schemes to bypass regulatory requirements. Therefore, on 3 January 2018, SEBI issued a circular number CFD/DIL3/CIR/2018/2 (the circular) to make certain amendments to the circular dated 10 March 2017.

The recent circular is applicable from the date of its issue i.e. 3 January 2018. In this issue of First Notes, we have provided an overview of the key amendments/relaxations given in the circular.

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