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# IAS 1 — PRESENTATION OF FINANCIAL STATEMENTS

## 1. GLOBAL STANDARDS FOR GLOBAL MARKETS

Modern economies rely on cross-border transactions and the free flow of international capital. More than a third of all financial transactions occur across borders, and that number is expected to grow.

Investors seek diversification and investment opportunities across the world, while companies raise capital, undertake transactions or have international operations and subsidiaries in multiple countries.

In the past, such cross-border activities were complicated by different countries maintaining their own sets of national accounting standards.

This patchwork of accounting requirements often added cost, complexity and ultimately risk both to companies preparing financial statements and investors and others using those financial statements to make economic decisions.

Applying national accounting standards meant amounts reported in financial statements might be calculated on a different basis.

## 2. BENEFITS OF IFRS STANDARD

IFRS Standards address this challenge by providing a **high quality, internationally recognised set of accounting standards** that bring **transparency, accountability and efficiency to financial markets around the world.**

IFRS Standards bring **transparency** by enhancing the **international comparability and quality of financial information**, enabling investors and other market participants to make informed economic decisions.

IFRS Standards strengthen **accountability** by reducing the information gap between the providers of capital and the people to whom they have entrusted their money.

As a source of globally comparable information, **IFRS Standards are also of vital importance to regulators around the world.**

IFRS Standards contribute to economic **efficiency** by helping investors to identify opportunities and risks across the world, thus improving capital allocation.

For businesses, the use of a single, trusted accounting language **lowers the cost of capital and reduces international reporting costs.**

## 3. INTRODUCTION TO IAS 1

IAS 1 sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. It requires an entity to present a complete set of financial statements at least annually, with comparative amounts for the preceding year (including comparative amounts in the notes).

This standard deals with elements of financial statements — structure and content. The recognition, measurement and disclosure of specific transactions and other events are dealt with in other Standards and in Interpretations.

## 4. DEFINITIONS

**Impracticable** applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

**International Financial Reporting Standards (IFRSs)** are Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise:

(a) International Financial Reporting Standards;

(b) International Accounting Standards; and

(c) Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

**Material** Omissions or misstatements of items are material if they could - individually or collectively - influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

**Notes** contain information in addition to that presented in the Balance Sheet, statement of Profit or loss and statement of cash flows. Notes provide narrative descriptions or disaggregation's of items presented in those statements and information about items that do not qualify for recognition in those statements.

**Owners** are holders of instruments classified as equity.

**Profit or loss** is the total of income less expenses, excluding the components of other comprehensive income.

**Other comprehensive income** comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs.

**Total comprehensive income** is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. Total comprehensive income comprises all components of 'profit or loss' and of 'other comprehensive income'

**Reclassification adjustments** are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or previous periods.

## 5. FINANCIAL STATEMENT

Financial statements are structured representation of the financial position and financial performance of an entity. The financial statements should **enable its users to make economic decisions about the entity**. To meet this objective a complete set of financial statements is to be prepared by an entity.

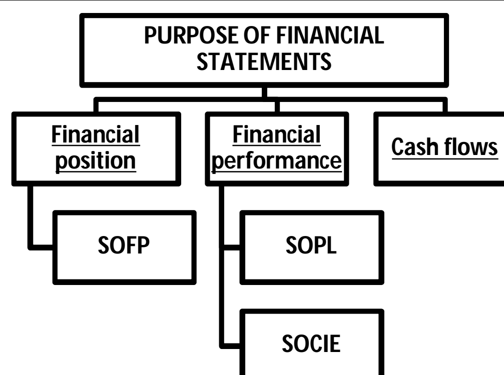
**A Complete set of financial statement comprises:**

- a **statement of financial position (**SOFP) as at the end of the period;
- a **statement of profit and loss (SOPL) and other comprehensive income for the period**. Other comprehensive income is those items of income and expense that are not recognised in profit or loss in accordance with IFRS Standards.
- a **statement of changes in equity** (SOCIE) for the period;
- a **statement of cash flows** for the period;

- **notes,** comprising a summary of significant accounting policies and other explanatory information; and
- **a statement of financial position as at the beginning of the preceding comparative period**
  - when an entity applies an accounting policy retrospectively or
  - makes a retrospective restatement of items in its financial statements, or
  - when it reclassifies items in its financial statements.
- Although this Standard uses the terms 'other comprehensive income', 'profit or loss' and 'total comprehensive income', an entity may use other terms to describe the totals as long as the meaning is clear. For example, an entity may use the term 'net income' to describe profit or loss.
- An entity may use titles for the statements other than those used in this Standard. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'.
- An entity may present a **single statement of profit or loss and other comprehensive income**, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.
- An entity **may present the profit or loss section in a separate statement of profit or loss**. If so, the separate statement of profit or loss shall immediately precede the statement presenting comprehensive income, which shall begin with profit or loss.
- An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.
- Many reports are presented by the management along with the financial statements by most of the entities. Such reports, statements are not within the scope of IFRSs though those may contain financial information.

An entity whose financial statements comply with IFRS Standards must make an explicit and unreserved statement of such compliance in the notes. An entity must not describe financial statements as complying with IFRS Standards unless they comply with all the requirements of the Standards. The application of IFRS Standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

## 6. PURPOSE OF FINANCIAL STATEMENTS




- Financial statements are a structured representation of **the financial position and financial performance of an entity.**

- The objective of financial statements is **to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.**
- Financial statements also **show the results of the management's stewardship of the resources entrusted to it**. To meet this objective, financial statements provide information about an entity's:

  (a) assets;

  (b) liabilities;

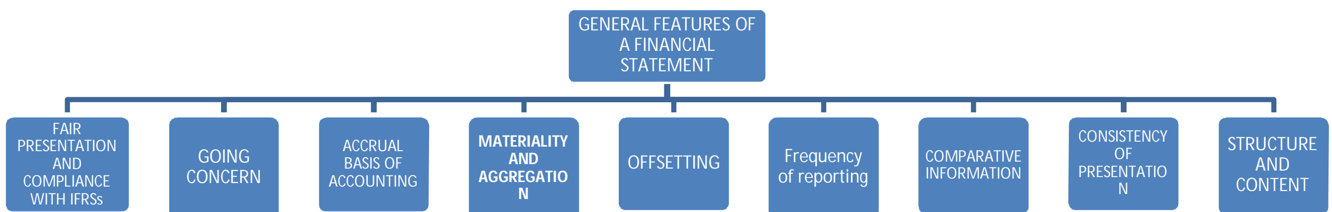
  (c) equity;

  (d) income and expenses, including gains and losses;

  (e) contributions by and distributions to owners in their capacity as owners; and

  (f) cash flows.
- This information, along with other information in the notes, **assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty**

## 7. GENERAL FEATURES OF A FINANCIAL STATEMENT




### 1. FAIR PRESENTATION AND COMPLIANCE WITH IFRSs

Financial statements shall present fairly the financial position, financial performance and cash flows of an entity.

Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses.

An entity whose financial statements comply with IFRS Standards must make an explicit and unreserved statement of such compliance in the notes.

An entity must not describe financial statements as complying with IFRS Standards unless they comply with all the requirements of the Standards.

The application of IFRS Standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

Inappropriate accounting policies **cannot be rectified** either by disclosure of accounting policies used or by notes or other explanatory materials.

In extremely rare circumstances, the entity may find it appropriate to make a departure from complying with the prescriptions laid down in the Standards.

This may happen in cases where themanagement concludes that complying with a requirement in an IFRS would be misleading, in which case the entity shall depart from the requirement in such manner as described below:

Where the management is of the opinion that fair presentation of the financial statements is achieved only with a deviation from a particular requirement and such deviation is required or not prohibited by the regulatory framework.

| SITUATION 1: | SITUATION 2: |
|---|---|
| **In case where regulatory framework does not prohibit, the treatment in financial statements should be on the following lines:**<br>• The entity can make the deviation from the requirement of a particular standard.<br>• Disclose that the financial statements present true and fair view of the financial position, performance and cash flows of the entity.<br>• Disclose that the requirements under the Standards have been complied with, except for that particular requirement.<br>• Give a description of the title of the Standard, and the accounting treatment required under the Standard.<br>• The nature of departure, and the reasons justifying that compliance with the requirement would be misleading.<br>• Financial effect of this departure for each period presented. | **In case where regulatory framework prohibits a departure, the requirements are as follows:**<br>• Comply with the relevant IFRSs for the transaction or event in question.<br>• Give a description of the title of the Standard, and the nature of requirement therein.<br>• The nature and extent of adjustments required to each item in financial statements in order to achieve fair presentation (though such adjustments should not be made). |

## 2. GOING CONCERN ASSUMPTION

An entity is required to make an assessment of its ability to continue as a going concern and prepare the financial statements on going concern basis unless the management -

(i) Either intends to liquidate the entity or cease trading or

(ii) Has no realistic alternative but to do so.

The Standard prescribes that in these situations, the entity shall prepare the financial statements by adopting any other appropriate basis of accounting, supported by disclosures covering:

- The basis on which financial statements are prepared and
- The reasons why the entity is not regarded as a going concern.

In making assessment of going concern, when the management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as going concern, the entity should disclose such uncertainties.

The going concern assessment is **based on assessment information of at least 12 months from the end of the financial period.**

| **GOING CONCERN CHECKLIST** |
|---|
| Does the entity has history of profitable operations and ready access to financial resources? |
| If yes it is normally considered as a going concern. Detailed analysis can be avoided. |
| If no, the management is required to carry out detailed analysis: |
| Current and expected profitability; |
| Debt repayment schedule; |
| Potential refinancing sources. |

## 3. ACCRUAL BASIS OF ACCOUNTING

**When preparing the financial statements, the entity shall adopt accrual basis of accounting except for cash flow statements.**

To this end, the criteria laid down in the Framework, for recognition of assets, liabilities, income and expense shall have to be followed.

## 4. MATERIALITY AND AGGREGATION

Where a line item is not, in itself, individually material, then it can be aggregated with other items. Flowing from this rationale, the Standard requires that

(i) Each material class of similar items should be presented separately in the financial statements, and

(ii) That items of dissimilar nature or function should also be presented separately.

## 5. OFFSETTING

Items of assets and liabilities, income and expenses are off-set against each other, only when such an off-setting reflects the substance of the transaction and is required or permitted by an IFRS.

| **EXAMPLES :** |
|---|
| Netting selling expenses with sales proceeds of the asset sold. |
| Foreign exchange gains and losses. |
| Gains and losses arising on financial instruments held for trading. However, an entity presents such gains and losses separately if they are material. |
| Measuring assets net of valuation allowances such as obsolescence allowance on inventories is not offsetting. |

**QUESTION 1:**

**X Ltd. Sold an item of property, Plant and equipment (PPE):**

| **Selling Price** | **Rs. 100 million** |
|---|---|
| **Cost** | **Rs. 85 million** |
| **Accumulated depreciation** | **Rs. 15 million** |
| **Selling expenses** | **Rs. 2 million** |

**Gain on sale of PPE (gross): Rs. 30 million. Should the company present gain and selling expenses separately?**

**SOLUTION 1 :**

Gain on sale of PPE Rs. 30 million can be presented net of selling expenses of Rs. 2 million.

**QUESTION 2 :**

**During 2019-20, X Ltd. Created a provision for warranty claim of Rs. 5 million under IFRS 37 "Provisions, Contingent Liabilities and Contingent Assets". Reimbursements as per IFRS 37. Rs. 2 million. Should the entity present warranty expenses of Rs. 5 million as an item of expense and related reimbursement as a separate item of income?**

**SOLUTION 2 :**

It shall present warranty provisions net of reimbursement as per IFRS 37.

## 6. FREQUENCY OF REPORTING

☺ **A complete set of Financial Statements needs to be presented at least annually.**

☺ **If the time-gap between two periods (other than for interim reporting) is shorter or longer than an annual period, the entity shall disclose the**

- **reasons for adopting such a longer or shorter period and**
- **mention the factthat the amounts are not entirely comparable.**

☺ **The financial information shall be for a minimum of two periods, one for current period and another for comparative previous period.**

☺ **Comparative information for the prior period(s) is required to be provided in the Notes to Accounts as well.**

☺ **Normally, an entity consistently prepares financial statements for a one-year period. However, for practical reasons, some entities prefer to report, for example, for a 52-week period. This Standard does not preclude this practice.**

## 7. COMPARATIVE INFORMATION

Comparative information shall be presented in respect of the previous period for all the amounts reported in the financial statements of the current period.

In other words, the financial information shall be for a **minimum** of two periods, one forcurrent period and another for comparative previous period.

Comparative information for the prior period(s) is required to be provided in the Notes to Accounts as well.

One additional related requirement is that, if and when there is a need to apply an accounting policy retrospectively, or to make a retrospective restatement of items in its financial statements, or when an entity re-classifies items in the financial statements, the entity shall also present an additional **statement of financial position as at the beginning of the earliest comparative period.**

When there is a change in presentation or classification of items of financial statements, comparative information are also reclassified and the nature, amount and the reason of reclassification are disclosed.

When reclassification of comparative period is impracticable an entity should disclose the reason for not reclassifying the amounts and the nature of adjustments that would have been made if the amount had been reclassified.

**QUESTION 3 :**

**X Ltd. found a material error in its financial statements for year 2021-22. How should X Ltd. present its financial statements for the year 2024-25?**

**SOLUTION 3 :**

If the error occurred before the earliest prior period presented (i.e. 2023-24), restating the opening SOFP, liabilities and equity for the earliest prior period presented (i.e. as on 1.4.2023). The entity shall restate its SOFP as on 31.3.2023. It shall present three SOFPs i.e. SOFP as on 1.4.2023, 31.3.2024 & 31.3.2025.

## 8. CONSISTENCY OF PRESENTATION

An entity is required to retain the same presentation and classification to ensure consistency of presentation unless

- **the change is due to change in the nature of entity's operation or**
- **would be appropriate or**
- **an IFRS requires such change.**

When changed above requirement of comparative information applies.

## 9. STRUCTURE AND CONTENT

Financial statements should be clearly identified and distinguished from other information that are presented in the same published document viz., annual report.

**Following information should be presented prominently in the financial statements:**

- **Name** of the reporting entity and any change from the end of preceding reporting period.
- Financial statements are of an **individual entity or a group of entities.**
- **Date** of the end of reporting period.
- **Presentation currency** as defined in IAS 21; and
- **Level of rounding off** used in presenting the amounts infinancial statements.

## 8. STATEMENT OF FINANCIAL POSITION (SOFP)

**An entity shall present the SOFP by classifying the assets and liabilities into current and non-current categories except when presentation in the order of liquidity is more relevant and provides reliable information.**

The standard does not specify the order of presentation or format to be used but prescribes only certain minimum line items.

Additional line items may also be presented if so warranted by the nature or function of the item.

For example, under the head Property, Plant & Equipment an entity may present classified information of assets that are measured using "Cost Model" and information about the other class of assets measured using "Revaluation Model".

There is an additional over-riding requirement in the standard that whichever method is applied, an entity should disclose separately, (but as a part of notes to accounts) the amounts expected to be recovered or settled within a period of twelve months from the reporting date, from other amounts.

**Deferred taxes should never be shown as part of current items.**

## 9. INFORMATION TO BE PRESENTED IN THE STATEMENT OF FINANCIAL POSITION

The statement of financial position shall include line items that present the following amounts:

(a) property, plant and equipment;

(b) investment property;

(c) intangible assets;

(d) financial assets (excluding amounts shown under (e), (h) and (i));

(da) groups of contracts within the scope of IFRS 17 that are assets, disaggregated as required by paragraph 78 of IFRS 17;

(e) investments accounted for using the equity method;

(f) biological assets within the scope of IAS 41 Agriculture;

(g) inventories;

(h) trade and other receivables;

(i) cash and cash equivalents;

(j) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations;

(k) trade and other payables;

(l) provisions;

(m) financial liabilities (excluding amounts shown under (k) and (l));

(ma) groups of contracts within the scope of IFRS 17 that are liabilities, disaggregated as required by paragraph 78 of IFRS 17;

(n) liabilities and assets for current tax, as defined in IAS 12 Income Taxes;

(o) deferred tax liabilities and deferred tax assets, as defined in IAS 12;

(p) liabilities included in disposal groups classified as held for sale in accordance with IFRS 5;

(q) non-controlling interests, presented within equity; and

(r) issued capital and reserves attributable to owners of the parent

## 10. CURRENT ASSETS :

**An asset is classified as current when:**

- It is expected to be realized or sold or consumed in the normal operating cycle of the entity — receivables and inventories are covered under this category or
- It is held primarily for the purpose of trading - inventories and certain financial assets fall under this category or
- It is expected to be realized within 12 months after the end of reporting period — other receivables are covered under this category or
- It is cash or a cash equivalent unless it is restricted from being exchanged or used to settle liability for at least 12 months after reporting period

**QUESTION 4 :**

X Ltd. has identified its operating cycle as 12 months comprising of :

| | |
|---|---|
| Raw material inventory holding period | 4 months |
| Production time | 1 month |
| Finished goods holding period | 3 months |
| Collection period | 4 months |
| Gross operating cycle | 12 months |

As on the reporting date on 31.3.2015, X Ltd. carried out age analysis of spare parts inventory as follows:

| | |
|---|---|
| Spare parts purchased on 1.7.2014 | Rs. 10 lakhs |
| Spare parts purchased on 1.2.2014 | Rs. 5 lakhs |
| Spare parts purchased on 1.10.2014 | Rs. 20 lakhs |

Classify spare parts into current and non-current.

**SOLUTION 4 :**

Spare parts inventary holding period is counted from the date of acquisition. If the holding period exceeds the operating cycle then spare parts inventory is classified as current or non-current assets applying operating cycle test.

(Amount in Rs. lakhs)

| | Age as on the reporting date (Months) | Current Asset | Non-Current |
|---|---|---|---|
| (i) Spare parts purchased on 1.7.2014 | 9 | 10.00 | |
| (ii) Spare parts purchased on 1.2.2014 | 14 | | 5.00* |
| (iii) Spare parts purchased on 1.10.2014 | 6 | 20.00 | |

*Spare parts expected to be consumed within 12 months after the reporting date ie. by 31.3.2016 are classified as current assets.

## 11. CURRENT LIABILITY :

**Similarly liability is current when:**

- It is expected to be settled in its normal operating cycle — trade payables and other operating payable or
- It is held primarily for trading — financial liabilities held for trading or
- It is due to be settled within 12 months after the end of reporting period — other payables or
- It cannot be unconditionally deferred for atleast 12 months after the reporting period.

**All other assets and liabilities are classified as non-current.**

## 12. REFINANCING OF A LIABILITY

Financial liabilities are classified as current when they are due to be settled within 12 months after the reporting period even if the original term was for a period longer than 12 months and an agreement to restructure/refinance on a long- term basis is made after the end of reporting period but before Financial Statements are authorised for issue.

**When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach.**

**An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.**

**QUESTION 5 :**

Entity X has taken 10% short term loans of Rs. 10,00,000 from a bank -which will fall due for payment on 30 June, 2019. The entity finalises accounts every March. The entity has discretion to roll over the loan till 30 June, 2019. Should the loan be classified as current liability?

**SOLUTION 5 :**

As per IAS 1, the loan is classified as **non- current liability since it enjoys the discretion** to roll over the loan for a period of more than 12 months after the reporting period.

However, when refinancing or rolling over of the obligation is **not at the discretion of the entity, the obligation will be classified as current.**

**QUESTION 6 :**

X Ltd. has identified its operating cycle as 12 months comprising of :

| | |
|---|---|
| Raw material inventory holding period | 4 months |
| Production time | 1 month |
| Finished goods holding period | 3 months |
| Collection period | 4 months |
| Gross operating cycle | 12 months |

As on the reporting date on 31.3.2015, X Ltd. carried out age analysis of various trade payables as follows:

| | |
|---|---|
| (i) Goods purchased on 1.7.2014 | Rs. 10 lakhs |
| (ii) Goods purchased on 1.2.2014 | Rs. 5 lakhs |
| (iii) Goods purchased on 1.10.2014 | Rs. 20 lakhs |

Classify trade payables into current and non-current.

**SOLUTION 6 :**

Trade payables are classified into current and non-current liabilities applying the test of settlement within the operating cycle or settlement within 12 months after the reporting date Ie. by 31.3.2016.

**(Amount in Rs. Lakhs)**

| | | Age as on the reporting date (Months) | Current liability | Non-current liability |
|---|---|---|---|---|
| (i) | Trade payables arising out of goods sold on 1.7.2014 | 9 | 10.00 | |
| (ii) | Trade payables arising out of goods sold on 1.2.2014 | 14 | | 5.00* |
| (iii) | Trade payables arising out of goods sold on 1.10.2014 | 6 | 20.00 | |

However, this trade payable item is subjected to another test that whether it is expected to settle within 12 months after the reporting date. In case the management is satisfied that these items will be settled by 31.3.2016, then such items are classified as current liability. For this the management may keep the evidence of negotiation with the counterparty and budget allocation.

**QUESTION 7:**

X Ltd. has unclaimed dividend of Rs. 20 lakhs as on 31.3.2019. Classify unclaimed dividend into current and non-current liabilities.

**SOLUTION 7 :**

Unclaimed dividend is classified as an item of current liability since it is payable on demand.

## 13. NORMAL OPERATING CYCLE

**Normal operating cycle** which comprise of acquisition of assets for processing to their realization in cash or cash equivalents, can be longer or shorter than a period of 12 months.

**When normal operating cycle is not clearly identifiable, it is assumed as 12 months**

## 14. SHARE CAPITAL

The information relating to share capital can be disclosed in SOFP or statement of changes in equity as part of SOFP or in the notes.

A description of nature and purpose of each reserve within equity should be disclosed.

**(a) The following need to be presented for each class of share capital:**

- Number of shares authorised
- Number of shares issued and fully paid and issued but not fully paid
- Par value per share or shares that have no par value
- A reconciliation of the number of shares outstanding at the beginning and end of the period
- Rights, preferences and restrictions attaching to that class of shares
- Shares in the entity held by itself or its subsidiaries or associates
- Shares reserved for issue under options and contracts for sale of shares

**(b) a description of the nature and purpose of each reserve within equity.**

An entity without share capital, such as a partnership or trust, shall disclose information equivalent to that required by previous paragraph, showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attaching to each category of equity interest.

## 15. FORMAT OF STATEMENT OF FINANCIAL POSITION

**Form of SOFP**

**Name of the Company:................ SOFP as at:.....................(Rupees in.................)**

| | Particulars | Note | As at the end of current reporting period | As at the end of previous reporting period |
|---|---|---|---|---|
| | 1 | 2 | 3 | 4 |
| | **Assets** | | | |
| **(1)** | **Non-Current Assets** | | | |
| | (a) Property, Plant and equipment | | | |
| | (b) Capital Work-in-Progress | | | |
| | (c) Investment Property | | | |
| | (d) Goodwill | | | |
| | (e) Other Intangible Assets | | | |
| | (f) Intangible Assets Under Development | | | |
| | (g) Biological Assets other than Bearer Plants | | | |
| | (h) Financial Assets | | | |
| | (i) Investments | | | |
| | (ii) Trade Receivables | | | |
| | (iii) Loans | | | |
| | (iv) Others (to be Specified) | | | |
| | (i) Deferred Tax Assets (Net) | | | |
| | (j) Other Non-Current Assets | | | |
| **(2)** | **Current Assets** | | | |
| | (a) Inventories | | | |
| | (b) Financial Assets | | | |
| | (i) Investments | | | |
| | (ii) Trade Receivables | | | |
| | (iii) Cash &Cash Equivalents | | | |
| | (iv) Bank Balances other than (iii) above | | | |
| | (v) Loans | | | |
| | (vi) Others (to be specified) | | | |
| | (c) Current Tax Assets (Net) | | | |
| | (d) Other Current Assets | | | |
| | **TOTAL ASSETS** | | | |
| | **EQUITY AND LIABILITIES** | | | |
| | **EQUITY** | | | |
| | (a) Equity Share Capital | | | |
| | (b) Other Equity | | | |
| | **LIABILITIES** | | | |
| **(1)** | **Non-Current Liabilities** | | | |

| | | | | |
|---|---|---|---|---|
| | (a) Financial Liabilities | | | |
| | (i) Borrowings | | | |
| | (ii) Trade Payables | | | |
| | (iii) Other Financial Liabilities (other than those specified in Item (b), to be specified) | | | |
| | (b) Provisions | | | |
| | (c) Deferred Tax Liabilities (Net) | | | |
| | (d) Other Non-Current Liabilities | | | |
| **(2)** | **Current Liabilities** | | | |
| | (a) Financial Liabilities | | | |
| | (i) Borrowings | | | |
| | (ii) Trade Payables | | | |
| | (iii) Other Financial Liabilities [other than those specified in Item (c)] | | | |
| | (b) Other Current Liabilities | | | |
| | (c) Provisions | | | |
| | (d) Current Tax Liabilities (Net) | | | |
| | **TOTAL** | | | |

## 16. STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Statement of comprehensive income can be presented as a single statement or as two statements, (i) Income statement and (ii) statement of other comprehensive income

An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period:

**(a) profit or loss for the period attributable to:**

(i) non-controlling interests, and

(ii) owners of the parent.

**(b) comprehensive income for the period attributable to:**

(i) non-controlling interests, and

(ii) owners of the parent.

If an entity presents profit or loss in a separate statement it shall present (a) in that statement.

## 17. INFORMATION TO BE PRESENTED IN THE PROFIT OR LOSS SECTION OR THE STATEMENT OF PROFIT OR LOSS

(a) revenue, presenting separately:

(i) interest revenue calculated using the effective interest method; and

(ii) insurance revenue (see IFRS 17);

(aa) gains and losses arising from the derecognition of financial assets measured at amortised cost;

(ab) insurance service expenses from contracts issued within the scope of IFRS 17 (see IFRS 17);

(ac) income or expenses from reinsurance contracts held (see IFRS 17);

(b) finance costs;

(ba) impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with Section 5.5 of IFRS 9;

(bb) insurance finance income or expenses from contracts issued within the scope of IFRS 17 (see IFRS 17);

(bc) finance income or expenses from reinsurance contracts held (see IFRS 17);

(c) share of the profit or loss of associates and joint ventures accounted for using the equity method;

(ca) if a financial asset is reclassified out of the amortised cost measurement category so that it is measured at fair value through profit or loss, any gain or loss arising from a difference between the previous amortised cost of the financial asset and its fair value at the reclassification date (as defined in IFRS 9);

(cb) if a financial asset is reclassified out of the fair value through other comprehensive income measurement category so that it is measured at fair value through profit or loss, any cumulative gain or loss previously recognised in other comprehensive income that is reclassified to profit or loss;

(d) tax expense;

(ea) a single amount for the total of discontinued operations (see IFRS 5).

## 18. ANALYSIS OF EXPENSE

Analysis of expense can be either by (i) nature of expenses or (ii) function of expenses.

Under nature of expenses method, the line items of expenses represent aggregation of expenses according to their nature, e.g., purchase of material, costs of transportation, employee benefits, etc.

**An example of a classification using the nature of expense method is as follows :**

| Revenue |
|---|
| Other income |
| Changes in inventories of finished goods and work in progress |
| Raw materials and consumables used |
| Employee benefits expense |
| Depreciation and amortisation expense |
| Other expenses |
| Total expenses |
| Profit before tax |

An example of a classification using the function of expense method is as follows:

| Revenue |
|---|
| Cost of sales |
| Gross profit |
| Other income |
| Distribution costs |
| Administrative expenses |
| Other expenses |
| Profit before tax |

**No item of income or expense should be presented as extraordinary items in the financial statements**

## 19. OTHER COMPREHENSIVE INCOME (OCI)

The other comprehensive income section shall present line items for the amounts for the period of:

(a) items of other comprehensive income (excluding amounts in paragraph (b)), classified by nature and grouped into those that, in accordance with other IFRSs:

  (i) will not be reclassified subsequently to profit or loss; and

  (ii) will be reclassified subsequently to profit or loss when specific conditions are met.

(b) The share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that, in accordance with other IFRSs:

  (i) will not be reclassified subsequently to profit or loss; and

  (ii) will be reclassified subsequently to profit or loss when specific conditions are met.

Following items are required to be presented as other comprehensive income:

**Examples of items that will not be reclassified to profit and loss**

a) **Remeasurement of defined benefit plans** - earlier referred as actuarial gains or losses on both plan obligation and plan assets. (IAS 19)

b) **For liabilities designated as fair value through profit or loss, change in fair value attributable to changes in liability's credit risk** — when fair value of borrowing decreases due to decrease in rating, such gains should be recognized in OCI (IFRS 9)

c) Changes in revaluation surplus; (IAS 16)

**Examples of items that will be reclassified to profit and loss**

a) Gains and losses arising from translating the financial statements of a foreign operation; (IAS 21)

b) Gains and losses from equity instruments/financial assets measured at fair value through OCI — entity can decide to designate equity instrument as fair value through OCI and if conditions are met, financial assets as fair value through OCI (IFRS 9)

c) Hedging transactions —

  (i) Effective portion of gains in a cash flow hedge, (IFRS 9)

  (ii) Change in value of time value of option contract when only intrinsic value is designated as hedging instrument, (IFRS 9)

  (iii) Changes in value of forward element, when only change in value of spot element is designated as hedging instrument. (IFRS 9)

## 20. TAX EFFECT OF OCI ITEMS – HOW TO PRESENT?

Each component of other comprehensive income is required to be disclosed either net of tax effect or on gross basis with a single amount showing the aggregate amount of income tax relating to those components.

The Standard provides an option to disclose the tax effect of each component of other comprehensive income either in the statement of other comprehensive income itself or separately in the notes.

An entity shall not present any items of income or expense as extraordinary items, in the statement(s) presenting profit or loss and other comprehensive income or in the notes.

## 21. FORMAT OF STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

**Statement of Profit and Loss and other comprehensive income for the year ended….**(Rupees in )
(using the nature of expense method) (Single statement format)

| | Particulars | Note No. | Figs for Current Reporting Period | Figs for Previous Reporting Period |
|---|---|---|---|---|
| **I** | Revenue from Operations | | XXX | XXX |
| **II** | Other Income | | XXX | XXX |
| **III** | **Total Revenue (I + II)** | | **XXX** | **XXX** |
| **IV** | **Expenses:**<br>Cost of Materials Consumed<br>Purchases of Stock-In-Trade<br>Changes in Inventories of Finished Goods, Stock-In-Trade & WIP | | <br>XXX<br>XXX<br>XXX | <br>XXX<br>XXX<br>XXX |
| | Employee Benefits Expense | | | |
| | Finance Costs | | | |
| | Depreciation and Amortization Expense | | | |
| | Other Expenses | | | |
| | **Total Expenses** | | **XXX** | **XXX** |
| **V** | Profit/(Loss) before Exceptional Items & Tax (III—IV) | | XXX | XXX |
| **VI** | Exceptional Items | | XXX | XXX |
| **VII** | Profit/(Loss) before Tax (V -VI) | | XXX | XXX |
| **VIII** | Tax Expense: | | | |
| | (1) Current Tax | | XXX | XXX |
| | (2) Deferred Tax | | XXX | XXX |
| **IX** | Profit/(Loss) for the period from Continuing Operations (VII—VIII) | | **XXX** | **XXX** |
| **X** | Profit / (Loss) from Discontinued Operations | | XXX | XXX |
| **XI** | Tax Expense of Discontinued Operations | | XXX | XXX |
| **XII** | Profit/(Loss) from Discontinued Operations (After Tax) (X-XI) | | XXX | XXX |
| **XIII** | Profit / (Loss) for the period (IX + XII) | | **XXX** | **XXX** |
| **XIV** | Other Comprehensive Income: | | | |
| | **A** (i) Items that **will not be** re-classified to Profit or Loss | | XXX | XXX |
| | (ii) Income Tax relating to Items that **will not be** re-classified to Profit or Loss | | XXX | XXX |
| | **B** (i) Items that **will be** re-classified to Profit or Loss | | XXX | XXX |
| | (ii) Income Tax relating to Items that **will be** re-classified to Profit or Loss | | XXX | XXX |
| **XV** | Total Comprehensive Income for the period (XIII + XIV) (comprising Profit (Loss) & Other | | XXX | XXX |

| | Comprehensive Income) | | | |
|---|---|---|---|---|
| **XVI** | Profit attributable to :<br>a. Owner of parent<br>b. Minority Interest | | | |
| **XVII** | Total Comprehensive income attributable to :<br>a. Owner of parent<br>b. Minority Interest | | | |
| **XVIII** | Earnings per Equity Share (for Continuing Operation): | | | |
| | (1) Basic | | XXX | XXX |
| | (2) Diluted | | XXX | XXX |
| | Earnings per Equity Share (for Discontinued Operation): | | | |
| | (1) Basic | | XXX | XXX |
| | (2) Diluted | | XXX | XXX |
| | Earnings per Equity Share (for Discontinued & Continuing Operations) | | | |
| | (1) Basic | | XXX | XXX |
| | (2) Diluted | | XXX | XXX |

**PRESENTATION OF COMPREHENSIVE INCOME IN TWO STATEMENTS:**

**Statement of Profit and Loss for the year ended….**(Rupees in ..................................................... )
(using the nature of expense method)

| | Particulars | Note No. | Figs for Current Reporting Period | Figs for Previous Reporting Period |
|---|---|---|---|---|
| **I** | Revenue from Operations | | XXX | XXX |
| **II** | Other Income | | XXX | XXX |
| **III** | **Total Revenue (I + II)** | | **XXX** | **XXX** |
| **IV** | **Expenses:**<br>Cost of Materials Consumed<br>Purchases of Stock-In-Trade<br>Changes in Inventories of Finished Goods, Stock-In-Trade & WIP | | XXX<br>XXX<br>XXX | XXX<br>XXX<br>XXX |
| | Employee Benefits Expense | | | |
| | Finance Costs | | | |
| | Depreciation and Amortization Expense | | | |
| | Other Expenses | | | |
| | **Total Expenses** | | **XXX** | **XXX** |
| **V** | Profit/(Loss) before Exceptional Items & Tax (III—IV) | | XXX | XXX |
| **VI** | Exceptional Items | | XXX | XXX |
| **VII** | Profit/(Loss) before Tax (V -VI) | | XXX | XXX |
| **VIII** | Tax Expense: | | | |

| | (1) Current Tax | | XXX | XXX |
|---|---|---|---|---|
| | (2) Deferred Tax | | XXX | XXX |
| **IX** | Profit/(Loss) for the period from Continuing Operations (VII—VIII) | | **XXX** | **XXX** |
| **X** | Profit / (Loss) from Discontinued Operations | | XXX | XXX |
| **XI** | Tax Expense of Discontinued Operations | | XXX | XXX |
| **XII** | Profit/(Loss) from Discontinued Operations (After Tax) (X-XI) | | XXX | XXX |
| **XIII** | Profit / (Loss) for the period (IX + XII) | | **XXX** | **XXX** |
| **XIV** | Profit attributable to :<br>c. Owner of parent<br>d. Minority Interest | | | |
| **XV** | Earnings per Equity Share (for Continuing Operation): | | | |
| | (1) Basic | | XXX | XXX |
| | (2) Diluted | | XXX | XXX |
| | Earnings per Equity Share (for Discontinued Operation): | | | |
| | (1) Basic | | XXX | XXX |
| | (2) Diluted | | XXX | XXX |
| | Earnings per Equity Share (for Discontinued & Continuing Operations) | | | |
| | (1) Basic | | XXX | XXX |
| | (2) Diluted | | XXX | XXX |

**Statement of Profit and Loss and other comprehensive income for the year ended….**(Rupees in )
(using the nature of expense method) (Single statement format)

| | **Particulars** | **Note No.** | **Figs for Current Reporting Period** | **Figs for Previous Reporting Period** |
|---|---|---|---|---|
| **I** | Profit / (Loss) for the period | | **XXX** | **XXX** |
| **II** | Other Comprehensive Income: | | | |
| | **A** (i) Items that **will not be** re-classified to Profit or Loss | | XXX | XXX |
| | (ii) Income Tax relating to Items that **will not be** re-classified to Profit or Loss | | XXX | XXX |
| | **B** (i) Items that **will be** re-classified to Profit or Loss | | XXX | XXX |
| | (ii) Income Tax relating to Items that **will be** re-classified to Profit or Loss | | XXX | XXX |
| **III** | Total Comprehensive Income for the period (I + II) (comprising Profit (Loss) & Other Comprehensive Income) | | XXX | XXX |
| **IV** | Total Comprehensive income attributable to :<br>c. Owner of parent<br>d. Minority Interest | | XXX | XXX |

## 22. RECLASSIFICATION ADJUSTMENTS

Some IFRSs specify the timing and amount of income -and expenses recognized in other comprehensive income to be reclassified into profit or loss. These adjustments are termed as reclassification adjustments.

**Examples include:**

- The portion of other comprehensive income attributable to foreign operations is recognized in profit or loss, at the time of disposal of foreign operations. (IAS 21)

Such reclassification requires adjustment to retained earnings (profit or loss) of the earliest comparative period presented. The reclassification adjustments effected during the reporting period need to be disclosed.

## 23. STATEMENT OF CHANGES IN EQUITY

An entity shall present a statement of changes in equity as part of SOFP showing:

- Total comprehensive income for the period, showing separately, a breakup of amounts attributable to owners (shareholders of parents) and non-controlling interests (shareholders of subsidiaries, other than parent)
- Effects of retrospective application or restatement, recognized during the period
- For each component of equity a reconciliation between carrying amounts at the beginning and at the end of the period in respect of:
  - Profit or loss (basic income statement) or Other comprehensive income
  - Transactions with owners and changes in ownership interests in subsidiaries that do not result in loss of control.
  - Items such as capital reserve
  - Changes that arise from transactions with owners (issue or buy back of shares, etc.) and certain transactions with subsidiaries that do not affect 'control' over subsidiary and require to be accounted for as equity transactions.

The Standard requires that the changes (that constitute all or some of the foregoing elements) in equity should be presented in the form of a statement, showing separately, a breakup of amounts attributable to owners (shareholders of parents) and non-controlling interests (shareholders of subsidiaries, other than parent) in respect of

- Profit or loss (basic income statement)
- Other comprehensive income
- Transaction with owners

## 24. FORMAT OF STATEMENT OF CHANGES IN EQUITY

**Statement of Changes in Equity**

**Name of the Company :.............................................................................................. Statement of Changes in Equity for the period ended.......... (Rupees in...............................)**

A. Equity Share Capital

| Balance at the beginning of the Reporting Period | Changes in Equity Share Capital during the year | Balance at the end of the Reporting Period |
|---|---|---|
| | | |

B. Other Equity:

| Particulars | Information to be provided in 14 columns, see note 2 below. | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Balance at the beginning of the Reporting Period | | | | | | | | | | | | | | |
| Add/Less: Changes in Accounting Policy or Prior Period Errors | | | | | | | | | | | | | | |
| Restated Balance at the beginning of the Reporting Period | | | | | | | | | | | | | | |
| Add/Less: Total Comprehensive Income for the year | | | | | | | | | | | | | | |
| Dividends | | | | | | | | | | | | | | |
| Transfer to Retained Earnings | | | | | | | | | | | | | | |
| Any other Change (to be specified) | | | | | | | | | | | | | | |
| Balance at the End of the Reporting Period | | | | | | | | | | | | | | |

Note 1: **Information / Amounts to be presented for the following items separately in 14 Columns -**

1. Share Application Money Pending Allotment
2. Equity Component of Compound Financial Instruments
3. Capital Reserve
4. Securities Premium Reserve
5. Other Reserves (specify nature)
6. Retained Earnings
7. Debt Instruments through Other Comprehensive Income
8. Equity Instruments through Other Comprehensive Income
9. Effective Portion of Cash Flow Hedges
10. Revaluation Surplus
11. Exchange Differences on translating the Financial Statements of a Foreign Operation
12. Other Items of Other Comprehensive Income (specify nature)
13. Money received against Share Warrants
14. Total

## 25. STATEMENT OF CASH FLOWS

A cash flow statement in accordance with the prescriptions under IFRS 7 is required to be presented.

Information about the cash flows of an entity is useful in providing users of financial statement with a basis to assess the ability of the entity to generate cash and cash equivalents, and the need of the entity to utilise those cash flows.

Primarily statement of cash flows captures the difference between accrual basis income and cash income.

It also provides structured information about cash flows resulting from operating activities, investment activities and financing activities.

## 26. NOTES TO ACCOUNTS

Disclosures under Notes to Accounts, will include, among others

(i) the measurement basis (such as historical cost, current cost, net realizable value, fair value or recoverable amount)

(ii) accounting policies adopted

(iii) disclose information required by IFRS not specifically disclosed elsewhere,

(iv) information not presented elsewhere but required for understanding of the financial statements

(v) a statement of unreserved compliance with IFRS.

**Management Judgements**

The disclosures should also include a description of the areas in which management has exercised judgement, or has adopted estimations, [e.g., assumptions used in measurement of defined benefit obligation], which have the most significant effect on the amounts recognized in the financial statements.

**Sources of estimation uncertainty**

A specific disclosure requirement relates to assumptions that the management makes about the future, and other major sources of uncertainties that carry the risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in subsequent reporting periods.

**Examples include estimation of the effect of technological obsolescence on inventories carried.**

Notes should be presented in a systematic manner and cross- reference should be made to each item in the balance sheet, Profit or loss and cash flows.

**Disclosures as to how an entity manages its Capital**

These include information that would facilitate users of financial statements to evaluate the entity's objectives, policies and processes for managing capital. This requirement is supplemented by a clarification to the effect that, an entity may provide a description of what it manages as capital, whether it is subject to externally imposed capital requirements (such as Basel II norms for Banks), and the manner in which it is meeting the objectives for managing the capital.

No disclosure is required in situations where an entity has established its own internal norms for managing capital, and where such internal norms are not met.

**Puttable instruments classified as equity** when an entity classifies puttable instruments as equity in accordance with IAS 32, the following disclosures should be made:

- Summary quantitative data about amount classified as equity.
- Objectives, policies and processes for managing its obligation of repurchase or redeem instruments when required to be done.
- Expected cash outflow on redemption or repurchase.
- Information about how the expected cash outflow on redemption or repurchase was determined.

## 27. OTHER DISCLOSURES

**Dividend related:** Dividends proposed or declared after reporting period but before financial statements are authorised for issue and cumulative preference dividends that are not recognized. Disclosure that these are not recognized shall be made in the notes.

**General Information related:** The entity's domicile, legal form, country of incorporation, address of registered office, nature of entity's operation, principal activities, name of the parent and ultimate parent.

## 28. COMPARISON WITH IND AS 1

**The following are key differences between Ind AS 1 and corresponding IAS 1:**

- The term fair presentation is used instead of true and fair view presentation, which is just a change in nomenclature
- Additional information on 52-week period for annual financial statements is given in IFRS
- Balance sheet is referred as statement of financial position
- Statement of Profit or loss is referred as statement of comprehensive income
- Statement of comprehensive income can be presented as a single statement or as two statements, (i) Income statement and (ii) statement of other comprehensive income
- Analysis of expense can be either by (i) nature of expenses or (ii) function of expenses.
- A long term loan arrangement where a breach of material provision has resulted in loan being due, should be treated as current as per IFRS even if lender has agreed for restructuring before the approval of financial statements for issue.

## 29. PROBLEMS FOR SELF PRACTICE

### QUESTION 8 :

An entity purchase goods or 24 months credit but the creditor has the call option that can be exercised after 15 months. On the reporting date such creditor was outstanding for 3 months. Operating cycle of the entity is 6 months.

Should the creditor be classified as current or non-currents.

### SOLUTION 8 :

This creditor is not to be settled by normal operating cycle of the entity. It will be guided by the timing of the settlement from the reporting date. In this case the amount of creditor can be called by 12 months after the reporting date. Although it will not be settled within the operating cycle, it is classified as a current liability considering the call obligation.

### QUESTION 9 :

X Ltd. has created provision for tax for the year 2014-15 amounting to Rs. 10 lakhs and advance tax of Rs. 9 lakhs.

Classify the provision into current and non-current.

### SOLUTION 9 :

Provision for tax net of advance tax is reversed when the assessment is over and the entity gets confirmation that there is no additional liability. Since the assessment is expected to be carried out by the tax authority during the assessment year which falls within 12 months after the reporting period, the tax provision is classified as current liability.

### QUESTION 10 :

X Ltd. has the following investments as on 31.3.2015. How should the company classify these investments into current and non-current assets for the purpose of IAS 1?

Investments in equity shares and bond classified as financial assets as at fair value through profit or loss :Rs. 10 lakhs

Investments in equity shares and bond classified as financial assets as at fair value through other comprehensive income :Rs. 20 lakhs

Investments in subsidiary :Rs 50 lakhs

Investments in associates :Rs 20 lakhs

Investments in subsidiary which planned to be sold during 2014-15 :Rs. 40 lakhs.

**SOLUTION 10 :**

| Name of the investment | Classification | Remarks |
|---|---|---|
| (i) Investments in equitv shares and bond classified as financial assets as at fair value through profit | Current asset | If these investments are expected to be realised within 12 months |
| or loss : Rs. 10 lakhs | Non-current asset | If these investments are not expected to be realised within 12 months |
| (ii) Investments in equity shares and bond classified as financial assets as at fair value through other | Current asset | If these investments are ex- pected to be realised within 12 months |
| comprehensive income: Rs. 20 lakhs | Non-current asset | If these investments are not ex- pected to be realised within 12 months |
| (III) Investments in subsidiary : Rs. 50 lakhs | Non-current asset | Classified as non-current unless the subsidiary is held for sale - Refer to item (v) |
| (iv) Investments in associates | Non-current asset | Classified as non-current unless the associate is held for sale. |
| (v) Investments in subsidiary held for sale | Current asset | This investment is expected to be realised within 12 months as per IFRS 5.<br>This is presented separately as per IFRS 5. |

**QUESTION 11 :**

(i) Prepaid expense Rs. 10 lakhs for repairs and maintenance.

This is an advance to service provider and it is expected that repairs will be carried out by June 30, 2016.

Operating cycle of the company 15 months

(ii) Advance to contractor Rs. 20 lakhs for construction of new office building.

The advance is expected to be adjusted against works completed by 30.6.2015.

How should the company classify these advances into current and non-current assets for the purpose of IAS 1?

**SOLUTION 11 :**

| Name of the investment | Classification | Remarks |
|---|---|---|
| (i) Prepaid expense Rs. 10 lakhs for repairs and maintenance | Current asset | This is treated as current asset although expected to be realised beyond 12 months after the reporting period since the operating cycle of the company is 15 months and the prepaid expense is expected to be adjusted against the service cost within the operating cycle of the entity. |
| (ii) Advance to contractor Rs. 20 lakhs for construction of new-office building | Non-current asset | Classified as non-current because the advance will be realised in the form of a non-current asset. |

# IAS 2 INVENTORIES

## 1. OBJECTIVE OF THIS STANDARD

The objective of this Standard is to prescribe the accounting treatment for inventories.

A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised.

This Standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value.

It also provides guidance on the cost formulas that are used to assign costs to inventories.

## 2. DEFINITIONS

**Inventories are assets:**

- held for sale in the ordinary course of business (finished goods);
- in the process of production for such sale (WIP) ; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services (raw material).

**Net realizable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13 Fair Value Measurement.)

## 3. TYPES OF INVENTORIES:

Inventories comprise three components:

- **Finished goods** held for sale by a manufacturing entity and goods held by trading entity - "held for sale in the ordinary course of business"
- **Work-in-progress**, typically materials that are issued for production out of stores and in the production process and other semi-finished goods - "in the process of production for such sale"
- **Raw materials** in stores and other spares - "material or supplies to be consumed in the production process or in the rendering of services

## 4. SCOPE

1. This Standard applies to all inventories, except:
   a. (b) financial instruments (see IAS 32 Financial Instruments: Presentation and IFRS 9 Financial Instruments); and
   b. (c) biological assets related to agricultural activity and agricultural produce at the point of harvest (see IAS 41 Agriculture).

2 This Standard does not apply to the measurement of inventories held by:

(a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at net realisable value, changes in that value are recognised in profit or loss in the period of the change.

(b) commodity broker-traders **(Broker-traders are those who buy or sell commodities for others or on their account.)** who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognised in profit or loss in the period of the change.

The inventories referred to in paragraph 2(b) are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. When these inventories are measured at fair value less costs to sell, they are excluded from only the measurement requirements of this Standard.

## 5. MEASUREMENT

**Inventories are measured at** lower of **cost and net realizable value (NRV).**

**PROMLEM : 1**

**An enterprise has in its stock, 10,000 bags of cement purchased at a cost of Rs. 180 per bag. The terms of trade are that the cement is delivered at the buyer's door, and the cost of delivery of Rs. 10 per bag is paid by the seller. The selling price of cement is Rs. 187 per bag. Find out the value of closing stock.**

**SOLUTION : 1**

| Valuation of closing stock | | Rs. |
|---|---|---|
| a. Cost per bag | | 180 |
| b. Net Realisable value | | |
| S.P | 187 | |
| (-) Cost of delivery per bag | 10 | 177 |
| Net selling price (N.R.V) | 177 | 177 |
| ∴ Cost of Inventory | | |
| 177 x 10,000 | | 17,70,000 |

## 6. COST OF INVENTORIES

Cost of inventories comprises all purchase costs, costs of conversion and other costs incurred in bringing the inventories to the present location and condition.

## 7. PURCHASE COSTS

- Costs of purchase comprises the purchase price, import duties, other taxes, transport, handling and other costs directly attributable to the procurement of goods, materials and services.
- Taxes do not include those taxes that are subsequently recoverable from the taxing authorities. Trade discounts and rebates are deducted in determination of costs of purchase.

## 8. CONVERSION COSTS

- Conversion cost comprises the cost of labour, fixed overhead and variable overhead.
- Fixed overheads are those indirect costs that remain relatively constant regardless of the production.
- Example of Fixed overheads - depreciation and maintenance of factory buildings, equipment and right-of-use assets used in the production process, and the cost of factory management and administration.
- Variable overheads are those that vary directly or nearly directly with the production. Example - indirect materials and indirect labour.

## 9. ALLOCATION OF THE OVERHEADS

The allocation of the overheads is on the following basis:

**Variable overhead –** Based on actual rate per unit.

**Amount of Allocation = Variable overheads per unit X Actual Production**

**Fixed overhead –** If actual production is less than normal capacity, use normal capacity. Otherwise use actual capacity.

- Fixed overheads to be included in cost of inventory= Actual Production X Allocation per unit

**Case 1 : Actual Production and Normal Capacity are same.**

The overheads will be included in Cost of inventory at the rate determined on the basis of **Normal Capacity.**

- **Allocation per Unit = Fixed production overheads / Normal Capacity**

**Case 2 : Actual Production is less than Normal Capacity**

- The overheads will be included in Cost of inventory at the rate determined on the basis of **Normal Capacity.**
- When Actual Production is less than Normal Capacity an element of fixed overheads will remain unallocated.
- Such unallocated Fixed overheads should be recognised as an expense in the period in which they are incurred.
- **Allocation per Unit = Fixed production overheads / Normal Capacity**

**Case 3 : Actual Production is more than Normal Capacity**

- In the periods of abnormally high production the amount of fixed overheads allocated to each unit is revised so that inventories are not valued above cost. In this case the fixed overheads will be included in Cost of inventory at the rate determined on the basis of **actual Capacity.**
- **Allocation per Unit = Fixed production overheads / Actual Capacity**

**PROBLEM 2 :**

| | Case 1 | Case 2 | Case 3 |
|---|---|---|---|
| Normal Capacity | | | |
| Fixed Overheads | | | |
| Actual Production | | | |
| Allocation of fixed overheads per unit | | | |
| Actual sales | | | |
| Actual inventory | | | |
| Amount included in cost of sales | | | |
| Amount included in cost of inventory | | | |
| Amount Charged as period cost (Under absorption ) | | | |

**PROBLEM 3 :**

**AS Ltd.'s normal production volume is 50,000 units and the Fixed Overheads are estimated at Rs. 5,00,000. Give the treatment of Fixed Production OH under AS-2, if actual production during a period was – (a) 42,000 units, (b) 50,000 units and (c) 60,000 units.**

**SOLUTION 3 :**

Fixed Production OH Recovery Rate (based on Normal Capacity) = Rs. 5,00,000 ÷ 50,000 = Rs. 10 per unit.

The treatment of Fixed OH in different cases is as under :

| | Particulars | Situation (a) | Situation (b) | Situation (c) |
|---|---|---|---|---|
| 1. | Normal Production | 50,000 units | 50,000 units | 50,000 units |
| 2. | Actual Production | 42,000 units | 50,000 units | 60,000 units |
| 3. | Difference in Production (1 – 2) | 8,000 units (Short) Actual <Normal | Nil Actual = Normal | 10,000 units (Excess) Actual >Normal |
| 4. | Recovery Rate to be used as per AS – 2 | Normal Rate = Rs. 10 per unit | Normal Rate = Rs. 10 per unit | Revised Rate = Rs. 5,00,000 ÷ 60,000 = Rs. 8.33 per unit |
| 5. | Inventoriable Costs, i.e. Recovered Costs | 42,000 units x Rs. 10 = Rs. 4,20,000 | 50,000 units x Rs. 10 = Rs. 5,00,000 | 60,000 units x Rs. 8.33 = Rs. 5,00,000 |
| 6. | Balance treated as Period Costs | Rs. 80,000 | Nil | Nil |

## 10 . NORMAL CAPACITY

Normal capacity is the production expected to be achieved on an average over number of periods or seasons under normal circumstances taking into account loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity.

## 11. TREATMENT FOR JOINT PRODUCTS

- When more than one product is produced, the cost is to be allocated to the joint products on a rational and consistent basis.
- For example, such allocation may be based on **relative sales value** at the separately identifiable stage or at the completion.

**PROBLEM 4 :**

**5,000 units of Exe and 2,500 units of Wye arise jointly from a production process, involving a total cost of Rs. 2,60,000. If the Sales Value at split off point is Rs. 100 and Rs. 60 respectively for the products Exe and Wye, explain how the total Joint Cost of conversion will be allocated to the products.**

**SOLUTION : 4**

- In respect of Joint Products, where the costs of conversion of each product are not separately identifiable, then such costs should be allocated on some rational basis, e.g. Sales Value at Split Off Point.

| | Particulars | Exe | Wye | Total |
|---|---|---|---|---|
| 1. | Production Quantity | 5,000 units | 2,500 units | 7,500 units |
| 2. | Sale Price per unit | Rs. 100 | Rs. 60 | |
| 3. | Total Sales Value (1 x 2) | Rs. 5,00,000 | Rs. 1,50,000 | Rs. 6,50,000 |
| 4. | Joint Costs apportioned (based on Sales Value) (based on 3) | Rs. 2,00,000 | Rs. 60,000 | Rs. 2,60,000 |
| 5. | Cost of Conversion per unit (4 ÷ 1) | Rs. 40 | Rs. 24 | |

## 12. BY PRODUCTS, SCRAPS ETC.

If not very significant are valued at net realisable value and this value is deducted from the cost of main product.

**PROBLEM 5 :**

**Company purchases chemicals in drums. These are not returnable. Their cost cannot be ascertained since, the cost of chemicals includes cost of these drums. Are these inventories within the meaning of IAS - 2?**

**SOLUTION : 5**

These are neither held for sale in ordinary course of business nor in the process of production for such sale nor for being used in such production. Hence, these do not satisfy the definition of inventories and IAS-2 does not apply to their valuation. These may be valued at their net realizable value.

**PROBLEM 6 :**

**In a manufacturing process of Vijoy Limited, one by-product BP emerges besides two main products MP1 and MP2 apart from scrap. Details of cost of production process is here under:**

| Item | Unit | Amount (Rs) | Output (Unit) | Closing stock as on 31.03.2012 |
|---|---|---|---|---|
| **Raw Material** | **15000** | **1,60,000** | **MP1 – 6250** | **800** |
| **Wages** | **-** | **82,000** | **MP2 – 5000** | **200** |
| **Fixed Overhead** | **-** | **58,000** | **BP – 1600** | **-** |
| **Variable Overhead** | **-** | **40,000** | **-** | **-** |

**Average market price of MP1 and MP2 is Rs80 per unit and Rs 50 per unit respectively, by product is sold @ 25 per unit. There is a profit of Rs 5,000 on sale of by-product after incurring separate processing charges of Rs 4,000 and packing charges of Rs 6,000. Rs 6,000 was realized from sale of scrap.**

NRV of By-product = Sale Price 40,000 (1,600 x 25) – Further Cost 10,000 = 30,000

NRV of By-product and Scrap = 30,000 + 6,000 = 36,000

Net Joint Cost = 3,40,000 – 36,000 = 3,04,000.

| Particulars | MP 1 | MP 2 | Total |
|---|---|---|---|
| Production Quantity | 6,250 | 5,000 | 11,250 |
| Apportionment Joint Cost based on sale value (80 x 6,250) : (50 x 5,000) or 2:1 | 2,02,667 | 1,01,333 | 3,04,000 |
| Average Joint Cost | 32.43 | 20.27 | - |
| Closing Stock Units | 800 | 200 | - |
| **Value** | **25,944** | **4,054** | **29,998** |

**Note:** it is assumed that Net Realisable Value is more than Cost. The Profit on by-product is irrelevant, since only Net Realisable Value has to be considered.

## 13. OTHER COSTS

- Other costs are included only to the extent they are incurred to bring the inventory to present location and condition.
- Cost of designing products for specific customers is an example of cost to be included.

## 14. COSTS EXCLUDED:

a. Abnormal amount of wasted materials, labours or other production costs.
b. Storage costs, unless those costs are necessary in the production process before a further production stage.
c. Administration overheads that do not contribute to bringing inventories to their present location and condition; and
d. Selling costs
e. Borrowing costs: Included if inventories are qualifying assets under **IAS 23, *"Borrowing costs"***

## 15. DEFERRED SETTLEMENT PURCHASES

**When inventories are purchased on deferred settlement basis, i.e., payment for the inventories are made at a later point of time, that in substance isa financing arrangement (normally when more than twelve months), interest cost is to be recognized as interest expense over the period of financing by adopting a discount rate.**

**PROBLEM 7 : [ Inventories purchased on defer payment basis]**

**The company found that its inventories of raw materials include an item amounting to Rs. 50,00,000 purchased on defer payment basis.**

**As per terms of the purchased contract, the company shall make 10% down payment.**

**Balance in two equal annual instalments. Date of purchase of the item of inventories is 1.1.2019.**

**Incremental borrowing rate of the company is 10%.**

## 16. COST OF AGRICULTURAL PRODUCE HARVESTED FROM BIOLOGICAL ASSETS

In accordance with IAS 41 Agriculture inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less costs to sell at the point of harvest. This is the cost of the inventories at that date for application of this Standard.

## 17. TECHNIQUES FOR MEASUREMENT OF COST

- Costs can be measured using standard cost method or retail inventory method as appropriate.
- **Standard Cost method** is used for normal levels of consumption for a given volume of output. It is a predetermined cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.
- **The retail inventory method** is used where the inventories are generally large and volatile. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin.

**PROBLEM 8 :**

**The selling price of an item in a retail department is Rs. 1,000. The retail department uses a gross margin of 25%. What should be the valuation of that item ?**

**SOLUTION 8 :**

## 18. COST FORMULA

The cost formula is for valuation of items stock of raw materials that are used in the production or to be used in the production. Hence, selection of appropriate cost formula becomes essential for the valuation of stock.

**Items of inventory which are not ordinarily interchangeable** are valued using the Specific Identification method.

**Items of inventory which are not ordinarily interchangeable**: FIFO or Weighted Average Method.

**Specific identification method**

- It means directly linking the cost with specific item of inventories.
- This method has application in following conditions:
  1. In case of purchase of items that are segregated for a specific project and not ordinarily interchangeable between projects.
  2. In case of Goods and services produced and segregated for a specific project

**First in First Out (FIFO)**

- The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first.

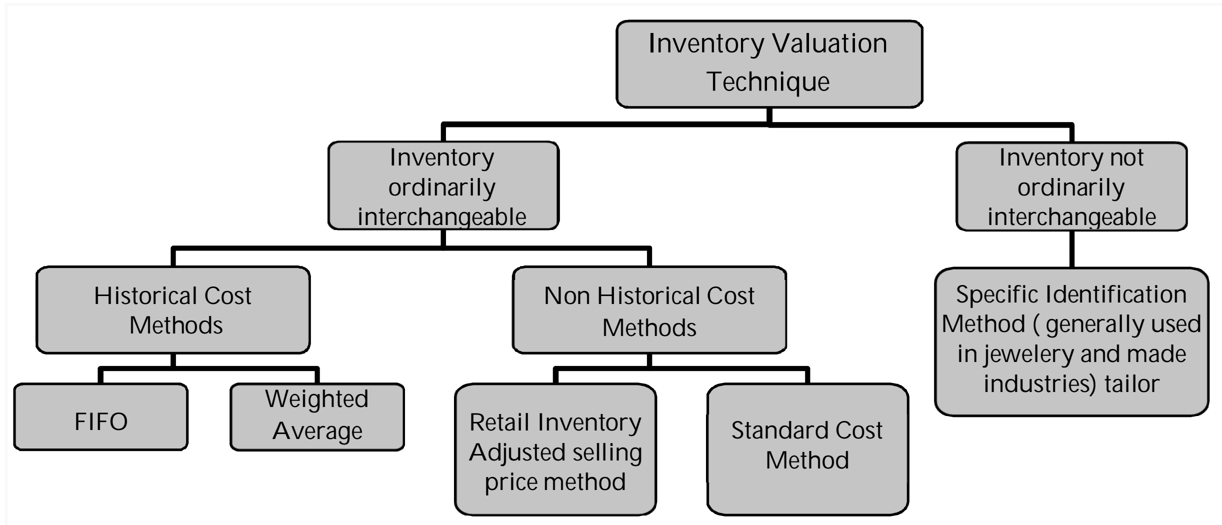
**Weighted Average Cost**

- The average may be calculated on a periodic basis, or after every purchase depending upon the circumstances of the enterprise.

## 19. SAME COST FORMULA

An entity normally is required to adopt the **same cost formula for all inventories having similar nature and use to the entity. However, the use of different formula for inventories with different nature of use has to be justified.**

For example, inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.




## 20. NET REALISABLE VALUE

**NRV constitutes the estimated selling price less the cost of completion and the cost necessary to make the sale. The estimates are to be based on reliable evidence after taking into consideration price fluctuation or costs directly relating to events after the end of the period to the extent they conform to conditions existing at the end of the period.**

In some cases, the cost of inventories may not be recoverable wholly or partially. In such cases, NRV becomes the reliable measure because assets should not be carried in excess of amounts expected to be realized from their sale or use.

Inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to group similar or related items.

**PROBLEM 9 :**

| Item | NRV | Cost | Lower Value |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

**PROBLEM : 10**

**ASF Ltd. produces 4 different types of capacitors. A, B, C and D. For the year 2013-14 their closing stock of finished goods have been valued as follows :**

| | A | B | C | D |
|---|---|---|---|---|
| Cost of Production | Rs. 5,00,000 | Rs. 6,00,000 | Rs. 4,00,000 | Rs. 2,50,000 |
| Net Realizable Value | Rs. 4,80,000 | Rs. 6,25,000 | Rs. 4,10,000 | Rs. 2,10,000 |

**Find out the value of inventory.**

**SOLUTION 10:**

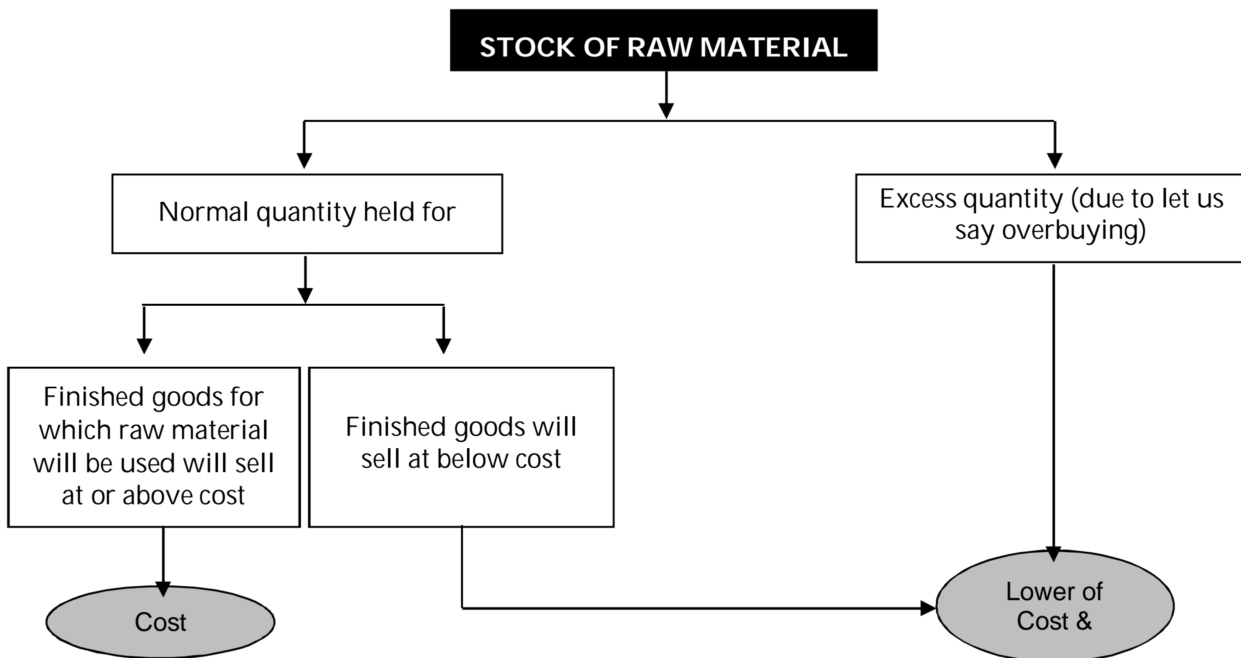
1. **Product Cost or NRV whichever is lower**

| Product | Cost or NRV whichever is lower |
|---|---|
| A | 4,80,000 |
| B | 6,00,000 |
| C | 4,00,000 |
| D | 2,10,000 |
| | 16,90,000 |

## 21. VALUATION OF MATERIALS AND SUPPLIES HELD AS WIP

**Valuation of materials and supplies held as WIP** is based on the NRV of Finished goods. Raw materials are not written down below cost if the finished goods are expected to be sold at or above cost. However, if there are indications that cost may not be recoverable (e.g., decline in price of materials, indicating that the cost of finished product exceeds NRV) then the inventories are written down to NRV. Replacement cost of the materials can be the best available measure of NRV.

**If finished product in which raw material or supplies is used is sold below its cost, raw material or supplies is written down to its NRV (replacement price of raw material.)**




**PROBLEM 11 :**

**A raw material costing Rs. 150 has a NRV (Replacement Cost) Rs.130. The Finished goods for which this Raw Material has other cost to incur Rs.60. At what price raw material should be valued if Finished Goods has a NRV.**

**A. Rs.210 or above**

**B. Less than Rs. 190**

**C. Rs.200**

**SPLUTION 11 :**

**A. Rs.210 or above**

There is no need to write down inventory of raw material. Raw material will be valued at Rs. 150.

**B. Less than Rs. 190**

As the NRV of Finished goods is less than its cost Rs. 210, the raw material should be valued at Rs. 130.

**C. Rs.200**

The finished goods is sold at Rs 10 below its cost, the raw material should be valued at Rs. 140 (i.e. Rs. 150 - Rs. 10)

**PROBLEM 12 :** **The cost of production (per unit) of a product is given below :**

| | |
|---|---|
| **Raw material** | **Rs. 300** |
| **Direct labour** | **90** |
| **Overheads** | **30** |
| | **420** |

**At the end of the year, the firm has 1,500 units of raw material which are to be valued for financial statements. The current replacement cost of raw material is Rs. 280 per unit. Find out the value of raw material inventory if the selling price of the finished goods is (i) Rs. 450, or (ii) Rs. 390.**

**SOLUTION : 12**

**When S.P. of finished goods is Rs. 450**. As per AS-2 raw material held for use in production are not written down below cost if the finished good in which they are used are experted to be sold at or above cost. However material may be shown at NRV if the finished goods can be sold at a price lower than the cost.

As the finished goods can be sold above cost, value of raw-material

= 300 x 1,500= 4,50,000

**When S.P. of finished goods is 390,** value of closing stock of raw material,

= 1,500 x 280= 4,20,000

## 22. INVENTORY HELD TO SATISFY FIRM SALES OR SERVICE CONTRACT

**Estimates of net realisable value also take into consideration the purpose for which the inventory is held.**

For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices. Provisions may arise from firm sales contracts in excess of inventory quantities held or from firm purchase contracts.

Such provisions are dealt with under IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

**PROBLEM 13 :**

**Stock of "A" 5,000 units, costing @ Rs.50, out of this 3,000 units are to supplied under a firm contract at Rs. 45 each. The general price is Rs. 49.**

**SOLUTION 13 :**

Value of 3,000 units @ Rs.45 = 1,35,000

Value of 2,000 units @ Rs.49 = 98,000

Total = 2,33,000

**PROBLEM 14. :**

**In the above example, if the general selling price is Rs. 52, how the valuation will be done ?**

**SOLUTION 14 :**

Value of 3,000 units @ Rs.45 = 1,35,000

Value of 2,000 units @ Rs.50 = 1,00,000

Total **= 2,35,000**

**PROBLEM 15 :**

**In the above example, if the firm contract is to supply 8,000 units @ Rs.45, how the valuation will be done ?**

**SOLUTION 15 :**

Stock of 5,000 units will be valued at Rs.45.

In addition, there is a contingent loss on the supply of balance 3,000 units @ Rs. 45. This loss should be provided as per IAS 37.

**PROBLEM 16 :**

**A dealer of sanitary fitting holds 1000 pcs of wash basins for delivering a constructor under firm contract. The contract quantity is 900 pcs @ Rs. 3,400 whereas retail price of the same is Rs. 4,200.**

**What should be the net realisable value of the inventories?**

**SOLUTION 16 :**

As per IAS 2, the net realisable value of the quantity of inventories held to satisfy firm sales or services contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices.

Accordingly, net realisable value of 1000 pcs of wash basin should be-

900 X 3,400 = Rs. 30,60,000

100 X 4,200 = Rs. 4,00,000

**Rs. 34,80,000**

## 23. RECOGNITION IN INCOME STATEMENT

The standard provides for three circumstances, in which the carrying amount of inventories will be through income statement.

- **On sale** — the carrying amount of inventories sold shall be recognized as expense in period when the related revenue is recognized.
- **On write down** — when inventories are written down to NRV, the write down and other losses shall be recognized as expense in the period of incurrence.
- **On reversal of write down** — the amount of inventories recognized as expense shall be reduced in the period in which the reversals arise.

## 24. ALLOCATED OF INVENTORY TO OTHER ASSET ACCOUNTS

- Some inventories may be allocated to other asset accounts.
- for example, inventory used as a component of self-constructed property, plant or equipment.
- Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

## 25. DISCLOSURES

**In the financial statements:**

- Amount of inventories that are recognized as expense
- Any write down and reversal of any write down of inventories

**In the notes to accounts**:

- **In the significant accounting policies section,**
  - Accounting policies relating to measurement of inventories
  - Cost formula used
- **In the relevant section under notes for inventories**
  - Carrying amount of inventories with appropriate classifications,
  - Carrying amount of inventories that are carried at fair value less cost to sell
  - Circumstances that led to reversal of a write-down
  - Carrying amount of inventories that are pledged as securities

## 26. JUDGMENTS

**In this standard, judgments are required to be made by the management in the following areas:**

- **Deciding on the cost formula to be used**
- **Circumstances that lead to write-down and reversal of write down**

## 27. DIFFERENCES BETWEEN IAS 2 AND IND AS 2

***Classification of Expenses:*** Paragraph 38 of IAS 2 dealing with recognition of inventories as an expense based on function-wise classification, has been deleted. Ind AS 1 requires only nature-wise classification of expenses.

## 28. PROBLEMS FOR SELF PRACTICE

**PROBLEM 17 :**

**Can interest on customs duty paid be included in the value of inventory?**

**SOLUTION 17 :**

No. Interest on custom duty should not be included in inventory valuation.

Interest cost relating to qualifying assets can only be capitalised over the cost of inventory as per IAS-23 "Borrowing cost"

**PROBLEM : 18**

**Asia Biscuit Ltd. has a normal capacity of 6,000 tonnes and the fixed annual overheads are Rs. 24,000. During the year, it manufactured only 5,500 tonnes at a variable cost consisting of material and labour @ Rs. 6 and 4 per tonne. At the end of the year, it had 1,800 tonnes of inventory. Find out the value of inventory as per IAS-2.**

**SOLUTION 18 :**

**Calculation of Valuation on Inventory**

| | **Rs.** |
|---|---|
| Material cost per unit | 6 |
| Labour cost | 4 |
| Prime cost | 10 |
| Add : Fixed overhead (24,000 / 6000) | 4 |
| Cost per unit | 14 |
| No. of units | 1,800 |
| ∴ Value of Inventory | 25,200 |

**PROBLEM : 19**

**Blue Lagoon Ltd. produces a consumer durable whose cost of production consists of variable element of Rs. 240 per unit. The total annual production overheads are Rs. 25,00,000 out of which 40% are fixed. The company has an normal capacity of 10,00,000 per annum, but during the year 2003-04, it produced 20,00,000 units, out of which 1,00,000 units are still unsold at the end of the year. Find out the value of the closing stock.**

**SOLUTION 19 :** **Blue Lagoon Ltd.**

| Valuation of closing stock | Rs. | Rs. |
|---|---|---|
| Variable cost | 240 | |
| Add : Fixed production overhead per unit | | |
| $\frac{10,00,000}{20,00,000}$ | 0.50 | |
| Variable overhead per unit | | |
| $\frac{15,00,000}{20,00,000}$ | 0.75 | |
| Cost per unit | | 241.25 |
| No. of units in closing stock | | 1,00,000 |
| Value of closing inventory (1,00,000 x 241.25) | | 2,41,25,000 |

**PROBLEM : 20**

**Cap Products Ltd. has an annual capacity of 40,000 units. The production overheads for the year are estimated at Rs. 3,20,000 whereas the total variable cost incurred is Rs. 6,90,000. The administrative costs and selling costs were Rs. 2,00,000 and Rs. 1,80,000 respectively. At the end of year, there were 6,000 units in stock. Find out the value of inventory given that the factory remained closed for one month for non receipt of orders which is a normal practice.**

**SOLUTION 20 :**

**Valuation of Inventory** **Rs.**

| | | |
|---|---|---|
| a. | Variable cost | 6,90,000 |
| b. | Production overhead | 3,20,000 |
| c. | Total cost | 10,10,000 |
| d. | No. of units produced | 40,000 |
| e. | Cost per unit | 25.25 |
| f. | No. of units in closing stock | 6,000 |
| g. | ∴ Value of closing inventory | 1,51,500 |
| **Note :** | Administration and selling cost should not be included in inventory valuation as per IAS – 2 | |

**PROBLEM : 21**

**How will you value the inventories in the following case. Per kilogram of Finished Goods consisted of Material Cost Rs. 100 per kg, Direct Labour Cost Rs. 20 per kg and Direct Variable Production Overhead Rs. 10 per kg. Fixed Production charges for the year on normal capacity of 1,00,000 kg is Rs. 10 lakhs. 2,000 kg of Finished Goods are on stock at the year-end.**

**SOLUTION 21 :** **Computation of Value of Stock (2,000 kgs)**

| Particulars | Rs. |
|---|---|
| Direct Material (2,000 kgs x Rs. 100 per kg) | 2,00,000 |
| Direct Labour Cost (2,000 kgs x Rs. 20 per kg) | 40,000 |
| Direct Variable Production Overhead (2,000 kgs x Rs. 10 per kg) | 20,000 |
| Fixed Production Overheads (Rs. 10 lakhs ÷ 1 lakhs kg x 2,000 kg) | 20,000 |
| **Value of Closing Stock at the end of the year** | **2,80,000** |

**PROBLEM : 22**

**AS Ltd. produces four Joint Products L, M, N and P from a joint process, incurring a cost of Rs. 5,71,200. Allocate the Joint Costs with the following information.**

| Particulars | L | M | N | P |
|---|---|---|---|---|
| **Quantity Produced (in '000s)** | **10 kg** | **12 kg** | **14 kg** | **16 kg** |
| **Sales Price per Kg** | **Rs. 13** | **Rs. 17** | **Rs. 19** | **Rs. 22** |
| **Stock Quantity at end of year** | **1,625 kg** | **400 kg** | **Nil** | **1,550 kg** |

**SOLUTION 22 :**

The Sales Value at Split Off Point may be used for apportionment in the given case.

| Particulars | L | M | N | P |
|---|---|---|---|---|
| 1. Production Quantity | 10,000 kg | 12,000 kg | 14,000 kg | 16,000 kg |
| 2. Sale Price per kg | Rs. 13 | Rs. 17 | Rs. 19 | Rs. 22 |
| 3. Total Sale Value (1 x 2) | Rs. 1,30,000 | Rs. 2,04,000 | Rs. 2,66,000 | Rs. 3,52,000 |
| 4. Joint Costs apportioned (based on Sales Value) (based on 3) | Rs. 78,000 | Rs. 1,22,400 | Rs. 1,59,600 | Rs. 2,11,200 |
| 5. Average Joint Costs per kg (4÷1) | Rs. 7.80 | Rs. 10.20 | Rs. 11.40 | Rs. 13.20 |
| 6. Closing Stock Quantity (given) | 1,625kg | 400 kg | Nil | 1,550 kg |
| 7. Value of Closing Stock (5 x 6) | Rs. 12,675 | Rs. 4,080 | Nil | Rs. 20,460 |

**Note :** It is presumed that the NRV of the products as at the B/S date, are above the respective costs.

**PROBLEM : 23**

**ASF Ltd purchased Raw Material 'Z' at Rs. 500 per kilolitre a few weeks back. Its current market price is on steep decline. The Finished Goods in which Z is incorporated is expected to be sold below cost. The Company has 1000 kilolitres of Z in stock at the year-end. The current market price of Z is Rs. 330 per kilolitre. At what rate raw material inventories be valued for Balance Sheet purchases?**

**SOLUTION 23 :**

The Finished Goods in which Z is incorporated is expected to be sold below cost. Hence, they should be valued at Cost or NRV whichever is lower.

Raw Material Z should be valued at the replacement cost of Rs. 330 per kilolitre. The total value of raw material for Balance Sheet purposes is Rs. 330 x 1,000 kilolitres = **Rs. 3,30,000.**

**PROBLEM 24 :**

**X Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 2018. Till March, 2019, 75% of the stocks were sold. The company wants to disclose closing stock at Rs.10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.2019.**

**SOLUTION 24 :**

As per IAS 2 "Inventories", the inventories are to be valued at lower of cost and net realizable value.

In this case, the cost of inventory is Rs.10 lakhs. The net realizable value is11,00,000 x 90% = Rs.9,90,000. So, the stock should be valued at Rs.9,90,000.

**PROBLEM : 25**

**Raw materials inventory of a company includes certain material purchased at Rs.100 per kg. The price of the material is on decline and replacement cost of the inventory at the year end is Rs.75 per kg. It is possible to convert the material into finished product at conversion cost of Rs.125.**

**Find out the value of inventory, If selling price is (i) Rs.175 and (ii) Rs.235.**

**SOLUTION 25 :**

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

(i) When selling price of the finished product is Rs.175, the raw material should be valued at Rs.75 per kg because the selling price of the finished product isless than Rs.225 (i.e. 100 + 125) per kg.

(ii) When selling price of the finished product is Rs.235, the raw material should be valued at Rs.100 per kg because the selling price of the finished product isnot less than Rs.225 (i.e. 100 + 125) per kg.

**PROBLEM : 26**

**U.S.A. Ltd. purchased raw material @ Rs.400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting Year Company is having 10000 kg of raw material in stock. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realizable value of the raw material for valuation of inventories at the end of the year. However replacement cost of raw material is Rs.300 per kg. How will you value the inventory of raw material?**

**SOLUTION 22 :**

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the stock of raw material at Rs. 30,00,000 (10,000 Kg. @ Rs.300 per kg.).

**PROBLEM : 27**

**Can PT Ltd. a wire netting company, while valuing its finished stock at the year end include interest on Bank Overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses?**

**SOLUTION 27 :**

Cost of inventories comprise of all costs of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition. Interest and other borrowing costs are usually considered as overheads that don't contribute to bringing the inventories to their present location and condition. Therefore, the proposal of PT Ltd., to include interest on bank over draft as an element of cost is not acceptable. Interest on bank overdraft will not form part of cost of production. However, as per IAS 23, "Borrowing Costs", borrowing cost on qualifying asset can be capitalised.

# IAS 8 — ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

## 1. INTRODUCTION

IAS 8 covers hierarchy for selection and application of accounting policies. This standard prescribes criteria for selecting and changing an accounting policy, treatment of changes in accounting estimate and corrections of errors by enhancing relevance and comparability over time and with the financial statements of other entities.

## 2. DEFINITIONS:

**Accounting policies** are the

- specific principles,
- bases,
- conventions,
- rules and
- practices

applied by an entity in preparing and presenting financial statements.

**A change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

**Material Omissions** or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission ormisstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

**Prior period errors** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.
- **Such errors include the effects of**
  - o Mathematical mistakes,
  - o Mistakes in applying accounting policies,
  - o Oversights or
  - o Misinterpretations of facts and fraud.

**Retrospective application** is applying a **new accounting policy** to transactions, other events and conditions **as if that policy had always been applied.**

**Retrospective restatement** is **correcting the recognition, measurement and disclosure** of amounts of elements of financial statements **as if a prior period error had never occurred.**

**Impracticable -** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

- The effects of the retrospective application or retrospective restatement are not determinable;
- The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

- The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
  - Provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognized, measured or disclosed; and
  - Would have been available when the financial statements for that prior period were authorised for issue from other information.

**Prospective applications of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:**

- **Applying the new accounting policy to transactions**, other events and conditions occurring after the date **as at which the policy is changed**; and
- Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

## 3. ACCOUNTING POLICIES

**Selection and application of accounting policies**

The hierarchy for selecting and applying accounting policies for transactions and other events is prescribed by this standard.

- If an IFRS specifically applies to a transaction, that IFRS shall be applied in determining the accounting policies.
- IFRSs are accompanied by guidance to assist entities in applying their requirements. All such guidance states whether it is an integral part of IFRSs. Guidance that is an integral part of the IFRSs is mandatory. Guidance that is not an integral part of the IFRSs does not contain requirements for financial statements.
- In the absence of an IFRS 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

  **(i)** **Relevant** to economic decisions of the users of financial statements

  **(ii)** **Reliable.**

- **While assessing relevance and reliability the following factors should be considered:**

  – Represent faithfully the financial position, financial performance and cash flows of the entity

  – Reflect the economic substance of transactions, other events and conditions and not merely legal form

  – Neutral i.e., free from bias

  – Prudent

  – Complete in all material respects

  For the purpose of attributes that management shall use in developing and applying accounting policies, the following shall be considered

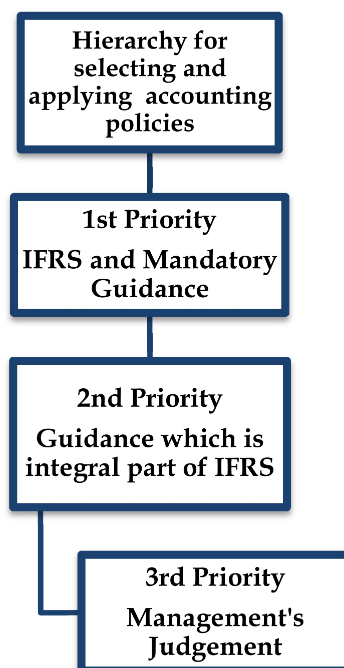
  – Requirements in other IFRS dealing with similar issues

  – Definitions, recognition, measurement criteria as set out in **Framework.**

  – Guidance from other standard setting bodies which has similar conceptual framework, for example, US GAAP

  – Other accounting literature and

  – Accepted industry practices.




## 4. CONSISTENT APPLICATION OF ACCOUNTING POLICIES

Such accounting policy selected by an entity is required to be applied consistently for all similar transactions and other events unless required by an IFRS to do so. . If an IFRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

## 5. CHANGES IN ACCOUNTING POLICIES

Consistency of application extends not only for similar transactions in a reporting period but also for transactions across different reporting periods. This consistency ensures better comparability for the users of financial statements. A change in an accounting policy hampers the comparability of financial statements of the entity. Hence, the change in an accounting policy is permitted only when:

- It is required by an IFRS or;
- It results in presenting more reliable and relevant information to the users.

## 6. APPLYING CHANGES IN ACCOUNTING POLICY

Change in accounting policy triggered by initial application of an IFRS is accounted for in accordance with the **transitional provisions** and **in the absence of transitional provisions or voluntary change** in accounting policy, **the accounting policy is applied retrospectively.**

## 7. VOLUNTARY CHANGE IN ACCOUNTING POLICY- EXAMPLES

- Change in accounting policy for inventory valuation from FIFO to weighted average cost.
- Changing from writing off to capitalization of interest relating to construction of non-current assets.

**EXAMPLE :**

**During 20X5, Menz Co has reported depreciation in its expenses. However, the directors feel that they should split depreciation into two parts i.e. depreciation on factory equipment and depreciation on office furniture. Depreciation on factory equipment will be reported in the cost of sales and depreciation on office furniture will be reported in expenses. The proposed financial statements are as follows:**

**Statement of comprehensive income**

| | 20X6 | 20X5 |
|---|---|---|
| | $ | $ |
| Sales | | |
| Cost of Sales | | |
| Add: Depreciation on equipment | X | |
| Gross profit | | |

| | | |
|---|---|---|
| **Expenses** | | |
| **Depreciation** | | **X** |
| **Depreciation on office furniture** | **X** | |
| **Profit** | | |

**Required:**
**Decide whether this is a permissible change.**
**Answer : Yes, as it will result into greater accuracy.**

## 8. THE FOLLOWING ARE NOT CONSIDERED AS CHANGES IN ACCOUNTING POLICIES:

1. The application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring **(E. g., introduction of a formal retirement gratuity scheme to replace adhoc ex-gratia payment)**

**EXAMPLE**

**ICC Ltd. manufactured bags until 20X5. It had 5 motor vehicles at that time which were used for the delivery of bags. ICC Ltd. classified all these motor vehicles as non-current assets in 20X5. However, in 20X6 shareholders have approved a proposal for a change in the nature of the business from manufacture of bags to sale of used motor vehicles. ICC Ltd classified all the existing 5 vehicles as current assets (not non-current assets) during 20X6 as they will be sold as part of normal business. This change in classification will not be treated as a change in accounting policy.**

2. The application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

**EXAMPLE:**

**If Healthcare Foundation obtains a government grant for the first time in 20X5, this grant will be dealt with in the financial books under IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance". This is a transaction which was not in existence in earlier years. Therefore it cannot be treated as a change in accounting policy.**

3. **REVALUATION OF ASSETS :** The initial application of a policy to revalue assets in accordance with IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets is a change in an accounting policy to be dealt with as a revaluation in accordance with IAS 16 or IAS 38, rather than in accordance with this Standard.

## 9. RETROSPECTIVE APPLICATION

Retrospective application of an accounting policy would mean a change in accounting policy being applied from the date when the transaction occurred initially. That is, as if the policy was applied from the inception of the transaction.

Accordingly, the opening balance of each of the component of equity (retained earnings) of the earliest comparative period presented is adjusted for the retrospective effect.

The comparatives and the current period transactions are presented according to the new accounting policy. The standard envisages the practical difficulty that could arise on such retrospective application and provides certain relaxations in cases of such impracticability.

## 10. IMPRACTICABILITY OF RETROSPECTIVE RESTATEMENT AND THE CONCERNED TREATMENTS

The grounds for impracticability of retrospective restatement and the concerned treatments are as follows:

- **Impracticability in determination of amounts affecting the prior period's comparative information that is presented** - period specific effects — the new accounting policy is applied to the carrying amounts of assets and liabilities at the beginning of earliest period presented for which retrospective application is possible.
- **Impracticability at the beginning of current period, in determination of cumulative adjustment of applying new accounting policy to all prior periods presented** - adjustments are made from the earliest date practicable.

## 11 . DISCLOSURES ABOUT ACCOUNTING POLICIES

An entity, on initial application of an IFRS, is required to disclose the following:

- Its title
- Nature of change in accounting policy,
- If transitional provision applies, its description and the extent of effect on future periods
- The effect of change for each line item affected and the respective basic & diluted earnings per share.
- If retrospective application is impracticable, an explanatory statement for the same.

**On voluntary change in accounting policy the entity is required to disclose additionally the reasons why application will result in more reliable and relevant financial information.**

When an entity has not applied a new IFRSs issued but is not effective, such fact, along with a reasonable estimate of impact application of new IFRS on the entity's financial statements is required to be disclosed.

**PROBLEM : 1**

**An entity starts a business in July 2X05. The business was small in nature and therefore the entity did not follow any specific accounting standards for valuation of inventory. Over the decade the entity flourishes, becomes a big company and decided to apply IAS 2 on inventories from the financial year 2X16-2X17. It decided to follow the weighted average method for valuation of inventory. Now following questions will arise.**

**i. Shall entity do such valuation retrospectively or prospectively?**

**ii. What is meant by retrospective application?**

**iii. If it is to be applied as if it was applied from July 2X05, then what about the accounts already presented? Does entity need to change all the accounts?**

**iv. How would the effect be given?**

**SOLUTION 1 :**

(i) It will depend upon whether the company is following the standard as per the new IFRS or is it applying voluntarily. In the above case, the entity itself is taking the decision to apply the standard and therefore it will be treated as **voluntary application.** If it falls under voluntary application then, IAS 8 states that the policy should be applied retrospectively.

(ii) As per definition, retrospective application assumes that the policy had always been applied. It does not state any specific period. 'Had always been applied' indicates that policy was applied right from the day 1, i.e. from July 2X05.

(iii) The entity is not supposed to change the accounts which are already presented. However, it needs to give the effect of the change in policy while presenting the accounts for the year in which new policy is adopted. In the current case, the new policy is adopted from the F.Y. 2X16-2X17. Therefore, the effect will be given to the concerned items, in the financial statements of F.Y. 2X16-2X17.

(iv) IAS 8 states that the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented.

**PROBLEM : 2**

**Continuing the above illustration, assume that company might be following the weighted average method of valuation of stock right from July 2X05. In reality, company might have applied other methods like specific identification, LIFO or FIFO etc. Company might have changed also the method during the period as it was not following any specific standard at that time. However, now, in F.Y. 2X16-2X17, the company decided to follow IAS and accordingly decides the weighted average method of valuation. Analyse**

**SOLUTION 2 :**

The company needs to calculate the closing inventory of every year since 2X05-2X06 assuming that it was following the said method from day 1.

This will change the figure of gross profit and net profit as inventory valuation will make direct impact on the

profits of the company. Net profits will affect the equity as well. Similarly, the closing balances of inventory from year to year will also change. Thus, company will make the calculations from the year 2X05-2X06 to 2X15-2X16.

The provisions further state that company will adjust the opening balances of equity and other related amounts for the **earliest prior period presented.** It means, if company is presenting the accounts for F.Y. 2X16-2X17, it need to give comparative figures for F.Y. 2X15-2X16 also. Therefore, the **earliest prior period presented** will be F.Y. 2X15-2X16 in the above mentioned case. Thus the net effect on profit of last 11 years (from F.Y. 2X05-2X06 to F.Y. 2X15-2X16) will be adjusted through the equity and inventory balances of the year 2X15-2X16.

Thereafter the new policy will be continued and every year the valuation of inventory will be done using weighted average method.

**PROBLEM : 3**

**During 20X2, Delta Co. changed its accounting policy for depreciating property, plant and equipment, so as to apply much more fully a components approach, whilst at the same time adopting the revaluation model.**

**In years before 20X2, Delta's asset records were not sufficiently detailed to apply a components approach fully. At the end of 20X1, management commissioned an engineering survey, which provided information on the components held and their fair values, useful lives, estimated residual values and depreciable amounts at the beginning of 20X2. However, the survey did not provide a sufficient basis for reliably estimating the cost of those components that had not previously been accounted for separately, and the existing records before the survey did not permit this information to be reconstructed.**

**Delta's management considered how to account for each of the two aspects of the accounting change. They determined that it was not practicable to account for the change to a fuller components approach retrospectively, or to account for that change prospectively from any earlier date than the start of 20X2. Also, the change from a cost model to a revaluation model is required to be accounted for prospectively. Therefore, management concluded that it should apply Delta's new policy prospectively from the start of 20X2.**

**Additional information:**

| | | |
|---|---|---|
| **(i)** | **Particulars Property, plant and equipment at the end of 20X1:** | |
| | **Cost** | **Rs 25,000** |
| | **Depreciation** | **Rs 14,000** |
| | **Net book value** | **Rs 11,000** |
| **(ii)** | **Prospective depreciation expense for 20X2 (old basis)** | **Rs 1,500** |
| **(iII)** | **Some results of the engineering survey:** | |
| | **Valuation** | **Rs 17,000** |
| | **Estimated residual value** | **Rs 3,000** |
| | **Average remaining asset life** | **7 years** |
| | **Depreciation expense on existing property, plant and equipment for 20X2 (new basis)** | **Rs 2,000** |

**You are required to prepare relevant note for disclosure in accordance with IAS 8.**

**SOLUTION 3 :**

**Extract from the notes**

From the start of 20X2, Delta Co. changed its accounting policy for depreciating property, plant and equipment, so as to apply much more fully a components approach, whilst at the same time adopting the revaluation model. Management takes the view that this policy provides reliable and more relevant information because it deals more accurately with the components of property, plant and equipment and is based on up-to-date values.

The policy has been applied prospectively from the start of 20X2 because it was not practicable to estimate the effects of applying the policy either retrospectively, or prospectively from any earlier date.

Accordingly, the adoption of the new policy has no effect on prior years.

The effect on the current year is to :

- increase the carrying amount of property, plant and equipment at the start of the year by Rs 6,000 (i.e. 17000- 11,000);
- create a revaluation surplus at the start of the year of Rs 6,000;
- increase depreciation expense by Rs 500 (i.e 2,000 – 1,500);

## 12. CHANGES IN ACCOUNTING ESTIMATES

Estimates are essential for providing a fair presentation of the financial statements, when financial information cannot be measured accurately. These accounting estimates require making certain judgments based on available and reliable information. There may be a change in judgment requiring change in the accounting estimates. By its nature estimates are bound for a change.

**For example, estimates may be required of:**

**(a) bad debts;**

**(b) inventory obsolescence;**

**(c) the fair value of financial assets or financial liabilities;**

**(d) the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and**

**(e) warranty obligations.**

- **The effect of change in accounting estimate is <u>recognized prospectively</u> in the profit or loss from the period of change.**
- **If the change affects items of assets, liabilities and equity, the carrying amounts are adjusted in the period of change.**
- **The nature and amount of change in an accounting estimate that has an effect in the current period or is expected to have in future periods is required to be disclosed.**
- For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period.
- However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life.
- **The entity shall state the fact, if it is impracticable to estimate impact on future periods.**
- **A change in accounting estimate thus does not relate to a prior period nor is it an error.**
- **A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.**

**PROBLEM : 4**

**An entity procures a second-hand machine and determines the depreciation charge based on the expected life of the machine. However, at a future period, the entity realises that the estimated life of the machine does not match the original estimate. As a result, there is a change in the rate of depreciation from 10% to 12%.**

**Required:**

**Can this change in the depreciation rate quality for retrospective restatement?**

SOLUTION 4 :

The change to the rate of depreciation cannot be carried out retrospectively since the circumstances and information available at the time of original estimation are different from the information and circumstances on the date of the change.

**PROBLEM : 5**

**The original cost of equipment is $115,000 and an estimated useful life of ten years with a nil residual value. It is depreciated on a straight line basis annually that comes to $11,500 p.a. The carrying amount of the equipment after three years will be $80,500.**

**It was decided in the fourth year that the remaining useful life of the equipment is only three years and not seven years.**

**Required:**

**State the accounting treatment of the asset in the books.**

SOLUTION 5 :

The depreciation should be charged in that year (and in the next two years) by bringing forward the carrying amount divided by the revised remaining useful life i.e. $80,500/3 = $26,833. The depreciation charged for the past three years should not be changed

The effect due to the increase in the annual depreciation from $11,500 to $26,833 in the current and the next two years should be disclosed.

## 13. ERRORS

Errors may pertain to recognition, measurement, presentation or disclosure of financial statements.

Errors include failure to use reliable and available information when the financial statements are authorized for issue, mathematical mistakes, mistakes in applying accounting policies, oversights, misinterpretation of facts and frauds.

**PROBLEM 6 :**

**Sunshine Enterprises prepares its financial statements by recording a purchase of a CNC machine during 20X5, worth Rs 50,000 under purchases instead of purchase of non-current assets and the error comes to light in the following accounting year. Discuss whether the change would warrant a prior period adjustment.**

SOLUTION 6 :

Considering the nature of the transaction and the value of the transaction, it is a material transaction. Therefore this is a prior period error.

**PROBLEM 7 :**

**Rose International is preparing its financial statements as at 31 December 20X5. Due to a change in the estimated life of the machinery, the company auditors decide to change the rate of depreciation from 10% to 15%. Discuss whether the change would warrant a prior period adjustment.**

SOLUTION 7 :

This transaction does not qualify for a prior period adjustment. This is because the change in the rate of depreciation is not a correction of an error or a change in the accounting policy. The determination of the rate of depreciation is based on 'estimates'.

**PROBLEM 8 :**

**Jupiter Ltd. is preparing its financial statements for 20X6. The management wishes to change the valuation of its inventory from the FIFO method to the Weighted Average method. Discuss whether the change would warrant a prior period adjustment.**

SOLUTION 8 :

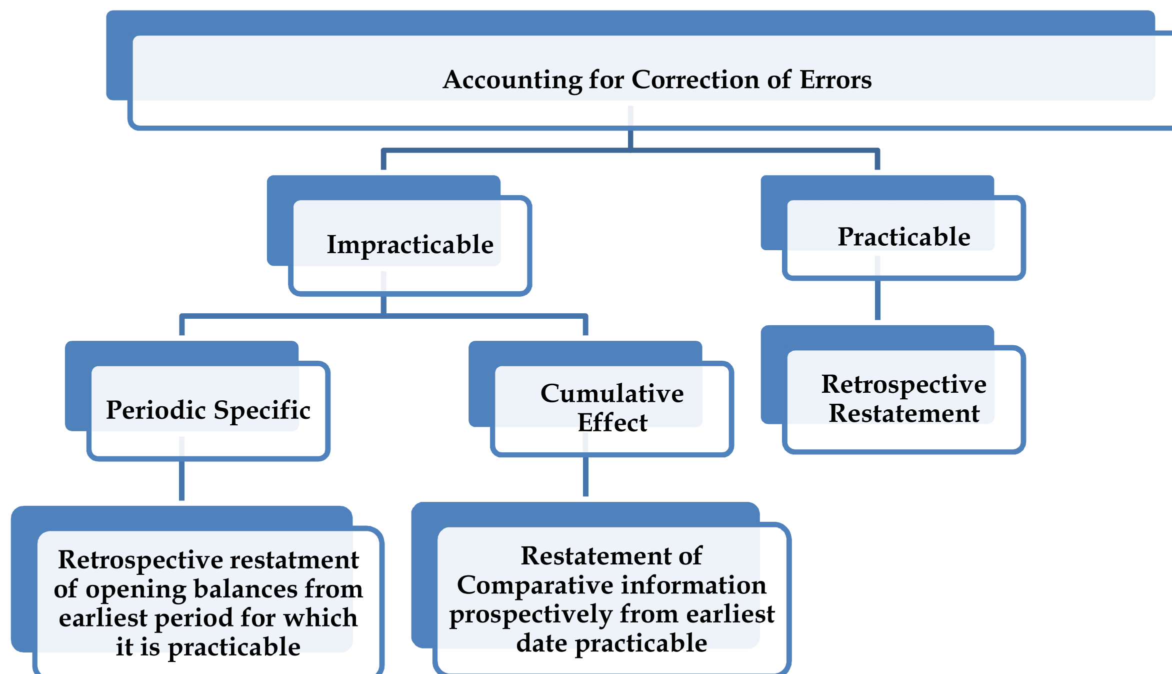
The above change in inventory valuation method falls under the purview of change in accounting policy.

## 14. ACCOUNTING FOR CORRECTION OF ERRORS

**Errors pertaining to prior periods are made good by restating the comparative information for prior periods presented, if it relates to that comparative period, or by restating the assets, liabilities and equity for the earliest prior period presented.**

Where it is impracticable to determine the period specific effects of an error, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable.

Where it is impracticable to determine the cumulative effect of an error on all prior periods, the entity shall restate the comparative information prospectively from the earliest date practicable.




## 15. DISCLOSURES ABOUT PRIOR PERIOD ERRORS

The entity is required to disclose the following:

- Nature of prior period errors
- Effect on each line item for the prior period presented and the basic & diluted EPS
- Amount of correction at the beginning of earliest prior period presented
- The fact of impracticability of retrospective restatement.

## 16. SIXTH COMPONENT OF FINANCIAL STATEMENTS

Whenever there is retrospective application of accounting policies or retrospective restatement of prior period errors, an additional element of financial statement in the form of SOFP as at the beginning of earliest comparative period is required to be presented.

**PROBLEM 9 :**

1. **During 20X2, Beta Ltd. discovered that some products that had been sold during 20X1 were incorrectly included in inventory at March 31, 20X1 at ₹ 6,500.**
2. **Beta's accounting records for 20X2 show sales of ₹ 1,04,000, cost of goods sold of ₹ 86,500 (including ₹ 6,500 for the error in opening inventory), and income taxes of ₹ 5,250.**
3. **In 20X1, Beta Ltd. reported:**
   - □ Sales of ₹ 73,500
   - □ Cost of goods sold of ₹ 53,500
   - □ Profit before income taxes of ₹ 20,000
   - □ Income taxes of ₹ 6,000
   - □ Profit of ₹ 14,000
4. **20X1 opening retained earnings was ₹ 20,000 and closing retained earnings was ₹ 34,000.**
5. **Beta's income tax rate was 30 per cent for 20X2 and 20X1. It had no other income or expenses.**
6. **Beta Ltd. had ₹ 5,000 of share capital throughout, and no other components of equity except for retained earnings. Its shares are not publicly traded and it does not disclose earnings per share.**

**You are required to prepare relevant extract from the statement of profit and loss and statement of changes in equity. Also what should be disclosed in the notes.**

**SOLUTION 9 :**

**Beta Ltd.**
**Extract from the statement of profit and loss** **(Amount in Rs)**

| | 20X2 | Restated 20X1 |
|---|---|---|
| Sales | 104,000 | 73,500 |
| Cost of goods sold | (80,000) | (60,000) |
| Profit before income taxes | 24,000 | 13,500 |
| Income taxes | (7,200) | (4,050) |
| Profit | 16,800 | 9,450 |

**Beta Ltd.**
**Statement of changes in equity** **(Amount in Rs)**

| | Share Capital | Retained Earnings | Total |
|---|---|---|---|
| Balance as at March 31, 20X0 | 5,000 | 20,000 | 25,000 |
| Profit for the year ended March 31, 20X1, as restated | ___ | 9,450 | 9,450 |
| Balance as at March 31, 20X1 | 5,000 | 29,450 | 34,450 |
| Profit for the year ended March 31, 20X2 | ___ | 16,800 | 16,800 |
| Balance as at March 31, 20X2 | 5,000 | 46,250 | 51,250 |

**Extract from the notes:**

Some products that had been sold in 20X0-20X1 were incorrectly included in inventory at March 31, 20X1 at rs 6,500. The financial statements of March 31, 20X1 have been restated to correct this error. The effect of the restatement on those financial statements is as summarised above. There is no effect in March 31, 20X2.

## 17. MAJOR CHANGE IN IND AS 8 VIS-À-VIS IAS 8

***Guidance to the Standard:*** Paragraph 9 of IAS 8 provides that IFRSs are accompanied by guidance to assist entities in applying their requirements. Guidance that is an integral part of IFRSs is mandatory. Guidance that is not an integral part of IFRSs does not contain requirements for financial statements. In Ind AS 8, paragraph 9 has been modified by not including the text given in the context of the guidance forming non-integral part of the Ind AS as such guidance has not been given in the Ind ASs.

## 18. PROBLEMS FOR SELF-PRACTICE

**PROBLEM 10 :**

**The Daily Press Ltd was incorporated on 1 January 20X9. The draft statement of financial position for the year ended 20Y0 and 20X9 is given below:**

| | 20Y0 | 20X9 |
|---|---|---|
| | $ | $ |
| **Property, plant and equipment** | 434 | 358 |
| **Research and development** | | 17 |
| **Other assets** | 1 349 | 1 ,350 |
| **Total assets** | 1 ,800 | 1,725 |
| **Share capital** | | |
| **Retained earnings** | | |
| **Year ended 20X9** | 150 | 150 |
| **Year ended 20Y0** | 75 | 75 |
| **Liabilities** | 75 | |
| | 1 500 | 1 ,500 |
| **Total equity and liabilities** | 1,800 | 1,725 |

**The following information is relevant:**

**During 20X9 the company had capitalised Research and Development costs. However during 20Y0, the company realised that the expense did not meet with the requirements of research and development.**

**Required:**

**Redraft the statement of financial positions after making the relevant changes.**

**SOLUTION 10 :**

This change in accounting policy should be applied retrospectively as follows (the tax implications as a consequence of this challenge have been ignored for the purposes of this illustration):

| | 20Y0 | 20X9 |
|---|---|---|
| | $ | $ |
| Property, plant and equipment | 434 | 358 |
| Research and development * | - | - |
| Other assets | 1 ,349 | 1 ,350 |
| Total assets | **1,783** | **1,708** |
| | | |
| Share capital | 150 | 150 |
| Retained earnings | | |
| Year ended 20X94 (WI ) | 58 | 58 |
| Year ended 20Y0 | 75 | |
| Liabilities | 1500 | 1500 |
| Total equit and liabilities | 1,783 | 1,708 |

**Wokrings**

**W1 Adjustment re-capitalised borrowing cost**

| | 20X9 |
|---|---|
| | $ |
| Retained earnings as given | 75 |
| Less: R & D expenses | (17) |
| **Balance c/f** | **58** |

Research and development (R & D) expenses have been expensed and therefore the R & D expenses shown in the statement of financial position for 20X9 and 20Y0 becomes nil.

**PROBLEM 11 :**

**The following partial statement of profit or loss and retained earning statement data ware obtained from the records of Mars Ltd for 20X6 and 20X5:**

| | 20X9 | 20X8 |
|---|---|---|
| | $ | $ |
| **Delivery expenses** | **15,000** | **42,000** |
| **Depreciation expenses** | **30,000** | **28,000** |
| **Income tax expenses** | **22,000** | **24,000** |
| **Net income** | **70,000** | **74,000** |
| **Retained earning statement** | | |
| **Retained earning – beginning** | **134,000** | **60,000** |
| **Add : Net income** | **70,000** | **74,000** |
| **Retained earning – ending** | **204,000** | **134,000** |

**During 20Y0, Mars Limited discovered that a delivery truck, purchased 20X8, was erroneously charged to Delivery Expense, The truck cost $30,000, had a 10 year life, and no salvage value. Mars Ltd uses the straight-line depreciation method. The income tax rate is 40%**

**Required:**

**Discuss and illustrate the accounting and financial reporting implications of this situation for Mars Ltd.**

**SOLUTION 11 :**

| Effect of error 20X8 | | Over / Under | Total |
|---|---|---|---|
| | $ | $ | $ |
| Statement of profit or loss: | | | |
| Delivery expense | 42,000 | (30,000) | 12,000 |
| Depreciation expense | 28,000 | 3,000 | 31,000 |
| Income tax expense W1 | 24,000 | 10,800 | 34,800 |
| Net income | 94,000 | (16,200) | 77,800 |
| Statement of financial position: | | | |
| Non-current assets | | 30,000 | |
| Accumulated depreciation | | (3,000) | |
| Net non-current assets | | 27,000 | |
| Income tax payable | | (10,800) | |
| **Retained earnings** | | 16,200 | |

| Effect of error 20X9 | Amount | Over / Under | Total |
|---|---|---|---|
| | $ | $ | $ |
| Statement of profit or loss: | | | |
| Delivery expense | 15,000 | | 15,000 |
| Depreciation expense | 30,000 | 3,000 | 33,000 |
| Income tax expense W2 | 22,000 | (1,200) | 20,800 |
| Net income | 67,000 | 1,800 | 68,800 |
| **Statement of financial position:** | | | |
| Non-current assets | | 30,000 | |
| Accumulated depreciation | | (6,000) | |
| Net non-current assets | 27,000 | 24,000 | 51,000 |
| Income tax payable | (10,800) | 1,200 | (9,600) |
| **Retained earnings** | **16,200** | **(25,200)** | **41,400** |

Statement of retained earnings

| | $ |
|---|---|
| Increase in depreciation | 6,000 |
| Increase in tax expenses | 9,600 |
| Increase in profit | 14,400 |
| Decrease in delivery expenses | (30,000) |
| Increase in non-current assets | 30,000 |
| Increase in accumulated depreciation | (6,000) |
| Increase in IT payable | (9,600) |
| **Increase in retained earnings** | **14,400** |

| **W1** | **20X8** |
|---|---|
| Decrease in delivery expenses | 30,000 |
| Increase in depreciation | (3,000) |
| Increase to income before tax | 27,000 |
| Increase in tax @ 40% | 10,800 |
| **W2** | **20X9** |
| Increase in depreciation | 3,000 |
| Decrease to income before tax | (3,000) |
| Decrease in tax @ 40% | 1,200 |

**PROBLEM 12 :**

**During 20X6, Dolly Co discovered that some products that had been sold during 20X5 were incorrectly included in inventory on 31 December 20X5 at $9,750.**

**Dolly's accounting records for 20X6 show sales of $1,56,000, cost of goods sold of $129,750, (including $9,750 for the error in opening inventory), and income taxes of $7,875.**

**In 20X5 Dolly reported**

| | $ |
|---|---|
| **Sales** | **10,250** |
| **Cost of goods sold** | **(80,250)** |
| **Profit before income taxes** | **30,000** |
| **Income taxes** | **(9,000)** |
| **Profit** | **21,000** |

**In 20X5 opening retained earnings were $30,000 and closing retained earnings were $51,000.**

**Dolly's Income tax rate was 30 percent for 20X6 and 20X5. It had no other income or expenses.**

**Dolly had $7,500 of share capital throughout, and no other components of equity except for retained earnings. Its shares are not publicly traded and it does not disclose earnings per share**

**Required:**

**Discuss and illustrate the accounting and financial reporting implications of this situation for Dolly Co,**

Revetrospective restatement of errors of Dolly Co

Extract from the SOPL

| | 20X6 | 20X5 |
|---|---|---|
| | $ | $ |
| Sales | 156,000 | 110,250 |
| Cost of goods sold | (120,000) | (90,000) |
| Profit before income taxes | 36,000 | 20,250 |
| Income taxes | (10,800) | (6,075) |
| **Profit** | **25,200** | 14,175 |

Dolly co

Statement of changes in equity

| | Share capital | Retained earning | Total |
|---|---|---|---|
| | $ | $ | $ |
| Balance on 31 December 20X4 | 7,500 | 30,000 | 37,500 |
| Profit for the year ended 31 December as restated | | 14,175 | 14,175 |
| Balance on 31 December 20X5 | 7,500 | 44,175 | 51 ,675 |
| Profit for the year ended 31 December 20X6 | | 25,200 | 25,200 |
| **Balance on 31 December 20X6** | **7,500** | **69,375** | **76,875** |

Extracts from the notes

Some products that had been sold in 20X5 were incorrectly included in inventory on 31 December 20X5 at $9,750. The financial statements of 20X5 have been restated to correct this error. The effect of the restatement on those financial statements is summarised below. There is no effect in 20X6.

| | 20X5 |
|---|---|
| | $ |
| (Increase) in cost of goods sold | 9,750 |
| Decrease in income tax expense | (2,925) |
| Decrease in profit | 6,825 |
| (Decrease) in inventory | (9, 750 |
| Decrease in income tax payable | 2,925 |
| Decrease in equity | 6,825 |

# IAS 10 — EVENTS AFTER THE REPORTING PERIOD

## 1. INTRODUCTION

Financial Statements are representative of the state of affairs and performance of an entity as on the reporting date. Invariably, there will be transactions and events that occur after reporting date but before the financial statements are issued to the public.

The standard provides guidance determining the period up to which such events should be considered, when an entity should adjust the financial statements for such events and when entity should not adjust, but need to disclose the fact.

## 2. EVENTS AFTER THE REPORTING PERIOD

**Events after the reporting period** are

- those events,
- **favorable and unfavorable**,
- that occur between the end of the reporting period (SOFP date) and the date when the financial statements are authorised for issue.

## 3. PROCESS INVOLVED IN AUTHORISING THE FINANCIAL STATEMENTS

The process involved in authorising the financial statements for issue will vary depending upon the management structure, statutory requirements and procedures followed in preparing and finalising the financial statements.

In some cases, an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been issued. In such cases, the financial statements are **authorised for issue** on the date of issue, not the date when shareholders approve the financial statements.

EXAMPLE : DATE OF BOARD AUTHORISATION FOR ISSUE

**The management of an entity completes draft financial statements for the year to 31 December 20X1 on 28 February 20X2. On 18 March 20X2, the board of directors reviews the financial statements and authorises them for issue.**

**The entity announces its profit and selected other financial information on 19 March 20X2.**

**The financial statements are made available to shareholders and others on 1 April 20X2.**

**The shareholders approve the financial statements at their annual meeting on 15 May 20X2 and the approved financial statements are then filed with a regulatory body on 17 May 20X2.**

**The financial statements are authorised for issue on 18 March 20X2 (date of board authorisation for issue).**

In some cases, the management of an entity is required to issue its financial statements to a **supervisory board** (made up solely of non-executives) for approval.

**In such cases, the financial statements are authorised for issue when the management authorises** them for issue to the supervisory board.

EXAMPLE: (DATE OF MANAGEMENT AUTHORISATION FOR ISSUE TO THE SUPERVISORY BOARD).

On 18 March 20X2, **the management of an entity authorises financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests.**

**The supervisory board approves the financial statements on 26 March 20X2.**

**The financial statements are made available to shareholders and others on 1 April 20X2.**

**The shareholders approve the financial statements at their annual meeting on 15 May 20X2 and the financial statements are then filed with a regulatory body on 17 May 20X2.**

**The financial statements are authorised for issue on 18 March 20X2 (date of management authorisation for issue to the supervisory board).**

Events after the reporting period include all events up to the date when the financial statements are authorised for issue, even if those events occur after the public announcement of profit or of other selected financial information.

## 4. TWO TYPES OF EVENTS CAN BE IDENTIFIED:

- **Adjusting events after the reporting period -** Those that provide evidence of conditions that existed at the end of the reporting period; and
- **Non-adjusting events after the reporting period -** Those that are indicative of conditions that arose after the reporting period.

## 5. ADJUSTING EVENTS

Adjustments are to be made for events that provide evidence of **conditions that existed at the end of the reporting period.**

The emphasis here is that the event provides evidence of conditions that existed at the date of balance sheet, though the event itself has arisen after the balance sheet date.

## 6. EXAMPLES OF ADJUSTING EVENTS:

- Settlement of a court case where the entity had a present obligation according to IAS 37 which may result either in adjusting earlier provision or create a new one.
- Bankruptcy of a customer after reporting period usually confirms that the customer was credit-impaired at the end of the reporting period.
- Sale of inventories after the reporting period gives an indication of the NRV.
- the determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date (IAS 19 Employee Benefits).
- Discovery of fraud or errors

**The management is required to make adjustments in the financial statements for such events.**

## 7. NON-ADJUSTING EVENTS

When the events are those that are **indicative of the conditions** that arose **after the reporting period**, these are called non-adjusting events.

An entity **should not adjust** the amounts recognized in its financial statements to reflect non-adjusting events after the reporting period.

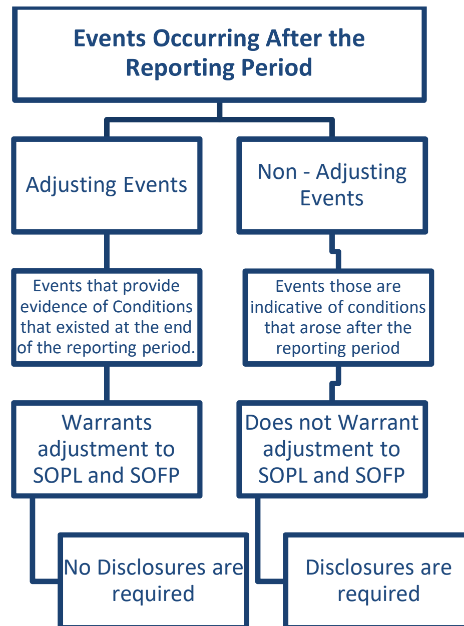
**For example** decline in the market value of investments after the end of reporting period but before the financial statementsare authorized for issue, is not required to be adjusted, because these are not indicative of conditions that existed at the end of reporting period.

## 8. EXAMPLES OF NON-ADJUSTING EVENTS

The following are the examples of non-adjusting events:

1. Major business combination after the reporting date;
2. Disposing of assets, subsidiary, associate or joint ventures;
3. Announcing a plan to discontinue an operation, or classification of assets as held for sale under **IAS 5** Non-current Assets held for Sale and Discontinued Operations.
4. Purchase of major assets;
5. Expropriation of major assets by the government
6. Destruction of major production plant or asset by a fire after the reporting period.
7. Announcing or commencing the implementation of major restructuring.
8. Major transaction in ordinary shares like offer of right, bonus, buy back, share split or fresh issue or potential share transaction like issue of stock option
9. Abnormally large change in the asset price or exchange rate.
10. Change in tax rate that affect deferred tax asset and liability significantly.
11. Major litigation arising from events occurring after the reporting period.

**Classification of Events Occurring After the Reporting Date**




## 9. DATE ON WHICH FINANCIAL STATEMENTS ARE AUTHORISED FOR ISSUE

The date when the financial statements are authorized for issue is the date of authorization by the directors or the management.

The date of declaration of profit or other financial informationto the public may be earlier than the date the financial statements are authorized for issue.

## 10. DIVIDENDS

Dividends declared to equity holders after the end of reporting period are not considered as liability at the end of reporting period (as there is no present obligation as per **IAS 37**).

Only a disclosure to that extent is required in the notes in accordance with **IAS 1.**

## 11. GOING CONCERN

The entity is not allowed to prepare the financial statements on a going concern basis if the entity intends to liquidate the entity or to cease trading or it has no realistic alternative but to do so after the reporting period but before the financial statements are authorized for issue.

In such cases there needs to be a **fundamental change in the basis of accounting** rather than an adjustment or a disclosure.

**Additional disclosures about the basis of preparation of financial statements and the management estimation of uncertainties are to be made in accordance with IAS 1.**

## 12. DISCLOSURES

In the notes to accounts:

- **Date of approval for issue**
- **Identification of the appropriate level of management which gave the authorization.**
- **The fact that the financial statements can be altered either by owners or others (this may be possible by the concerned jurisdiction laws)**
- Where non-adjusting events are material and the nondisclosure of which could influence the economic decisionsof the users, the nature and an estimate of financial impact shall be given

## 13. UPDATING DISCLOSURE ABOUT CONDITIONS AT THE END OF THE REPORTING PERIOD

The disclosures already made in the notes to accounts shall be updated on receipt of information about the conditions that existed at the end of reporting period.

One example of the need to update disclosures is when evidence becomes available after the reporting period about a contingent liability that existed at the end of the reporting period. In addition to considering whether it should recognise or change a provision under IAS 37, an entity updates its disclosures about the contingent liability in the light of that evidence.

## 14. MAJOR CHANGE IN IND AS 10 VIS-À-VIS IAS 10 RESULTING IN CARVE OUT

*As per IFRS:* Rectification of any breach after the end of the reporting period is a nonadjusting event.

*Carve Out:* As a consequence to carve-out (resulted in carve out) stated in Ind AS 1 above, Ind AS 10 provides, in the definition of Events after the reporting period' that in case of breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.

# PROBLEMS FOR SELF PRACTICE

**QUESTION 1 :**

**A case is going on between ABC & Co and Tax department on claiming the exemption for certain goods, for the year 20X1-20X2. The court has issued the order on 15th April and rejected the claim of the company. Accordingly, company is liable to pay the additional tax. Shall company account for such tax in the year 20X1-20X2 or shall it account for in the years 20X2-20X3?**

**SOLUTION : 1**

To decide whether, the event is adjusting or not adjusting two conditions need to be satisfied,

(a) There has to be evidence

(b) The event must have been related to period ending on reporting date.

Here both the conditions are satisfied. Court order is a conclusive evidence and the liability is related to earlier year. Therefore, the event will be considered as adjusting event and accordingly the amounts will be adjusted in accounts.

**QUESTION 2:**

**Company has 100 finished cars on 31st March, 20X2, which is having a cost of $ 4,00,000 each. On 30th of April, new guidelines of pollution control are implemented (which was already expected to come) and as per the new government rules, the cars which do not satisfy the conditions of using new engines which emit less carbon-dioxide are totally banned for the sale. Therefore, the demand for such cars drops drastically and selling price came down to $3,00,000. The accounts of the company for the year 20X1-20X2 are not yet approved. Shall company value its stock at $ 4,00,000 each or shall it value at $3,00,000 each?**

**SOLUTION : 2**

Since the changed conditions provide the evidence about the net realizable value of the cars and therefore the amount of $ 3,00,000 should be considered for the valuation of stock.

**QUESTION 3 :**

**ABC Ltd. has purchased the new machinery during the year 20X1-20X2. The asset was finally installed and made ready for use on 15th March 20X2. However, the company involved in installation and training, has not yet submitted the final bills for the same.**

**The supplier company sent the bills on 10th April 20X2, when the accounts were not yet approved. Shall the company include the amount of capitalization in the year 20X1-20X2 or in the year 20X2-20X3?**

**SOLUTION : 3**

As per the above provisions, the cost of installation and training of new machine was an integral part of the cost of asset purchased. Therefore, even if the details are available after reporting period, they provide proof about the circumstances that existed at the end of reporting period.

Therefore, the cost will be considered for the year 20X1-20X2.

**QUESTION 4 :**

**ABC Co declares the dividend on 15th July 20X2 as the results of year 20X1-20X2 as well as Q1 ending 30th June 20X2 are better than expected. The accounts of the company are approved on 20th July 20X2 for the financial year ending 31st March 20X2. State, whether the dividend will be accounted in F.Y. 20X2-20X3 or will it be considered as proposed dividend and accounted in the year 20X1-20X2?**

**SOLUTION : 4**

As per the interpretation of the provision of Ind AS 10, the dividend is declared in the year 20X2-20X3. Therefore, the event did not exist on the end date of reporting period i.e. on 31st March 20X2. Therefore, it will be accounted in the year 20X2-20X3 and not in 20X1-20X2, even if accounts of 20X1-20X2 were approved after the declaration of dividend.

**QUESTION 5 :**

**ABC Ltd. has announced its Interim results for Quarter 1, ending 30th June 20X2 on 5th July 20X2. However, till that time the AGM for the year 20X1-20X2 was not held. The accounts for 20X1-20X2 were approved by the board of directors on 15th July 20X2. What will be the period after the reporting date as per the definition of IAS 10?**

**SOLUTION : 5**

As per IAS 10, even if partial information is published, still the reporting period will be considered as the period between end date of reporting period and approval of accounts. In the above case the accounts are approved on 15th July. Therefore, the period after the reporting date would be 31st March to 15th July.

**QUESTION 6 :**

**ABC Ltd. is in the legal suit with the excise department. Company gets a court order in its favour, on 15th April 20X2, which resulted into reducing the excise liability as on 31st March 20X2. The management has not considered the effect of the transaction as the event is favourable to the company. Company's view is favourable events after the reporting date should not be considered as it would hamper the realization concept of accounting. Comment in the light of IAS 10?**

**SOLUTION : 6**

As per IAS 10, even favourable event needs to be considered. What is important is whether the conditions exists as on the end of the reporting period and there is a conclusive evidence for the same.

**QUESTION 7 :**

**ABC Ltd. is trading company in Laptops. On 31st March 20X2 company has 50 laptops which were purchased at $45,000 each. Company has considered the same price for calculation of closing inventory. On 15th April 20X2, advanced version of same series of laptops is introduced in the market. Therefore, the price of the current laptops crashes to $ 35,000 each. Company does not want to value the stock as $35,000 as the event of reduction took place after the 31st March 20X2 and the reduced prices were not applicable as on 31st March 20X2. Comment**

**SOLUTION : 7**

As per IAS 10, the decrease in the net realizable value of the stock after reporting period should be considered as adjusting event.

**QUESTION 8 :**

**JCB manufactures and sales earth moving machines. The machines are dispatched on 25th March 20X2 for exports. The machines reached the customer on 15th April 20X2. The details of the price of sale, foreign exchange rate etc. are available on 4th April 20X2. The accounts were approved by the management on 15th May 20X2. Shall company consider it as the sale of 20X1-20X2 and adjust the accounts for the information received on 4th April or not?**

**SOLUTION : 8**

As per IAS 10, any information received after the reporting period for determining purchase of cost or sale of asset, related to earlier financial year, should be considered as an adjusting event.

**QUESTION : 9**

**L Ltd had provided for a bad debt of $50,000 towards the total amount of $90,000 receivable from M at the end of reporting period, i.e. 31 December 2019. The financial statements were authorised on 3st July 2020. In the meanwhile, M was declared insolvent on 30 June 2020 and nothing could be recovered from it.**

**Required:**

**Is this an adjusting event? State the reasons.**

**SOLUTION : 9**

This is an adjusting event because on 30 June 2020:

- it indicates that the previously recognised loss at the end of reporting period needs to be adjusted the financial
- statements have not yet been authorised for issue (financial statements are authorised for issue on 31 July 2020).

**QUESTION : 10**

**Sham Ltd, is being sued for anti-competitive behavior. This is denied by Sham Ltd, and only a contingent liability was shown in the financial statements on 31 December 20X8.**

**On 14 January the court awards $70 million as damages against Sham Ltd The date for the approval of the financial statements by the management for the issue to the Supervisory Board is March 9, 20X9.**

**Required:**

**Determine whether the event has occurred before or after the reporting period and give the accounting entries and the disclosures.**

**SOLUTION : 10**

This is an event occurring after the end of reporting period but before approval of the financial statements for issue. This event affects the valuation of company's liabilities. Hence this is an adjusting event. Sham Ltd must create a provision for $70 million in the financial statements for 20X8, to replace the contingent liability.

**ACCOUNTING ENTRY**

| | | |
|---|---|---|
| Dr Legal cost account | $70m | |
| Cr Provision account | | $70m |

Being creation of a provision on account of court order dated 14 January 20X9

**Disclosure**

The company had a contingent liability of $70 million on 31 December 20X8, in respect of the court case. The court order was passed on 14 January 20X9, according to which a liability of $70 million became payable. Since this happening related back to the reporting date, i.e. 31 December 20X8, the company provided for the liability, of $70 million rather than treating it as a contingent liability in its financial statements.

**QUESTION : 11**

**Sun Engineering was preparing its financial statements for 20X8. The company's lathe machine is under repair. Its carrying value in the books is $175,000. While the financial statements are under preparation, on 27 January 20X9, the company is informed that the machine is irreparable and the scrap value is $25,000**

**Required:**

**Discuss how this would be dealt with in the books. Give the accounting entries.**

**SOLUTION : 11**

The financial statements are not authorised for issue. Also it is an event after the reporting period and it affects the valuation of the asset at the end of reporting period. Hence it is an adjusting event. Therefore Sun engineering would have to reduce the carrying cost of the machine to $25,000.

**Accounting entry**

The following accounting entry would have to be recorded in the financial books of the company:

| | | |
|---|---|---|
| Dr Impairment loss on lathe machine Account | $150,000 | |
| Cr Lathe machine | | $150,000 |

(Being impairment loss on lathe machine recognised)

**QUESTION : 12**

**Sona Lights has prepared its financial statements for the period to 31 December 20X9.**

**On 28 January 20Y0 (before the authorisation of the financial statements), the directors declare dividends totalling $2 million.**

**Required:**

**Explain whether this is an adjusting event or a non-adjusting event and mention the effect of this event In the financial statements.**

**SOLUTION : 12**

In accordance with IAS 10, proposed dividends are not to be recorded in the books by way of a liability. Therefore it is a non-adjusting event.

The financial statements do not warrant any adjustment entries.

However the notes to financial statements should disclose the amount of proposed dividends In the note on retained earnings.

**QUESTION : 13**

**Exchange rates plummeted on 2 October 20X7. As a result, the market value of an investment held by Venus Ltd decreased by $3 million and continued at the same level until the date of authorisation of the company's financial statements on 12 December 20X7. The value of the investments as at 30 September 20X7 was $5 million.**

**Required:**

**How will this event be dealt with in the financial statements of Venus Ltd at 30 September 20X7? Give the necessary disclosures to be made in the financial statements.**

**SOLUTION : 13**

This is an event after the end of the reporting date. The event does not affect the value of the company's assets / liabilities on the date of the statement of financial position. However, this is a significant event, which will influence the financial position of the company in the future, Hence a disclosure regarding the post-statement of financial position decline in the value of investments is to be made in the financial statements.

**Disclosure**

The value of stocks held in Venus Ltd is $5 million as at the end of the reporting date. However, due to a crash in the foreign currency markets and the stock exchanges during October 20X7, the value declined to $3 million and continued at the same level until the date of approval of financial statements of the company on 12 December 20X7.

**QUESTION : 14**

**Delta is an entity which prepares financial statements till 30 September each year, Each year the financial statements are authorised for issue on 30 November. During the year ended 30 September 2013 the following transactions occurred:**

**On 1 April 2013, Delta subscribed for 40 million $ 1 loan notes in Epsilon. The loan notes were issued at 90 cents and under the terms of issue were redeemable at $ 1.20 on 31 March 2018. Interest is payable on 31 March in arrears at 4% of par value. This represents an effective annual rate of return for Delta of 9.9%.**

**Delta's intention is to hold the loan notes until redemption. Until 31 October 2013 Epsilon was a successful company with a good reputation for settling all of Its liabilities on their due dates. However, due to an event which occurred on 31 October 2013, three of Epsilon's major customers became insolvent and this caused liquidity problems for Epsilon. During November 2013 Epsilon entered into negotiations with all its creditors, including Delta. Delta agreed to forego the interest payments due on 31 March 2014 and 2015, with the payments from 31 March 2016 onwards resuming as normal.**

**Explain and show how the event would be reported in the financial statements of Delta for the year ended 30 September 2013.**

SOLUTION 14 :

The asset will be recognised and measured under IFRS 9 Financial Instruments. Effect of impairment is not adjusted as it is a non-adjusting event as it gives evidence of conditions arising after the end of the reporting period.

Therefore the financial statements are not adjusted but Delta should disclose the nature of the event and an estimate of its financial effect as non-disclosure could influence the economic decisions which the users of the financial statements might make.

**QUESTION : 15**

**On 10 April 2012, a water leak at one of Delta's warehouses damaged a consignment of inventory. This inventory been manufactured prior to 31 March 2012 at a total cost of $800,000. The net realisable value of the inventory prior to the damage, was estimated at $960,000. Because of the damage Delta was required to spend a further $150,000 on repairing and re-packaging the inventory, The inventory was sold on 15 May 2012 for proceeds of $900,000. Any adjustment in respect of this event would be regarded by Delta as material.**

**Explain and show how the event would be reported in the financial statements of Delta for the year ended 31st March 2012.**

SOLUTION 15 :

The event causing the damage to the inventory occurred after the reporting date. Under the principles of IAS 10 — Events after the Reporting Date — this is a non-adjusting event as it does not affect conditions at the reporting date.

Non-adjusting events are not recognised in the financial statements, but are disclosed where their effect is material.

## MCQs

**1. IAS 10 identifies the period covered by the events as starting immediately after the reporting period, and ending on the date of:**

(A) Issue of the financial statements.

(B) Approval of the financial statements for issue.

(C) Publication of the financial statements.

2. (A) On 29 January 20X9, the management of a company completes draft financial statements for the to 31st December 20X8.

(B) On 4 February 20X9, the board of directors reviews the financial statements and approves them for announced on 19 March 20X9.

(C) On 15 February 20X9, the company announces its profit. Other selected financial information is announced on 19 March 20X9.

(D) On 18 March 20X9, the financial statements are made available to shareholders, and others.

(E) On 25 April 20X9, the shareholders approve the financial statements at the annual meeting.

(F) On 29 April 20X9. the approved financial statements are then filed with a regulatory body.

Which of the above dates marks the end of the period covered by IAS 10?

**3. There is a settlement, after the reporting period, of a court case that confirms that the company had a present obligation at the end of reporting period. You need to:**

(A) adjust the financial statements.

(B) leave the financial statements, but note the details.

(C) ignore it.

**4. You learn of the bankruptcy of a customer that occurs after the reporting period -You need to:**

(A) adjust the financial statements.

(B) leave the financial statements, but note the details.

(C) ignore it.

**5. You learn of a change to the proceeds from assets sold; before the reporting period, You need to:**

(A) adjust the financial statements.

(B) leave the financial statements, but note the details.

(C) ignore it.

**6. You learn of a decline in market value of investments, between the reporting period, and the date when the financial statements are approved for issue. You need to**

(A) adjust the financial statements.

(B) leave the financial statements, but disclose in notes to accounts.

(C) ignore it.

**7. You announce plans to reorganise your group, between the reporting period, and the date when the financial statements are approved for issue. The plans include the disposal ot a major division. You need to:**

(A) adjust the financial statements.

(B) leave the financial statements, but disclose in notes to accounts.

(C) ignore it.

**8. 5% of your assets are held in Euros. Your currency loses 1% of its value against the Euro, before the financial statements are approved. You need to:**

(A) adjust the financial statements.

(B) leave the financial statements, but disclose in notes to accounts.

(C) ignore it as it does not have a material effect on the financial statements. The value of the assets for which there is euro loss is only 5% of the total assets. The euro currency loss is just 1% of the assets facing the currency loss.

## MCQs - SOLUTION

1. The Correct option is **(B)**
2. The Correct option is **(B)**
3. The Correct option is **(A)**
4. The Correct option is **(A)**
5. The Correct option is **(A)**
6. The Correct option is **(B)**
7. The Correct option is **(B)**
8. The Correct option is **(C)**

# IAS 16 PROPERTY, PLANT AND EQUIPMENT

## 1. INTRODUCTION

Property, Plant & Equipment (PPE) are held for productive use and intended to be used for more than one accounting period. They are not made available for sale in the ordinary course of business. IAS 16 prescribes specific accounting treatment PPE. The principal issues addressed are recognition of assets, determination of carrying amounts, depreciation charge and impairment losses to be recognized.

## 2. SCOPE

This Standard shall be applied in accounting for property, plant and equipment except when another Standard requires or permits a different accounting treatment.

This Standard does not apply to:

(a) property, plant and equipment classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

(b) biological assets related to agricultural activity other than bearer plants (see IAS 41 Agriculture). This Standard applies to bearer plants but it does not apply to the produce on bearer plants.

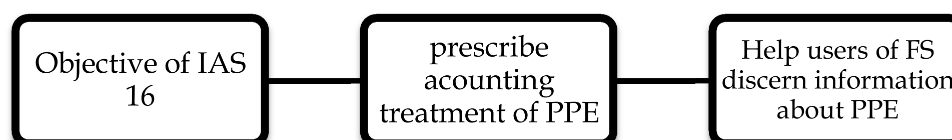
(c) the recognition and measurement of exploration and evaluation assets (see IFRS 6 Exploration for and Evaluation of Mineral Resources).

(d) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b)–(d).

An entity using the cost model for investment property in accordance with IAS 40 Investment Property shall use the cost model in this Standard for owned investment property.

## 2. OBJECTIVE




## 3. DEFINITIONS

**Carrying amount** is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.

| Cost | xxx |
|---|---|
| Less : accumulated depreciation | xxx |
| Less : Accumulated impairment loss | xxx |

**Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 **Share-based Payment.**

**Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.

**Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life.

**Entity-specific value** is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

**Fair value** is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

**An impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

**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.

**Recoverable amount** is the higher of an asset's net selling price and its value in use.

**The residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**Useful fife is:**

The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from the asset by an entity.

**A bearer plant** is a living plant that:

(a) is used in the production or supply of agricultural produce;

(b) is expected to bear produce for more than one period; and

(c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

## 4. FOUR AREAS ADDRESSED IN THIS STANDARD

1. The amount at which the assets should be recorded initially on **acquisition**
2. How **value changes** subsequent to acquisition should be reflected in the accounts for both value increases and decreases
3. **Allocation of expense** over future periods as **depreciation charge**
4. Recording of the ultimate **disposal of assets**

## 5. RECOGNITION

An entity can recognise the cost of an item of PPE as an asset only if it satisfies two conditions (recognition criteria):

- **The entity expects future economic benefits from that item of PPE.**
- **The cost of that item can be measured reliably.**

Judgment has to be exercised by individual entities for determining whether individual items qualify as an item of PPE.

The aggregation criteria can be applied for insignificant items to capitalize as an asset.

## 6. TREATMENT OF SPARE PARTS AND STAND-BY EQUIPMENT

| TYPES OF SPARES PARTS | ACCOUNTING TREATMENT |
|---|---|
| 1. Major spares and stand by equipments which are expected to be used for period over more than one accounting periods. | To be recognised as property, plant and equipment and depreciated over their useful lives. |
| 2. Spares parts and servicing equipment which can be used only in connection with a particular item of property, plant and equipment (i.e. non-inter changeable items) | To be recognised as property, plant and equipment and depreciated over the periods not exceeding the remaining useful life of the related asset. |
| 3. Other items of spare parts and servicing equipment | • Expensed on use.<br>• Unused items from part of inventory. |

**PROBLEM 1:**

**Comment on whether the following items purchased by an entity can be recognised as property, plant and equipment:**

**(a) Small spares for Rs 5,000.**

**(b) Standby equipment expected to be used for 3 years.**

**SOLUTION 1 :**

Costs of items that do not directly result in future economic benefit to the entity, but is required for future economic benefits derived out of other assets is also capitalised.

**EXAMPLE 1:**

**Chemical handling plant installed by a chemical manufacturer to comply with environmental requirements does not directly result in future economic benefits.**

## 7. MEASUREMENT AT INITIAL RECOGNITION

PPE is initially recognized **at cost**. Historical cost comprises of

- The **purchase price** (cash price alone if terms are on deferred credit basis),
- **Non-refundable taxes** after deducting trade discounts and rebates
- **Cost directly attributable** to bringing the asset to the present location and condition and
- **Estimated cost of dismantling, restoration** of the site on which it is located.

**Examples of directly attributable costs are:**

(a) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

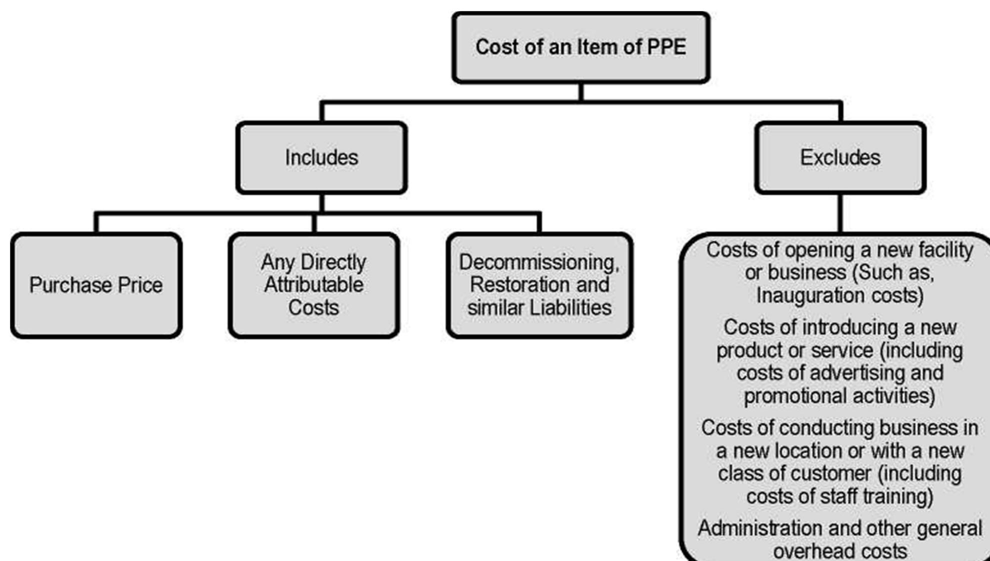
(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees




## 8. DISCOUNTING IN CASE PAYMENT IS DEFERRED BEYOND NORMAL CREDIT TERMS:

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with IAS 23.

**PROBLEM : 2**

**ASF Ltd purchased a plant for Rs 200 million. The seller granted rebate 0.5%. The gross price includes GST Rs 18 Million for which the buyer will get tax refund and non-refundable GST of Rs 10 million. It has also incurred Rs 15 million for transport, Rs 5 million for installation and 3 million for testing and professional fee. It has earned Rs 0.2 million from selling goods produced out of testing. The company borrowed Rs 100 million for financing new plant @ 10%. The entire process of purchasae to make the operational took 15 months. The company earned Rs 0.1 million from short-term parking of money borrowed pending payment to supplier and meeting all costs.**

**What should be initial cost of the plant ?**

SOLUTION : 2

**PROBLEM : 3**

**The purchase price of a machine is Rs 110,000. Other costs are as follows: freight Rs 2,000, import duty Rs 5,000, installation expenses Rs 1,000. These are all initial costs. What will be the cost of machinery?**

SOLUTION : 3

**PROBLEM : 4**

**The total price paid for machinery is Rs 110,000; this is the basic price of Rs 100,000 plus Value Added Tax (VAT) of Rs 10,000. The entity gets a credit of VAT paid on the machinery, while calculating the tax payable on the 'finished goods sold. Tax paid of Rs 10,000 while purchasing the machinery will be treated as refundable and hence not included in the cost of machinery. What will be the cost of machinery?**

SOLUTION : 4

**PROBLEM : 5**

**The total cost of a large computerised machine is Rs 40,000. Butter Co do not have enough cash, so agree to pay for it a year later, however they will pay Rs 45,000. Explain Treatment.**

**SOLUTION : 5**

**PROBLEM : 6**

**Rohan Ltd set up fire safety devices around its factory premises. The price paid for devices is Rs 110,000 (Rs 100,000 plus VAT of $10 000). The entity pets a credit of Rs 10,000 while calculating the tax payable on the finished goods sold.**

**Additional costs are freight Rs 2,000, import duty Rs 5,000, installation expenses Rs1,000. The initial estimate of dismantling and removing the item is Rs 3,000. After the machine was put to use, Rs 1,500 was spent for maintenance. Calculate the initial cost of the asset as per IAS 16 :**

**SOLUTION : 6**

**PROBLEM 7 :**

**On March 01, 2009, X Ltd. purchased Rs.5 lakhs worth of land for a factory site. Company demolished an old building on the property and sold the material for Rs.10,000. Company incurred additional cost and realized salvaged proceeds during the March 2009 as follows:**

| | |
|---|---|
| **Legal fees for purchase contract and recording ownership** | **Rs. 25,000** |
| **Title guarantee insurance** | **Rs. 10,000** |
| **Cost for demolition of building** | **Rs. 50,000** |

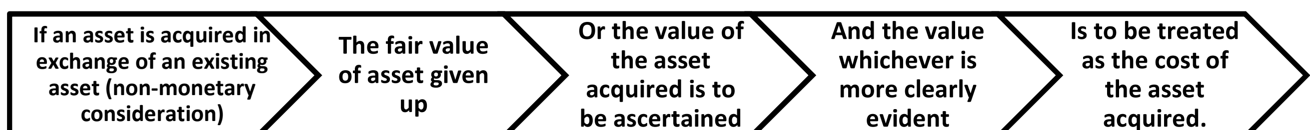
**Compute the balance to be shown in the land account on March 31, 2009 SOFP.**

**SOLUTION 7 :**

**Calculation of the cost for Purchase of Land**

| **Particulars** | | **Rs.** |
|---|---|---|
| Cost of Land | | 500,000 |
| Legal Fees | | 25,000 |
| Title Insurance | | 10,000 |
| Cost of Demolition | 50,000 | |
| Less: Salvage value of Material | 10,000 | 40,000 |
| Cost of the Asset | | 5,75,000 |

## 9. COST OF PPE IN EXCHANGE TRANSACTION



If property, plant and equipment is acquired in exchange for a non-monetary asset, it should be recognised at its fair value unless

(a) the exchange transaction lacks commercial substance or

(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

**PROBLEM 8 :**

**Entity A exchanges surplus land with a book value of ₹10,00,000 for cash of ₹20,00,000 and plant and machinery valued at ₹25,00,000. What will be the measurement cost of the assets received?**

**SOLUTION 8 :**

Since the transaction has commercial substance. The plant and machinery would be recorded at ₹ 25,00,000, which is equivalent to the fair value of the land of ₹ 45,00,000 less the cash received of ₹ 20,00,000.

**PROBLEM 9 :**

**Entity A exchanges car X with a book value of ₹13,00,000 and a fair value of ₹13,25,000 for cash of ₹15,000 and car Y which has a fair value of ₹13,10,000. The transaction lacks commercial substance as the company's cash flows are not expected to change as a result of the exchange. It is in the same position as it was before the transaction. What will be the measurement cost of the assets received?**

**SOLUTION 9 :**

The entity recognises the assets received at the book value of car X. Therefore, it recognises cash of ₹ 15,000 and car Y as PPE with a carrying value of ₹ 12,85,000

**PROBLEM 10 :**

If one fixed asset is taken in exchange for another fixed asset say for Ex. Machine 'A' is taken in exchange for Motor Car 'B', which has a book value of Rs. 1,50,000. Fair value of car given up is 1,70,000. Fair value of machine 'A' is Rs. 1,80,000. Fair value of Machine is more evidently known. Journalise.

**SOLUTION : 10**

| | | | |
|---|---|---|---|
| Machine 'A' a/c | Dr. | 1,80,000 | |
| To Motor car a/c | | | 1,50,000 |
| To P&L a/c | | | 30,000 |

**PROBLEM : 11**

If a machine is taken by issuing 1000 equity shares of Rs. 100 each. Then fair value of Machine or fair value of securities given up whichever is more evidently (reliably) known will be considered say it is Rs. 1,50,000. Journalise.

**SOLUTION : 11**

| | | | |
|---|---|---|---|
| Machine a/c | Dr. | 1,50,000 | |
| To Equity share capital a/c | | | 1,00,000 |
| To Securities premium a/c | | | 50,000 |

**PROBLEM : 12**

**X Ltd. purchased a machinery and 10,000 equity shares of the company has been issued as a consideration. Market price of equity share of par value of Rs. 10 is Rs. 12.**

**Fair market value of machinery (checked from the price quotation as well as latest transaction price of the seller) is Rs. 1,10,000.**

**Find out the value of the PPE to be recognised at initial recognition.**

**SOLUTION : 12**

**PROBLEM : 13**

**A piece of machinery is acquired in exchange for a plot of land. The fair value of the machinery is agreed at Rs 200,000 and the fair value of the plot at Rs 250,000 (its book value is Rs 225,000). The difference of Rs 50,000 is to be settled by cash. What is the cost at which the machinery acquired will be recorded at?**

**SOLUTION : 13**

**PROBLEM 14 :**

**PQR Ltd. has purchased a machinery for Rs. 20,00,000. The price was agreed to be paid in 3 months. On due date, due to liquidity crunch, the company was unable to pay the amount on time. The supplier however, agreed to take allotment 10,000 fully-paid equity shares @ Rs. 10 of the company in fully and final settlement. The shares are listed and the day of allotment was Rs. 300 as per share. What should be the amount at which the Machinery should be recorded?**

**SOLUTION 14 :**

The transaction must be treated as if the amount of Rs. 20,00,000 was paid on or due date to supplier and he paid back the amount of Rs. 20,00,000 and obtain allotment of shares. This is the substance of the transaction.

In view of this, the machinery must be continued to be reflected at Rs. 20,00,000 and no adjustment to be made to its cost.

| **The journal entry will be:** | **Dr.** | **(Rs.)** | **Cr. (Rs.)** |
|---|---|---|---|
| Supplier for Machinery | Dr. | 20,00,000 | |
| To Equity shares capita a/c (10,000 x Rs. 10) | | | 1,00,000 |
| To Securities premium account | | | 19,00,000 |

**PROBLEM 15 :**

**XYA Ltd. Has a machine whose book value is Rs. 1 lakh. It intends to acquire a new machine (new model). The new model is priced at Rs. 20 lakhs. The vendor is wiling to give credit of Rs. 20,000 if the old machine is traded in, how is the new machine to be recorded?**

**SOLUTION 15 :**

| | | | |
|---|---|---|---|
| New machine a/c | Dr. | 20.00 | |
| Loss on exchange | Dr. | 0.80 | |
| To old machine a/c | | | 1.00 |
| To Cash / Bank | | | 19.80 |

**<u>If it is not possible to ascertain the FV, then Net Book Value of asset given up can also be treated as cost of acquisition.</u>**

**Consider the following chart**

| Possible situations | 1 | 2 | 3 | 4 |
|---|---|---|---|---|
| Fair value of asset acquired | 12.00 (more clearly evident) | Not clearly evident | 12.00 | Not measured at fair value |
| Fair value of asset given up | 10.00 | 10.00 | Not clearly evident | Not measured at fair value * |
| Carrying amount of asset | 8.00 | 8.00 | 8.00 | 8.00 |
| Cost is measured at: | 12.00 | 10.00 | 12.00 | 8.00 |

## 10. SELF-CONSTRUCTED ASSETS

In case of self-constructed assets, all the costs directly attributable to the specific asset and allocated costs are to be included. The internal profit included in cost is to be eliminated.

**PROBLEM : 16**

**An X department transfer's material to the Y department at a profit of 15%, and Y uses the materials in manufacturing products for sale. One such product is to be used by the company as a non-current asset. The average transfer cost of the material received by Y from X per product is Rs 11,500 and the average other costs are Rs 3, 500 and total cost, Rs 15,000. What is the amount to be recognised as non-current asset?**

**SOLUTION : 16**

The amount to be recognised initially as an asset is:

| | Rs |
|---|---|
| Total cost of similar products sold: | |
| Less: internal profits: 11,500 x 15/115 | |
| Amount to be recognised in non-current assets | |

**PROBLEM : 17**

**An entity constructs a building for its own use. It spends Rs 50m on materials (Rs 2m of which was lost in a fire) and Rs 5m on wages and other direct expenses. For constructing the building, it uses borrowed funds of Rs 30m on which it pays interest of Rs 3m, up to the date of completion of construction. What is the amount to be recognised as cost of building?**

**SOLUTION : 17**

**The total cost is calculated as:**

| | Rs |
|---|---|
| Cost of materials (excluding abnormal loss) | |
| Wages and other direct costs | |
| Interest | |
| **Total** | |

**PROBLEM 18 :**

**Comment and give your views on the following – A company has made additions to its factory buildings by its own workmen, at a cost of Rs. 4,50,000 for wages and materials. The lowest estimate from an outside contractor to carry out the same work was for Rs. 6,00,000. The directors contend that as they were fully entitled to employ an outside contractor, it is reasonable to debit the factory building account with Rs. 6,00,000.**

**SOLUTION 18 :**

The contentions of the directors is not acceptable in view of IAS-16. Cost means what it actually cost the company and not what it would cost to the company, had it acted alternatively. Internal / notional profit margins are not allowed to be added.

**PROBLEM 19 :**

| PQR Ltd. constructed a PPE and incurred the following expenses on its construction: | |
|---|---|
| Material | 16,00,000 |
| Direct Expenses | 3,00,000 |
| Direct Labour | 6,00,000 |
| (1/15th of the total labour time was chargeable to the construction) | |
| Total Office & Administrative Expenses | 9,00,000 |
| (4% is specifically attributable to the construction of a fixed asset) | |
| Depreciation on assets used for the construction of fixed asset | 15,000 |
| **Calculate the cost of the PPE** | |

**SOLUTION 19 :**

**Calculation of cost of PPE**

| | |
|---|---|
| Material | 16,00,000 |
| Direct expenses | 3,00,000 |
| Direct labour (1/15th of Rs.6,00,000) | 40,000 |
| Office and administrative expenses (4% of Rs.9,00,000) | 36,000 |
| Depreciation on assets used for the construction of this asset | 15,000 |
| Cost of fixed assets constructed | 19,91,000 |

## 11. BEARER PLANTS

- Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management.
- Consequently, references to 'construction' in this Standard should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

## 12. SUBSEQUENT COSTS

Subsequent costs are capitalised if the recognition criteria are met.

**Replacement at regular intervals, performance of regular major inspections** (for example, an aircraft) **qualify for recognition when the criteria are satisfied.** The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard.

When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

**PROBLEM 20 :**

**What happens if the cost of the previous part/inspection was/ was not identified in the transaction in which the item was acquired or constructed?**

**SOLUTION 20 :**

De-recognition of the carrying amount occurs **regardless** of whether the cost of the previous part/inspection was identified in the transaction in which the item was acquired or constructed.

**PROBLEM 21 :**

**What will be your answer in the above question, if it is not practicable for an enterprise to determine the carrying amount of the replaced part/inspection?**

**SOLUTION 21 :**

It may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/existing inspection component was when the item was acquired or constructed.

## 13. GOVERNMENT GRANTS

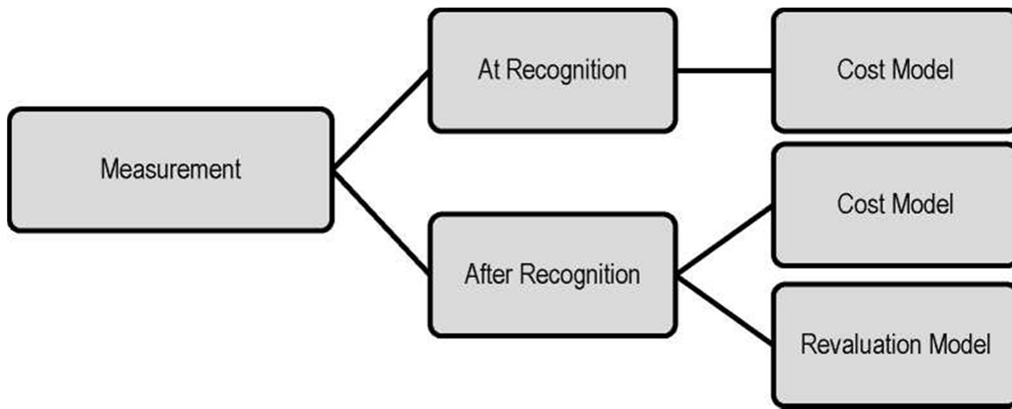
The carrying amount of an item of property, plant and equipment may be reduced by government grants in accordance with IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.

## 14. SUBSEQUENT MEASUREMENT

Measurement after initial recognition shall be done by the entity either by adopting

- 'cost model' or
- 'revaluation model'

for a particular class of PPE.




However, an entity can choose to apply 'cost model' for a class of PPE and 'revaluation model' for another class of asset.

## 15. EXAMPLES OF SEPARATE CLASSES OF PPE

Examples of a class of PPE would be land, buildings, machinery, vehicles, office equipments, ships, aircrafts, furniture and fixtures, bearer plants etc.

## 16. COST MODEL

Under 'cost model' an item of PPE is carried at historical cost less accumulated depreciation and impairment losses if any.

**Historical Cost – Any Accumulated Depreciation – Any Accumulated Impairment Losses**

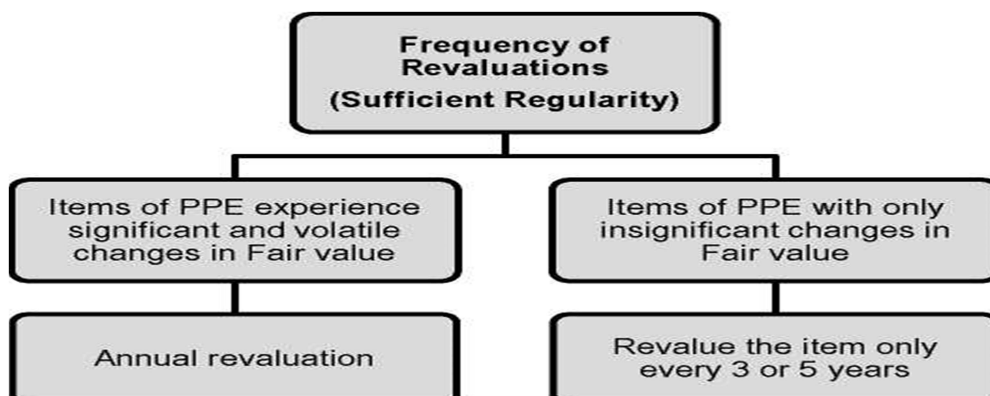
## 17. REVALUATION MODEL

- Under 'revaluation model' an item of PPE is carried at revalued amount.
- If an item of PPE is measured subsequently by adopting 'revaluation model', entire class of such asset should be measured by adopting 'revaluation model'.

  **REASON – To avoid selective revaluation and to avoid the reporting of amounts in financial statements that are a mixture of costs and values as at different dates**
- Only those items of plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

| | Rs |
|---|---|
| • **Fair Value at the date of revaluation** | |
| • **Less : Any subsequent Accumulated Depreciation** | |
| • **Less : Any subsequent Accumulated Impairment Losses** | |
| • **Carrying Amount** | |

- Revaluation date need not necessarily be reporting date.
- Revaluation should be made with sufficient regularity to ensure that there is no material deviation from the fair value that would have been at the end of reporting period.




- The revalued amount should not exceed the net recoverable value of the asset.

## 18. DETERMINATION OF FAIR VALUE

**The fair value of the items of PPE is determined in the following order based on the availability of the information.**

- Market value determined by appraisal- where market-based evidence of fair value is available
- Estimated cash flow method
- Depreciated replacement cost approach-where no market- based evidence of fair value is available

## 19. ACCOUNTING TREATMENT OF REVALUATION

**Technique 1:** Gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset.

1. **Gross carrying amount may be restated proportionately** to the change in the carrying amount
2. Accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses

**Case 1 - Details of the PPE before and after revaluation are as follows:**

| Particulars | Cost / Revalued Cost | Accumulated depreciation | Net book value |
|---|---|---|---|
| PPE before revaluation | 1,000 | 400 | 600 |
| Fair Value | | | 1,500 |
| Revaluation Gain | | | 900 |
| Gain allocated proportionately to cost and depreciation | 1,500 | 600 | 900 |
| PPE after revaluation | 2,500 | 1,000 | 1,500 |

**Technique 2: Accumulated depreciation Is eliminated** against the Gross Carrying amount of the asset

**Case 2 – Details same as above**

| Particulars | Cost / Revalued Cost | Accumulated depreciation | Net book value |
|---|---|---|---|
| PPE before revaluation | 1,000 | 400 | 600 |
| PPE after revaluation | 1,500 | | 1,500 |
| Revaluation gain | 500 | 400 | 900 |

**The increase on revaluation is Rs 900 (i.e., 500 + 400).**

**PROBLEM 22 :**

**A Ltd. has an item of plant with an initial cost of ₹ 1,00,000. At the date of revaluation, accumulated depreciation amounted to ₹ 55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.**

**Pass Journal Entries with regard to Revaluation?**

**SOLUTION 22 :**

The entries to be passed would be:

| ₹ | | Rs | Rs |
|---|---|---|---|
| Accumulated depreciation | Dr. | 55,000 | |
| To Asset A/c | | | 55,000 |
| (Being elimination of accumulated depreciation against the cost of the asset) | | | |
| Asset A/c | Dr | 20,000 | |
| To Revaluation Surplus | | | 20,000 |
| (Being increase of net asset value to Fair value) | | | |

**Note:** The net result is that the asset has a carrying amount of ₹ 65,000 [1,00,000 – 55,000 + 20,000.]

**PROBLEM 23 :**

**The Board of Directors of Fair Brother Ltd. seek your advice in the finalisation of financial statements for the year ended 30-6-2019. On a review of financial statements, it is noticed that the company has written up its PPE by Rs. 50 lakhs and the accumulated depreciation of Rs. 10 lakhs transferred to profit and loss account.**

**SOLUTION 23 :**

The transfer of accumulated depreciation of Rs. 10 lakhs to profit and loss account, in the present case, is not in consonance with IAS 16. The Standard prescribes the following two alternative methods of' presentation of revalued amounts of PPE in the financial statements:

i. Restating both the gross book value and accumulated depreciation to give a net book value equal to the net revalued amount, or

ii. Restating the net book value by adding these in the net increase on account of revaluation.

Hence, in view of the above, the treatment adopted by Fair Brother Ltd. is not correct.

## 20. REVALUATION FOR THE FIRST TIME

**If an entity does revaluation for the first time** and there is an increase in carrying amount of an item of PPE as a result of such revaluation, it should be recognized in the **other comprehensive income** and accumulated in equity under the heading of **revaluation surplus**.

In case of downward revaluation for first time by entity, **the loss should be recognized in the profit or loss**.

## 21. SUBSEQUENT REVALUATION

**In case of any subsequent revaluation, the treatment is as follows:**

- **If there is a revaluation surplus**, it should be recognized in other comprehensive income if the previous revaluation has also resulted in a surplus. If prior revaluation has resulted in a loss, the revaluation surplus should be recognized to profit or loss to the extent of previous loss and the balance in other comprehensive income.
- **If there is revaluation loss**, it should be recognized in the other comprehensive income to the extent of previous revaluation surplus. The balance should be recognized in the profit or loss.

The revaluation surplus in the other comprehensive income should be transferred to retained earnings (recycled within equity) when the asset is derecognized.

## 22. TRANSFERS FROM REVALUATION SURPLUS

The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred to the **retained earnings** when the asset is derecognised.

This may involve transferring the whole of the surplus when the asset is retired or disposed of.

However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the **surplus transferred would be the difference between the depreciation based on the revalued carrying amount of the asset and depreciation based on its original cost.**

Transfers from revaluation surplus to the retained earnings are not made through profit or loss.

**PROBLEM : 24**

**An entity owns a building which originally costs Rs 2,00,000. The property is depreciated over 50 years on SLM basis with no residual value. At the start of year 2, the building was revalued at Rs 2,30,000. Show treatment.**

**SOLUTION : 24**

| | | Rs |
|---|---|---|
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |

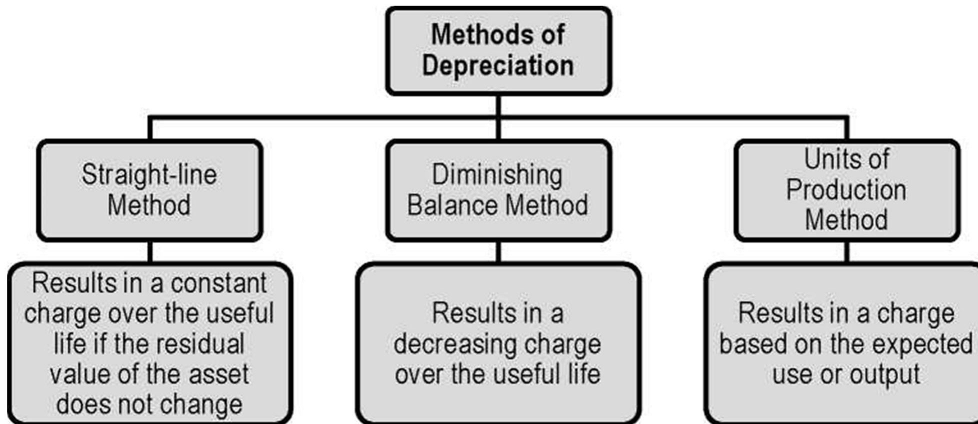
Journal Entry :

| |
|---|
| |

## 23. DEPRECIATION

Depreciation has to be made on a systematic basis over the useful life of the asset. Method of depreciation is selected considering factors like

- Type of asset,
- Nature of use and
- Other economic conditions to reflect the pattern of economic benefits.




## 24. COMPONENT APPROACH:

- Each significant component of PPE shall be depreciated separately.
- More than one significant component of a PPE having similar useful life can be depreciated collectively.
- Other parts which are insignificant shall be depreciated separately.
- As a corollary, cost of replacing such parts is capitalised, if recognition criteria are met with consequent derecognition of carrying amount of the replaced part.

**Example :** It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

**PROBLEM : 25**

X Ltd., a steel manufacturing industry commissioned a power plant at its steel plant at a cost of Rs 700/- crore

| | | |
|---|---|---|
| | | |
| | | |
| | | |
| | | |

**Calculate depreciation. Residual value may be assumed to be 5%.**

**SOLUTION : 25**

| | | | | |
|---|---|---|---|---|
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |

## 25. CHANGE IN METHOD OF DEPRECIATION

Depreciation method is reviewed at least at each financial year. If there is change in consumption pattern of the expected future economic benefits, depreciation method can be changed. Such a change in depreciation method is regarded as change in accounting estimate and given effect **prospectively as per IAS 8.**

## 26. IMPORTANT PRINCIPLES RELATING TO DEPRECIATION CHARGES-

1. Depreciation charge begins when the **asset is available for use** i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.
2. Depreciation charged **separately for each significantly part of the asset**.
3. Depreciation charged **ends when the asset is classified as held for sale** under IFRS 5 or derecognised.
4. Depreciation is charged **even if the fair value of the asset is more than the depreciable amount.**
5. Repair and maintenance charge does not negate the requirement of depreciation charge.
6. If the residual amount of the asset exceeds the carrying amount there should be no depreciation charge. Depreciation charge will resume when the residual amount becomes less than the carrying amount.
7. **Three methods of depreciation are set out in IAS 16 – straight line method, reducing balance method and production unit method.**
8. Depreciation **does not cease when the asset remain idle or retires from active use** unless the depreciable amount is zero.

**PROBLEM 26 :**

**ABC Ltd. purchased on credit, an asset costing Rs. 5,00,000 during the year 2003. It charges depreciation @ 15% WDV on this types of asset. During the year, it has paid Rs. 2,20,000 to the supplier, including the interest for the delayed payment. Rs. 3,00,000 together with interest will be payable next year. The amount of depreciation provided for the year is Rs. 33,000 i.e. 15% of Rs. 2,20,000. Comment.**

**SOLUTION 26 :**

The Company's policy of providing depreciation is not correct. It should provide depreciation on the total cost of the asset excluding borrowing cost i.e. 15% x 5,00,000 i.e. Rs. 75,000. Interest for delayed payment should not be considered for providing depreciation.

**PROBLEM 27 :**

**Y Ltd. has purchased a plant for Rs. 1,50,00,000. Its expected useful life is 10 years. Estimated scrap value is Rs. 10,00,000. The company charges depreciation based on straight line method. In the 4$^{th}$ year life is revised to 8 year. What accounting adjustment are required**

**SOLUTION 27 :**

In the 4$^{th}$ year, the useful life is revised to 8 years from 10 years. In this instance, the unamortized depreciable amount [Rs. 1,50,00,000 – (Rs. 14,00,000 x 3) – Rs. 10,00,000] = Rs. 98,00,000 should be written off over 5 years. Each year Rs. 19,60,000 will be charged.

## 27. DERECOGNITION

An item of PPE is derecognised when it is-

(i) Disposed of or
(ii) No further economic benefit is expected out of usage, i.e. abandoned or scrapped

Disposal of an asset can take place by sale, by donation or by entering into finance lease. When an asset is given on finance lease, it is derecognises and a finance lease receivable is recognised in accordance with IAS 17.

The resultant gains or losses should be included in profit or loss (calculated as the difference between net disposal proceeds, if any and the carrying amount of the asset).

**PROBLEM : 28 [Deferred receivable arising out of de-recognition of PPE]**

WDV of an item of PPE is Rs. 10,00,000. The asset is sold for Rs. 12,00,000 during 2019. However, the buyer will pay the sale proceeds after one year. The company shall de-recognise the asset and recognise receivables at discounted value of Rs. 11,00,000. How should it be accounted for as per IAS 16?

Take one year borrowing rate of the buyer for discounting. Assume that it is 10%.

**SOLUTION : 28**

As per IAS 16 receivables shall be discounted and interest element shall be segregated.

IAS Accounting on de-recognition in 2019 (Amount in Rs.)

| | | | |
|---|---|---|---|
| Receivables A/C (12,00,000 / 1.10) | Rs. | 10,90,909 | |
| To PPE A/C | Cr. | | 10,00,000 |
| To Profit on sale of PPE A/C | Cr. | | 90,909 |

## 28. COMPENSATION FROM THIRD PARTIES FOR ITEMS OF PPE THAT WERE IMPAIRED, LOST OR GIVEN UP

Compensation from third parties for items of PPE that were impaired shall be included in the profit or loss when compensation becomes receivable.

**PROBLEM 29 :**

**Entity A carried plant and machinery in its books at ₹2,00,000. These were destroyed in a fire. The assets were insured 'New for old' and were replaced by the insurance company with new machines that cost ₹20,00,000. The machines were acquired by the insurance company and the company did not receive the ₹20,00,000 as cash compensation. State, how Entity A should account for the same?**

**SOLUTION 29 :**

Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with **IAS 16**. Entity A should separately recognise a receivable and a gain in the Statement of Profit and Loss resulting from the insurance proceeds once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

## 29. SCRAPPED ASSET.

- When an asset is scrapped, it is removed from the PPE category and classified separately if there is any realisable value.
- Scrapped asset is classified into current asset if the scrap sale is expected to take place within 12 months from the reporting date.
- Otherwise it is classified as non-current. Scrapped asset is measured at net realisable value which is entity-specific valuation.
- Scrapped or abandoned assets are distinguished from non-current assets held for sale as defined in IFRS 5. Assets which are temporarily taken out of operation are not classified as asset abandoned.

## 30. CASE STUDY - PROBLEM

**On 1 April 20X1, Sun ltd purchased some land for ₹ 10 million (including legal costs of ₹ 1 million) in order to construct a new factory. Construction work commenced on 1 May 20X1. Sun ltd incurred the following costs in relation with its construction:**

– **Preparation and levelling of the land – ₹ 3,00,000.**

– **Purchase of materials for the construction – ₹ 6·08 million in total.**

– **Employment costs of the construction workers – ₹ 2,00,000 per month.**

– **Overhead costs incurred directly on the construction of the factory – ₹ 1,00,000 per month.**

– **Ongoing overhead costs allocated to the construction project using the company's normal overhead allocation model – ₹ 50,000 per month.**

– **Income received during the temporary use of the factory premises as a car park during the construction period – ₹ 50,000.**

– **Costs of relocating employees to work at the new factory – ₹ 300,000.**

– **Costs of the opening ceremony on 31 January 20X1 – ₹ 150,000.**

**The factory was completed on 30 November 20X1 and production began on 1 February 20X2. The overall useful life of the factory building was estimated at 40 years from the date of completion. However, it is estimated that the roof will need to be replaced 20 years after the date of completion and that the cost of replacing the roof at current prices would be 30% of the total cost of the building.**

**At the end of the 40-year period, Sun ltd has a legally enforceable obligation to demolish the factory and restore the site to its original condition. The directors estimate that the cost of demolition in 40 years' time (based on prices prevailing at that time) will be ₹ 20 million. An annual risk adjusted discount rate which is appropriate to this project is 8%. The present value of ₹ 1 payable in 40 years' time at an annual discount rate of 8% is 4 6 cents.**

**The construction of the factory was partly financed by a loan of ₹ 17 5 million taken out on 1 April 20X1. The loan was at an annual rate of interest of 6%. During the period 1 April 20X1 to 31 August 20X1 (when the loan proceeds had been fully utilised to finance the construction), Sun Ltd received investment income of ₹ 100,000 on the temporary investment of the proceeds.**

**Required:**

**Compute the carrying amount of the factory in the Balance Sheet of Sun Ltd at 31 March 20X2. You should explain your treatment of all the amounts referred to in this part in your answer.**

**30. CUSE STUDY SOLUTION**

Computation of the cost of the factory

| Description | Included in P.P.E. ₹ '000 | Explanation |
|---|---|---|
| Purchase of land | 10,000 | Both the purchase of the land and the associated legal costs are direct costs of constructing the factory. |
| Preparation and levelling | 300 | A direct cost of constructing the factory |
| Materials | 6,080 | A direct cost of constructing the factory |
| Employment costs of construction workers | 1,400 | A direct cost of constructing the factory for a seven-month period |
| Direct overhead costs | 700 | A direct cost of constructing the factory for a seven-month period |
| Allocated overhead costs | Nil | Not a direct cost of construction |
| Income from use as a car park | Nil | Not essential to the construction so recognised directly in profit or loss |
| Relocation costs | Nil | Not a direct cost of construction |
| Opening ceremony | Nil | Not a direct cost of construction |
| Finance costs | 700 | Capitalise the interest cost incurred in an eight-month period (purchase of land would trigger off capitalisation) |
| Investment income on temporary investment of the loan proceeds | (100) | offset against the amount capitalised |
| Demolition cost recognised as a provision | <u>920</u> | Where an obligation must recognise as part of the initial cost |
| Total | <u>20,000</u> | |
| **Computation of accumulated depreciation** | | |
| Total depreciable amount | 10,000 | All of the net finance cost of 600 (700 – 100) has been allocated to the depreciable amount. Also acceptable to reduce by allocating a portion to the nondepreciable land element principle |
| Depreciation must be in two parts:<br>Depreciation of roof component<br>Depreciation of remainder | <br>50<br>58 | <br>10,000 x 30% x 1/20 x 4/12<br>10,000 x 70% x 1/40 x 4/12 |
| Total depreciation | 108 | |
| Computation of carrying amount | <u>19,892</u> | 20,000 – 108 |

## 30. DISCLOSURES

**In the Financial Statements:**

- Gross carrying amount and accumulated depreciation at the beginning and the end of the period.In the Notes to Accounts
- Measurement bases
- Depreciation method
- Depreciation rates or useful lives
- Reconciliation of carrying amount at the beginning and at the end of the period — showing additions, held for sale under IFRS 5, acquisitions through business combinations, revaluations, impairments, depreciations and exchange differences
- Existence of restrictions for assets pledged as security
- Assets under construction
- Contractual commitments to procure assets

**For revalued items** — effective date of revaluation, whether independent valuer was involved, methods and assumptions used corresponding carrying amount if cost model had been followed

## 31. CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND SIMILAR LIABILITIES

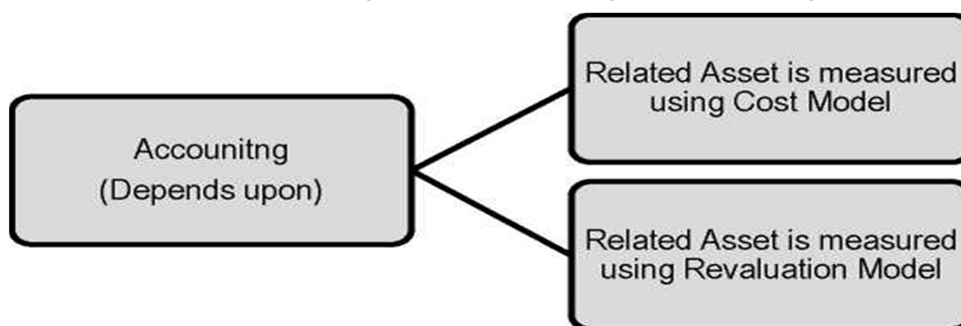
An entity is required to include in the cost of items of Property, Plant and Equipment initial estimate of costs of dismantling and removing the item and restoring the site on which it is located. This initial estimate is correspondingly recognized as liability in accordance with IAS 37. Initial measurement thus is as per the provisions of IAS 37.

Accounting for subsequent changes in the measurement of the estimate is dealt with by this interpretation. Such estimates are referred to as existing decommissioning, restoration and similar liabilities in this interpretation.

Such changes in measurement of existing decommissioning, restoration and similar liabilities may be due to the following:

- **A change** in estimated outflow of resources embodying economic benefits.
- **A change** in current market based discount rate.
- An increase that reflects the passage of time.

Accounting for the first two cases are based on the model adopted by the entity for subsequent measurement of the related assets. The change that reflects passage of time is recognized in the profit or loss as finance cost.




**If the related asset is measured using cost model:**

- Any decrease in the liability is reduced from the carrying amount of the asset. If the decrease in the liability exceeds the carrying amount of the asset, the excess is recognized in profit and loss.
- In case of increase in the liability, the carrying amount of asset is increased and simultaneously the asset must be subject to impairment test if there is an indication that the new carrying amount may not be recoverable.

**If the related asset is measured using revaluation model:**

- Any decrease in the liability is first compared with the carrying amount had the entity followed cost model.

- A decrease in liability that exceeds the notional carrying amount of the asset, such excess is taken to profit or loss. Balance is adjusted against revaluation surplus.
- If the decrease in liability is less than the notional carrying amount then it is fully adjusted against the revaluation surplus.
- If there had been a revaluation deficit earlier then the adjustment is to profit or loss

- Any increase in liability is adjusted first against revaluation surplus if any in respect of that asset and thebalance shall be recognized in profit and loss.
- **Disclosures**

In the financial statements

- Change in revaluation arising from change in liability should be separately identified and disclosed.

**PROBLEM 31 :**

**An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on April 1, 2017. The plant has a useful life of 40 years. Its initial cost was ` 1,20,000 which included an amount for decommissioning costs of ` 10,000, which represented ` 70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on March 31. On March, value of the decommissioning liability has decreased by ` 8,000. The discount rate has not yet changed.**

**How the entity will account for the above changes in decommissioning liability if it adopts cost model?**

**SOLUTION 31 :**

On March 31, 2027, the plant is 10 years old. Accumulated depreciation is ₹ 30,000 (₹ 120,000 × 10/years). Because of the unwinding of discount (5 per cent) over the 10 years, the decommissioning liability has increased from ₹ 10,000 to ₹ 16,300. On March 31, 2027, the discount rate has not changed. However, the entity estimates that, as a result of technological advances, the net present value of the decommissioning liability has decreased by ₹ 8,000. Accordingly, the entity adjusts the decommissioning liability from ₹ 16,300 to ₹ 8,300. On this date, the entity makes the following journal entry to reflect the change

| | | ₹ | ₹ |
|---|---|---|---|
| Decommissioning liability | Dr. | 8,000 | |
| To Cost of asset | | | 8,000 |

Following this adjustment, the carrying amount of the asset is ₹ 82,000 (₹ 1,20,000 – ₹ 8,000 – ₹ 30,000), which will be depreciated over the remaining 30 years of the asset's life giving a depreciation expense for the next year of ₹ 2,733 (₹ 82,000 ÷ 30). The next year's finance cost for the unwinding of the discount will be ₹ 415 (₹ 8,300 × 5 per cent).

If the change in the liability had resulted from a change in the discount rate, instead of a change in the estimated cash flows, the accounting for the change would have been the same but the next year's finance cost would have reflected the new discount rate.

## 32. MAJOR CHANGES IN IND AS 16 VIS-À-VIS IAS 16

1. ***Reduction in the Carrying Amount of PPE:*** Paragraph 28 has been shown as deleted since Ind AS 20 "*Accounting for Government Grants and Disclosure of Government Assistance*"does not permit the option of reducing the carrying amount of an item of property, plant and equipment by the amount of government grant received in respect of such an item, as permitted in IAS 20.
2. ***Fair Value Model:*** Paragraph 5 of Ind AS 16 has been modified, since Ind AS 40, *Investment Property'*, prohibits the use of fair value model.

## PROBLEMS FOR SELF PRACTICE

**PROBLEM 32 :**

**Discuss the following as an element of cost of a PPE :**

**a. General Administration expenses.**

**b. Wages payable for the erection of a machinery.**

**c. Conveyance expenses paid for the purchase of plant.**

**d. Interest paid on loan taken to purchase the asset.**

**e. Cost of design of machinery.**

**f. Interest payable on a Hire Purchase agreement.**

**g. Penalty payable to a supplier of machine for delayed payment.**

**h. Overheads of the company.**

**i. Non technical staff's salary during the installation period.**

**SOLUTION : 32**

a. General administrative expenses are normally not capitalised unless the cost is incurred to bring the asset to its present location and working condition.
b. It should be capitalised being a direct cost.
c. It should be capitalised.
d. If interest relates to qualifying assets as per IAS 23, then interest can be capitalised.
e. Cost of design of machine should be capitalised being a direct cost.
f. If it relates to a qualifying asset interest can be capitalised.
g. Penalty should not be capitalised. It is not related to bringing the assets to its present locations and conditions.
h. Overheads are generally not capitalised.
i. Non-technical staff salary should not be capitalised being an item of general overhead.

**PROBLEM : 33**

**The net written down value of an asset is Rs. 8,50,000 as on 1/1/23. During the year, 2023, the asset has been discarded as it has been found to be of no use to the firm. The annual depreciation charge of this asset for the year 2023 is Rs. 1,30,000. However, on 31-12-23, the net realizable value of the discarded asset has been estimated to be Rs. 3,50,000 only. Show the presentation of this asset in the financial statements for the year 2023.**

**SOLUTION : 33**

The asset has been discarded during the year. So the depreciation for the year 2022-23 need not be provided for. The W.D.V of the asset is Rs. 8,50,000 and the N.R.V is Rs. 3,50,000. Therefore loss of Rs. 5,00,000 will be recognised in the statement of profit and loss . The asset will be shown in the SOFP at Rs. 3,50,000. The details of the fact should be disclosed in the notes to accounts.

**PROBLEM : 34**

**The carrying amount of an asset is Rs. 5,60,000 and its net realizable value is Rs. 420,000. It has been replaced by a new machine for which an amount of Rs. 2,30,000 has been paid besides handing over the old asset in an exchange offer. The market price of the new asset is Rs. 7,15,000. Find out the amount at which the new asset be shown in the SOFP, and the amount to be charged to the** statement of profit and loss**.**

**SOLUTION : 34**

The new asset F.V should be taken at its market price i.e. Rs. 7,15,000/-

Out of Rs. 7,15,000; Rs. 2,30,000 has been paid in cash. It means the old asset has been exchanged for Rs. (7,15,000 – 2,30,000) i.e. 4,85,000

The book value of old asset is Rs. 5,60,000

Therefore Loss of Rs. 75,000/- (5,60,000 – 4,85,000) should be recognised in the statement of profit and loss for the year.

**PROBLEM : 35**

**A company obtained term loan during the year ended 31st March, 2002 to the extent of Rs. 650 lakhs for modernisation and development of its factory. Building worth Rs. 120 lakhs were completed and Plant and Machinery worth Rs. 350 lakhs were installed by 31st March, 2002. A sum of Rs. 70 lakhs has been advanced for assets, the installation of which is expected in the following year. Rs. 110 lakhs has been utilised for Working Capital requirements. Interest paid on the loan of Rs. 650 lakhs during the year 2001-2002 amounted to Rs. 58.50 lakhs. How should the interest amount be treated in the Accounts of the Company?**

**SOLUTION : 35**

Interest on borrowed funds should be treated in the following manner :

| | *Nature of interest* | *Treatment* |
|---|---|---|
| i. | Interest attributable to the contribution or acquisition of fixed assets for the period upto the completion of construction or acquisition of fixed assets. | Include in the gross book value of the asset to which it relates |
| ii. | Interest attributable to money spent on the working capital | Charge as an expense in the statement of profit and loss |

Thus, the interest amount of Rs. 58.50 lakhs should be treated in the following manner :

| *Interest Amount Rs. Lakhs* | *Treatment* |
|---|---|
| $10.80\left(\frac{120 \times 58.5}{650}\right)$ | Add to the cost of building |
| $31.50\left(\frac{350 \times 58.5}{650}\right)$ | Add to the cost of plant and machinery |
| $6.30\left(\frac{70 \times 58.5}{650}\right)$ | Add to the cost of capital work in progress |
| $9.90\left(\frac{110 \times 58.5}{650}\right)$ | Charge as an expense in the profit and loss account for the year ending 31-3-2002 |

**QUESTION : 36**

**Amna Ltd. contracted with a supplier to purchase a specific machinery to be installed in Department A in two months time. Special foundations were required for the plant, which were to be prepared within this supply lead time. The cost of site preparation and laying foundations were Rs.47,290. These activities were supervised by a technician during the entire period, who is employed for this purpose of Rs.15,000 per month. The Technician's services were given to Department A by Department B, which billed the services at Rs.16,500 per month after adding 10% profit margin.**

**The machine was purchased at invoice value of Rs.52,78,000. Sales Tax was charged at 4% on the invoice and Rs. 18,590 transportation charges were incurred to bring the machine to the factory. An Architect was engaged at a fee of Rs. 10,000 to supervise machinery installation at the factory premises. Also, payment under the invoice was due in 3 months. However, the Company made the payment in 2nd month. Ascertain the amount at which the asset should be capitalized.**

**SOLUTION : 36**

**(a) Calculation of Cost of Machine**

| **Particulars** | | | **Rs.** |
|---|---|---|---|
| Purchase Price | | Given | 52,78,000 |
| Add: | Sales Tax at 4% on invoice price | Rs.52,78,000 x 4% | 2,11,120 |
| | Site Preparation Cost | Given | 47,290 |
| | Technician's Salary | Specific/Attributable* overheads for 2 months (See Note) | 30,000 |
| | Initial Delivery Cost | Transportation | 18,590 |
| | Professional Fees for Installation | Architect's Fees | 10,000 |
| | **Total Cost of Asset** | | **55,95,000** |

**Note:** *Internally booked profits should be eliminated in arriving at the cost of Fixed Assets.

**QUESTION : 37**

**Rohan Ltd set up fire safety devices around its factory premises. The price paid for devices is Rs 110,000 (Rs 100,000 plus VAT of $10 000). The entity pets a credit of Rs 10,000 while calculating the tax payable on the finished goods sold.**

**Additional costs are freight Rs 2,000, import duty Rs 5,000, installation expenses Rs1,000. The initial estimate of dismantling and removing the item is Rs 3,000. After the machine was put to use, Rs 1,500 was spent for maintenance. Calculate the initial cost of the asset.**

**SOLUTION : 37**

| | **Rs** |
|---|---|
| Purchase price (excluding refundable tax of Rs 10 ,000) | 100,000 |
| Freight | 2,000 |
| Import duty | 5,000 |
| Installation expenses | 1,000 |
| Initial estimate of dismantling and removing the item | 3,000 |
| **Total initial cost** | **111,000** |

Note - Maintenance charges of Rs 1,500 are to be shown as an expense and not as an asset.

**QUESTION : 38**

**A piece of machinery is acquired in exchange for a plot of land. The fair value of the machinery is agreed at Rs 200,000 and the fair value of the plot at Rs 250,000 (its book value is Rs 225,000). The difference of Rs 50,000 is to be settled by cash. What is the cost at which the machinery acquired will be recorded at?**

**SOLUTION : 38**

The machinery acquired will be recorded at Rs 200,000.

The accounting entry will be

| | Rs | Rs |
|---|---|---|
| Dr Machinery | 200,000 | |
| Dr Cash 50,000 | | |
| Cr Land | | 225,000 |
| Cr Profit on sale of land | | 25,000 |

Being the sale of land partially in exchange of machinery and partially for cash and the resultant profit accounted for.

**PROBLEM : 39**

**No depreciation has been charged for the year ended 31st March, 2020, in respect of a spare bus purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year. Comment**

**SOLUTION : 39**

Depreciation is not due to use alone. It also takes place due to effluxion of time or obsolescence. Secondly, as per generally accepted accounting principles depreciation is charged when asset is ready for use.

**PROBLEM : 40**

**Y Ltd. Purchased an existing bottling unit. The method of charging depreciation on machinery of the acquired unit, was different from that followed by the company in its other units. The company wants to continue to charge depreciation for the acquired unit, in the method followed earlier by them and which was not consistent with their own method. Comment.**

**SOLUTION : 40**

Yes, the company can continue to follow the previous method of charging depreciation for the acquired company, even if it is not in agreement with the method followed by Y Ltd., for their other units.

**PROBLEM : 41**

**State your views on the following :**

**The company has set up a factory on coastal land in view of the corrosive climate. The machine life was reducing faster and, therefore, it wanted to charge a higher rate of depreciation.**

**SOLUTION : 41**

Yes, the Company can charge a higher rate of depreciation.

Such higher depreciation rates or the useful lies of the assets should be disclosed by way of notes to the accounts in the financial statements.

**PROBLEM : 42**

**The following note appeared in the financial statements for the year 2002-03 of TALCO ltd. Non depreciation has been provided during the year on fixed asset pursuant to an upward revaluation of fixed assets carried out in the current year. Comment.**

**SOLUTION : 42**

Treatment is not correct. The depreciation should to be provided on the revalued amount.

**PROBLEM : 43**

**Cash profit of a organization will be effected by providing lower depreciation on fixed assets. State with reasons whether the given statement is true or false.**

**SOLUTION : 43**

False: Providing higher or lower depreciation on Fixed Assets will not affect the cash profit because depreciation is a non-cash expenditure.

**PROBLEM : 44**

**In the Trial Balance of M/s. Aditya Ltd. as on 31-3-2012, balance of machinery appears Rs. 5,60,000. The company follows rate of depreciation on machinery @ 10% p.a. on Written Down Value Method. On scrutiny it was found that a machine appearing in the books on 1-4-2011 at Rs. 1,60,000 was disposed of on 30-9-2011 at Rs.1,35,000 in part exchange of a new machine costing Rs. 1,50,000.**

**You are required to calculate:**

**a) Total depreciation to be charged in the Profit and Loss Account.**
**b) Loss on exchange of machine.**
**c) Book value of machinery in the SOFP as on 31.3.2012.**

**SOLUTION : 44**

**(i) Total Depreciation to be charged in the Profit and Loss Account**

| | **Rs.** |
|---|---|
| Depreciation on old machinery in use [10% of (5,60,000-1,60,000)] | 40,000 |
| Add: Depreciation on new machine @ 10% for six months $\left(1,50,000 \times 10\% \times \frac{6}{12}\right)$ | 7,500 |
| Total depreciation on machinery in use | 47,500 |
| Add: Depreciation on machine disposed of (10% for 6 months) $\left(1,60,000 \times 10\% \times \frac{6}{12}\right)$ | 8,000 |
| So, total depreciation to be charged in Profit and Loss A/c | 55,500 |

**(ii) Loss on Exchange of Machine**

| | **Rs.** |
|---|---|
| Book value of machine as on 1.4.2011 | 1,60,000 |
| Less: Depreciation for 6 months @ 10% | (8,000) |
| Written Down Value as on 30.9.2011 | 1,52,000 |
| Less: Exchange value | (1,35,000) |
| Loss on exchange of machine | 17,000 |

**(iii) Book Value of Machinery in the SOFP as on 31.3.2012**

| | Rs. |
|---|---|
| Balance as per trial balance | 5,60,000 |
| Less: Book value of machine sold | (1,60,000) |
| | 4,00,000 |
| Add: purchase of new machine | 1,50,000 |
| | 5,50,000 |
| Less: depreciation on machinery in use | (47,500) |
| | 5,02,500 |

**PROBLEM : 45**

**Entity A, a supermarket chain, is renovating one of its major stores. The store will have more available space for in store promotion outlets after the renovation and will include a restaurant. Management is preparing the budgets for the year after the store reopens, which include the cost of remodelling and the expectation of a 15% increase in sales resulting from the store renovations, which will attract new customers.**

**SOLUTION : 45**

The expenditure in remodelling the store will create future economic benefits (in the form of 15% of increase in sales) and the cost of remodelling can be measured reliably, therefore, it should be capitalised.

**PROBLEM : 46**

**Entity A has an existing freehold factory property, which it intends to knock down and redevelop. During the redevelopment period the company will move its production facilities to another (temporary) site. The following incremental costs will be incurred:**

1. **Setup costs of ₹5,00,000 to install machinery in the new location.**
2. **Rent of ₹15,00,000**
3. **Removal costs of ₹3,00,000 to transport the machinery from the old location to the temporary location.**

**Can these costs be capitalised into the cost of the new building?**

**SOLUTION : 46**

Constructing or acquiring a new asset may result in incremental costs that would have been avoided if the asset had not been constructed or acquired. These costs are not to be included in the cost of the asset if they are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The costs to be incurred by the company do not meet the requirement of IAS 16 and therefore, cannot be capitalised.

**PROBLEM : 47**

**Entity A, which operates a major chain of supermarkets, has acquired a new store location. The new location requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the supermarket will be closed.**

**Management has prepared the budget for this period including expenditure related to construction and remodelling costs, salaries of staff who will be preparing the store before its opening and related utilities costs. What will be the treatment of such expenditures?**

**SOLUTION : 47**

Management should capitalise the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The supermarket cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset.

However, the cost of salaries, utilities and storage of goods are operating expenditures that would be incurred if the supermarket was open. These costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

**PROBLEM : 48**

**An amusement park has a 'soft' opening to the public, to trial run its attractions. Tickets are sold at a 50% discount during this period and the operating capacity is 80%. The official opening day of the amusement park is three months later. Management claim that the soft opening is a trial run necessary for the amusement park to be in the condition capable of operating in the intended manner. Accordingly, the net operating costs incurred should be capitalised. Comment.**

**SOLUTION : 48**

The net operating costs should not be capitalised, but should be recognised in the Statement of Profit and Loss.

Even though it is running at less than full operating capacity (in this case 80% of operating capacity), there is sufficient evidence that the amusement park is capable of operating in the manner intended by management. Therefore, these costs are specific to the start-up and, therefore, should be expensed as incurred.

**PROBLEM : 49**

**Entity A is a large manufacturing group. It owns a number of industrial buildings, such as factories and warehouses and office buildings in several capital cities. The industrial buildings are located in industrial zones, whereas the office buildings are in central business districts of the cities. Entity A's management want to apply the revaluation model as per IAS 16 to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings. State whether this is acceptable under IAS 16 or not with reasons?**

**SOLUTION : 49**

Entity A's management can apply the revaluation model only to the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location. **IAS 16**permits assets to be revalued on a class by class basis. The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement. All properties within the class of office buildings must, therefore, be carried at revalued amount

**PROBLEM : 50**

**Entity A has a policy of not providing for depreciation on PPE capitalised in the year until the following year, but provides for a full year's depreciation in the year of disposal of an asset. Is this acceptable?**

**SOLUTION : 50**

The depreciable amount of a tangible fixed asset should be allocated on a systematic basis over its useful life. The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use

**PROBLEM : 51**

**Entity A purchased an asset on 1st January 2013 for ₹1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.**

**On 1st January 2017, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years.**

**Calculate the amount of depreciation for each year, if company charges depreciation on Straight Line basis.**

**SOLUTION : 51**

The entity has charged depreciation using the straight-line method at ₹ 10,000 per annum i.e (1,00,000/10 years).

On 1st January 2017, the asset's net book value is [1,00,000 – (10,000 x 4)] ₹ 60,000.

The remaining useful life is 4 years.

The company should amend the annual provision for depreciation to charge the unamortised cost over the revised remaining life of four years.

Consequently, it should charge depreciation for the next 4 years at ₹ 15,000 per annum i.e. (60,000 / 4 years).

**PROBLEM : 52**

**Entity B constructs a machine for its own use. Construction is completed on 1st November 2016 but the company does not begin using the machine until 1st March 2017. Comment**

**SOLUTION : 52**

The entity should begin charging depreciation from the date the machine is ready for use – that is, 1st November 2016. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation

**PROBLEM : 53**

**A property costing ₹10,00,000 is bought in 2016. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years. The estimated residual value in 20 years' time, based on 2016 prices, is: Case (a) ₹10,00,000 Case (b) ₹9,00,000. Calculate the amount of depreciation.**

**SOLUTION : 53**

**Case (a)** The company considers that the residual value, based on prices prevailing at the SOFP date, will equal the cost. There is, therefore, no depreciable amount and depreciation is correctly zero.

**Case (b)** The company considers that the residual value, based on prices prevailing at the SOFP date, will be ₹ 9,00,000 and the depreciable amount is, therefore, ₹ 1,00,000. Annual depreciation (on a straight line basis) will be ₹ 5,000 [{10,00,000 – 9,00,000} ÷ 20].

**PROBLEM : 54**

**Entity B manufactures industrial chemicals and uses blending machines in the production process. The output of the blending machines is consistent from year to year and they can be used for different products. However, maintenance costs increase from year to year and a new generation of machines with significant improvements over existing machines is available every 5 years. Suggest the depreciation method to the management.**

**SOLUTION : 54**

Management should determine the depreciation method based on production output. The straight-line depreciation method should be adopted, because the production output is consistent from year to year. Factors such as maintenance costs or technical obsolescence should be considered in determining the blending machines' useful life

**PROBLEM : 55**

**On 1st April 20X1, an item of property is offered for sale at ₹ 10 million, with payment terms being three equal installments of ₹ 33,33,333 over a two years period (payments are made on 1st April 20X1, 31st March 20X2 and 31st March 20X3).**

**The property developer is offering a discount of 5 percent (i.e. Rs 5 million) if payment is made in full at the time of completion of sale. Implicit interest rate of 5.36 percent p.a.**

**Show how the property will be recorded in accordance of IAS 16.**

**SOLUTION : 55**

IAS 16 requires that the cost of an item of PPE is the cash price equivalent at the recognition date. Hence, the purchaser that takes up the deferred payment terms will recognise the acquisition of the asset as follows:

| On 1St April 20X1 | *(INR)* | *(INR)* |
|---|---|---|
| Property, Plant and Equipment Dr. | 95,00,000 | |
| To Cash | | 33,33,333 |
| To Accounts Payable | | 61,66,667 |
| (Initial recognition of property) | | |

| | | |
|---|---|---|
| On 31st March 20X2<br>Interest Expense Dr.<br>Accounts payable Dr.<br>To Cash<br>(Recognition of interest expense and payment of second installment) | 3,30,533<br>30,02,800 | <br><br><br>33,33,333 |
| On 31st March 20X3<br>Interest Expense Dr.<br>Accounts payable Dr.<br>To Cash<br>(Recognition of interest expense and payment of final installment) | 1,69,467<br>31,63,867 | <br><br><br>33,33,334 |

**PROBLEM : 56**

**Pluto Ltd owns land and building which are carried in its balance sheet at an aggregate carrying amount of ₹ 10 million. The fair value of such asset is ₹ 15 million. It exchanges the land and building for a private jet, which has a fair value of ₹ 18 million, and pays additional ₹ 3 million in cash.**

**Show the necessary treatment as per IAS 16.**

**SOLUTION : 56**

Provided that the transaction has commercial substance, the entity should recognised the private jet at a cost of ₹ 18 million (its fair value) and should recognise a profit on disposal of the land and building of ₹ 5 million, calculated as follow:

| | (₹ 000) |
|---|---|
| Fair value of Asset acquired | 18,000 |
| Less: Carrying amount of land and building disposed<br>Cash Paid | (10,000)<br>(3,000) |
| Profit on exchange of assets | 5,000 |

The required journal entry is therefore as follow:

| | | |
|---|---|---|
| Property, Plant and Equipment (Private Jet) Dr. | 18,000 | |
| To Property, Plant and Equipment (Land and Building) | | 10,000 |
| To Cash | | 3,000 |
| To Profit on exchange of assets | | 5,000 |

**PROBLEM : 57**

**Jupiter Ltd. has an item of plant with an initial cost of ₹ 100,000. At the date of revaluation accumulated depreciation amounted to ₹ 55,000. The fair value of asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.**

**Find out the entries to be passed?**

**SOLUTION : 57**

**Method – I:**

| | | | |
|---|---|---|---|
| Accumulated depreciation | Dr. | 55,000 | |
| To Asset Cost | | | 55,000 |
| Asset Cost | Dr. | 20,000 | |
| To Revaluation reserve | | | 20,000 |

The net result is that the asset has a carrying amount of ₹ 65,000 (100,000 – 55,000 + 20,000).

**Method – II:**

| | | | | |
|---|---|---|---|---|
| Carrying amount (100,000 – 55,000) = | | 45,000 | | |
| Fair value (revalued amount) | | 65,000 | | |
| Surplus | 20,000 | | | |
| % of surplus (20,000/ 45,000) | | 44.44% | | |

Entries to be Made:

| | | | |
|---|---|---|---|
| Asset (1,00,000 x 44.44%) | Dr. | 44,444 | |
| To Accumulated Depreciation (55,000 x 44.44%) | | | 24,444 |
| To Surplus on Revaluation | | | 20,000 |

**PROBLEM : 58**

**Venus Ltd. is a large manufacturing group. It owns a considerable number of industrial buildings, such as factories and warehouses, and office buildings in several capital cities. The industrial buildings are located in industrial zones whereas the office buildings are in central business districts of the cities. Venus's Ltd. management want to apply the IAS 16 revaluation model to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings. Is this acceptable under IAS 16, Property, Plant and Equipment?**

**SOLUTION : 58**

Venus's Ltd. management can apply the revaluation model to just the office buildings.

The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location.

IAS 16 permits assets to be revalued on a class-by-class basis.

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can therefore be applied to these classes for subsequent measurement. All properties within the class of office buildings must therefore be carried at revalued amount. Separate disclosure of the two classes must be given in accordance with IAS 16.

**PROBLEM : 59**

**An item of PPE was purchased for ₹ 9,00,000 on 1 April 20X1. It is estimated to have a useful life of 10 years and is depreciated on a straight line basis. On 1 April 20X3, the asset is revalued to ₹ 9,60,000. The useful life remains unchanged at ten years.**

**Show the necessary treatment as per IAS 16.**

**SOLUTION : 59**

| **Calculation of Additional Depreciation:** | *(INR)* |
|---|---|
| Actual depreciation for 20X3-20X4 based on revalued amount (9,60,000/8) | 1,20,000 |
| Depreciation for 20X4-20X5 based on historical cost (9,00,000/10) | (90,000) |
| Additional Depreciation | 30,000 |

In the profit or loss for 20X3-20X4, a depreciation expense of ₹ 1,20,000 will be charged. A reserve transfer, which will be shown in the statement of changes in equity, may be undertaken as follows:

| | | | |
|---|---|---|---|
| Revaluation surplus | Dr. | 30,000 | |
| To Retained earnings | | | 30,000 |

The closing balance on the revaluation surplus on 31 March 20X4 will therefore be as follows:

| | |
|---|---|
| Balance arising on revaluation (9,60,000 – 7,20,000) | 240,000 |
| Transfer to retained earnings | (30,000) |
| | 210,000 |

**PROBLEM : 60**

**An asset which cost ₹ 10,000 was estimated to have a useful life of 10 years and residual value ₹ 2000. After two years, useful life was revised to 4 remaining years.**

**Calculate the depreciation charge.**

**SOLUTION : 60**

| | Year-1 | Year-2 | Year-3 |
|---|---|---|---|
| Cost | 10,000 | 10,000 | 10,000 |
| Less: Accumulated Depreciation | (800) | (1,600) | (3,200) |
| Carring Amount | 9,200 | 8,400 | 6,800 |
| Charges for year | $\frac{10,000 - 2,000}{10} = 800$ | $\frac{10,000 - 2,000}{10} = 800$ | $\frac{8,400 - 2,000}{4} = 1,600$ |

**PROBLEM : 61**

**An entity acquired an asset 3 years ago at a cost of ₹ 5 million. The depreciation method adopted for the asset was 10 percent reducing balance method.**

**At the end of Year 3, the entity estimates that the remaining useful life of the asset is 8 years and determines to adopt straight –line method from that date so as to reflect the revised estimated pattern of recovery of economic benefits.**

**Show the necessary treatment in accordance of IAS 16.**

**SOLUTION : 61**

Change in Depreciation Method shall be accounted for as a change in an accounting estimate in accordance of IAS 8 and hence will have a prospective effect.

Depreciation Charges for year 1 to 11 will be as follows:

| | |
|---|---|
| Year 1 | ₹ 500,000 |
| Year 2 | ₹ 450,000 |
| Year 3 | ₹ 405,000 |
| Year 4 to Year 11 | ₹ 456,000 p.a. |

**PROBLEM : 62**

**MS Ltd. has acquired a heavy machinery at a cost of ₹ 1,00,00,000 (with no breakdown of the component parts). The estimated useful life is 10 years. At the end of the sixth year, one of the major components, the turbine requires replacement, as further maintenance is uneconomical. The remainder of the machine is perfect and is expected to last for the next four years. The cost of a new turbine is ₹ 45,00,000. Assume 5% discount rate and straight line method of depreciation.**

**Can the cost of the new turbine be recognised as an asset, and, if so, what treatment should be used?**

**SOLUTION : 62**

The new turbine will produce economic benefits to MS Ltd., and the cost is measurable. Hence, the item should be recognised as an asset. The original invoice for the machine did not specify the cost of the turbine; however, the cost of the replacement — ₹ 45,00,000 — can be used as an indication (usually by discounting) of the likely cost, six years previously.

If an appropriate discount rate is 5% per annum, ₹ 45,00,000 discounted back six years amounts to ₹ 33,57,900 [₹ 45,00,000/(1.05)6], i.e., the approximate cost of turbine before 6 years.

The current carrying amount of the turbine which is required to be replaced of ₹ 13,43,160 would be derecognised from the books of account, (i.e., Original Cost ₹ 33,57,900 as reduced by accumulated depreciation for past 6 years ₹ 20,14,740, assuming depreciation is charged on straight-line basis.)

The cost of the new turbine, ₹ 45,00,000 would be added to the cost of machine, resulting in a revision of carrying amount of machine to ₹ 71,56,840. (i.e., ₹ 40,00,000* – ₹ 13,43,160 + ₹ 45,00,000).

*Original cost of machine ₹ 1,00,00,000 reduced by accumulated depreciation (till the end of 6 years) ₹ 60,00,000.

**PROBLEM 63 :**

**On April 1, 20X1, XYZ Ltd. acquired a machine under the following terms:**

| | ₹ |
|---|---|
| **List price of machine** | **80,00,000** |
| **Import duty** | **5,00,000** |
| **Delivery fees** | **1,00,000** |
| **Electrical installation costs** | **10,00,000** |
| **Pre-production testing** | **4,00,000** |
| **Purchase of a five-year maintenance contract with vendor** | **7,00,000** |

**In addition to the above information XYZ Ltd. was granted a trade discount of 10% on the initial list price of the asset and a settlement discount of 5%, if payment for the machine was received within one month of purchase. XYZ Ltd. paid for the plant on April 20, 20X1. At what cost the asset will be recognised?**

**SOLUTION : 63**

In accordance with IAS 16, all costs required to bring an asset to its present location and condition for its intended use should be capitalised. Therefore, the initial purchase price of the asset should be:

| | ₹ |
|---|---|
| List price | 80,00,000 |
| Less: trade discount (10%) | (8,00,000) |
| | 72,00,000 |
| Import duty | 5,00,000 |
| Delivery fees | 1,00,000 |
| Electrical installation costs | 10,00,000 |
| Pre-production testing | 4,00,000 |
| Total amount to be capitalised at April 1, 20X1 | **92,00,000** |

Maintenance contract is a separate contract to get service, therefore, the maintenance contract cost of ₹ 7,00,000 should be taken as a prepaid expense and charged to the profit or loss over a period of 5 years.

In addition the settlement discount received of ₹ 3,60,000 (₹ 72,00,000 x 5%) is to be shown as other income in the profit or loss

**PROBLEM : 64**

**The term of an operating lease allows a tenant, XYZ Ltd. to tailor the property to meet its specific needs by building an additional internal wall, but on condition that the tenant returns the property at the end of the lease in its original state. This will entail dismantling the internal wall. XYZ Ltd. incurs a cost of ₹ 25,00,000 on building the wall and present value of estimated cost to dismantle the wall is ₹ 10,00,000. At what value should the leasehold improvements be capitalised in the books of XYZ Ltd.**

**SOLUTION : 64**

The leasehold improvement is not only the cost of building the wall, but also the cost of restoring the property at the end of the lease. As such both costs i.e., ₹ 35,00,000 are capitalised when the internal wall is built and will be recognised in profit and loss over the useful life of the asset (generally the lease term) as a part of depreciation charge).

**PROBLEM : 65**

**X Limited started construction on a building for its own use on April 1, 20X0. The following costs are incurred:**

| | ` |
|---|---|
| **Purchase price of land** | **30,00,000** |
| **Stamp duty & legal fee** | **2,00,000** |
| **Architect fee** | **2,00,000** |
| **Site preparation** | **50,000** |
| **Materials** | **10,00,000** |
| **Direct labour cost** | **4,00,000** |
| **General overheads** | **1,00,000** |

**Other relevant information: Material costing ₹ 1,00,000 had been spoiled and therefore wasted and a further ₹ 1,50,000 was spent on account of faulty design work. As a result of these problems, work on the building was stopped for two weeks during November 20X0 and it is estimated that ₹ 22,000 of the labour cost relate to that period. The building was completed on January 1, 20X1 and brought in use April 1, 20X1. X Limited had taken a loan of ₹ 40,00,000 on April 1, 20X0 for construction of the building (which meets the definition of qualifying asset as per IAS 23). The loan carried an interest rate of 8% per annum and is repayable on April 1, 20X2.**

**Calculate the cost of the building that will be included in tangible non-current asset as an addition?**

**SOLUTION : 65**

Only those costs which are directly attributable to bringing the asset into working condition for its intended use should be included. Administration and general costs cannot be included. Abnormal cost also should be excluded. The cost of spoilt materials and faulty designs are abnormal costs. The labour cost incurred during the stoppage is an abnormal cost and should not to be included. The interest on loan should be capitalised from April 1, 20X0, and capitalisation of interest on loan must cease when the asset is ready to use i.e., January 1, 20X1.

Amount to be included in Property, Plant and Equipment (PPE) :

| | ₹ |
|---|---:|
| Purchase price of land | 30,00,000 |
| Stamp duty & legal fee | 2,00,000 |
| Architect fee | 2,00,000 |
| Site preparation | 50,000 |
| Material (10,00,000 – 2,50,000) | 7,50,000 |
| Direct labour cost (4,00,000 – 22,000) | 3,78,000 |
| General overheads | Nil |
| Interest (40,00,000 x 8%) x 9/12 | 2,40,000 |
| **Total to be capitalized** | **48,18,000** |

**PROBLEM : 66**

**XYZ Ltd. purchased an asset on January 1, 20X0, for ₹ 1,00,000 and the asset had an estimated useful life of ten years and a residual value of ₹ nil. The company has charged depreciation using the straight-line method at ₹ 10,000 per annum. On January 1, 20X4, the management of XYZ Ltd. Reviews the estimated life and decides that the asset will probably be useful for a further four years and, therefore, the total life is revised to eight years. How should the asset be accounted for remaining years?**

**SOLUTION : 66**

Change in useful economic life of an asset is change in accounting estimate, which is to be applied prospectively, i.e., the depreciation charge will need to be recalculated. On January 1, 20X4, when the asset's net book value is ₹ 60,000. The company should amend the annual provision for depreciation to charge the unamortised cost (namely, ₹ 60,000) over the revised remaining life of four years. Consequently, it should charge depreciation for the next four years at ₹ 15,000 per annum.

**PROBLEM : 67**

**ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:**

| | | |
|---|---|---|
| **1.** | **Cost of the plant (cost per supplier's invoice plus taxes)** | **₹ 25,00,000** |
| **2.** | **Initial delivery and handling costs** | **₹ 2,00,000** |
| **3.** | **Cost of site preparation** | **₹ 6,00,000** |
| **4.** | **Consultants used for advice on the acquisition of the plant** | **₹ 7,00,000** |
| **5.** | **Interest charges paid to supplier of plant for deferred credit** | **₹ 2,00,000** |
| **6.** | **Estimated dismantling costs to be incurred after 7 years** | **₹ 3,00,000** |
| **7.** | **Operating losses before commercial production** | **₹ 4,00,000** |

**Please advise ABC Ltd. on the costs that can be capitalized in accordance with IAS 16.**

**SOLUTION : 67**

According to IAS 16, these costs can be capitalized:

| | | |
|---|---|---|
| 1. | Cost of the plant | ₹ 25,00,000 |
| 2. | Initial delivery and handling costs | ₹ 2,00,000 |
| 3. | Cost of site preparation | ₹ 6,00,000 |
| 4. | Consultants' fees | ₹ 7,00,000 |
| 5. | Estimated dismantling costs to be incurred after 7 years | ₹ 3,00,000 |
| | | ₹ 43,00,000 |

**Note:** Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of ₹ 2,00,000 and operating losses before commercial production amounting to ₹ 4,00,000 are not regarded as directly attributable costs and thus cannot be capitalized. They should be written off to the Statement of Profit and Loss in the period they are incurred.

**PROBLEM : 68**

**B Ltd. owns an asset with an original cost of ₹ 2,00,000. On acquisition, management determined that the useful life was 10 years and the residual value would be ₹ 20,000. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value.**

**At the end of year 8, management has reviewed the useful life and residual value and has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by the company. As a result, the residual value will reduce to ₹ 10,000.**

**How would the above changes in estimates be made by B Ltd.?**

**SOLUTION : 68**

The above changes in estimates would be effected in the following manner:

The asset has a carrying amount of ₹ 56,000 at the end of year 8 [₹ 2,00,000 – ₹ 1,44,000] i.e. Accumulated Depreciation.

**Accumulated depreciation is calculated as**

Depreciable amount {Cost less residual value} = ₹ 2,00,000 – ₹ 20,000 = ₹ 1,80,000.

Annual depreciation = Depreciable amount / Useful life = 1,80,000 / 10 = ₹ 18,000.

Accumulated depreciation = 18,000 × No. of years (8) = ₹ 1,44,000.

Revision of the useful life to 12 years results in a remaining useful life of 4 years (12 – 8).

The revised depreciable amount is ₹ 46,000. (56,000 – 10,000)

Thus, depreciation should be charged in future at ₹ 11,500 per annum (₹ 46,000/4 years)

**PROBLEM : 69**

**X Ltd. has a machine which got damaged due to fire as on January 31, 20X1. The carrying amount of machine was ₹ 1,00,000 on that date. X Ltd. sold the damaged asset as scrap for ₹ 10,000. X Ltd. has insured the same asset against damage. As on March 31, 20X1, the compensation proceeds was still in process but the insurance company has confirmed the claim. Compensation of ₹ 50,000 is receivable from the insurance company. How X Ltd. will account for the above transaction?**

**SOLUTION : 69**

Impairment or losses of items of property, plant and equipment and related claims for or payments of compensation from third parties are separate economic events and should be accounted for separately. X Ltd. should account for the above transaction as given below: At the time of sale of scrap machine, X Ltd. should write off the carrying amount of asset from books of account and provide a loss of ₹ 90,000. (i.e., carrying amount of ₹ 1,00,000 – realised amount of ₹ 10,000). As on March 31, 20X1, X Ltd. should recognise income of ₹ 50,000 against the compensation receivable in its profit or loss.

**PROBLEM : 70**

**An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on April 1, 20X1. The plant has a useful life of 40 years. Its initial cost was ₹ 1,20,000.; This included an amount for decommissioning costs of ₹ 10,000, which represented ₹ 70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on March 31. Assume that a market-based discounted cash flow valuation of ₹ 1,15,000 is obtained at March 31, 20X4. It includes an allowance of ₹ 11,600 for decommissioning costs, which represents no change to the original estimate, after the unwinding of three years' discount. On March 31, 20X5, the entity estimates that, as a result of technological advances, the present value of the decommissioning liability has decreased by ₹ 5,000. The entity decides that a full valuation of the asset is needed at March 31, 20X5, in order to ensure that the carrying amount does not differ materially from fair value. The asset is now valued at ₹ 1,07,000, which is net of an allowance for the reduced decommissioning obligation.**

**How the entity will account for the above changes in decommissioning liability if it adopts revaluation model?**

**SOLUTION : 70**

| **At March 31, 20X4:** | **₹** |
|---|---|
| Asset at valuation (1) | 1,26,600 |
| Accumulated depreciation | Nil |
| Decommissioning liability | (11,600) |
| Net assets | 1,15,000 |
| Retained earnings (2) | (10,600) |
| Revaluation surplus (3) | 15,600 |

**Notes:**

(1) Valuation obtained of ₹ 1,15,000 plus decommissioning costs of ₹ 11,600, allowed for in the valuation but recognised as a separate liability = ₹ 1,26,600.

(2) Three years' depreciation on original cost ₹ 1,20,000 × 3/40 = ₹ 9,000 plus cumulative discount on ₹ 10,000 at 5 per cent compound = ₹ 1,600; total ₹ 10,600.

(3) Revalued amount ₹ 1,26,600 less previous net book value of ₹ 1,11,000 (cost ₹ 120,000 less accumulated depreciation ₹ 9,000).

The depreciation expense for 20X4-20X5 is therefore ₹ 3,420 (₹ 1,26,600 × 1/37) and the discount expense for 20X5 is ₹ 600. On March 31, 20X5, the decommissioning liability (before any adjustment) is ₹ 12,200. However, as per estimate of the entity, the present value of the decommissioning liability has decreased by ₹ 5,000. Accordingly, the entity adjusts the decommissioning liability from ₹ 12,200 to ₹ 7,200.

The whole of this adjustment is taken to revaluation surplus, because it does not exceed the carrying amount that would have been recognised had the asset been carried under the cost model. If it had done, the excess would have been taken to profit or loss. The entity makes the following journal entry to reflect the change.

| | | | |
|---|---|---|---|
| Decommissioning liability | Dr. | 5,000 | |
| To Revaluation surplus | | | 5,000 |

As at March 31, 20X5, the entity revalued its asset at ₹ 1,07,000, which is net of an allowance of ₹ 7,200 for the reduced decommissioning obligation that should be recognised as a separate liability. The valuation of the asset for financial reporting purposes, before deducting this allowance, is therefore ₹ 1,14,200. The following additional journal entry is needed:

**Notes:**

| | | ₹ | ₹ |
|---|---|---|---|
| Accumulated depreciation (1) | Dr. | 3,420 | |
| To Asset at valuation | | | 3,420 |
| Revaluation surplus (2) | Dr. | 8,980 | |
| To Asset at valuation (3) | | | 8,980 |

(1) Eliminating accumulated depreciation of ₹ 3,420 in accordance with the entity's accounting policy.

(2) The debit is to revaluation surplus because the deficit arising on the revaluation does not exceed the credit balance existing in the revaluation surplus in respect of the asset.

(3) Previous valuation (before allowance for decommissioning costs) ₹ 1,26,600, less cumulative depreciation ₹ 3,420, less new valuation (before allowance for decommissioning costs) ₹ 1,14,200.

Following this valuation, the amounts included in the balance sheet are:

| | |
|---|---:|
| Asset at valuation | 1,14,200 |
| Accumulated depreciation Nil | |
| Decommissioning liability | (7,200) |
| Net assets | 1,07,000 |
| Retained earnings (1) | (14,620) |
| Revaluation surplus (2) | 11,620 |

**Notes:**

(1) ₹ 10,600 at March 31, 20X4, plus depreciation expense of ₹ 3,420 and discount expense of ₹ 600 = ₹ 14,620.

(2) ₹ 15,600 at March 31, 20X4, plus ₹ 5,000 arising on the decrease in the liability, less ₹ 8,980 deficit on reva

# IAS 20 — ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

## 1. INTRODUCTION

The receipt of Government assistance by an entity may be significant for the preparation of financial statements for two reasons.

- Firstly, if resources have been transferred, an appropriate method of accounting for transfer must be found.
- Secondly, it is desirable to give an indication of the extent to which the entity has benefitted from such assistance during the reporting period.

This facilitates comparison of an entity's financial statements with those of prior periods and with those of other entities. IAS 20 specifies the appropriate accounting treatment and disclosure requirements for government grant and other forms of assistance.

## 2. DEFINITIONS

**Government** refers to government, government agencies and similar bodies whether local, national or international.

**Government assistance** is action by government designed to provide an economic benefit specific to an entity or range ofentities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

**Government grants** are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity

This exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

**Grants related to assets** are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

**Grants related to income** are government grants other than those related to assets.

**Forgivable loans** are loans which the lender undertakes to waive repayment of, under certain prescribed conditions. Forgivable loan becomes a grant when government forgives the loan granted to the entity.

A government may declare forgiveness of loan granted by other lenders like bank. For example, the term loan taken by an entity from a syndicate of banks is paid by government in public interest.

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13 Fair Value Measurement.)

## 3. IAS 20 DOES NOT DEAL WITH (SCOPE EXCLUSION )

1. Government assistance in the form of benefits that are available in determining taxable profits like, tax holidays, reduced tax rates.
2. Government participation in the ownership of the entity is also excluded from the scope of the standard.
3. Benefits provided indirectly, such as provision of infrastructure for setting up unit in a backward area **(e.g. general transport and communication network, the supply of improved facilities such as irrigation or water reticulation which is available on an ongoing indeterminate basis for the benefit of an entire local community)** or imposing trading restrictions on competitors.
4. When the value of resources transferred by the Government is not reasonably determinable, such grants are not recognized as government grants **(Example - Free technical or marketing advice and the provision of guarantees. )**
5. When the transactions with Government evoking the grant cannot be distinguished from the normal trading activities of the entity, such grants are not recognized. **Example - government procurement policy that is responsible for a portion of the entity's sales.**

## 4. DETERMINATION OF NATURE OF ASSISTANCE

Any action by the Government that results in **economic benefit** to an entity or range of entities **qualifying** under certain criteria will be under the gamut of Government assistance.

These assistance when it involves **transfer of resources** qualify as Government grants.

**The manner in which the grant is received does not affect the accounting method to be adopted.**

**Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of liability to the government.**

The above grants which are not recognized and those Government assistance which do not involve transfer of resources, are disclosed as other Government assistance benefitting the entity.

## 5. RECOGNITION OF GOVERNMENT GRANT

Grants are to be recognized if there is reasonable assurance that

- the entity would comply with the conditions attached and
- the grant will be received

Mere receipt does not necessarily mean that the conditions associated with grant are complied with. Once a government grant is recognized, any related contingent liability is treated according to IAS 37.

## 6. NATURE OF GOVERNMENT GRANTS

1. **Grants which relates to income and**
2. **Gants related to assets.**

Recognition of grants depends on this classification.

## 7. GRANTS RELATED TO ASSETS :

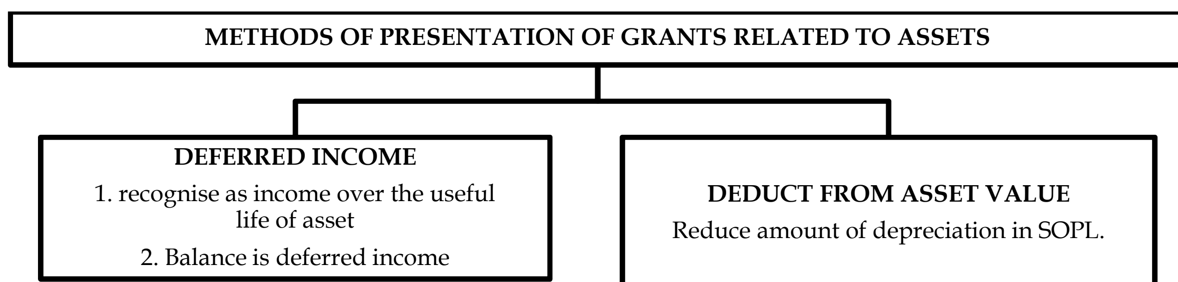
**Grants related to assets are grants** whose **primary condition** is that an entity qualifying for the grant should **purchase, construct or otherwise acquire long-term assets.** There may be other subsidiary conditions attached to it. A condition imposed is considered as primary condition, where due to the condition the entity embarks on a course of action, which it would otherwise not have taken.

**Examples of such grant:**

Subsidy on purchase price of plant and machinery by companies belonging to a specific industry.

## 8. METHODS OF PRESENTATION IN FINANCIAL STATEMENT OF GRANTS RELATED TO ASSETS –

1. Recognise grant as deferred income in the SOFP and apportioned to profit or loss on systematic and rational basis over the useful life of the asset.
2. Deduct the grant in calculating the carrying amount of the asset. The grant is recognized in profit or loss over the life of depreciable asset as reduced depreciation expense.




## 8. PRESENTATION IN STATEMENT OF CASHFLOWS

In the statement of cash flows the receipt of the grant and purchase of asset are disclosed as separate items, whichever method is followed.

**PROBLEM 1 :**

**A Limited establishes solar panels to supply solar electricity to its manufacturing plant. The cost of solar panels is 1,00,00,000 with a useful life of 10 years. The depreciation is provided on straight line method basis. The government gives 50,00,000 as a subsidy. The company treated this grant as a deferred income. Examine how the Government grant be realized. state how the same will be disclosed in the Statement of cash flows.**

**SOLUTION 1 :**

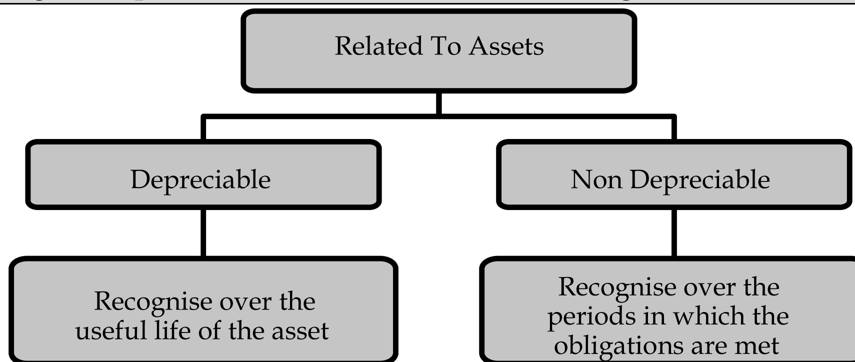
A Limited will set up 50,00,000 as deferred income and will credit 5,00,000 equally to its statement of profit and loss over next 10 years.

A Limited will show Rs 1,00,00,000 being acquisition of solar panels as outflow in investing activities. The receipt of Rs 50,00,000 from government will be shown as inflow under financing activities.

## 9. GRANTS RELATED TO NON-DEPRECIABLE ASSETS

It may also require the fulfilment of certain obligations and would then be recognised in profit or loss over the periods that bear the cost of meeting the obligations.

**For example:**
**A grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognise the grant in profit or loss over the life of the building.**




**PROBLEM 2 :**

**Nischit Ltd. has acquired a generator on 1.4.2019 for Rs.50 lakhs. On 2.4.2019, it applied to IREDA (Indian Renewable Energy Development Authority) for a subsidy of 10% of the cost as the generator was using solar energy. The subsidy was granted in June, 2019 after the accounts for 2018-19 were finalised. The company has not accounted for the subsidy for the year ended 31.3.2019. Give your views on the following:**

**How should the subsidy be accounted in the accounting year 2019-20?**

**SOLUTION 2 :**

The subsidy should be treated as deferred income and allocated over the remaining useful life in the proportion in which depreciation is charged.

Alternatively, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

**PROBLEM 3 :**

**A fixed asset was purchased for Rs.10 lakhs. Government grant received towards it amounted Rs.4 Iakhs. Show the accounting treatment if it is a depreciable asset with Rs.2 Iakhs residual value and 4 years useful life. The company treated this grant as a deferred income. The company adopts Straight Line method of providing depreciation.**

**SOLUTION 3. :**

| | **Rs. In lakhs** | |
|---|---|---|
| Credit the grant as deferred income<br>Bank A/c Dr.<br>To Deferred Govt. Grant A/c<br>(The book value of asset is Rs.10 lakhs, residual value is Rs.2 lakhs and life is 4 years, hence depreciation to be charged Rs.2 lakhs p.a. for 4 years). | | |

The grant has to be recognised in P&L account over the life of asset in proportion to depreciation. Depreciation is Rs.2 lakhs p.a. for 4 years hence, grant to be written-off will be Rs.1 lakh p.a. for 4 years. The entry every year will be as follows every year.

Deferred Government Grant A/c Dr.

To Profit and Loss A/c

**PROBLEM 4 :**

**A company purchased on April 1, 2010 special purpose machinery for Rs.1 crore, and received Central Government subsidy for 25% of the price. Effective life of the machinery is 8 years. Explain the accounting treatment.**

**SOLUTION 4 :**

Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, machinery will be recorded in the books by Rs.1 crore and depreciation will be charged on it for Rs.12.5 lakhs (i.e. Rs.1 crore / 8 years) per year on straight line method. Government subsidy of Rs.25 lakhs will be treated as deferred income which will be recognized as income in the statement of profit and loss every year by Rs.3.125 lakhs (i.e. Rs.25 lakhs / 8 years).

Alternatively, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the SOPL over the useful life of a depreciable asset by way of a reduced depreciation charge. Therefore, on the basis of this alternative, the cost of special purpose machinery will be recorded in the books after reducing it by the amount of government subsidy of Rs.25 lakhs. Thus the depreciable value of the machinery recorded in the books will be Rs.75 lakhs (i.e. Rs.1 crore – Rs.25 lakhs). Depreciation of Rs.9.375 lakhs (i.e. Rs. 75 lakhs / 8 years) will be charged on it every year on straight line method.

**PROBLEM 5 :**

**Mr. X set up a new factory in the backward area and purchased plant for Rs.500 lakhs for the purpose. Purchases were entitled for the CENVAT credit of Rs.10 lakhs and also Government agreed to extend the 25% subsidy for backward area development. The company treated this grant as a deferred income. Determine the depreciable value for the asset.**

**SOLUTION 5 :**

| | **Rs. (in lakhs)** |
|---|---|
| Cost of the plant | |
| Less: CENVAT | |
| Depreciable Value | |

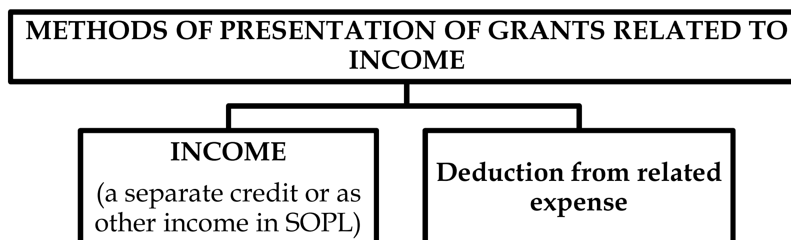
The grant has to be recognised in P&L account over the life of asset in proportion to depreciation.

## 10. GRANT RELATED TO REVENUE

**Grants related to income** are to be recognized in the profit and loss over the periods, on a systematic basis to match with the related costs which they are intended to compensate. They are prohibited to be credited to shareholders' interests.

## 11. PRESENTATION OF REVENUE GRANT

Revenue grants can be presented either as an item of income under head "other income" or netted against the related expense in the statement of profit or loss.

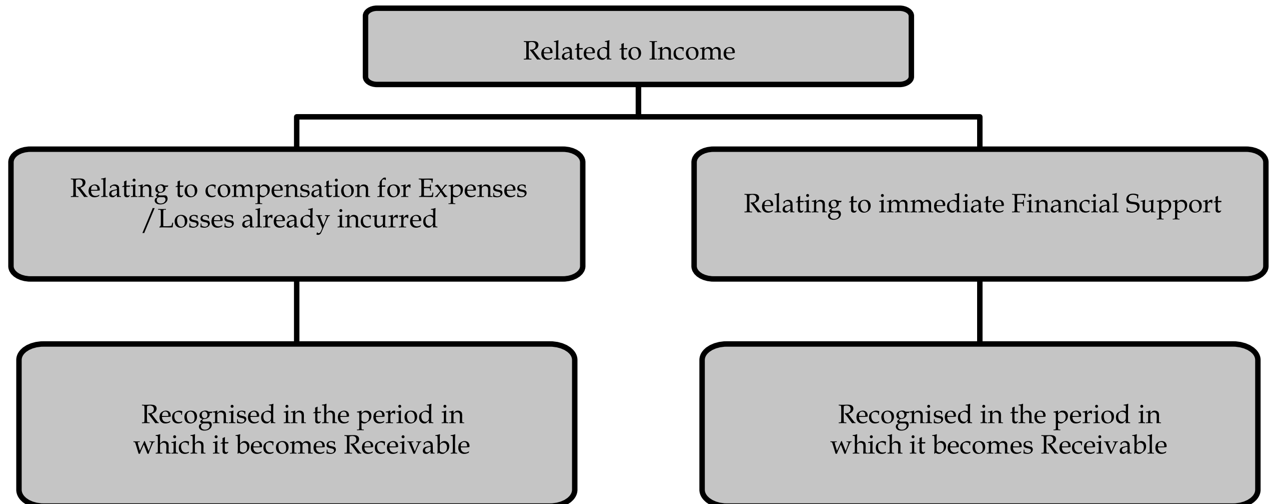



## 12. GOVERNMENT GRANTS THAT ARE RECEIVABLE AS COMPENSATION FOR EXPENSES OR LOSS

**Government grants that are receivable as compensation for expenses or loss** that were already incurred or for the purpose of giving immediate financial support to the entity shall be **recognized in the profit and loss in the period in which they become receivable.**

**EXAMPLE OF SUCH GRANT**

- Subsidy for purchase of products of medium, small and microenterprises which is comparatively costlier than market price of comparable products available from other sources.
- Subsidy for selling goods at government determined price.
- **expenses incurred on environmental protection by way of cleaning up and land filling as per government scheme.**




**PROBLEM 6 :**

**ASF Ltd. receives grant of Rs. 10 million as compensation for expenses incurred on environmental protection by way of cleaning up and land filling as per government scheme. The terms and conditions of the grant includes release of grant only when specified activities are performed and evaluated by the government authority.**

**During 2020-21 the company performed the specified activities and received the grant. The company spent Rs. 13 million on environmental protection, plantation, etc. How should the entity recognise the grant?**

SOLUTION 6 :

**The grant is compensation for expense already incurred and there is no future costs arising out of the grant. So applying IAS 20 the grant is accounted for under the head "Other Income" in the Statement of Profit and Loss.**

**A government grant may become receivable by an entity as compensation for expenses or losses incurred in a previous period. Such a grant is recognised in profit or loss of the period in which it becomes receivable, with disclosure to ensure that its effect is clearly understood.**

**PROBLEM 7 :**

**Explain the treatment of the following : Rs. 25 lacs received from the local authority for providing medical facilities to the employees.**

SOLUTION 7 :

Given grant is in the nature of revenue nature. If the company has already complied with the conditions then government grant should be immediately recognised in the profit and loss account. However if the medical facilities are to be provided over a period of time it may be treated as a deferred income and should be recognised on systematic basis.

## 13. NON-MONETARY GRANTS

In case of **Non-monetary grants** (Land, Plant & machinery etc.) the standard requires the entity to record both the grant and the assets at **either**

1. **Fair value.**
2. **Nominal value**
   - The benefit of a government loan at a below-market rate of interest is treated as a government grant.

- The loan shall be recognised and measured in accordance with IFRS 9 Financial Instruments.
- The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IFRS 9 and the proceeds received.
- The benefit is accounted for in accordance with this Standard.
- The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

**PROBLEM : 8**

**X Ltd. has been granted a 4% Government Loan amounting to Rs 100 lakhs for establishing manufacturing facilities in designated backward region. The loan is for a period of 4 years. The principal shall be repaid in 4 equal annual instalments commencing from 1st year. Market Interest rate is 10%. Measure the government grant and show how would the grant be recognised in the profit and loss ?**

**SOLUTION 8 :**

## 15. REPAYMENT OF GOVERNMENT GRANTS

A grant becomes refundable due to non-fulfillment of the conditions attached to the grant.

A government grant that becomes repayable shall be accounted for as a change in accounting estimate as per **IAS 8** 'Accounting Policies, Changes in Accounting Estimates and Errors'.

## 16. REPAYMENT OF A GRANT RELATED TO INCOME

Repayment of a grant related to income shall be applied first against any unamortised deferred credit recognised in respect of the grant.

To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment shall be recognised immediately in profit or loss.

**PROBLEM 9 :**

**X Ltd. received a revenue grant of Rs.10 crores during 2016-17 from Government for welfare activities to be carried on by the company for its employees. The grant prescribed the conditions for utilization.**

**However during the year 2018-19, it was found that the prescribed conditions were not fulfilled and the grant should be refunded to the Government.**

**State how this matter will have to be dealt with in the financial statements of X Ltd. for the year ended 2018-19.**

**SOLUTION 9 :**

The amount refundable in respect of a government grant related to revenue, is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement. Therefore, refund of grant of Rs.10 crores should be shown in the profit and loss account of the company during the financial year 2008-09.

**PROBLEM 10 :**

**Supriya Ltd. received a grant of Rs.2,500 lakhs during the last accounting year (2018-19) from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2019-20, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full. Elucidate the current accounting treatment, with reference to the provisions of IAS 20.**

**SOLUTION 10 :**

Government grants sometimes become refundable because certain conditions are not fulfilled. The amount refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement. In the present case, the amount of refund of government grant should be shown in the profit & loss account of the company duringthe year 2019-20.

## 17. REPAYMENT OF A GRANT RELATED TO AN ASSET

Repayment of a grant related to an asset shall be recognised by -

1. Reducing the deferred income balance by the amount repayable,or
2. Increasing the carrying amount of the asset.

The cumulative additional depreciation that would have been recognised in SOPL to date in the absence of the grant shall be recognised immediately in SOPL.

Circumstances giving rise to repayment of a grant related to an asset may require consideration to be given to the possible impairment of the new carrying amount of the asset.

**PROBLEM 11 :**

**The company received grant amounting to Rs. 30 million at year 0 which is related to depreciable asset. The company follows a policy of recognizing income out of the grant in proportion to depreciation @ Rs. 2 million p.a. Because of its failure to adhere to terms and conditions, the entire grant becomes repayable at the end of Year 5 when unamortised deferred grant is Rs. 20 million.**

**Show accounting entry for repayment of grant.**

**SOLUTION 11 :**

**Accounting Entry**

| Date | Particulars | | Dr. | Cr. |
|---|---|---|---|---|
| Year 5 | Deferred Grant A/c | Dr. | | |
| | P & L A/c | Dr. | | |
| | To Bank A/c | Cr. | | |

**PROBLEM 12 :**

**RST Ltd. set up a plant at a cost of Rs. 360 lacs with an expected life of 9 years. The company received a grant from the state government, of Rs. 80 lacs which was to be utilized after fulfilling certain conditions. The company treated this grant as a deferred income. The company could not fulfil the conditions and the grant was to be refunded. At the time of refund, balance in the deferred income was Rs. 72 lacs. What should be the treatment of refund of grant?**

**SOLUTION : 12**

**Accounting Entry**

| | |
|---|---|
| Deferred income account | Dr. |
| Profit and loss A/C | Dr |
| To Bank A/C | |

## 18. DISCLOSURES

**In the notes to accounts:**

- **Accounting policy** adopted by the entity, including **methods of presentation** of grants
- nature and extent of government grants recognized
- an indication of other forms of government assistance from which the entity has directly benefited
- unfulfilled conditions and other contingencies attached to grants, and
- significant decreases expected in the level of government grants.

## 19. MAJOR CHANGES IN IND AS 20 VIS-À-VIS IAS 20

1. ***Non-Monetary Grant:*** IAS 20 gives an option to measure non-monetary government grants either at their fair value or at nominal value. Ind AS 20 requires measurement of such grants only at their fair value. Thus, the option to measure these grants at nominal value is not available under Ind AS 20.
2. ***Grant related to Assets:*** IAS 20 gives an option to present the grants related to assets, including non-monetary grants at fair value in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset. Ind AS 20 requires presentation of such grants in balance sheet only by setting up the grant as deferred income. Thus, the option to present such grants by deduction of the grant in arriving at the carrying amount of the asset is not available under Ind AS 20.
3. ***Presentation of Grants Related to Income:*** IAS 20 requires presentation of grants related to income in the separate income statement. This requirement is not provided in Ind AS 20 consequential to the removal of option regarding two statement approach in Ind AS 1. Ind AS 1 requires that the components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

## PROBLEMS FOR SELF-PRACTICE

**PROBLEM : 13**

**Government gives a grant of ₹ 10,00,000 for research and development of H1N1 vaccine to A Pharmaceuticals Limited. There is no condition attached to the grant. Examine how the Government grant be realized.**

**SOLUTION : 13**

The entire grant should be recognised immediately in profit or loss.

**PROBLEM : 14**

**Government gives a grant of ₹ 10,00,000 for research and development of H1N1 vaccine to A Pharmaceuticals Limited even though similar vaccines are available in the market but are expensive. The entity has to ensure by developing a manufacturing process over a period of 2 years that the costs come down by at least 40%. Examine how the Government grant be realized.**

**SOLUTION : 14**

The entire grant should be recognised immediately as deferred income and charged to profit or loss over a period of two years.

**PROBLEM : 15**

**A village of artisans in a district got devastated because of an earthquake. A Limited was operating in that district and was providing employment to the artisans. The government gave a grant of ₹ 10,00,000 to A Limited so that 100 artisans are rehabilitated over a period of 3 years. Government releases ₹ 2,00,000. Examine how the Government grant be realized.**

**SOLUTION : 15**

A Limited will recognise Rs 10,00,000 as government grant and set it up as a deferred income and will recognise it in its profit or loss over the period of three years as per the principles enunciated in IAS 20.

**PROBLEM : 16**

**A Limited received from the government a loan of Rs 50,00,000 @ 5% payable after 5 years in a bulleted payment. The prevailing market rate of interest is 12%. Interest is payable regularly at the end of each year. Calculate the amount of government grant and Pass necessary journal entry. Also examine how the Government grant be realized.**

**SOLUTION : 16**

The fair value of the loan is calculated at Rs 37,38,328.

| Year | Opening Balance | Interest calculated @ 12% | Interest paid @ 5% on 50,00,000 + principal paid | Closing Balance |
|---|---|---|---|---|
| (a) | (b) | (c) = (b) x 12% | (d) | (e) =(b) + (c) – (d) |
| 1 | 37,38,328 | 4,48,600 | 2,50,000 | 39,36,928 |
| 2 | 39,36,928 | 4,72,431 | 2,50,000 | 41,59,359 |
| 3 | 41,59,359 | 4,99,123 | 2,50,000 | 44,08,482 |
| 4 | 44,08,482 | 5,29,018 | 2,50,000 | 46,87,500 |
| 5 | 46,87,500 | 5,62,500 | 52,50,000 | Nil |

A Limited will recognise Rs 12,61,672 (50,00,000 – 37,38,328) as the government grant and will make the following entry on receipt of loan:

| | | | |
|---|---|---|---|
| Bank Account | Dr. | 50,00,000 | |
| To Deferred Income | | | 12,61,672 |
| To Loan Account | | | 37,38,328 |

Rs 12,61,672 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

**PROBLEM : 17**

**Continuing with the facts given in the above question, state how the grant will be recognized in the statement of profit or loss assuming:**

**a) the loan is an immediate relief measure to rescue the enterprise**

**b) the loan is a subsidy for staff training expenses, incurred equally, for a period of 4 years**

**c) the loan is to finance a depreciable asset.**

**SOLUTION : 17**

Rs 12,61,672 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

Assuming (a), the loan is an immediate relief measure to rescue the enterprise. Rs 12,61,672 will be recognised in profit or loss immediately.

Assuming (b), the loan is a subsidy for staff training expenses, incurred equally, for a period of 4 years. Rs 12,61,672 will be recognised in profit or loss over a period of 4 years.

Assuming (c), the loan is to finance a depreciable asset. Rs 12,61,672 will be recognised in profit or loss on the same basis as depreciation.

**PROBLEM : 18**

**ABC Ltd. has received the following grants from the Government of Delhi for its newly started pharmaceutical business:**

- **₹ 20 lakhs received for immediate start-up of business without any condition.**
- **₹ 50 lakhs received for research and development of drugs required for the treatment of cardiovascular diseases with following conditions:**
- **that drugs should be available to the public at 20% cheaper from current market price: and**
- **the drugs should be in accordance with quality prescribed by the World Health Organisation [WHO].**

**How should ABC Ltd. recognise the government grants in its books of accounts?**

**SOLUTION : 18**

ABC Ltd. should recognise the grants in the following manner:

- ₹ 20 lakhs has been received for immediate start-up of business. This should be recognised in Statement of Profit and Loss immediately as there are no conditions attached to the grant.
- ₹ 50 lakhs should be recognised in profit or loss on a systematic basis over the periods which the entity recognises as expense the related costs for which the grants are intended to compensate provided that there is reasonable assurance that ABC Ltd. will comply with the conditions attached to the grant.

**PROBLEM : 19**

**A Limited received from the government a loan of ₹1,00,00,000 @ 5% payable after 5 years in a bulleted payment. The prevailing market rate of interest is 12%. Interest is payable regularly at the end of each year. Calculate the amount of government grant and Pass necessary journal entry. Also examine how the Government grant be realized. Also state how the grant will be recognized in the statement of profit or loss assuming that the loan is to finance a depreciable asset.**

**SOLUTION : 19**

The fair value of the loan is calculated at ₹ 74,76,656.

| Year | Opening Balance | Interest calculated @ 12% | Interest paid @ 5% on ₹ 1,00,00,000 + principal paid | Closing Balance |
|---|---|---|---|---|
| (a) | (b) | (c) = (b) x 12% | (d) | (e) =(b) + (c) – (d) |
| 1 | 74,76,656 | 8,97,200 | 5,00,000 | 78,73,856 |
| 2 | 78,73,856 | 9,44,862 | 5,00,000 | 83,18,718 |
| 3 | 83,18,718 | 9,98,246 | 5,00,000 | 88,16,964 |
| 4 | 88,16,964 | 10,58,036 | 5,00,000 | 93,75,000 |
| 5 | 93,75,000 | 11,25,000 | 1,05,00,000 | Nil |

A Limited will recognise ₹ 25,23,344 (₹ 1,00,00,000 – ₹ 74,76,656) as the government grant and will make the following entry on receipt of loan:

| | | | |
|---|---|---|---|
| Bank Account | Dr. | 1,00,00,000 | |
| To Deferred Income | | | 25,23,344 |
| To Loan Account | | | 74,76,656 |

₹ 25,23,344 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

₹ 25,23,344 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

If the loan is to finance a depreciable asset. ₹ 25,23,344 will be recognised in profit or loss on the same basis as depreciation.

**PROBLEM : 20**

Two Government grants were received during. the year

Training of new staff : $ 214000

Acquisition of new equipment with a 10 vear life : $300000

Both grants were received on 1 April 2012. The equipment was purchased at date ana has been accounted for correctly. The training took place from October to December 2012.

**SOLUTION : 20**

1) Training grant is a grant related Income, It is recognised when the cast is incurred. The training cost can be accounted for as either

   (a) Income- separate credit / other income - the treatment is correct or

   (b) Deducted from the related expense i.e. training cost

2) Grant for new equipment is a capital grant accounted for any of the following two ways

(a) Deferred Income — in which case it will have to be taken out of other Income and credited to deferred income.

Dr Other income $300000

Cr Deferred grant income $300000

The deferred grant is released to the income statement over life of asset - 10 years

OR

(b) Deducted from the capitalized cost or equipment. In this case the equipment is depreciated over its useful life of 10 years and as the capitalized amount is reduced by $300000 the depreciation charged is reduced by $300000 p.a.

**PROBLEM : 21**

On 1 October 2006 Epsilon opened a new factory in an area designated by the government as an economic development area. On that day the government provided Epsilon with a grant of $20 million to assist them in the development of the factory. This grant was in two parts:

1) $ 12 million of the grant related to the construction of a large factory at a cost of $60 million, The land was leased so the whole of the $60 million is depreciable over the estimated 30 year useful life of the factory.
2) The remaining $8 million was received subject to keeping at least 200 employees working at the factory for a period of at least five years. If the number drops below 200 at any time in any financial year in this five year period then 20% of the grant is repayable in that year.

From 1 October 2006, 250 workers were employed at the factory and estimates are that this number is likely to increase over the next four years.

Your assistant has recognised the $12 million received in respect of the factory as a credit to the income statement in the current year, on the basis that, the factory has been constructed and brought into use.

He has not recognised any of the $8 million employment grant on the basis that this is potentially repayable. He has charged $2 million in depreciation to the income statement

**SOLUTION : 21**

Grants should be recognised as income over periods necessary to match them with the related costs at which they are intended to be compensated, on a systematic basis.

1) Grant related to the construction of a large factory can be presented by either of the two methods in the SOFP

a) As deferred income and then credit the grant to income over the life of the asset.

| **Statement of Profit / Loss** | **$’000** |
|---|---|
| Grant (credit) | 400 |

| Statement of Financial Position | | **$’000** |
|---|---|---|
| Liability | 1200 - 40 | |
| Current liability<br>Non-current liability | 1160-40 | 40<br>1120 |

**Alternative treatment**

b) Deduct the grant from the cost of the asset

a) Asset (Capitalised cost) = ($60 million — $12 million) = $48 million

b) This would result in a reduced depreciation charge of $l.6 million giving the same net result in the income statement under both the methods

2) Grant related to the employment of staff —

The condition is for 5 years. It means the cost for meeting the condition is incurred over this period. Grant is recognised when cost is incurred so it will be recognised as income over this period.

The grant is probably not going to be repaid as the condition of employing 250 workers is fulfilled and is likely to be fulfilled so delaying recognition is in appropriate. Unless the likelihood of repayment is remote, if it is, then it would be appropriate to disclose the possible repayment as a contingent liability.

$1.6 million ($8 million x 1/5) of the employment grant should be recognised in the income statement for the current year. IAS 20 allows this amount either to be shown as 'other income' or as a reduction in the relevant expense.

The unrecognised balance of $6.4 million ($8 miilion — $l.6 million) would be shown as deferred income in Statement of Financial Position. $l.6 million is shown as a current liability and $4.8 million as a non-current liability.

# IAS 23 — BORROWING COSTS

## 1. INTRODUCTION

An entity may incur borrowing costs in relation to acquisition, construction or production of assets. There may be certain borrowing costs that need to be capitalised and others which needs to be expensed off. IAS 23 provides for the borrowing costs that need to be capitalised and that are to be expensed off.

## 2. SCOPE

- An entity shall apply this Standard in accounting for borrowing costs.
- The Standard does not deal with the actual or imputed cost of equity, including preferred capital **not classified as a liability (Irredeemable Preferred Capital).**
- An entity is **not required** to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:
- A qualifying asset measured at fair value {For example: A biological asset}
- Inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

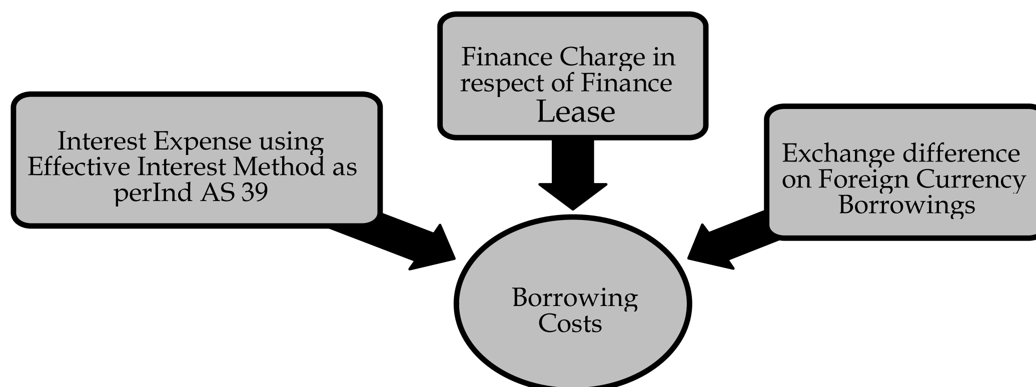
## 3. DEFINITIONS

**Borrowing costs** are interests and other costs incurred by an entity in connection with the borrowing of funds.

A **qualifying asset** is an asset that necessarily takes **substantial period of time** to get ready for its intended use or sale.

## 4. BORROWING COSTS MAY INCLUDE:

- Interest expense calculated using **effective interest rate** method as described in IFRS 9.
- Finance charges in respect of assets acquired under finance leases and
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.




**PROBLEM : 1**

**A.S.F Ltd. took a loan of USD 20,000 at 6% p.a. on 1st April, for a specific capital expansion project. The interest was payable annually. The exchange rate at the date of the loan was 1 USD = Rs. 45.00. However, the Company could have taken a corresponding Rupee Loan from Banks at 12% p.a. on that date. At the end of the year, the exchange rate was 1 USD = Rs. 48.00. How will you treat the Borrowing Costs and exchange differences in the above case?**

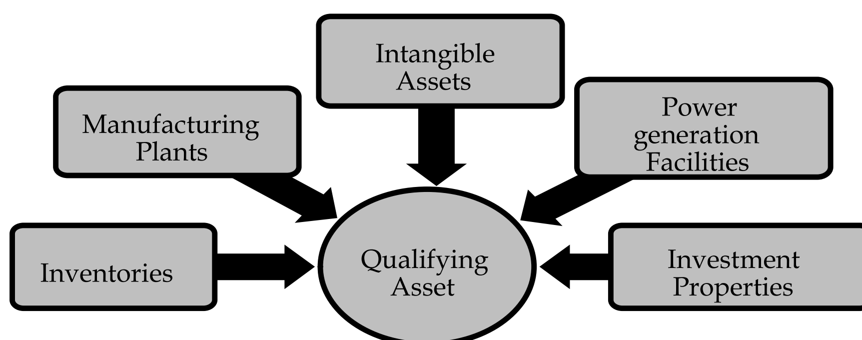
**Analyse the impact of the following changes independently. What would be the accounting treatment if the Rupee Loan were to carry interest at 14% p.a.? What will be the treatment if the exchange rate at the end of the year were 1 USD = Rs. 46.00?**

**SOLUTION : 1**

| Particulars | Situation 1<br>Interest at 12% | Situation 2<br>Interest at 14% | Situation 3<br>1 USD = Rs. 46.00 |
|---|---|---|---|
| 1. Interest on Local Currency Borrowings. | $20,000 x Rs. 45 x 12% = Rs. 1,08,000 | $20,000 x Rs. 45 x 14% = Rs. 1,26,000 | $20,000 x Rs. 45 x 12% = Rs. 1,08,000 |
| 2. Interest on Foreign Currency Borrowings | $20,000 x 6% x Rs. 48 = Rs. 57,600 | $20,000 x 6% x Rs. 48 = Rs. 57,600 | $20,000 x 6% x Rs. 46 = Rs. 55,200 |
| 3. Interest Difference between Foreign & Local Currency Borrowings = (1) – (2) | Rs. 50,400 | Rs. 68,400 | Rs. 52,800 |
| 4. Exchange Difference in Principal repayable at the end of the year | $20,000 x (48 – 45) = Rs. 60,000 | $20,000 x (48 – 45) = Rs. 60,000 | $20,000 x (46 – 45) = Rs. 20,000 |
| 5. Further Amt to be treated as Borrowing Costs = (3) or (4), whichever is **less**. | Rs. 50,400 | Rs. 60,000 | Rs. 20,000 |
| 6. Exchange Difference to be taken to P&L Account = (4) – (5) | Rs. 9,600 | Nil | Nil |
| **7. Borrowing Costs under IAS 23 = (2)+(5)** | **Rs. 1,08,000** | **Rs. 1,17,600** | **Rs. 75,200** |

## 5. EXAMPLES OF QUALIFYING ASSETS ARE:

- Manufacturing plants,
- Power generation facilities,
- Inventories that require a substantial period of time to bring them to a saleable condition.




## 6. NOT QUALIFYING ASSETS.

- Those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time.
- Assets that are ready for their intended use or sale when acquired.
- Financial assets.

**PROBLEM 2 :**

**A Firm produces its finished products in a peak season of five to six months in a year. No production takes place during the rest of the year. However sales takes place throughout the year and therefore large inventories need to be carried resulting in interest burden. Can this interest be included in the valuation of Finished Goods?**

**SOLUTION 2 :**

IAS – 23 permits the capitalization of Borrowing Costs that are directly attributable to the acquisition / construction / production of a Qualifying Asset.

The inventories which are large in quantity on a repetitive basis over a short period of time, are not Qualifying Assets. Hence, in the instant case, **the interest costs are not includible.**

**The interest relating to the period during which Finished Goods are held in stock after its production should be recognised as an expense in the period in which it is incurred.**

**PROBLEM 3 :**

**A.S.F. Ltd. dealing in timber finds it advantageous to store selected grades of timber for a prolonged period in order to improve their quality. It desires to include an actual interest cost of holding the timber as part of the value of unsold timber in inventory, and consults you in order to determine whether, in your opinion, such a method of valuation would be fair and reasonable and in accordance with generally accepted accounting principles. You are required to indicate your opinion with reasons.**

**Would your answer be different if the Company did not actually incur any interest charges for holding the timber but desired to include notional interest charges which could be imputed to the Company's own paid-Up Capital and Reserves which are invested in holding the timber for maturity?**

**SOLUTION 3 :**

1. **Nature of Timber :** Timber is a maturing product and it usually gains in quality and value if stored for a longer period. Hence, interest paid on funds necessary to hold the timber stock for a prolonged period contributes to the bringing of the stock to its present condition of improved quality.
2. **IAS –23 :** As per IAS 23 inventories which require a substantial period of time to bring them to a saleable condition as a Qualifying Asset and permits capitalization of borrowing costs directly attributable to the asset as part of the Cost of the Asset.
3. **Conclusion :** The Company's contention to include actual interest cost of holding the timber in valuing the stock, appears to be fair and reasonable.
4. **Imputed Interest :** Imputed interest on the basis of the value of paid-up capital and reserves or on any other basis is not an expenditure incurred. To include an item in the value of closing stock, (on the historic cost system), the item should represent an expenditure actually incurred and must not be a notional one. Therefore, inclusion of interest in valuing the closing stock of timber cannot be considered to be fair, reasonable or in conformity with generally accepted accounting principles.

## 7. CONDITIONS TO BE FULFILLED TO BE ELIGIBLE FOR CAPITALISATION

For the Borrowing Costs to beeligible for capitalization, the following conditions are to be noted:

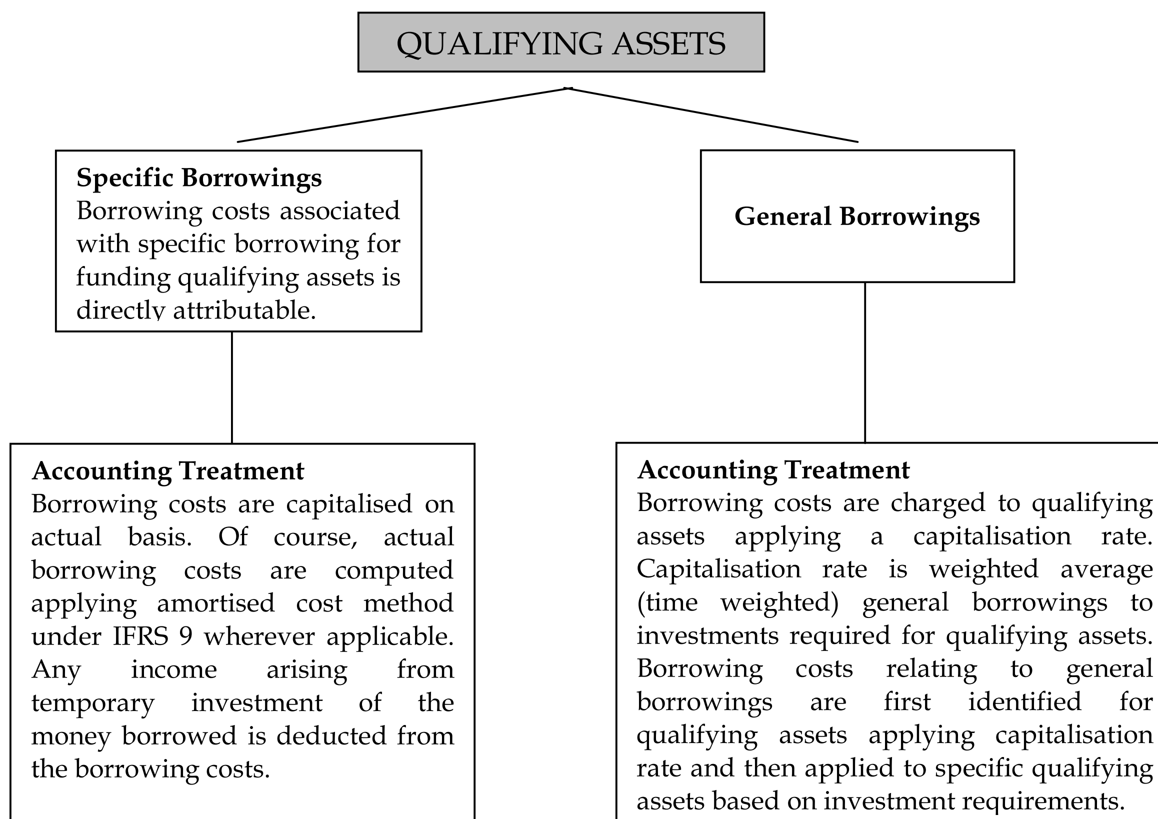
- The BORROWING COST should be **directly attributable** to the acquisition, construction or production of a qualifying asset.
- The BORROWING COST**could have been avoided** if the expenditure of QA had not been made.
- It is probable that the QA would give **future economic benefits**.

## 8. MEASUREMENT OF BORROWING COST TO BE CAPITALIZED

- In case of **specific borrowings** the capitalisation rate should be the actual borrowing cost incurred. The income from temporary investment on borrowed amounts should be deducted from actual BORROWING COST.
- **In case the entity borrows funds generally** and uses them for obtaining a qualifying asset, the borrowing costs eligible for capitalization shall be determined by applying **capitalisation rate**. The capitalisation rate should be the weighted average cost of the BORROWING COST outstanding. The

BORROWING COST capitalised**should not exceed** the actual BORROWING COST incurred.

Notional saving in interest from the temporary use of funds for the company's working capital requirement cannot be construed as Income and hence cannot be deducted from the borrowing cost for the purpose of capitalisation.




**PROBLEM 4 :**

**A Company borrows for investment in a power plant. Since presently there is requirement for only 50% of the money raised and the balance will be required after six months of year 1, the entity invested such funds temporarily for 6 months @ 4% p.a.Borrowing Costs for Year 1 as per amortised cost method was Rs. 1015.51 million and Investment Income Rs. 99.05 million**

**How much borrowing cost should the entity capitalised as per IAS 23 for year 1?**

**SOLUTION 4 :**

To the extent that an entity borrows funds specially for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on the borrowing during the period less any investment income on the temporary investment of those borrowings. [IAS 23]

Borrowing Costs for Year 1 –

| | | |
|---|---|---|
| As per amortised cost method | = | Rs. 1015.51 million |
| Less Investment Income | = | - Rs. 99.05 million |
| | | Rs. 916.46 million |

**PROBLEM : 5**

**Rainbow Limited borrowed an amount of Rs.150 crores on 1.4.2018 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized Rs.19.50 crores for the accounting period ending on 31.3.2019. Due to surplus fund, out of Rs.150 crores, an income of Rs.3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of account with reference to IAS 23.**

**SOLUTION : 5**

In case of specific borrowings the capitalisation rate should be the actual borrowing cost incurred. The income from temporary investment on borrowed amounts should be deducted from actual borrowing cost.

Hence, in the above case, treatment of account of Rainbow Ltd. is incorrect. The amount of borrowing costs capitalized should be calculated as follows:

| | |
|---|---|
| Actual interest (11% of Rs.150 crores) | Rs.16.50 crores |
| Less: Income on temporary investment from specific borrowings | Rs.3.50 crores |
| Borrowing costs to be capitalised. | Rs.13.00 crores. |

**PROBLEM :**

- **Advise X Limited on the Weighted Average cost of Borrowing and the interest cost to be capitalised based on the following:**
- **Total Borrowings and interest costs of X Limited for year ending 31st March 2005 are as follows:**

| Date | Loan | Amount | Interest |
|---|---|---|---|
| 1 -04-2004 | 18% Bank Loan | 1000 | 180 |
| 1-10-2004 | 14% Debentures | 2000 | 140 |
| 1-07-2004 | 16% Term Loan | 3000 | 360 |
| | Total | 6000 | 680 |

**Qualifying assets in which these borrowed funds are utilized are:**

| Asset | Rs '000 | Period |
|---|---|---|
| Factory Shed | 2500 | 12 Months |
| Plant 1 | 1500 | 9 Months |
| Plant 2 | 1000 | 7 Months |

## 9. COMMENCEMENT OF CAPITALISATION

In order to commence the capitalisation of BORROWING COST the following three conditions are to be satisfied:

- Expenditure on QA is to be incurred
- Borrowing costs are incurred
- Activities crucial for the preparation of QA to its intended use or sale should be in progress.

**PROBLEM: 6**

**An entity has incurred expenditure on the purchase of equipment for installing power plant and incurred borrowing costs. But construction activities have not been started by the end of the reporting period. Can the entity capitalise the related borrowing costs?**

**SOLUTION : 6**

The answer is in negative. IAS 23 requires that 'it incurs expenditures for the asset' and IAS 23 requires that 'it undertakes activities that are necessary to prepare the asset for its intended use or sale'. Both the conditions should be satisfied apart from incurring borrowing costs. In the given case although the entity has incurred expenditure for the asset but not carried out any activity to prepare the asset for its intended use.

Therefore, borrowing costs incurred on acquisition of equipment is not sufficient to capitalise the borrowing costs without any associated construction activities do not qualify for capitalisation.

## 10. SUSPENSION OF CAPITALISATION

An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset. An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation.

**Exception:**

1. An entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work.
2. An entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

**Example:Capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.**

**PROBLEM : 7**

**ABC Ltd commenced construction of a flyover in Mumbai in January 2016 under BOLT schemes. The same was completed in February 2017. Due to heavy seasonal rains in July 2016 in the area, the work on the flyover had to be suspended for a month. The Company accordingly suspended capitalization of Borrowing Costs of Rs. 12.50 lakhs for that month. Comment.**

**SOLUTION : 7**

1. **Principles :** Capitalisation of borrowing cost should be suspended during **extended period** in which active development is interrupted.
2. **Analysis :** In the instant case, it has been mentioned that the construction activity was interrupted for a month due to seasonal rain. Though the rain was heavy, the period cannot be considered as extended period leading to substantial delay in suspension of construction activities. This period can be considered as temporary delay and hence eligible for capitalization purposes.
3. **Conclusion :** Borrowing Costs of Rs. 12.50 lakhs incurred by ABC Ltd. should be capitalised. Suspension of capitalisation by the Company is not a correct treatment as per IAS – 23.

## 11. CESSATION OF CAPITALISATION

Capitalisation should cease when substantially all activities necessary in the preparing the QA for its intended use or sale are complete. In case of completion of construction in parts, the capitalisation should cease for the completed portion of the asset.

**PROBLEM 8 :**

**Capitalisation of borrowing cost on part ceases on completion of the parts (eg each building is distinct from other buildings in a business park). The question could arise if an entire building itself is not complete, yet individual floors are complete and ready for use (for example, a high-rise office building). In that circumstance, when should capitalization of borrowing costs cease?**

**SOLUTION 8 :**

As per IAS 23 "when the construction of a qualifying asset is completed in parts and acompleted part is capable of being used while construction continues for the other parts, capitalisation ofborrowing costs in relation to a part should cease when substantially all the activities necessary to preparethat part for its intended use or sale are complete".

If individual floors of a large building are substantially complete and ready for their intended use, capitalization ofborrowing costs on those parts ceases.

**PROBLEM : 9**

**A.S. Foundation Ltd. is establishing an integrated steel plant consisting of four phases. It is expected that the full plant will be established over several years, but pending that, Phase I and Phase II would be started as soon as they are completed. Following is the detail of the work done on the different phases of the plant during the current year.**

| | PHASE I | Phase II | Phase III | Phase IV |
|---|---|---|---|---|
| **Cash expenditure** | **Rs. 20,00,000** | **Rs. 35,00,000** | **Rs. 25,00,000** | **Rs. 40,00,000** |
| **Plants Purchased** | **28,00,000** | **40,00,000** | **30,00,000** | **48,00,000** |
| **Total expenditure** | **48,00,000** | **75,00,000** | **55,00,000** | **88,00,000** |
| **Total expenditure** | | | | **2,66,00,000** |
| **Loan taken @16%** | | | | **2,40,00,000** |

**During current year, Phase I and II have become operational. Find out the amount to be capitalized and to be expensed during the year.**

**SOLUTION : 9**

**Option I – The loan amount is apportioned in the ratio of expenditure :**

| Particulars | Phase I | Phase II | Phase III | Phase IV |
|---|---|---|---|---|
| Total expenditure | | | | |
| Apportionment of loan amount in the ratio of expenditure | | | | |
| Interest @ 16% | | | | |

Charge to P&L A/c. (Phase I & II)
17,75,638

Capitalised (Phase III & IV)
20,64,361

**PROBLEM : 10**

**In February, a Company took a Bank Loan to be used specifically for the construction of a new Factory Building. The construction was completed in September and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the Building till its completion was Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st December (end of accounting year) amounted to Rs. 25 lakhs. Can Rs. 25 lakhs be treated as part of the cost of Factory Building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?**

**SOLUTION : 10**

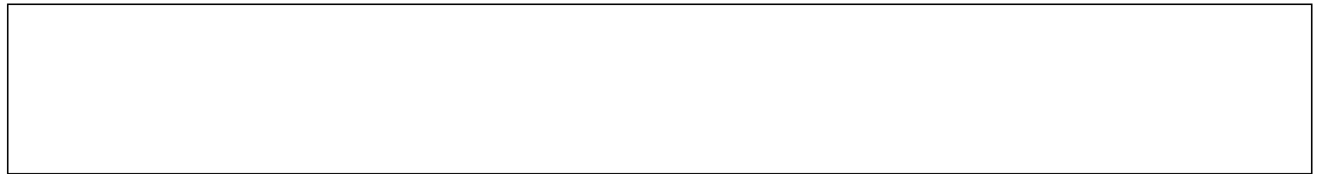
1. **Principle :** As per IAS – 23, capitalization of Borrowing Costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed. Interest on the amount that has been used for the construction of the building upto the date of completion (September) i.e. Rs. 18 lakhs alone can be capitalized. It cannot be extended to Rs. 25 lakhs.
2. **Conclusion :** In the above case, interest can be capitalized only for the period up to September, i.e. Building put to use. Hence the Company should add Rs. 18 lakhs to the cost of the Factory Building. The balance interest of Rs. 7 lakhs should be charged to Profit and Loss Account for the year as an expense.

## 12. DISCLOSURES

In the notes to accounts

- Accounting policy followed for treatment of BORROWING COST
- Amount of BORROWING COST capitalised during the period.
- Capitalisation rate that is used to determine the amount eligible for capitalization.

**ILLUSTRATION**



T1 – Amount borrowed

T2 - Activity to make assets ready for intended use has started

T2 – T3 Activity in progress

T3 – T4 Normal / unavoidable delay

T4 – T5 Abnormal / avoidable delay

T5 – T6 Activity started again

T6 – Asset substantially complete

T7 – Borrowing Fully refunded

## 13. MAJOR CHANGE IN IND AS 23 VIS-À-VIS IAS 23

**Exchange Difference:** IAS 23 provides no guidance as to how the adjustment for exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (as prescribed in paragraph 6(e)) is to be determined. Ind AS 23 provides guidance in this regard.

## PROBLEMS FOR SELF PRACTICE

**PROBLEM : 11**

**A Co. Ltd. has generally borrowed funds and used the funds to acquire qualifying assets also. How should the amount of borrowing cost eligible for capitalisation be determined?**

**SOLUTION : 11**

It is possible that a company may raise borrowings for general purpose. A part of such fundscould be used for production, or acquisition of a qualifying asset. In such circumstances, the rate of capitalization should be determined by applying a capitalization rate which should be theweighted average of the borrowing costs applicable to the general borrowings of the enterprisethat are outstanding during the period.

**PROBLEM : 12**

**A.S. Ltd. had purchased during the year, a ship on deferred payment basis, payable over next 10 years. The Company has computed the interest payable over these 10 years and debited Interest Suspense A/c. Every year, 1/10th of the same is written off to P&L Account, treating the same as Deferred Revenue Expenditure. Comment.**

**SOLUTION : 12**

1. **Principle :** As per IAS – 23, Borrowing Costs that are directly attributable to – (a) Acquisition, (b) Construction, or (c) Production of a Qualifying Asset should be capitalised as part of the cost of that asset.
2. **Analysis :** In the instant case, the ship is ready for use, but payment to the supplier / vendor is deferred over a period of 10 years. Hence, this interest payable is not eligible for capitalisation as Borrowing Costs.
3. **Conclusion :**IAS – 23 requires that Other Borrowing Costs, which are not capitalised in accordance with IAS – 23 should be charged to the P&L Account. Hence, the Company's policy to defer the same and write off over ten years is **not proper**.

**PROBLEM : 13**

**A.S. Ltd. has obtained Institutional term loan of Rs. 580 Lakhs for modernisation and renovation of its Plant & Machinery. Plant and Machinery acquired under the modernisation scheme and installation completed on 31st March amounted to Rs. 406 lakhs, Rs. 58 lakhs has been advanced to suppliers for additional assets and the balance loan of Rs. 116 lakhs has been utilised for Working Capital purpose. The Accountant is in a dilemma as to how to account for the total interest of Rs. 52.20 lakhs incurred during the year, on the entire Institutional Term Loan of Rs. 580 lakhs. Give your views.**

SOLUTION : 13

1. **Principle :** As per IAS – 23, Borrowing Costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be **capitalised as part of the cost** of that asset. Other Borrowing Costs should be recognised as an expense in the period in which they are incurred.
2. **Analysis :** Interest Rate for the Term Loan = Rs. 52.20 lakhs ÷ Rs. 580 lakhs = 9%
3. **Conclusion :** The treatment for the total interest of Rs. 52.20 lakhs is given below

| Propose / Utilisation | Loan Amount | Interest Amount | Accounting Treatment |
|---|---|---|---|
| Plant & Machinery purchased under modernisation scheme | Rs. 406 Lakhs | Rs. 406 Lakhs x 9% = Rs. 36.54 lakhs | Added to Cost of Plant and Machinery. |
| Advance to Suppliers for additional assets | Rs. 58 Lakhs | Rs. 58 lakhs x 9% = Rs. 5.22 Lakhs | Kept in Interest Suspense A/c (Capital WIP A/c) till the date of acquisition / installation of additional assets & capitalised later on asset creation. |
| Working Capital | Rs. 116 lakhs | Rs. 116 lakhs x 9% = Rs. 10.44 lakhs | Written off to P&L Account . |
| **Total** | **Rs. 580 lakhs** | **Rs. 52.20 lakhs** | |

**PROBLEM : 14**

**A.S. Ltd. borrowed Rs. 12 Crores for its capital expansion which lasted for 18 months. The relevant borrowing rate was 12.5%. During this period, the Company invested the temporary surplus funds at 4.5% on short-term basis and earned interest of Rs. 25 lakhs, which was offered as Miscellaneous Income in the P & L A/c. The Company has capitalised the entire interest cost and added to its Plant and Machinery. Is this correct?**

SOLUTION : 14

1. **Principle :** For Specific Borrowings, Amount to be capitalised = **Actual Borrowing Costs** on that Borrowing during the period Less Income on the temporary Investment of those borrowings, if any.
2. **Analysis :** In the above case, the correct accounting treatment will be –

   Actual Borrowing Costs = Rs. 12 Crores x 12.5% p.a. x 18 months = Rs. 2.25 Crores

   **Less :** Interest on temporary investment of these borrowings = Rs. 0.25 Crores

   Borrowing Costs to be capitalised under IAS – 23 = Rs. 2.00 Crores
3. **Conclusion :** Crediting the amount of Rs. 0.25 Crores to P & L A/c as Miscellaneous Income is **not** proper. This amount should be used to reduce the amount of Borrowing Costs eligible for capitalisation.

**PROBLEM 15 :**

**A.S. Ltd. has undertaken a project for expansion as per the following details :**

| *Month* | *Plan* | *Actual* |
|---|---|---|
| **April** | **Rs. 2,00,000** | **Rs. 2,00,000** |
| **May** | **Rs. 2,00,000** | **Rs. 3,00,000** |
| **June** | **Rs. 10,00,000** | **--** |
| **July** | **Rs. 1,00,000** | **--** |
| **August** | **Rs. 2,00,000** | **Rs. 1,00,000** |
| **September** | **Rs. 5,00,000** | **Rs. 7,00,000** |

**The Company pays to its Bankers at the rate of 12% p.a. interest being debited on a monthly basis. During the half year, the Company had Rs. 10 Lakhs Overdraft upto 31st July, surplus cash in August and again Overdraft of over Rs. 10 lakhs from 1st September. The Company had a strike during June and hence, could not continue the work during June. Work again commenced on 1st July and all the works were completed on 30th September. Assume that expenditure were incurred on 1st day of each month. Calculate the interest to be capitalised, giving reasons wherever necessary. You may assume that –**

**a. Overdraft will be less, if there is no capital expenditure.**

**b. The Board of Directors considering facts and circumstances, has decided that any capital expenditure taking more than 3 months will be substantial period of time.**

**SOLUTION : 15**

1. **Analysis :**
   a. The given situation is a case of Specific Borrowing, since there would not have been any overdraft, if there is no capital expenditure.
   b. The Capitalisation should commence from 1st April till 30th September, since the work is completed as on that date.
   c. The actual expenditure incurred (and not the plan expenditure) is relevant.
2. Statement showing interest to be capitalised :

| Month | Actual Expense on Qualifying Asset | Interest to be capitalised at 12% p.a. i.e. 1% p.m. | Cumulative Amount |
|---|---|---|---|
| April | Rs. 2,00,000 | 2,00,000 x 1% = Rs. 2,000 | 2,02,000 |
| May | Rs. 3,00,000 | (2,02,000 + 3,00,000) x 1% = Rs. 5,020 | 5,07,020 |
| June | Nil | (See Note Below) 5,07,020 x 1% = Rs. 5,070 | 5,12,090 |
| July | Nil | 5,12,090 x 1% = Rs. 5,121 | 5,17,211 |
| August | Rs. 1,00,000 | Cash Surplus – No Overdraft – hence no interest cost. | 6,17,211 |
| September | Rs. 7,00,000 | (6,17,211 + 7,00,000) x 1% = Rs. 13,172 | 13,30,383 |

**Note : Suspension of Capitalisation –**

- Due to strike, the Company could not continue the work in June. As per IAS – 23, Borrowing Costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are **interrupted**.
- Capitalisation of borrowing costs is not normally suspended in these expended period if – (a) substantial technical and administrative work is being carried out or (b) a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.
- It is assumed that during the strike period, the Company has carried out substantial technical and administrative work on the project. Accordingly, Borrowing Costs are capitalised for June month also. Alternative treatments are possible.

**PROBLEM : 16**

**A.S. Ltd borrowed Rs. 1500 lakhs at 12% interest for creation of integrated additional plant facilities. The expenditure was incurred in the phase manner, each resulting in specifically identifiable capital asset as under –**

| *Particulars Phase I* | *Phase II* | *Phase III* | |
|---|---|---|---|
| **Asset Created** | **Plant L** | **Plant M** | **Plant N** |
| **Machinery Purchased** | **Rs. 500 lakhs** | **Rs. 400 lakhs** | **Rs. 600 lakhs** |
| **Cost of Buildings** | **Rs. 150 lakhs** | **Rs. 100 lakhs** | **Rs. 150 lakhs** |
| **Other Utilities** | **Rs. 50 lakhs** | **Rs. 50 lakhs** | **Rs. 100 lakhs** |
| **Total Costs Rs. 700 lakhs** | **Rs. 550 lakhs** | **Rs. 850 lakhs** | |

**Note :**

**a. Each of the above Plants is a part of a continuous process whereby output of L is transferred to M for further processing and thereafter to N, before sale to customers.**

**b. Plant N includes machinery on which a Capital Grant of Rs. 100 lakhs is received from the Government.**

**Determine the amount to be capitalised in respect of each of the above Plants. You need not allocate the same between machinery, buildings and other utilities.**

**SOLUTION : 16**

1. Total Borrowing Costs = Rs. 1500 lakhs x 12% = Rs. 180 lakhs
2. Eligible Expenditure in each phase = Cost of assets created Less Grants & Progress Payments received.
3. Interest on borrowed funds is allocated in the ratio of expenditure incurred in various phase.
4. The amount to be capitalised in respect of each Plant is as under -

| Particulars | Plant L | Plant M | Plant N |
|---|---|---|---|
| Cost of Plant | Rs. 700 lakhs | Rs. 550 lakhs | Rs. 850 – Rs. 100= Rs. 750 lakhs |
| Interest Cost of Rs. 180 lakhs apportioned in the ratio 700 : 550 : 750 | Rs. 63 lakhs | Rs. 49.50 lakhs | Rs. 67.50 lakhs |

**PROBLEM :17**

**A.S. Ltd. purchased machinery from Kusuma Ltd. on 30-9-2006. The price was Rs. 370.44 lakhs after charging 8% Sales Tax and giving a trade discount of 2% on the quoted price. Transport charges were 0.25% on the quoted price and installation charges 1% on the quoted price.**

**A Loan of Rs. 300 lakhs was taken on the trial from the bank on which interest at 15% per annum was to be paid. Expenditure incurred on the trial run was Materials Rs. 35,000, Wages Rs. 25,000 and Overheads Rs. 15,000.**

**The Machinery was ready for use on 1.12.2006, but it was actually put to use only on 1.5.2007. Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2006 to 1.5.2007. The entire loan amount remained unpaid on 1.5.2007.**

**SOLUTION : 17**

| Particulars | Computation | Rs. Lakhs |
|---|---|---|
| Quoted Price<br>**Less :** Trade Discount at 2% | [(370.44 ÷ 108 x 100) x 100 ÷ 98]<br>2% of 350.000 | 350.000<br>7.000 |
| Net Price<br>**Add :** Sales Tax at 8% | <br>8% of 343.000 | 343.000<br>27.440 |
| Sub-Total / Invoice Value | <br>0.25% on Quoted Price 0.25% x 350.000 | 370.440<br>0.875 |

| | | | |
|---|---|---|---|
| **Add :** | Transportation Charges | 1.00% on Quoted Price 1.00% x 350.000 | 3.500 |
| **Add :** | Installation Charges | Materials + Wages + OH = 0.350 + 0.250 + 0.150 | 0.750 |
| **Add :** | Expenses on Trial Run | 300.00 x 15% x 2 ÷ 12 i.e. from 30.9.2006 to 1.12.2006 | 7.500 |
| **Add :** | Borrowing Costs | | |
| | **Total Cost of Asset** | | **383.065** |

- Capitalisation of Borrowing Costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete. In the above case, this period ends on 1-12-2006 when the asset was ready for use.
- Other Borrowing costs (i.e. not capitalised under IAS – 23) should be written off as an Expense in the P&L Account. Hence, the interest for the period 1.12.2006 and 1.5.2007 on Rs. 300 lakhs, amounting to Rs. 18.75 lakhs should be expensed off.

**PROBLEM : 18**

**X Ltd. began construction of a new building on 1st January, 2007. It obtained Rs.1 lakh special loan to finance the construction of the building on 1st January, 2007 at an interest rate of 10%. The company's other outstanding two non-specific loans were:**

| Amount | Rate of Interest |
|---|---|
| **Rs.5,00,000** | **11%** |
| **Rs.9,00,000** | **13%** |

**The expenditure that were made on the building project were as follows:**

| | | Rs. |
|---|---|---|
| **January** | **2007** | **2,00,000** |
| **April** | **2007** | **2,50,000** |
| **July** | **2007** | **4,50,000** |
| **December** | **2007** | **1,20,000** |

**Building was completed by 31st December, 2007. Following the principles prescribed in IAS 23 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.**

**SOLUTION : 18**

**(i) Computation of average accumulated expenses**

| | | *Rs.* |
|---|---|---|
| Rs. 2,00,000 x 12 / 12 | = | 2,00,000 |
| Rs. 2,50,000 x 9 / 12 | = | 1,87,500 |
| Rs. 4,50,000 x 6 / 12 | = | 2,25,000 |
| Rs. 1,20,000 x 1 / 12 | = | 10,000 |
| 6,22,500 | | |

**(ii) Calculation of average interest rate other than for specific borrowings**

| Amount of loan (in Rs.) | Rate of interest | | Amount of interest (in Rs.) |
|---|---|---|---|
| 5,00,000 | 11% | = | 55,000 |
| 9,00,000 | 13% | = | 1,17,000 |
| 14,00,000 | | | 1,72,000 |

Weighted average rate of interest = 12.285% (approx)

$$\left(\frac{1,72,000}{14,00,000} \times 100\right)$$

**(iii) Interest on average accumulated expenses**

| | | Rs. |
|---|---|---|
| Specific borrowings (Rs. 1,00,000 X 10%) | = | 10,000 |
| Non-specific borrowings (Rs. 5,22,500 X 12.285%) | = | 64,189 |
| Amount of interest to be capitalized | = | 74,189 |

**(iv) Total expenses to be capitalized for building**

| | *Rs.* |
|---|---|
| Cost of building Rs.(2,00,000 + 2,50,000 + 4,50,000 + 1,20,000) | 10,20,000 |
| *Add:* Amount of interest to be capitalised | 74,189 |
| | 10,94,189 |

**(v) Journal Entry**

| *Date* | *Particulars* | | *Dr. (Rs.)* | *Cr. (Rs.)* |
|---|---|---|---|---|
| 31.12.2007 | Building account | Dr. | 10,94,189 | |
| | To Bank account | | | 10,94,189 |

(Being amount of cost of building andborrowing cost thereon capitalized)

**PROBLEM : 19**

**R Ltd has borrowed Rs. 25 crores from financial institution during the financial year 2001-02 These borrowings are used to invest in shares of A Ltd, a subsidiary company, which is implementing a new project estimated to cost 50 crores. As on 31st March, 2002 since the said project was not yet complete, the Directors of R Ltd, resolved to capitalise the interest on the borrowings amounting to Rs.3 crores and add it to the cost of investments. As a statutory auditor, please comment.**

**SOLUTION : 19**

This cannot be done for two reasons -

(a) investment is not a qualifying asset under IAS-23, and

(b) Only borrowing cost incurred upto acquisition is allowed to be capitalized, which would always be nil in the case of investments.

**PROBLEM : 20**

**On 20.4.2003 JLC Ltd. obtained a loan the bank for Rs.50 lakhs to be utilized as under.**

| | **Rs. Lakh** |
|---|---|
| **Construction of a shed** | **20** |
| **Purchase of machinery** | **15** |
| **Working capital** | **10** |
| **Advance for purchase of truck** | **5** |

**In March, 2004 construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31.3.2004 was Rs.9 lakh. Show the treatment of interest under IAS 23. .**

**SOLUTION : 20**

Firstly it is assumed that the construction of the shed and machinery is part of the same plant. Secondly, it is assumed that it has taken substantial period of time to construct the shed and install the machinery. In respect of the truck, it is ready for use when purchased and hence interest on it cannot be capitalised. Interest on working capital in the given example cannot be capitalised. On the above basis, the interest to be capitalised under IAS-23 is in respect of the plant (shed and machinery), ie, 35/50 * 9 = Rs.6.3 lakhs .

**PROBLEM : 21**

**Axe Limited began construction of a new plant on 1 April, 2008 and obtained a special loan of Rs.4,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.**

**The expenditure that were made on the project of plant were as follows:**

| | Rs. |
|---|---|
| 1st April, 2008 | 5,00,000 |
| 1st August, 2008 | 12,00,000 |
| 1st January, 2009 | 2,00,000 |

The company's other outstanding non-specific loan were was Rs.23,00,000 at an interest rate of 12%.

The construction of the plant completed on 31st March, 2009. **You are required to:**

(a) Calculate the amount of interest to be capitalized as per provisions of IAS 23 "Borrowing Cost".

(b) Pass a Journal entry for capitalizing the cost and the borrowing cost in respect of the plant.

**SOLUTION : 21**

Total expenses to be capitalised for borrowings -

| | Rs. |
|---|---|
| Cost of Plant (5,00,000 + 12,00,000 + 2,00,000) | 19,00,000 |
| Add: Amount of interest to be capitalised (W.N.2) | 1,54,000 |
| | **20,54,000** |

**Journal Entry**

| | | Rs. | Rs. |
|---|---|---|---|
| 31st March, 2009 | Plant A/c Dr.<br>To Bank A/c<br>(Being amount of cost of plant and borrowing cost thereon capitalised) | 20,54,000 | <br>20,54,000 |

**Working Notes:**

1. Computation of average a accumulated expenses

| Date | Particulars | Rs. |
|---|---|---|
| 1st April, 2008 | Rs.5,00,000 x $\frac{12}{12}$ | 5,00,000 |
| 1st August, 2008 | Rs.12,00,000 x $\frac{8}{12}$ | 8,00,000 |
| 31st March, 2009 | Rs.2,00,000 x $\frac{3}{12}$ | 50,000 |
| | | **13,50,000** |

2. Amount of interest capitalised

| | Rs. |
|---|---|
| On specific borrowing (Rs.4,00,000 x 10%) | 40,000 |
| On non-specific borrowings (Rs.13,50,000 – Rs.4,00,000) x 12% | 1,14,000 |
| **Amount of interest to be capitalised** | **1,54,000** |

**PROBLEM : 22**

**Asset 'A' is constructed from 1.2.2008 to 30.3.2009 from borrowing of Rs.10 lakhs taken from SBI on 1.7.2008 at 12% per annum interest. The surplus funds were invested till 31.3.2009 which earned interest Rs.15,000. Show how much borrowing cost will be capitalized during the year 2008-2009 and 2009-2010. Loan is being repaid in 5 equal annual instalment.**

**SOLUTION : 22**

| | Rs. |
|---|---|
| Interest for 2008-09 (1.7.2008 to 30.3.2009)= 10,00,000 x $\frac{12}{100}$ x $\frac{9}{12}$ | 90,000 |
| Less: Interest earned on surplus funds | 15,000 |
| Borrowing cost to be capitalised with asset 'A' | 75,000 |
| Interest for 2009-10 (upto 30.6.2009) = 10,00,000 x $\frac{12}{100}$ x $\frac{3}{12}$ | 30,000 |
| Rs. 2 Iakhs is repaid after one year i.e. on 30.6.2009 (1.7.09 to 31.3.10) | |
| = 8,00,000 x $\frac{12}{100}$ x $\frac{9}{12}$ | 72,000 |
| Borrowing cost | 1,02,000 |

Out of the above Rs.30,000 will be capitalized with asset 'A' as the asset is now completed. The cost incurred thereafter i.e. Rs.72,000 will be charged to Profit andLoss account.

**PROBLEM : 23**

**Parvesh Ltd. had the following borrowings during a year in respect of capital expansion:**

| Plant | Cost of Asset (Rs.) | Remarks |
|---|---|---|
| **Plant P** | **100 lakhs** | **No specific borrowings** |
| **Plant Q** | **125 lakhs** | **Bank loan of Rs.65 lakhs at 10%** |
| **Plant R** | **175 lakhs** | **9% Debentures of Rs.125 lakhs were issued.** |

**In addition to the specific borrowings stated above, the Company had obtained term loans from two banks**

1) **Rs.100 lakhs at 10% from Corporation Bank and**
2) **Rs.110 lakhs at 11.50% from State Bank of India, to meet its capital expansion requirements.**

**Determine the amount of borrowing costs to be capitalized in each of the above Plants, as per IAS-23.**

**SOLUTION : 23**

**(1) Computation of actual borrowing costs incurred during the year**

| Sources | Loan amount (Rs. In lakhs) | Interest rate | Interest amount (Rs. In lakhs) |
|---|---|---|---|
| Bank Loan | 65.00 | 10% | 6.50 |
| 9% Debentures | 125.00 | 9% | 11.25 |
| Term Loan from Corporation Bank | 100.00 | 10% | 10.00 |
| Term Loan from State Bank of India | 110.00 | 11.5% | 12.65 |
| Total | 400.00 | | 40.40 |
| Specific Borrowings included in above | 190.00 | | 17.75 |

**(2) Weighted Average Capitalization Rate for GeneralBorrowing**

$$= \frac{\text{Total Interest - Interest on Specific borrowings}}{\text{Total Borrowings - Specific borrowings}}$$

$$= \frac{(40.40 - 17.75)}{(400 - 190)} = 22.65/210 = 10.79\% \text{ (approx)}$$

**(3) Capitalization of Borrowing Costs under will be as under:**

| Plant | Borrowing | Loan Amount | Interest Rate | Interest Amount | Cost of Asset | |
|---|---|---|---|---|---|---|
| P | General | 100 | 10.79% | 10.79 | | 110.79 |
| Q | Specific | 65 | 10.00% | 6.50 | 71.50 | |
| | General | 60 | 10.79% | 6.47 | 66.47 | 137.97 |
| R | Specific | 125 | 9.00% | 11.25 | 136.25 | |
| | General | 50 | 10.79 | 5.39 | 55.39 | 191.64 |
| | Total | 400 | | 40.40 | | 440.40 |

**Note:-** The amount of borrowing costs capitalized should not exceed the actual interest cost.

**PROBLEM : 24**

X Limited began construction of a new plant on 1st April 2011 and obtained a special loan of 8 lakhs to finance the construction of the plant. The rate of interest on loan was 10 per cent per annum.

The expenditure that was made on the project of plant construction was as follows:

| | ₹ |
|---|---|
| 1-4-2011 | 10,00,000 |
| 1-8-2011 | 24,00,000 |
| 1-1-2012 | 4,00,000 |

The Company's other outstanding non specific loan was ` 46,00,000 at an interest of 12 percent per annum.

The construction of the plant was completed on 31-3-2012. You are required to calculate the amount of interest to be capitalized as per the provision of IAS 23 of the borrowing cost (including cost).

**SOLUTION : 24**

**(i) Computation of average accumulated expenses**

| | | ₹ |
|---|---|---|
| ₹10,00,000 x 12 / 12 | = | 10,00,000 |
| ₹ 24,00,000 x 8 / 12 | = | 16,00,000 |
| ₹ 4,00,000 x 3 / 12 | = | 1,00,000 |
| | | 27,00,000 |

**(ii) Non-specific Borrowings**

Non-specific Borrowings = Average accumulated capital expenses –Specificborrowings

= ₹ 27,00,000–₹ 8,00,000 = ₹ 19,00,000

**(iii) Interest on average accumulated expenses**

| | | ₹ |
|---|---|---|
| Specific borrowings (₹ 8,00,000 X 10%) | = | 80,000 |
| Non-specific borrowings (₹ 19,00,000× 12%) | = | 2,28,000 |
| Amount of interest to be capitalized | | 3,08,000 |

**(iv) Total expenses to be capitalized for Plant**

| | ₹ |
|---|---|
| Cost of plant ₹ (10,00,000 + 24,00,000 + 4,00,000) | 38,00,000 |
| *Add:* Amount of interest to be capitalised | 3,08,000 |
| Total cost of plant | 41,08,000 |

# IAS 40 INVESTMENT PROPERTY

## 1. INTRODUCTION

The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements. Recognition and measurement principles prescribed in this Standard are closely aligned with IAS 16 (Property, Plant and Equipment). The critical areas that deserve special attention are:

- Exercising judgement in the determination of whether or not a property qualifies to be classified and accounted for as Investment property
- Reclassification of assets, into and out of the category of investment property
- Extensive disclosures

## 2. DEFINITIONS

**Carrying amount** is the amount at which an asset is recognised in the statement of financial position.

**Cost** is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 **Share-based Payment.**

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13 Fair Value Measurement.)

**Investment property** is property (land or a building—or part of a building—or both) held **(by the owner or by the lessee as a right-of-use asset)** to earn rentals or for capital appreciation or both, rather than for:

(a) Use in the production or supply of goods or services or for administrative purposes; or

(b) Sale in the ordinary course of business.

**EXAMPLE OF INVESTMENT PROPERTIES**

1. **Land held for long-term capital appreciation.**
2. **Land held for currently undetermined future use.**
3. **A building owned by the entity (or a right-of-use asset relating to a building held by the entity) and leased out under one or more operating leases.**
4. **A building that is vacant but is held to be leased out under one or more operating leases.**
5. **Property that is being constructed or developed for future use as investment property.**

**Owner-occupied property** is property held (by the owner or by the lessee **as a right-of-use asset)** for use in the production or supply of goods or services or for administrative purposes.

**EXAMPLE OF ASSETS WHICH ARE NOT INVESTMENT PROPERTIES**

1. **Property intended for sale in the ordinary course of business or in the process of construction or development for such sale (IAS 2)**
2. **Property constructed on behalf of third parties**
3. **Owner-occupied property including property held for future development and subsequent use as owner occupied property.**
4. **Property occupied by employees whether or not the employees pay at market rates.**
5. **Owner occupied property awaiting disposal.**
6. **property that is leased to another entity under a finance lease.**

## 3. AN OWNER-OCCUPIED PROPERTY VS INVESTMENT PROPERTY

| OWNER-OCCUPIED PROPERTY | INVESTMENT PROPERTY |
|---|---|
| property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes. | Investment property is property, being land or a building —or part of a building—or both, held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for<br>• use in the production or supply of goods or services or for administrative purposes; or<br>• sale in the ordinary course of business. |
| Does not generating cash flows independently from other assets of the entity. | Investment property is held to earn rentals or for capital appreciation generating cash flows independently from other assets of the entity. |
| Used for actively running the business | Used for earning a passive income such as rent or capital appreciation. |
| Expected to be used over a long period. Any appreciation in their value is not expected to be encashed in the normal course of business. | One of the purposes of holding the investment property is to earn capital appreciation. |
| Under the revaluation model, increase in carrying amount are recognized as "revaluation surplus" under the equity heading. | Under fair value model, all changes in fair value are recognized in SOPL. |

## 4. USE OF JUDGEMENT IN IDENTIFYING INVESTMENT PROPERTY

Investment property is held to earn rentals or for capital appreciation generating cash flows independently from other assets of the entity, and this is the vital factor that distinguishes an owner occupied property from an investment property. Broadly speaking, a property is classified and treated as investment property or owner occupied property, by using judgment in the following cases:

A Property, which is used as investment property and owner occupied property is accounted for separately if each such element is capable of being sold independency.

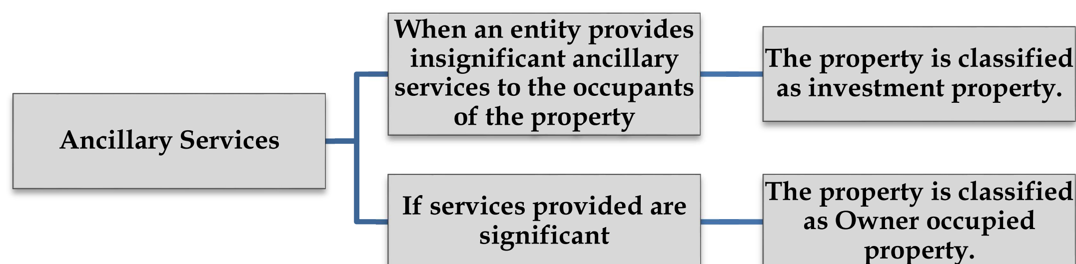
- If each element cannot be sold independency, is classified and accounted as either investment property or owner occupied property depending upon the significance of the intended usage.

| | | |
|---|---|---|
| | | |

- **Judgement is also needed to determine whether the acquisition of investment property is the acquisition of an asset or a group of assets or a business combination within the scope of IFRS 3 Business Combinations.**

## 5. ANCILLARY SERVICES

- When an entity provides insignificant ancillary services to the occupants of the property, the property is classified as investment property.



**PROBLEM : 1**

**X Ltd. runs a property as hotel. It has engaged a service provider which manages the hotel including guest services. The services provider provides reception, booking and cash management services.**

**The company controls and services rendered by the service provider and also periodically assess the service quality.**

**The service provider also provides a guarantee for minimum occupancy at an average rate 50%. The service provider will get special commission for occupancy over and above 50%. It gets 2% of revenue for providing minimum guarantee.**

**The auditor company also audits the hotel business as well.**

**Should the entity treat the hotel as an investment property?**

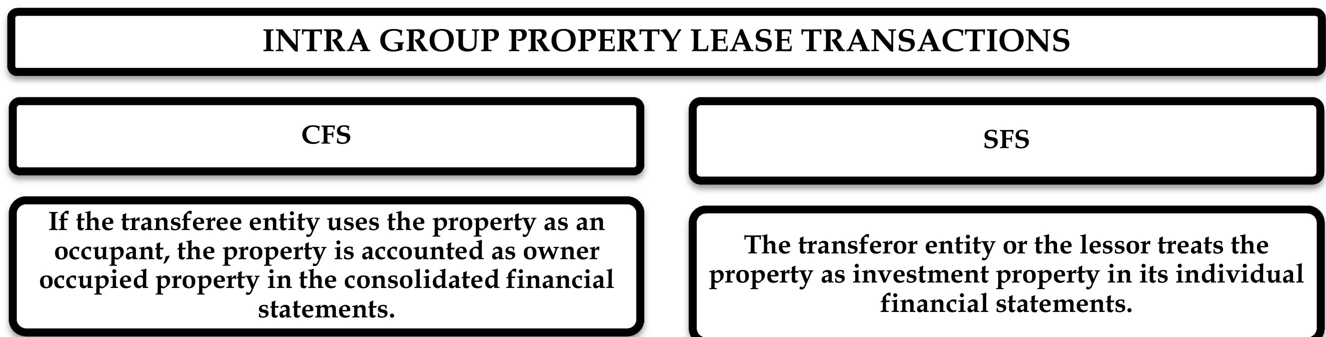
SOLUTION : 1

## 6. INTRA GROUP PROPERTY LEASE TRANSACTIONS

In intra group property lease transactions, accounting is based on the end use.

If the transferee entity uses the property as an occupant, the property is accounted as owner occupied property in the consolidated financial statements.

However, the transferor entity or the lessor treats the property as investment property in its individual financial statements.




**PROBLEM : 2**

**S1 Ltd. lets out a property to S2 Ltd. under operating lease. Both the companies are subsidiary of P Ltd.Analyse how would different companies treat the property in their respective separate financial statements and consolidated financial statements.**

SOLUTION : 2

## 7. INITIAL RECOGNITION:

The rationale behind the principles laid out in Framework for recognition of an asset stands extended to cover Investment Property also.

An investment property shall be recognized as an asset **when and only when:**

- **It is probable that future economic benefits that are associated with the investment property will flow to the entity; and**
- **The cost of the investment property can be measured reliably.**

expenses, ceremony expenses and repair maintenance expenses will be expensed off as and when incurred.

**PROBLEM 3 :**

**Modern Ventures Plc constructed a building at a cost of $2m with an intention to let it out. Municipal authorities contended that it has not followed the stipulated procedures or plans and ordered Modern Ventures to demolish a part of the building. Construction is complete: only an approval from the municipal authorities in the form of a completion certificate' is to be received. Should Modern Ventures Plc recognise the property as investment property?**

**SOLUTION 3 :**

If we look at the conditions for recognition, the second condition is satisfied i.e. the cost of the property can be measured reliably. However. it is not yet probable that the future economic benefits associated with the property in the form of rent income or capital appreciation will flow to Modern. The first condition is not satisfied.

Modern should not recognise the property as investment property it may have to consider an impairment loss.

## 8. MEASUREMENT AT INITIAL RECOGNITION

An Investment property shall initially be recognized **at cost**.

Transaction costs (such as Professional fees for legal services, property transfer taxes) shall be included in the initial measurement.

In this context, cost is defined as the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other **IFRSs.**

**PROBLEM 4 :**

**X Limited purchased a building for $ 30,00,000 in May 1, 20X1. The purchase price was funded by a loan. Property transfer taxes and direct legal costs of $ 1,00,000 and $ 20,000 respectively were incurred in acquiring the building. In 20X1-20X2, X Limited redeveloped the building into retail shops for rent under operating leases to independent third parties. Expenditures on redevelopment were:**

**$ 2,00,000 planning permission.**

**$ 7,00,000 construction costs (including $40,000 refundable purchases taxes).**

**The redevelopment was completed and the retail shops were ready for rental on September 2, 20X1.**

**What is the cost of building at initial recognition?**

**SOLUTION 4 :**

The cost of a purchased investment property comprises its purchase price and any direct attributable expenditure.

So, the cost of the building = (30,00,000 +1,00,000 + 20,000 + 2,00,000 + 7,00,000 - 40,000) = $ 39,80,000.

**Some important aspects would include:**

## 9. CONSIDERATION TO ACQUIRE AN INVESTMENT PROPERTY IS IN THE FORM OF SHARES

Where **consideration** to acquire an investment property is **in the form of shares**, **IAS 102** Share Based Payments shall apply.

## 10. SELF CONSTRUCTED INVESTMENT PROPERTY

For determination of cost of an investment property that bears the characteristics of a **self constructed asset**, principles under **IAS 16** shall apply until the date of completion. Any abnormal amounts of wasted material, labor or other resources incurred in constructing or developing the property shall be excluded. On the asset being developed fully and qualifies to be classified as investment property accounting for such asset would be governed by this Standard.

## 11. INVESTMENT PROPERTY IS ACQUIRED ON DEFERRED PAYMENT BASIS

- In case the investment property is acquired on Deferred Payment basis, the cost of investment property shall be its cash price and interest portion will accounted for accordingly on accrual basis.

**PROBLEM : 5**

**X Ltd. acquired an investment property under defer payment plan :**

**Down payment on date of acquisition Rs. 50,00,000. After 6 months Rs. 1,20,00,000. After 1 year Rs. 5,00,00,000**

**The incremental borrowing rate of the company is 11% p.a, find out cost of investment property at initial recognition ? How should X Ltd. account for the difference? Pass journal entries.**

SOLUTION : 5

| | | | |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |

Journal Entries

**PROBLEM 6 :**

**X Limited purchased a land worth of $ 1,00,00,000. It has option either to pay full amount at the time of purchases or pay for it over two years for a total cost of $ 1,20,00,000. What should be the cost of the building under both the payments method?**

**SOLUTION 6 :**

Using either payment method, the cost will be $ 1,00,00,00. If the second payment option is used, $ 20,00,000 will be treated as interest expenses over the period of credit i.e., 2 years.

## 12. INVESTMENT PROPERTY IS ACQUIRED IN EXCHANGE FOR NONMONETARY CONSIDERATION

- When an Investment property is acquired in exchange for nonmonetary consideration or combination of both monetary and non-monetary consideration, it shall be valued at its fair value or the fair value of the asset given up unless:
  - ✓ the transaction lacks commercial substance or
  - ✓ the fair value of neither the asset received nor the asset given up is reliably measurable.
  - ✓ If the asset is not measured at Fair Value, it is measured at the carrying amount of the asset given up. In this context, **carrying amount** is the amount at which an asset is recognised in the statement of financial position.

## 13. INVESTMENT PROPERTY HELD BY A LESSEE AS A RIGHT-OF-USE ASSET

An investment property held by a lessee as a right-of-use asset shall be recognised in accordance with IFRS 16

## 14. SUBSEQUENT EXPENDITURE

The expenses incurred for services are normally charged off to profit or loss under the head **"repairs and maintenance".**

The cost of the **replacing parts** of the investment property shall be **added to the carrying amount** of the investment property.

The **carrying amount of the replaced** parts shall be **derecognized** according to the de-recognition principles.

**PROBLEM : 7**

**X limited owns a building which is used to earn rentals. The building has a carrying amount of Rs 50,00,000. X limited recently replaced interior walls of the building and the cost of new interior walls is Rs 5,00,000. The original walls have a carrying amount of Rs 1,00,000. How X limited should account for the above costs?**

**SOLUTION 7 :**

**PROBLEM : 8**

**X Ltd. acquired land for Rs. 15 crores. and constructed buildings at a cost of Rs. 40 crores. to be used for letting out for commercial and residential purposes under varied lease terms. Interior walls in the common spaces were decorated at a cost of Rs. 120 lakhs. The useful life of the building is estimated at 50 years and that of interior decoration 15 years. After 10 years, the entity changed the interior decoration at a cost of Rs. 1.50 cr. and estimated new useful life of 15 years. Find out depreciation charge during 1-11 years and show accounting entry for the replacement of interior walls.**

**SOLUTION 8 :**

## 15. ACCOUNTING MODEL

Principles that govern Property, Plant and Equipment will apply to investment property as well.

For subsequent measurement, an entity shall carry the investment properties at **cost or fair value model.**

**The policy should be applied to all of its investment property.**

## 16. COST MODEL

An entity electing to apply cost model shall apply the principles of IAS 16 to those investment properties.

**PROBLEM : 9**

**On April 1, 20X1 an entity acquired an investment property (building) for $ 40,00,000. Management estimates the useful life of the building as 20 years measured from the date of acquisition. The residual value of the building is $ 2,00,000. Management believes that the straight-line depreciation method reflects the pattern in which it expects to consume the building's future economic benefits. What is the carrying amount of the building on March 31, 20X2 ?**

**SOLUTION : 9**

Cost of the asset is $ 40,00,000.

Depreciable amount = Cost less Residual value = (40,00,000 - 2,00,000) = 38,00,000

Depreciation for the year = Depreciable amount/useful life

= 38,00,000/20

= 1,90,000.

Carrying amount = Cost less accumulated depreciation

= (40,00,000 - 1,90,000) = $ 38,10,000.

## 17. FAIR VALUE MODEL

An entity selecting fair value model should measure all of its investment property at fair value.

Once an entity measures investment property at fair value, it should continue to do so until:

a. Disposal; or
b. The property becomes owner occupied property; or

c. The entity begins to develop the property for subsequent sales

Only in rare exceptions change from fair value model to cost model is permitted. It is assumed that an entity can determine the fair value on a continuing basis.

While determining the fair values, double counting is to be avoided in case of assets and liabilities that are recognized as specific assets or liabilities.

**EXAMPLE**

**The fair value of a leased furnished office will normally include the fair value of furniture also. In this situation, it should be ensured that the furniture value is not counted again.**

Equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment.

## 18. INVESTMENT PROPERTY THAT IS CLASSIFIED AS HELD FOR SALE

The investment property that is classified as held for sale shall be governed by the principles of IFRS 5.

**PROBLEM : 10 Which IAS/ IFRS is applicable ?**

| S.No. | Land And Building | Applicable IAS |
|---|---|---|
| **1** | **Land and building held as inventories (Buying developing and selling for short term profits)** | |
| **2** | **Land and building held for production, storage, distribution, services, administrative purpose.** | |

**SOLUTION 10 :**

**PROBLEM : 11**

**CA Ltd. and its subsidiaries have provided you, a list of the properties they own. Advise CA Ltd. and its subsidiaries as to which of the above-mentioned properties would qualify under IAS – 40 as investment properties. If they do not qualify thus, how should they be treated under IAS/IFRS?**

| | |
|---|---|
| **a) Land held by CA Ltd. for future sale after some 5 years**<br>**b) A vacant building owned by CA Ltd. and to be leased out under an operating lease.**<br>**c) Property held as a wing of real estate business**<br>**d) Property held by CA Ltd. as a warehouse to store goods.**<br>**e) Land, Building, Furniture fittings provided on rental basis.**<br>**f) S1 a subsidiary of CA Ltd lets out a property to S2 again a subsidiary of CA Ltd. under operating lease basis.**<br>**g) 50% property is let out on rental and 50% is used for services relating to consultancy. Also the property cannot be separated.** | |

**PROBLEM : 12**

**A hotel owned by CA Ltd. and appointed an external party Lucky firm for providing hotel management services. CA Ltd is not responsible for the hotel services as will be undertaken by Lucky Firm. Advise CA Ltd. as to which IAS / IFRS is applicable.**

SOLUTION 12 :

## 19. TRANSFERS

Often an entity may be faced with a need to convert an investment property into owner occupied property, or vice versa when there is change in use.. In short, such actions may be referred to as Transfers.

**A. When the entity uses the cost model**

Transfers between investment property, owner-occupied property and inventory do not change the carrying amount of inventory because all are held at cost.

**Transfers to and from investment property (IP) shall be made when** ***there is change in the use:***

| | | |
|---|---|---|
| | | |
| | | |
| | | |
| | | |

**PROBLEM 13 :**

**ASF Property holdings engaged in buying and selling properties on large scale. Property X purchased on 1/4/2014 @ Rs 50,000 including all other expenses. Every year the NRV of the property was 20-25% more than cost. The property will be depreciated over 25 years SLM, Salvage Value = 40%**

**On 1/4/2017 the entity decided to reclassify the property X as investment property to be let out on rent basis. Comment on the reclassification.**

SOLUTION 13 :

**PROBLEM 14 :**

**Moon Ltd has purchased a building on 1st April 20X1 at a cost of $ 10 million. The building was used as a factory by the Moon Ltd and was measured under cost model. The expected useful life of the building is estimated to be 10 years. Due to decline in demand of the product, the Company does not need the factory anymore and has rented out the building to a third party from 1st April 20X5. On this date the fair value of**

**the building is $ 8 million. Moon ltd uses cost model for accounting of its investment property. What is the amount at which building will be initially recognised as investment property?**

**SOLUTION 14 :** ($Million)

| | ($Million) |
|---|---|
| Carrying amount of the building after depreciation of 4 years (10-10/10*4). | 6 |
| The company has applied cost model under IAS 16 till now. | |
| There is no impairment as the fair value is greater than the carrying amount of building. | |
| Revaluation Surplus credited to Other Comprehensive Income | --- |
| (not applicable since cost model is used under IAS 16) | |
| Building initially recognised as Investment Property | 6 |
| (Cost model Ind AS 40) | |

2. **When entity uses fair value model for investment property**

   **For a transfer from investment property carried at fair value to owner-occupied property or inventories,** the property's deemed cost for subsequent accounting in accordance with IAS 16, IFRS 16 or IAS 2 shall be its fair value at the date of change in use.

   **If an owner-occupied property becomes an investment property that will be carried at fair value**, an entity shall apply IAS 16 for owned property and IFRS 16 for property held by a lessee as a right-of-use asset up to the date of change in use. The entity shall treat any difference at that date between the carrying amount of the property in accordance with IAS 16 or IFRS 16 and its fair value in the same way as a revaluation in accordance with IAS 16.

   (a) any resulting decrease in the carrying amount of the property is recognised in profit or loss. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is recognised in other comprehensive income and reduces the revaluation surplus within equity.

   **(b)** any resulting increase in the carrying amount is treated as follows:

   (i) to the extent that the increase reverses a previous impairment loss for that property, the increase is recognised in profit or loss. The amount recognised in profit or loss does not exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised.

   (ii) any remaining part of the increase is recognised in other comprehensive income and increases the revaluation surplus within equity. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to retained earnings. The transfer from revaluation surplus to retained earnings is not made through profit or loss.

   **For a transfer from inventories to investment property that will be carried at fair value,** any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in **profit or loss.**

   **When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value,** any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in **profit or loss.**

**Summary**

| S. No. | Transfer Type | Manner of transfer |
|---|---|---|
| 1 | **Investment property carried at fair value to owner occupied property or inventories** | The property's deemed cost for subsequent accounting in accordance with IAS 16, IFRS 16 or IAS 2 shall be its fair value at the date of change. |

| 2 | **owner-occupied property to investment property to be carried at fair value** | Entity shall apply IAS 16 for owned property and IFRS 16 for property held by a lessee as a right-of-use asset up to the date of change. Any difference at that date between the carrying amount and its fair value should be treated as a revaluation surplus in accordance with IAS 16. |
|---|---|---|
| 3 | **Inventory to investment property to be carried at fair value.** | Any difference between the fair value (as an investment property) at that date and its previous carrying amount (as inventory) shall be recognised in **profit or loss.** |

**EXAMPLE :**

**A building depreciates and has a net depreciated carrying value of $75,000, It is transferred to investment property at a fair value of $100,000 The difference of $25,000 should be accounted for as a revaluation surplus .**

## 20. RETIREMENT OR DISPOSALS

- The investment property shall be derecognized (eliminated from the statement of financial position) on disposal or when the investment property is permanently withdrawn from use and no further economic benefits are expected from its disposal.
- The disposal may be through sale or entering into finance lease.
- The date of disposal for investment property that is sold is the date the recipient obtains control of the investment property in accordance with the requirements for determining when a performance obligation is satisfied in IFRS 15.
- IFRS 16 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

## 21. GAINS OR LOSSES FROM DISPOSAL

**Gains or losses from disposal are the difference between the net disposal proceeds and the carrying amount, which shall be recognized in profit or loss during the period of disposal.**

It is possible that an investment property may be sold on deferred payment basis. Any deferred receipt of net consideration shall be bifurcated into cash price and interest portion.

**PROBLEM : 15**

**ASF Ltd owns an investment property X which it accounts for under the cost model. On 1 January 20X7. its cost is $250,000, and the accumulated depreciation $75,000. It sells the property on the same day for $180,000. It has another investment property Y, with a cost of $45,000 and accumulated depreciation $20,000. The property is transferred to the inventory category.**

**Required:**

**Explain the accounting for these transactions events.**

**SOLUTION 15 :**

The accounting entry for the sale of property X will be:

| | | ₹ | ₹ |
|---|---|---|---|
| Dr | Bank / cash 180,000 | | |
| Dr | Accumulated depreciation | 75,000 | |
| Cr | Property X | | 250,000 |
| Cr | Profit on sale of investment property | | 5,000 |

Being entry to record the sale of property and the profit on sale

The entry for the transfer of property Y wilI be

₹ ₹

| | | | |
|---|---|---|---|
| Dr | Inventory | 25,000 | |
| Dr | Accumulated depreciation | 20,000 | |
| | Cr Property Y | | 45,000 |

Being entry to transfer investment property Y to inventory

## 22. COMPENSATION RECEIVED

Compensation from third parties for investment property that was impaired, lost or given up shall be recognized in profit or loss when the compensation becomes receivable.

## 23. DISCLOSURES

The following general disclosures will apply.

- Accounting policy for measurement of investment (i.e fair value model or cost model).
- In situations calling for exercise of judgement for classification of a property as investment property, the criteria adopted to distinguish investment property from owner occupied property and from property held for sale in the ordinary course of business.
- The extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.
- If there has been no such valuation, that fact shall be disclosed.
- The amounts recognized in profit or loss, including:
  - ✓ Rental income from investment property
  - ✓ Direct operating expenses arising from investment property that generated rental income and those which did not generate, be disclosed separately.
- Existence of any restrictions on the realisability of investment property, and contractual obligations to purchase, construct or develop investment property (or for repairs, maintenance or enhancements).
- contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

## 24. ADDITIONAL DISCLOSURES

### (A) FAIR VALUE MODEL

An entity that applies the fair value model shall disclose a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing the following:

(a) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised in the carrying amount of an asset;

(b) additions resulting from acquisitions through business combinations;

(c) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;

(d) net gains or losses from fair value adjustments;

(e) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;

(f) transfers to and from inventories and owner-occupied property; and

(g) other changes.

When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, for example to avoid double-counting of assets or liabilities that are recognised as separate assets and liabilities, the entity shall disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any

recognised lease liabilities that have been added back, and any other significant adjustments.

In the exceptional cases, when an entity measures investment property using the cost model in IAS 16 or in accordance with IFRS 16, the reconciliation required shall disclose amounts relating to that investment property separately from amounts relating to other investment property. In addition, an entity shall disclose:

(a) a description of the investment property;

(b) an explanation of why fair value cannot be measured reliably;

(c) if possible, the range of estimates within which fair value is highly likely to lie; and

(d) on disposal of investment property not carried at fair value:

  (i) the fact that the entity has disposed of investment property not carried at fair value;

  (ii) the carrying amount of that investment property at the time of sale; and

  (iii) the amount of gain or loss recognised

**b. COST MODEL**

The following **additional disclosures** (generally on the lines of IAS 16, Property Plant and Equipment) shall apply.

- Depreciation method used
- Useful lives or the depreciation rates used
- Gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and at the end of the period
- A reconciliation of the carrying amount of investment property at the beginning and at the end of the period, showing the following:
  - ✓ Additions, disclosing separately those additions through business acquisitions, other acquisitions and by way of separate expenditure recognised as asset.
  - ✓ Additions resulting from acquisitions through business combinations
  - ✓ Assets classified as held for sale or included in a disposal group in accordance with IFRS 5 and other disposals
  - ✓ Depreciation,
  - ✓ Amount of impairment loss recognised, and the reversals thereof if any, during the period in accordance with IAS 36
  - ✓ Net exchange differences from translation of financial statements to a different presentation currency and on translating to presentation currency of the reporting entity.
  - ✓ Transfers to and from inventories and owner occupied property, and
  - ✓ Any other changes
- For investment properties accounted for under cost model, the fair value of properties; and when such a fair value cannot be reliably determined, supplemental information as to

  (i) description of the property,

  (ii) an explanation as to why fair value cannot be determined, and

  (iii) if possible the range of estimates within which fair value is highly likely to lie.

## 25. MAJOR CHANGES IN IND AS 40 VIS-A-VIS IAS 40

**Valuation Models:** IAS 40 permits both cost model and fair value model (except in some situations) for measurement of investment after initial recognition. Ind AS 40 permits only the cost model.

## 26. PROBLEM FOR SELF-PRACTICE

**PROBLEM : 16**

**X Ltd. has the following four properties carried in the books at cost model+ :**

**(I) Property A used as office building of the company – Cost Rs. 30 crores(cr). accumulated depreciation Rs. 20 crores., Net Rs. 10 crores. The company puts the property into renovation and intended to lease out under one or more operating leases.**

**(ii) Property B used under operating leases - Cost Rs. 50 cr. ,accumulated depreciation Rs. 20 cr., Net Rs. 30 cr. The property is put into renovation for sale.**

**(iii) Property C used under operating leases – Cost Rs. 40 cr. accumulated depreciation Rs. 20 cr., Net Rs. 20 cr. The property is put into sale.**

**(iv) Property D used under operating leases – Cost Rs. 40 cr., accumulated depreciation Rs. 20 cr., Net Rs. 20 cr. The property is put into renovation and intended to be used as office building after the renovation.**

**How should the transfer be evidenced ?**

**How would these transfers change the classification of the respective property ?**

**SOLUTION 16 :**

**Change in classification of the property :**

(i) **Property A : Owner occupied to Investment property**

In this case, original costs, accumulated depreciation and net carrying amount would not change.

(ii) **Property B : Investment property to Inventories**

The property shall be valued at lower of the cost and net realisable value. Depreciation charge would not arise.

(iii) **Property C : Remained in the category of Investment property**

In case of Property C, depreciation charge would continue till the asset is classified as held for sale as per IFRS 5. Once IFRS 5 applies, depreciation charge would not arise and the asset shall be measured at fair value less costs to sell.

(iv) **Property D : Investment property to Owner occupied.**

In this case, original costs, accumulated depreciation and net carrying amount would not change. Subsequent costs of renovation shall be added to the costs. In case of Property D, useful life of the property is re-estimated and depreciation charge is re-computed.

**PROBLEM 17 :**

**X Limited has an investment property (building) which is carried in Balance Sheet on March 31, 20X1 at $ 15,00,000. During the year X Limited has stopped letting out the building and used it as its office premise. On March 31, 20X1, management estimates the recoverable amount of the building as $ 10,00,000 and its remaining useful life as 20 years and residual value is nil. How should X Limited account for the above investment property as on March 31, 20X1?**

**SOLUTION 17 :**

At March 31, 20X1, X Limited must transfer the property from investment property to property, plant and equipment since there is a change in use of the said building. The transfer should be made at its carrying amount i.e., $15,00,000. Since recoverable amount of the property as on March 31, 20X1 is $10 Lakhs, impairment loss $ 5 Lakhs should be recognised in the Statement of Profit and Loss.

The entity must disclose the reclassification.

From April 20X1, X Limited will depreciate the building over its remaining useful life of 20 years.

**PROBLEM 18 :**

**In financial year 20X1-20X2, X Limited incurred the following expenditure in acquiring property consisting of 6 identical houses each with separate legal title including the land on which it is built.**

**The expenditure incurred on various dates is given below:**

**On April 1, 20X1 - Purchase cost of the property $ 1,80,00,000.**

**On April 1, 20X1 – Non-refundable transfer taxes $ 20,00,000 (not included in the purchase cost).**

**On April 2, 20X1- Legal cost related to property acquisition $ 5,00,000.**

**On April 6, 20X1- Advertisement campaign to attract tenants $ 3,00,000.**

**On April 8, 20X1 - Opening ceremony function for starting business $ 1,50,000.**

**Throughout 20X1-20X2, incurred $ 1,00,000 towards day-to-day repair maintenance and other administrative expenses.**

**X Limited uses one of the six houses for office and accommodation of its few staffs. The other five houses are rented to various independent third parties.**

**How X Limited will account for all the above mentioned expenses in the books of account?**

**SOLUTION 18 :**

The cost of the property = $(1,80,00,000 + 20,00,000 + 5,00,000) = $ 2,05,00,000.

Since five houses out of six are being rented, so 5/6th of the property cost will be accounted for as an investment property and 1/6th of the property cost will be accounted for as owner occupied property.

Cost of the investment property = $ 2,05,00,000 x 5/6 = $ 1,70,83,333

Cost of the owner occupied property = (2,05,00,000 - 1,70,83,333) = $ 34,16,667. All other costs, i.e., Advertisement

**PROBLEM 19 :**

**Khatir Holdings LLC holds a property lease. For which it paid a premium of $ 1m.**

**As per the terms. it has to pay $0.2m per annum for next five years, the present value of which is $0.76m. The asset's fair value is $ 1.9m.**

**Khatir wants to recognise the property as an investment property under IAS 40. as it intends to rent out the property. It seeks your advice to decide the initial cost of the property.**

**SOLUTION 19 :**

Khatir Holdings LLC can recognise the property as an investment property, as it intends to rent it out.

The present value of minimum lease payments is $1.76m (including the premium), while the fair value is $1.9m. The lower of the two (i.e. $1.76.m) will be recognised as the initial cost of the investment property.

**PROBLEM 20 :**

**A building held as investment property has a carrying value of $150,000. If transferred to owner-occupied: property (governed by IAS 16). What will be it deemed cost?**

**SOLUTION 20 :**

Its cost will be deemed to be $150,000.

**QUESTION 21 :**

**The carrying value of property X is $120,000 and of property Y, $160,000 they are revalued at $100,000 and $176,000 respectively. On the previous revaluations, X's value was increased by $14,000 (being the amount lying to the credit of revaluation surplus against this asset) and Y's value decreased by $10,000. Show the accounting entries under the alternative assumptions that the properties are:**

1. **Owner-occupied properties**
2. **Investment properties**

**SOLUTION 21 :**

1. **If the properties are owner-occupied**

   Revaluation **decrease in case of property X** is $20,000 (120,000 — 100,000).

   Credit balance in revaluation surplus against this asset is $14,000,

The following entry should be passed:

| | | | |
|---|---|---|---|
| Dr | Revaluation surplus (In equity) | $14,000 | |
| Dr | Profit / loss on revaluations (Statement of comprehensive income) (This account will be transferred to the ISOPL)) | $6,000 | |
| Cr | Property | $20,000 | |

Being loss on revaluation accounted for.

**Increase regarding property Y** is $16,000 (176,000 – 160,000)

previous reduction $10,000

This must have been recognised in profit or loss. according to IAS 16.

The following entry should be passed:

| | | | |
|---|---|---|---|
| Dr | property | $16,000 | |
| Cr | Profit / loss on revaluations | | $10,000 |
| Cr | Revaluation surplus (in equity) | | $6,000 |

Being profit on revaluation accounted for

2. If the properties are investment properties

   The gains or losses caused by increase or decrease in the fair values be recognised in the profit or loss immediately. There is no need to keep track of the earlier variations in the values.

**For property X**

| | | | |
|---|---|---|---|
| Dr | Loss on investment properties | $20,000 | |
| Cr | Investment property X | | $20,000 |

Being loss on revaluation of investment property transferred to statement of comprehensive income.

**For property Y**

| | | | |
|---|---|---|---|
| Dr | Investment properties | $16,000 | |
| Cr | Profit on investment property Y | | $16,000 |

Being profit on revaluation of investment property transferred to statement of comprehensive income.

# IAS 38 INTANGIBLE ASSETS

## 1. INTRODUCTION

Intangibles are identifiable non-monetary assets without physical existence. Since intangibles can be identified as a separate asset, appropriate accounting treatment is necessary.

**IAS 38 provides**

- ✓ identification technique,
- ✓ recognition criteria,
- ✓ amortisation method and
- ✓ disclosure aspects with respect to Intangibles.

## 2. SCOPE

This Standard shall be applied in accounting for intangible assets, **except**

1. Intangible assets that are within the scope of another Standard.
2. Financial assets, as defined in IAS 32 'Financial Instruments: Presentation'
3. The recognition and measurement of exploration and evaluation assets (IFRS 6 'Exploration for and Evaluation of Mineral Resources')
4. Expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources

If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For example, this Standard **does not apply to:**

(a) intangible assets held by an entity for sale in the ordinary course of business (see IAS 2 Inventories).

(b) deferred tax assets (see IAS 12 Income Taxes). (c) leases of intangible assets accounted for in accordance with IFRS 16 Leases.

(d) assets arising from employee benefits (see IAS 19 Employee Benefits).

(e) financial assets as defined in IAS 32. The recognition and measurement of some financial assets are covered by IFRS 10 Consolidated Financial Statements, IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures.

(f) goodwill acquired in a business combination (see IFRS 3 Business Combinations).

(g) contracts within the scope of IFRS 17 Insurance Contracts.

(h) non-current intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

(i) assets arising from contracts with customers that are recognised in accordance with IFRS 15 Revenue from Contracts with Customers.

Notes –

Rights held by a lessee under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are within the scope of this Standard and are excluded from the scope of IFRS 16.

This Standard applies to other intangible assets used (such as computer software), and other expenditure incurred (such as start-up costs), in extractive industries or by insurers.

## 3. INTANGIBLE ASSET

An **intangible asset** is an

- identifiable
- non-monetary
- asset
- without physical substance.
- Ex. Computer Software, Patent, Copyright, Trademarks, motion picture films, Goodwill, Licenses, import quotes, Franchises, and Marketing rights etc.

**Caution: In determining whether an asset that incorporates both intangible and tangible elements should be treated under IAS 16 "Property, Plant and Equipment" or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant.**

**For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment.**

**The same applies to the operating system of a computer.**

**When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.**

## 4. ASSET

An asset is a resource :

a. Controlled by an enterprise
b. as a result of past events and
c. From which future economic benefits are expected to flow to the enterprise.

## 5. DEFINITIONS

An **active market** is a market in which all the following conditions exist:

a) The items traded in the market are homogeneous;
b) Willing buyers and sellers can normally be found at any time; and
c) Prices are available to the public.

**Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

**Carrying amount** is the amount at which an asset is recognized in the Balance Sheet after deducting any accumulated amortisation and accumulated impairment losses thereon.

**Cost** is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRSs, e.g. IFRS 102 **Share-based Payment.**

**Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.

**Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

**Entity-specific value** is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

**Fair value of an asset** is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

**An impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

**Monetary assets** are money held and assets to be received in fixed or determinable amounts of money.

**Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

The **residual value** of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**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.

## 6. INITIAL RECOGNITION OF INTANGIBLE ASSET

Recognition of an intangible asset requires an entity to demonstrate that the items meet:

- Definition of an intangible asset
- The Recognition criteria

## 7. DEFINITION OF AN INTANGIBLE ASSET

To facilitate recognition, the Intangible Assets (IA) should possessthe characteristics of an asset.

These are:

- **Identifiable** – Asset is said to be identifiable if it is separable or capable of being separated and sold/transferred or arises out of contractual or other legal rights.

**Examples :**

License to operate buses on a route is separately identifiable as it arises from a legal right.

Mining rights granted by government to a mining company is separately identifiable as it arises from a legal right.

- **Control over asset** – Control exists if entity has power to obtain future economic benefit flowing from the asset and can restrict access to others. The enterprise should possess control over the asset obtaining legal rights, technical knowledge, patents or agreements, etc.

**Example 1 : Patent right**

A patent right gives production right of a specified drug to a company which gives it future economic benefit and also nobody else can use the said formula to launch a new product.

**Example 2: Market Share**

- Not controlled by the enterprise
- No direct economic benefit
- So it is not an intangible as per **IAS-38**

**Example 3 :*Training to Skilled staff***

- Not controlled by the enterprise
- So it is not an intangible as per **IAS-38**

**Example 4 :Specific Management and Technical Talent**

- The entity usually does not have the power over the employees to force him to stay with the entity.
- Not controlled by the enterprise
- So it is not an intangible as per **IAS-38**

| **Example 5: Customer Portfolio** |
|---|
| • Not controlled by the enterprise<br>• No legal rights to protect or other ways to control customer loyalty.<br>• So it is not an intangible as per **IAS-38** |

- **Future economic benefits** — The asset must be able to save cost or generate revenue in future or a combination of both.

**PROBLEM 1 :**

**ASF Ltd has an expertise in consulting business. In past years, company has gained a market share for its services of 30 percent and considers recognising it as an intangible asset. Is the action by company is justified?**

**SOLUTION 1 :**

Market share does not meet the definition of intangible assets as is not identifiable i.e. It is neither separable and nor arised from contractual or legal rights.

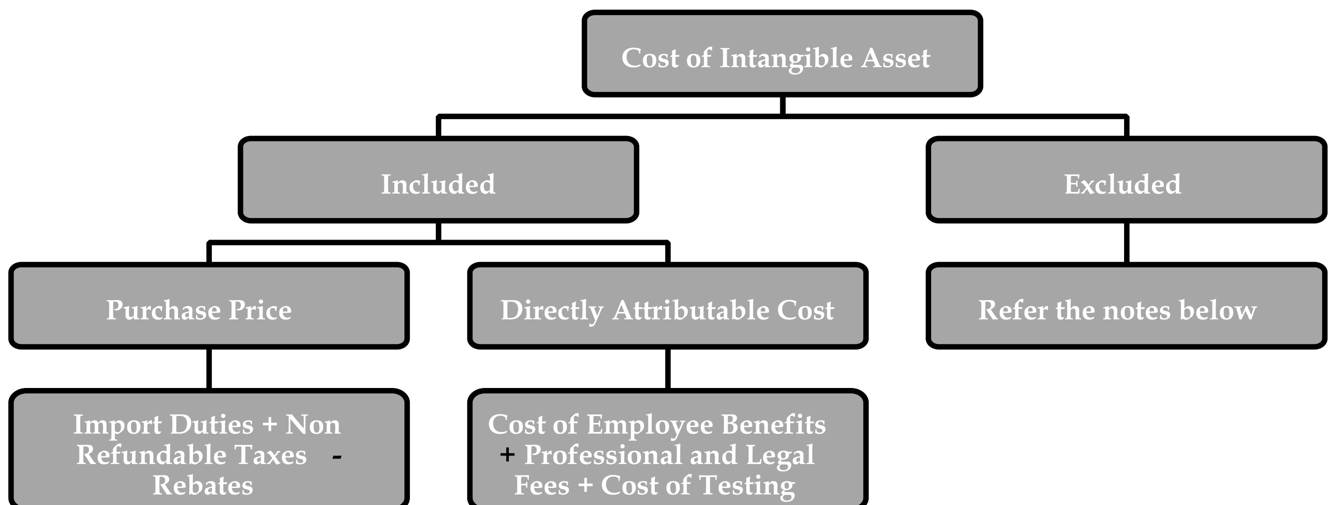
## 8. RECOGNITION CRITERIA

IA should be recognized only if the following recognition criteriaare met:

- The cost of the asset can be measured reliably
- It is possible that the expected future economic benefits attributable to the asset will flow to the entity.

## 9. MEASUREMENT

Intangible should be initially measured at **cost.**




## 10. COST OF SEPARATELY ACQUIRED

1. **IF IA IS DIRECTLY ACQUIRED** - The cost of separately acquired intangible asset will be included price paid, duties, taxes paid and any other expenses incurred directly to bring it into usable condition.

| | **Rs** |
|---|---|
| Purchase price<br>Import duties and other taxes, if any net of refundable duties;<br>Directly attributable expenditure which makes the intangible ready for its intended use | |
| Less : Trade discounts and rebates | |

**Examples of expenditures that are not part of the cost of an intangible asset are:**

(a) costs of introducing a new product or service (including costs of advertising and promotional activities);

(b) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(c) administration and other general overhead costs.

Cost depends onthe mode in which the IA is acquired.

## 11.IF IA IS ACQUIRED THROUGH EXCHANGE OF ANOTHER ASSET

**IF IA is acquired through exchange of another asset**, the cost of such an intangible asset is measured at fair value unless

(a) the exchange transaction lacks commercial substance or

(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

If an entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

**PROBLEM 2 :**

**X Ltd purchased a Patent (market value Rs. 10 Lakhs) from Y Ltd in exchange of investments worth Rs. 6 lakhs on the transaction date. X Ltd also paid Y Ltd Rs. 2.50 lakhs as balance consideration. At what amount should X Ltd record the patents ?**

**SOULITION 2 :** .

## 12.IF IA IS ACQUIRED THROUGH BUSINESS COMBINATIONS

Recognised at fair value on the date of acquisition as required by IFRS 3 — Business Combinations. If the intangible asset is separable but only together with other intangible asset then fair value of those intangible assets shall be measured as a whole.

## 13.PAYMENT DEFERRED BEYOND NORMAL CREDIT TERMS:

Under IAS 38, if payment for an intangible asset is deferred beyond normal credit terms, the difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised as per IAS 23.

**PROBLEM 3 :**

**A patent right was purchased for a total payment of Rs. 40 lacs as per deferred credit term as explained below. The normal deferred credit allowed by the seller is a 20% down payment and a balance in three equal annual instalments. The deferred credit term to the company is down payment 25% and balance in five equal annual instalments. The normal deferred credit allowed by the company does not include any interest, whereas in the special credit period it has charged 6% interest p.a. Advise the cost of Intangible asset.**

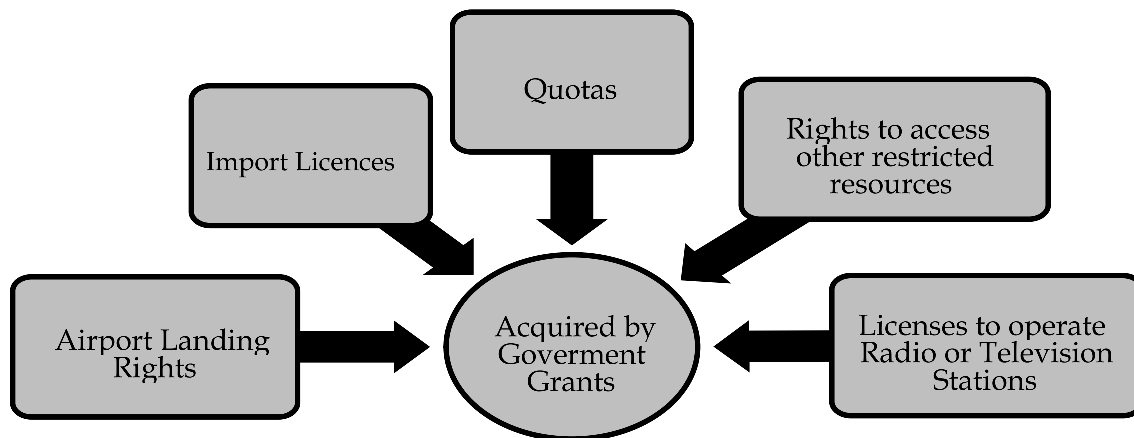
**SOLUTION 3 :**

**Calculation of the cost of the intangible asset**

| Year | Cash flow | D.F. @ 6% | D.C.F. (Rs.) |
|---|---|---|---|
| | | | |
| | | | |
| Patent should be capitalized at Rs. | | | |

## 14.IF IA IS ACQUIRED THROUGH GOVT GRANTS

Recognised as per IAS 20. (Fair value or nominal value plus any expenditure that is directly attributable to preparing the asset for its intended use.) (Examples – airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.)




**PROBLEM : 4**

**Due to contribution by ASF Ltd to the society, the Government has given a product license at a nominal consideration of Rs. 40 lakhs. The market value of license is Rs. 3 crores. The company has incurred Rs. 4 lakhs on registration of the license. X Ltd values license at nominal value.**

**At what amount the license should be recorded ?**

**SOULITION : 4**

**PROBLEM : 5 [Intangible assets and Government Grants]**

**On 1.4.2016, X Ltd. acquired a mining right from the Government at Rs. 10 cr. The fair value of the mining right as determined applying IFRS 13 is Rs. 100 cr. How should the entity account for the mining at initial recognition? It has been estimated that the minerals would extracted over a period of 30 years. X Ltd. decided to amortise the mining right over 30 years on straight line basis.**

**How should X Ltd. account for the intangible asset at initial recognition? How should it account for the related Government Grant? X Ltd values mining rights at fair value.**

**SOLUTION : 5**

The entity shall recognise the Mining Right at Rs.100 cr. and Government Grant at Rs. 90 cr. The Government Grant is amortised over 30 years on straight line basis.

**Accounting entry on initial recognition:**

| | | | |
|---|---|---|---|
| Mining Right A/c | Dr. | Rs.100 | |
| Government Grant A/c | Cr. | | Rs. 90 cr. |
| Bank A/c | Cr. | | Rs. 10 cr. |

## 15. INTERNALLY GENERATED GOODWILL

**Internally generated goodwill** shall not be recognized as an asset.

**Reason -** Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

**PROBLEM : 6**

**A.S. Ltd's networth is Rs 400 crores. The market capitalisation is Rs. 560 crores. Will the difference of Rs 160 crores be recognised as goodwill ?**

**SOULITION : 6**

## 16. INTERNALLY GENERATED INTANGIBLE ASSETS

The process of creating intangible assets - is classified into two distinct areas:

**Research Phase —** All expenses incurred are to be charged as expense as and when incurred.

**Reason -** In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred.

**Development Phase —**The development phase of a project is further advanced than the research phase. Expenses are to be capitalised if and only if the following conditions are met:

❖ **Technical feasibility** of completing IA

❖ **Availability of resources** (T**echnical, financial and other resources) -** for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

❖ **Intention to complete and use** IA

❖ **Ability to use or sell** the IA

❖ **Probability that IA will generate future economic benefits** (**the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.**

❖ **Expenditure attributable to IA can be measured reliably** - An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

## 17. COST OF INTERNALLY GENERATED INTANGIBLE ASSET

| *COST OF INTERNALLY GENERATED INTANGIBLES INCLUDES* | *COSTS NOT TO BE INCLUDED* |
|---|---|
| ➢ Expenditure on materials and services<br>➢ Salaries, wages and other employment related costs<br>➢ Any expenditure that is directly attributable to the generation of intangible asset; (e.g.fees to register a legal right;)<br>➢ amortisation of patents and licences that are used to generate the intangible asset.<br>➢ Overheads are necessary for the generation of the asset and that can be allocated on reasonable basis. | ➢ Selling, administrative and other general overheads unless such overheads are directly attributable in the generation of the intangible,<br>➢ Inefficiencies and initial operating losses incurred before an asset achieves planned performance, and<br>➢ Expenditure on staff training |

**PROBLEM 7 :**

**State your opinion on the following situation : Note No. 6 of Published Accounts of K Ltd. reads as follows : "The Company being a manufacturer of pollution control equipments entered into collaboration agreements with foreign manufacturers for technical know-how comprising the supply of drawings and designs and training of personnel for manufacture of different types of pollution control equipments. These agreements were concluded after the commencement of production at the beginning of the year. The collaboration amount of Rs. 100 lakhs is payable in five annual instalments. The Company has amortised the entire cost of technical know-how as a depreciable asset and has shown the same in the schedule of fixed assets."**

**SOLUTION : 7**

As per IAS – 38 the training cost incurred on personnel should not be capitalized. The company should capitalize only the cost related to design and drawings.

Training cost does not satisfy the criteria of intangible asset i.e. control. So it cannot be capitalized.

## 18. RECOGNITION OF EXPENSE

Expenditure on an intangible item shall be recognised as an expense unless:

- It forms part of cost of intangible asset.
- It is acquired in a business combination **and cannot be recognised as an intangible asset. If this is the case, it forms part of the amount recognised as goodwill at the acquisition date (see IFRS 3).**

**Expenditure that is recognised as an expense when it is incurred include:**

(a) expenditure on start-up activities (ie start-up costs), unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with IAS 16. Start-up costs may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie pre-opening costs) or expenditures for starting new operations or launching new products or processes (ie pre-operating costs).

(b) expenditure on training activities.

(c) expenditure on advertising and promotional activities (including mail order catalogues).

(d) expenditure on relocating or reorganising part or all of an entity.

**It is to be noted that once written off as expense, it shall not be recognised as cost of IA later.**

**PROBLEM : 8**

**Explain in brief as to how you will deal with the following. A company with the turnover of about Rs. 100 crores and annual advertising budget of Rs. 50 lakhs has taken up the marketing of a new product. It is estimated that the company will have a turnover of about Rs. 10 crores from the new product. The company has debited to its profit and loss account the total expenditure of Rs. 50 lakhs incurred on extensive special initial advertisement campaign for the said product.**

**SOLUTION : 8**

IAS-38 does not permit the capitalization of expenses incurred on advertising or brand promotion, etc. Thus the accounting treatment by the company of debiting the entire advertising expenditure of Rs. 50 lakhs to the profit and loss account of the year is correct.

**PROBLEM 9 :**

**How would you react to the following situations? Rs. 5 lakhs paid by a pharma company to the legal advisor defending the patent of a product treated as Capital Expenditure.**

**SOLUTION : 9**

**Legal expenses incurred by the company :** Legal expense of Rs. 5 lakhs incurred to defend the patent of a product of the pharma company is revenue expenditure pertaining to the asset since by this expenditure neither any endurable benefit can be obtained in future in addition to what is presently available nor the capacity of the asset would be increased. Payment of legal fees is normally revenue expenditure irrespective of the amount involved unless same is incurred to bring any new asset into existence. Hence, treating such expenditure as capital expenditure is incorrect.

## 19. SUBSEQUENT MEASUREMENT

An entity is given a choice to account intangible asset either under cost model or revaluation model. Within a particular class of intangible asset all the assets shall be accounted under same accounting model. A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. The items within a class of intangible assets are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements representing a mixture of costs and values as at different dates.

## 20. COST MODEL

Intangible assets shall be carried across less accumulated amortisation and any accumulated impairment losses.

## 21. REVALUATION MODEL

The intangible asset shall be revalued at such frequency that, at the reporting date there shall not be any material difference between the carrying amount and the fair value as on that date.

The fair value is determined by reference to an active market. As an exception if there is no active market at all or if subsequently there is no active market then the concerned intangible asset shall be carried at cost or previously recognised fair value after considering accumulated amortization or impairment loss respectively. The accounting treatment for any revaluation surplus is similar to IAS 16 Property, Plant and Equipment.

The revaluation model may be applied to an intangible asset that was received by way of a government grant and recognised at a nominal amount.

## 22. AMORTISATION

Amortisation refers to the allocation of an amount to be charged off over the useful life of the IA. Depreciable amount of IA is the cost less residual value distributed over the useful life of asset.

## 23. AMORTISATION METHOD

The amortisation should be based on the pattern in which the future economic benefits are consumed **(matching concept).** If pattern cannot be determined reliably then straight line method is to be used.

## 24. RESIDUAL VALUE

1. Should be taken as ZERO unless
   a. there is commitment by third party to purchase the IA at the end of its useful life or
   b. it is probable that an active market exists and will exist at the end of useful life.

## 25. SUBSEQUENT INCREASE OF RESIDUAL VALUE FOR CHANGES IN PRICES OR VALUE:

The residual value is reviewed at least at each financial year-end. If it increases to an amount equal to or greater than the asset"s carrying amount, amortisation charge is zero unless the residual value subsequently decreases to an amount below the asset"s carrying amount.

## 26. USEFUL LIFE

The entity may have intangible assets with finite useful life and **indefinite** useful life.

**The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset.**

**If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the**

**intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.**

The intangible asset having finite useful life shall be amortised over the useful life. The amortisation period shall be reviewed at each reporting period and any changes shall be accounted for as changes in accounting estimates per IAS 8.

Intangible asset having indefinite useful life shall not be amortised but tested for impairment annually and whenever there is an indication that the IA may be impaired.

**PROBLEM 10 :**

**Entity E purchased a patent right for Rs. 60 lakhs. It has been assessed that useful life is 10 years. However, another Group company intends to buy the patent after 5 years for 60% of the purchase price. The Entity also intends to sell it after 5 years.**

**There exists active market for similar patents. The entity wishes to adopt revaluation model.**

**1. At what cost the entity should recognise the patent initially?**

**2. If adopts revaluation model, does it need to adopt an amortization policy?**

**3 If the answer to Question (2) is an affirmative, what should be the useful life of the asset?**

**4 What should be amortization for year 1?**

**SOLUTION 10 :**

1. Entity E should recognize the patent initially at cost Rs. 60 lakhs.
2. It has to adopt amortisation policy irrespective of the fact that it has chosen revaluation model.
3. Useful life 5 years
4. The entity may follow straight line method amortisation.

Amortisation for year $1 = \frac{\text{Rs.60 lakhs X 40\%}}{5} = \text{Rs.4.8lakhs}$

**PROBLEM 11 :**

**Entity K has purchased copyright for a period of 30 Years. However, probable future economic benefit test shows that the copyright may generate cash flows for a period of only 15 years. What should be the useful life of the copyright?**

**SOLUTION 11 :** **-** 15 YEARS.

**PROBLEM : 12**

**An entity has acquired broadcasting right for a period of 5 years which is renewable with a nominal renewal fee if renewal the entity maintains a standard broadcasting quality. Earlier the entity got renewal and there is no report of inferior quality of broadcasting.**

**What should be the useful life of the asset?**

**If after 2 years, the licensing authority decides to auction the broad-casting right and no further renewal at nominal charge will be done, how should this evidence be reflected in the accounts?**

**SOLUTION** : 12

i. Broadcasting right has indefinite useful life. The initial acquisition price of the license is not amortised but tested for impairment under IAS 36.

ii. The decision of the licensing authority has made the indefinite useful life of the intangible asset to finite useful life of 3 years. The carrying amount of the broadcasting right is amortised over 3 years.

**PROBLEM 13 :**

**An enterprise acquired a patent right for Rs. 100 lacs. The product life cycle has been initially estimated to be 5 years. The estimated cash flow over the useful life of the patent are (Rs. in lacs) Year 1 : 150; Year – 2: 150, Year – 3 : 150, Year – 4 : 100, Year – 5 : 100. Initially a five year amortisation period has been decided and amortisation was decided in the ratio of estimated future cash flow. The amortisation is decided as follows:**

| Year | Net Operating Cash Flow (Rs. In lacs) | Amortised Amount (Rs. In lacs) |
|---|---|---|
| 1 | 150 | 23.08 |
| 2 | 150 | 23.08 |
| 3 | 150 | 23.08 |
| 4 | 100 | 15.38 |
| 5 | 100 | 15.38 |
| Total | 650 | 100.00 |

**After third year, it was ascertained that the patent will continue to maintain the market share for another six years but the estimated cash flow after fifth year is expected to be Rs. 75 lacs. What would be the change in amortisation?**

**SOLUTION 13 :**

The total amount amortised over 3 years Rs. in lacs

23.08 x 3

Balance amount to be amortised (100-69.24)

**Calculation of amortisation over next 6 years(Rs. in lacs)**

| Year | Expected cash flow | Calculation | Amortisation Amount |
|---|---|---|---|
| 1 | 100 | 100/500 x 30.76 | |
| 2 | 100 | 100/500 x 30.76 | |
| 3 | 75 | 75/500 x 30.76 | |
| 4 | 75 | 75/500 x 30.76 | |
| 5 | 75 | 75/500 x 30.76 | |
| 6 | 75 | 75/500 x 30.76 | |
| | 500 | | |

## 27. DERECOGNITION

An IA should be derecognized if:

- IA is disposed or,
- No future economic benefits are expected to flow, (retired from active use)

The gain or loss on derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds and carrying amount of the asset and the same shall be recognises in Profit and Loss when the asset is derecognized **unless IFRS 16 requires otherwise on a sale and leaseback.) Gains shall not be classified as revenue.**

**PROBLEM 14 :**

**In the past year, ASF Ltd. had spent and carried forward in the books a total of Rs. 5,00,000 on developing a cure for cancer. During the current year, it is decided to terminate this product as test results in the current year have proved adverse. Comment on the accounting treatment.**

**SOLUTION 14 :**

1. **Situation :** There is an intangible asset appearing in the company's Balance Sheet on account of deferral of R&D Expenditure. (Development Expenditure can be recognised as an asset subject to certain conditions).
2. **Year-end review :** As per IAS – 38, the amortisation period and the method should be reviewed atleast at the end of every accounting period. If the expected useful life of the asset is significantly different from the previous estimates, the amortisation period should be changed accordingly.
3. **Analysis :** In this case, since the Company had decided in the current year to terminate the product, because of adverse test result, deferral of the costs incurred on it cannot be justified. Hence, the entire unamortized expenditure of Rs. 5 lakhs should be expensed off in the current year and charged to SOPL.

## 28. INTANGIBLE ASSET CLASSIFIED AS HELD FOR SALE

An intangible asset classified as held for sale shall be governed by the principles of IFRS 5 and consequently shall not be further amortised.

## 29. DISCLOSURES

**In the Financial Statements**

- Gross carrying amount, accumulated amortisation and impairment loss at beginning and end of the year
- Aggregate amount of R&D expense recognised during the year.

**In the Notes to Accounts**

- Accounting policy adopted for IA

- Useful life and amortisation rate and method
- Reconciliation of carrying amount at beginning and end of year
- Amount of commitment for acquisition of IA to be shown as part of contingent liability.
- Differentiate between internally generated and other intangible assets.
- Intangible assets with indefinite useful lives, carrying amount and reasons supporting assessment of indefinite life.

**Intangible assets measured after recognition using the revaluation model**

**If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:**

**(a) by class of intangible assets:**

**(i) the effective date of the revaluation;**

**(ii) the carrying amount of revalued intangible assets; and**

**(iii) the carrying amount that would have been recognised had the revalued class of intangible assets been measured after recognition using the cost model; and**

**(b) the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders.**

**Research and development expenditure**

**An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period.**

## 30. MAJOR CHANGE IN IND AS 38 VIS-À-VIS IAS 38

**Intangible Assets acquired by way of Government Grant:**

With regard to the acquisition of an intangible asset by way of a government grant, IAS 38, Intangible Assets, provides the option to an entity to recognise both asset and grant initially at fair value or at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use. Ind AS 38 allows only fair value for recognising the intangible asset and grant in accordance with Ind AS 20.

## PROBLEM FOR SELF PRACTICE

**PROBLEM : 15**

**Company XYZ ltd has provided training to its staff on various new topics like GST, etc to ensure the compliance as per the required law. Can the company recognise such cost of staff training as intangible asset?**

**SOLUTION : 15**

It is clear that the company will obtain the economic benefits from the work performed by the staff as it increases their efficiency. But it does not have control over them because staff could choose to resign the company at any time.

Hence the company lacks the ability to restrict the access of others to those benefits. Therefore, the staff training cost does not meet the definition of an intangible asset

**PROBLEM : 16**

**Pluto Ltd. intends to open a new retail store in a new location in the next few weeks. Pluto Ltd has spent a substantial sum on a series of television advertisements to promote this new store. The Company has paid an amount of ₹ 800,000 for advertisements before 31 March 20X1. ₹ 700,000 of this sum relates to advertisements shown before 31 March 20X1 and ₹ 100,000 to advertisements**

**shown in April 20X1. Since 31 March 20X1, The Company has paid for further advertisements costing ₹ 400,000.**

**Pluto Ltd is of view that such costs can be carried forward as intangible assets. Since market research indicates that this new store is likely to be highly successful. Please explain and justify the treatment of the above costs in the financial statements for the year ended 31 March 20X1.**

**SOLUTION : 16**

Under IAS 38 – *Intangible Assets* – intangible assets can only be recognised if they are **identifiable** and have a **cost** which can be reliably measured.

These criteria are very difficult to satisfy for internally developed intangibles.

For these reasons, IAS 38 specifically prohibits recognising advertising expenditure as an intangible asset. The issue of how successful the store is likely to be does not affect this prohibition. Therefore such costs should be recognised as expenses.

However, the costs would be recognised on an accrual basis. Therefore, of the advertisements paid for before 31 March 20X1, **₹ 700,000** would be recognised as an expense and ₹ 100,000 as a pre-payment in the year ended 31 March 20X1. The ₹ 400,000 cost of advertisements paid for since 31 March 20X1 would be charged as expenses in the year ended 31 March 20X2.

**PROBLEM : 17**

**Mercury Ltd is preparing its accounts for the year ended 31 March 20X2 and is unsure about how to treat the following items.**

1. **The company completed a grand marketing and advertising campaign costing ₹ 4.8 Lakh. The finance director had authorised this campaign on the basis that it would create ₹ 8 lakh of additional profits over the next three years.**
2. **A new product was developed during the year. The expenditure totalled ₹ 3 lakh of which ₹ 1.5 lakh was incurred prior to 30 September 20X1, the date on which it became clear that the product was technically viable. The new product will be launched in the next four months and its recoverable amount is estimated at ₹ 1.4 lakh.**
3. **Staff participated in a training programme which cost the company ₹ 5 lakh. The training organisation had made a presentation to the directors of the company outlining that incremental profits to the business over the next twelve months would be ₹ 7 lakh.**

**What amounts should appear as intangible assets in accordance with IAS 38 in Mercury's balance sheet as on 31 March 20X2?**

**SOLUTION : 17**

The treatment in Mercury's financials as at 31 March 20X2 will be as follows:

1. **Marketing and advertising campaign:** no intangible asset will be recognised, because it is not possible to identify future economic benefits that are attributable only due to this campaign. All of the expenditure should be expensed in the statement of profit and loss.
2. **New product:** development expenditure appearing in the balance sheet will be valued at ₹ 1.5 lakh. The expenditure prior to the date on which the product becomes technically feasible is recognised in the statement of profit and loss.
3. **Training programme:** no asset will be recognised, because there is no control of the company over the staff and when staff leaves the benefits of the training, whatever they may be, also departs.

**PROBLEM : 18**

**Venus India Private Ltd acquired a software for its internal use costing ₹ 10,00,000. The amount payable for the software was ₹ 600,000 immediately and ₹ 400,000 in one year time. The other expenditure incurred were:-**

**Purchase tax : ₹ 1,00,000**

**Entry Tax : 10% ( recoverable later from tax department)**

**Legal fees: ₹ 87,000**

**Consultancy fees for implementation : ₹ 1,20,000 cost of capital of the company is 10%.**

**Calculate the cost of the software on initial recognition using the principles of IAS 38 Intangible Assets.**

SOLUTION : 18

| Particulars | Amount |
|---|---|
| Cash paid | 600,000 |
| Deferred consideration (₹ 400,000/1.1) | 3,63,636 |
| Purchase Tax | 1,00,000 |
| Entry tax *(not to be considered as it is a refundable tax)* | - |
| Legal fees | 87,000 |
| Consultancy fees for implementation | 1,20,000 |
| **Total Cost to be capitalised** | **12,70,636** |

**PROBLEM : 19**

**On 31st March 20X1, Earth India Ltd paid ₹ 50,00,000 for a 100% interest in Sun India Ltd. At that date Sun Ltd's net assets had a fair value of ₹ 30,00,000. In addition, Sun Ltd also held the following rights:**

**Trade Mark named "GRAND" – valued at ₹ 180,000 using a discounted cash flow technique.**

**Sole distribution rights to an electronic product. Future cash flows from which are estimated to be ₹ 150,000 per annum for the next 6 years.**

**10% is considered an appropriate discount rate.**

**The 6 year, 10% annuity factor is 4.36.**

**Calculate goodwill and other Intangible assets arising on acquisition.**

SOLUTION : 19

| Particulars | Amount | Amount |
|---|---|---|
| Purchase Consideration (A) | | 50,00,000 |
| Net Asset acquired | 30,00,000 | |
| Trade Mark | 1,80,000 | |
| Distribution Rights (1,50,000 x 4.36) | 6,54,000 | |
| Total (B) | | (38,34,000) |
| Goodwill on Acquisition | | 11,66,000 |

**PROBLEM : 20**

**Sun Ltd acquired a software from Earth Ltd. in exchange for a telecommunication license. The telecommunication license is carried at ₹ 5,00,000 in the books of Sun Ltd. The Software is carried at ₹ 10,000 in the books of the Earth Ltd which is not the fair value.**

**Advise journal entries in the following situations in the books of Sun Ltd and Earth Ltd:-**

1) **Fair value of software is ₹ 5,20,000 and fair value of telecommunication license is ₹ 5,00,000.**
2) **Fair Value of Software is not measureable. However similar Telecommunication license is transacted by another company at ₹ 4,90,000.**
3) **Neither Fair Value of Software nor Telecommunication license could be reliably measured.**

**SOLUTION : 20**

*INR in '000*

| Situation | Sun Ltd. | Earth Ltd. |
|---|---|---|
| 1 | Software Dr. 520<br>To Telecommunication license 500<br>To Profit on Exchange 20 | Telecommunication license Dr. 500<br>To Software 10<br>To Profit on Exchange 490 |
| 2 | Software Dr. 490<br>Loss on Exchange Dr. 10<br>To Telecommunication license 500<br>Note: The company may first recognise Impairment loss and then pass an entry. The effect is the same as impairment loss will also be charged to Income Statement. | Telecommunication license Dr. 490<br>To Software 10<br>To Profit on Exchange 480 |
| 3 | Software Dr. 500<br>To Telecommunication license 500 | Telecommunication license Dr. 10<br>To Software 10 |

**PROBLEM : 21**

**Expenditure on a new production process in 20X1-20X2:**

| | *INR* |
|---|---|
| **1st April to 31st December** | **2,700** |
| **1st January to 31st March** | **900** |
| | **3,600** |

**The production process met the intangible asset recognition criteria for development on 1st January 20X2. The amount estimated to be recoverable from the process is ₹ 1,000.**

**What is the carrying amount of the intangible asset at 31st March 20X2 and the charge to profit or loss for 20X1-20X2?**

**Expenditure incurred in FY 20X2-20X3 is ₹ 6,000.**

**At 31st March 20X3, the amount estimated to be recoverable from the process (including future cash outflows to complete the process before it is available for use) is ₹ 5,000.**

**What is the carrying amount of the intangible asset at 31st March 20X3 and the charge to profit or loss for 20X2-X3?**

**SOLUTION : 21**

| | *INR* |
|---|---|
| Total Expenditure | 3,600 |
| Less. Expenditure during Development phase | 900 |
| Expenditure to be transfer to profit or loss | 2,700 |

**1) Carrying Amount of Intangible Asset on 31st March 20X2**

Expenditure during Development Phase will be capitalised ₹ 900

(Recoverable amount is higher being ₹ 1,000, hence no impairment)

**2) Expenditure to be charged to profit or loss in 20X2-20X3**

| | *INR* |
|---|---|
| Opening balance of Intangible Asset | 900 |
| Add. Further expenditure during development phase | 6,000 |
| Expenditure for development phase | 6,900 |
| Recoverable Amount | 5,000 |
| Amount charged to profit or loss (Impairment Loss) | 1,900 |

**3) Carrying Amount of Intangible Asset on 31st March 20X3**

Value of Intangible Asset will be recoverable amount i.e. ₹ 5,000

**PROBLEM : 22**

1. **Saturn Ltd. acquired an intangible asset on 31st March 20X1 for ₹ 1,00,000. The asset was revalued at ₹ 1,20,000 on 31st March 20X2and ₹ 85,000 on 31st March 20X3.**
2. **Jupiter Ltd. acquired an intangible asset on 31st March 20X1 for ₹ 1,00,000. The asset was revalued at ₹ 85,000 on 31st March 20X2 and at ₹ 1,05,000 on 31st March 20X3.**

**Assuming that the year-end for both companies is 31st March, and that they both use the revaluation model, show how each of these transactions should be dealt with in the financial statements**

**SOLUTION : 22**

**Saturn Ltd.**

₹ 20,000 revaluation increase on 31st March 20X2 should be credited to the revaluation reserve and recognised in other comprehensive income. ₹ 20,000 of the revaluation decrease on 31st March 20X3 should be debited to revaluation reserve and remaining ₹ 15,000 should be recognised as an expense.

**Jupiter Ltd.**

₹ 15,000 revaluation decrease on 31st March 20X2 should be recognised as an expense in the Statement of Profit and loss. ₹ 15,000 out of the ₹ 20,000 increase on 31st March 20X3 should be recognised as income. The remaining ₹ 5,000 should be credited to revaluation reserve and recognised in other comprehensive income.

**PROBLEM : 23**

**X Limited engaged in the business of manufacturing fertilisers entered into a technical collabaration agreement with a foreign comapny Y Limited. As a result, Y Limited would provide the technical know-how enabling X Limited to manufacture fertiliser in a more efficient way. X Limited paid ₹ 10,00,00,000 for the use of know-how for a period of 5 years. X Limted estimates the production of fertiliser as follows:**

| **Year** | **(in metric tons)** |
|---|---|
| **1** | **50,000** |
| **2** | **70,000** |
| **3** | **1,00,000** |
| **4** | **1,20,000** |
| **5** | **1,10,000** |

**At the end of the 1st year, it achieved its targeted production. At the end of 2nd year, 65,000 metric tons of fertiliser was being manufactured, and X Limited considered to revise the estimates for the next 3 years. The revised figures are 85,000, 1,05,000 and 1,15,000 metric tons for year 3, 4 & 5 respectively.**

**How will X Limited amorise the technical know-how fees as per IAS 38?**

**SOLUTION : 23**

Based on the above data, it may be suitable for X Ltd. to use unit of production method for amortisation of techinical know-how.

The total estimated unit to be produced 4,50,00 MT. The technical know-how will be amortised on the basis of the ratio of yearly production to total production.

The first year charge should be a proportion of 50,000/4,50,000 on ₹ 10,00,00,000 = ₹ 1,11,11,111.

At the end of 2nd year, as per revised estimate the total number of units to be produced are 4,20,000 MT.

The amortisation for second year will be 65,000/4,20,000, and so on for remaining years unless the estimates are again revised.

The difference in amortisation for first year due to revision in estimates would also be provided in 2nd year. The actual amortisation provided for the 1st year is ₹ 1,11,11,111. The amortisation that would have provided on revised estimates is 50,000/4,20,000 on ₹ 10,00,00,000 = ₹ 1,19,04,762.

So, difference of ₹ 7,93,651 (₹ 1,19,04,762 – ₹ 1,11,11,111) would also be provided in 2nd year.

**PROBLEM : 24**

**X Ltd. purchased a patent right on April 1, 20X1, for ₹ 3,00,000; which has a legal life of 15 years. However, due to the competitive nature of the product, the management estimates a useful life of only 5 years. Straight-line amortisation is determined by the management to be the best method. As at April 1, 20X2, management is uncertain that the process can actually be made economically feasible, and decides to write down the patent to an estimated market value of ₹ 1,50,000 and decides to amortise over 2 years. As at April 1, 20X3, having perfected the related production process, the asset is now appraised at a value of ₹ 3,00,000. Furthermore, the estimated useful life is now believed to be 4 more years. Determine the value of intangible asset at the end of each financial year?**

**SOLUTION : 24**

| | |
|---|---|
| Original cost | ₹ 3,00,000 |
| Less: amortisation | (₹ 60,000) |
| Net Value | ₹ 2,40,000 |

**Value as on March 31, 20X1**

On April 1, 20X2, the impairment is recorded by writing down the asset to the estimated value of ₹ 1,50,000, which necessitates a ₹ 90,000 charge to profit & loss (carrying value, ₹ 2,40,000 less fair value ₹ 1,50,000).

Amortisation provided for the financial year 20X2-20X3 is ₹ 75,000 (₹ 1,50,000/2) Net value is = ₹ 1,50,000 – ₹ 75,000 = ₹ 75,000. **Value as on March 31, 20X4**

As of April 1, 20X3, the carrying value of the patent is ₹ 75,000.

Revalued amount of patent is ₹ 3,00,000.

Out of total revaluation gain of ₹ 2,25,000, ₹ 90,000 will be charged to profit & loss and balance amount of ₹ 1,35,000 – (₹ 2,25,000 – ₹ 90,000) will be credited to revaluation reserve.

**PROBLEM : 25**

**X Pharmaceutical Ltd. seeks your opinion in respect of following accounting transactions:**

1. **Acquired a 4 year license to manufacture a specialised drug at a cost of ₹ 1,00,00,000 at the start of the year. Production commenced immediately.**
2. **Also purchased another company at the start of year. As part of that acquisition the company acquired a brand with a FV of ₹ 3,00,00,000 based on sales revenue. The life of the brand is estimated at 15 years.**
3. **Spent ₹ 1,00,00,000 on an advertising campaign during the first six months. Subsequent sales have shown a significant improvement and it is expected this will continue for 3 years.**
4. **It has commenced developing a new drug 'Drug-A'. The project cost would be ₹ 10,00,00,000. Clinical trial proved successful and such drug is expected to generate revenue over the next 5 years.**

   **Cost incurred (accumulated) till March 31, 20X1 is ₹ 5,00,00,000.**

   **Balance cost incurred during the financial year 20X1-20X2 is ₹ 5,00,00,000.**
5. **It has also commenced developing another drug 'Drug B'. It has incurred ₹ 50,00,000 towards research expenses till March 31, 20X2. The technological feasibility has not yet been established.**

**How the above transactions will be accounted for in the books of account of X Pharmaceutical Ltd?**

**SOLUTION : 25**

X Pharmaceutical Ltd. is advised as under:

1. It should recognise the drug license as an intangible asset, because it is a separate external purchase, separately identifiable asset and considered successful in respect of feasibility and probable future cash inflows.

   The drug license should be recorded at ₹ 1,00,00,000.
2. It should recognise the brand as an intangible asset because it is purchased as part of acquisition and it is separately identifiable. The brand should be amortised over a period of 15 years.

   The brand will be recorded at ₹ 3,00,00,000.
3. The advertisement expenses of ₹ 1,00,00,000 should be expensed off.
4. The development cost incurred during the financial year 20X1-20X2 should be capitalised.

   Cost of intangible asset (Drug A) as on March 31, 20X2

| | |
|---|---|
| Opening cost | ₹ 5,00,00,000 |
| Development cost | ₹ 5,00,00,000 |
| Total cost | ₹ 10,00,00,000 |

5. Research expenses of ₹ 50,00,000 incurred for developing 'Drug B' should be expensed off since technological feasibility has not yet established.

**PROBLEM : 26**

**X Ltd. is engaged in the business of publishing Journals. They acquired 50% stake in Y Ltd., a company in the same industry. X Ltd. paid purchase consideration of ₹ 10,00,00,000 and fair value of net asset acquired is ₹ 8,50,00,000. The above purchase consideration includes:**

**(a) ₹ 30,00,000 for obtaining the skilled staff of Y Ltd.**

**(b) ₹ 50,00,000 by way of payment towards 'Non-compete Fee' so as to restrict Y Ltd. to compete in the same line of business for next 5 years.**

**How should the above transactions be accounted for by X Ltd?**

**SOLUTION : 26**

X Ltd. should recognise an intangible asset in respect of the consideration paid towards 'Non-Compete Fee'.

However, amount paid for obtaining skilled staff amounting to ₹ 30,00,000 does not meet the definition of intangible asset since X Ltd. has not established any right over the resource and should be expensed. The entity has insufficient control over the expected future economic benefits arising from a team of skilled staff.

Therefore, ₹ 50,00,000 will be separately recognised as an intangible asset, whereas amount paid for obtaining skilled staff does not meet the recognition criteria. However, since it is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date.

The value of goodwill is ₹ 1,00,00,000 (₹ 1,50,00,000 – ₹ 50,00,000).

**PROBLEM : 27**

**X Ltd. purchased a franchise from a restaurant chain at a cost of ₹ 1,00,00,000 and the franchise has 10 years life. In addition, the franchise agreement mentions that the franchisee would also pay the franchisor royalty as a percentage of sales made. Can the franchise rights be treated as an intangible asset under IAS 38?**

**SOLUTION : 27**

The franchise rights meets the identification criterion in the definition of an intangible asset since it arises from the contractual rights. It is acquired separately and its cost can be measured reliably. In addition X Ltd. will have future economic benefits and control over them from the franchise rights.

X Ltd. should recognise the franchise right as intangible asset and amortise it over 10 years. Royalty as a percentage of sales paid to the franchisor would be a charge to the profit and loss in the books of the X Ltd.

**PROBLEM : 28**

**An entity regularly places advertisements in newspapers advertising its products and includes a reply slip that informs individuals replying to the advertisement that the entity may pass on the individual's details to other sellers of similar products, unless the individual ticks a box in the advertisement.**

**Over a period of time the entity has assembled a list of customers' names and addresses. The list is provided to other entities for a fee. The entity would like to recognise an asset in respect of the expected future economic benefits to be derived from the list. Can the customer list be treated as an intangible asset under IAS 38?**

**SOLUTION : 28**

In this situation, the entity has no legal rights to the customer relationship, but exchange transactions have taken place that evidence separability of the asset and the control that the entity is able to exercise over the asset. Therefore, the list is an intangible asset. However, the entity may not recognise the asset because the cost of generating the customer list internally cannot be distinguished from the cost of developing the business as a whole.

**PROBLEM : 29**

**A software company X Ltd. is developing new software for the telecom industry. It employs 100 employs engineers trained in that particular discipline who are engaged in the development of the software. X Ltd. feels that it has an excellent HR policy and does not expect any of its employees to leave in the near future. It wants to recognise these set of engineers as a human resources asset in the form of an intangible asset. What would be your advice to X Ltd?**

**SOLUTION : 29**

Although, without doubt the skill sets of the employees make them extremely valuable to the company, however it does not have control over them. Merely having good HR policies would not make them eligible to be recognised as an intangible asset.

**PROBLEM : 30**

**X Ltd. has acquired a telecom license from Government to operate mobile telephony in two states of India. Can the cost of acquisition be capitalised as an intangible asset under IAS 38?**

**SOLUTION : 30**

Cost of acquisition of the telecom license can be capitalised as an intangible asset under the head Licenses, as it will lead to future economic benefits for X Ltd.

**PROBLEM : 31**

**X Ltd. purchased a standardised finance software at a list price of ₹ 30,00,000 and paid ₹ 50,000 towards purchase tax which is non refundable. In addition to this, the entity was granted a trade discount of 5% on the initial list price. X Ltd. incurred cost of ₹ 7,00,000 towards customisation of the software for its intended use. X Ltd. purchased a 5 year maintenance contract with the vendor company of ₹ 2,00,000. At what cost the intangible asset will be recognised?**

**SOLUTION : 31**

In accordance with IAS 38, the cost of a separately acquired intangible asset is its purchases price and non refundable purchase taxes, after deducting trade discounts and rebates and any directly attributable cost of preparing the asset for its intended use.

Therefore, the initial cost of the asset should be:

| | Amount (₹) |
|---|---:|
| List price | 30,00,000 |
| Less: trade discount (5%) | (1,50,000) |
| | 28,50,000 |
| Non refundable purchase tax | 50,000 |
| Customisation cost | 7,00,000 |
| Total cost | 36,00,000 |

The maintenance contract of ₹ 2,00,000 is an expense and therefore should be taken as a prepaid expense and charged to profit and loss over a period of 5 years.

**PROBLEM : 32**

**X Limited in a business combination, purchased the net assets of Y Limited for ₹ 4,00,000 on March 31, 20X1. The assets and liabilities position of Y Limited just before the acquisition is as follows:**

| **Assets** | **Cost (in ₹)** |
|---|---:|
| **Property, Plant & Equipment** | **1,00,000** |
| **Intangible asset 1** | **20,000** |
| **Intangible asset 2** | **50,000** |
| **Cash & Bank** | **1,30,000** |
| **Liabilities** | |
| **Trade payable** | **50,000** |

**The fair market value of the PPE, intangible asset 1 and intangible asset 2 is available and they are ₹ 1,50,000, ₹ 30,000 and ₹ 70,000 respectively.**

**How would X Limited account for the net assets acquired from Y Limited?**

**SOLUTION : 32**

X Limited will account for the assets acquired from Y Limited in following manner:

| Assets | Amount (₹) |
|---|---|
| Property, plant and equipment | 1,50,000 |
| Goodwill | 70,000 |
| Intangible asset 1 | 30,000 |
| Intangible asset 2 | 70,000 |
| Cash & Bank | 1,30,000 |
| **Liabilities** | |
| Trade payable | 50,000 |

**Note 1-** Goodwill is the difference between fair value of net assets acquired and purchase consideration paid when is calculated as follow:

Goodwill = ₹ 4,00,000 – ₹ (1,50,000 + 70,000 + 30,000 + 1,30,000 – 50,000)= ₹ 70,000.

**PROBLEM : 33**

**X Ltd. acquired Y Ltd. on April 30, 20X1. The purchase consideration is ₹ 50,00,000. The fair value of the tangible assets is ₹ 45,00,000. The company estimates the fair value of "in-process research projects" at ₹ 10,00,000. No other Intangible asset is acquired by X Ltd. in the transaction. Further, cost incurred by X Ltd. in relation to that research project is as follows:**

**(a) ₹ 5,00,000 – as research expenses**

**(b) ₹ 2,00,000 – to establish technological feasibility**

**(c) ₹ 7,00,000 – for further development cost after technological feasibility is established.**

**At what amount the intangible asset should be measured under IAS 38?**

**SOLUTION : 33**

X Ltd. should initially recognise the acquired "in house research project'' at its fair value i.e., ₹ 10,00,000. Research cost of ₹ 5,00,000 and cost of ₹ 2,00,000 for establishing technical feasibility should be charged to profit & loss. Costs incurred from the point of technological feasibility/asset recognition criteria until the time when development costs are incurred are capitalised. So, the intangible asset should be recognised at Rs. 17,00,000.

**PROBLEM : 34**

**X Ltd. acquired a patent right of manufacturing drug from Y Ltd. In exchange X Ltd. gives its intellectual property right to Y Ltd. Current market value of the patent and intellectual property rights are ₹ 20,00,000 and ₹ 18,00,000 respectively. At what value patent right should be initially recognised in the books of X Ltd. in following two situations?**

**(a) X Ltd. did not pay any cash to Y Ltd.**

**(b) X Ltd. pays ₹ 2,00,000 to Y Ltd.**

**So the intangible asset should be recognised at ₹ 17,00,000 (₹ 10,00,000 + ₹ 7,00,000)**

**SOLUTION : 34**

If an entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

The transaction at the fair value of the asset received adjusted for any cash received or paid. Therefore in case (a) patent is measured at ₹ 18,00,000, in case (b) it is measured at ₹ 20,00,000 (18,00,000 + 2,00,000).

**PROBLEM : 35**

**X Garments Ltd. spent ₹ 1,00,00,000 towards promotions for a fashion show by way of various on-road shows, contests etc.**

**After that event, it realised that the brand name of the entity got popular and resultantly, subsequent sales have shown a significant improvement. It is further expected that this hike will have an effect over the next 2-3 years.**

**How the entity should account for the above cost incurred on promoting such show?**

**SOLUTION : 35**

Expenditure of ₹ 1,00,00,000 though increased future economic benefits, but it does not result in creation of an intangible asset.

Such promotional cost should be expensed off.

**PROBLEM : 36**

**An entity is developing a new production process. During 20X1-20X2, expenditure incurred was ₹ 1,000, of which ₹ 900 was incurred before March 1, 20X2 and ₹ 100 was incurred between March 1, 20X2 and March 31, 20X2. The entity is able to demonstrate that at March 1, 20X2, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 500.**

**During 20X2-20X3, expenditure incurred is ₹ 2,000. At the end of 20X3, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 1,900.**

**SOLUTION : 36**

At the end of the financial year 20X2, the production process is recognised as an intangible asset at a cost of ₹ 100 (expenditure incurred since the date when the recognition criteria were met, i.e., March 1, 20X2). ₹ 900 expenditure incurred before March 1, 20X2 is recognised as an expense because the recognition criteria were not met until March 1, 20X2. This expenditure does not form part of the cost of the production process recognised in the balance sheet.

At the end of 20X3, the cost of the production process is ₹ 2,100 (₹ 100 expenditure recognised at the end of 20X2 plus ₹ 2,000 expenditure recognised in 20X3). The entity recognises an impairment loss of ₹ 200 to adjust the carrying amount of the process before impairment loss (₹ 2,100) to its recoverable amount (₹ 1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in IAS 36 are met.

**PROBLEM : 37**

**X Ltd. is engaged is developing computer software. The expenditures incurred by X Ltd. in pursuance of its development of software is given below:**

**(a) Paid ₹ 2,00,000 towards salaries of the program designers.**

**(b) Incurred ₹ 5,00,000 towards other cost of completion of program design.**

**(c) Incurred ₹ 2,00,000 towards cost of coding and establishing technical feasibility.**

**(d) Paid ₹ 7,00,000 for other direct cost after establishment of technical feasibility.**

**(e) Incurred ₹ 2,00,000 towards other testing costs.**

**(f) Cost of producing product masters for training material is ₹ 3,00,000.**

**(g)** **A focus group of other software developers was invited to a conference for the introduction of this new software. Cost of the conference aggregated to ₹ 70,000.**

**(h)** **On March 15, 20X0, the development phase was completed and a cash flow budget was prepared.**

**Net profit for the year was estimated to be equal ₹ 40,00,000. How X Ltd. should account for the above mentioned cost?**

**SOLUTION : 37**

Costs incurred in creating computer software, should be charged to research & development expenses when incurred until technical feasibility/asset recognition criteria have been established for the product. Here, technical feasibility is established after completion of detailed program design. In this case, ₹ 9,00,000 (salary cost of ₹ 2,00,000, program design cost of ₹ 5,00,000 and coding and technical feasibility cost of ₹ 2,00,000) would be recorded as expense. Cost incurred from the point of technical feasibility are capitalised as software costs. But the conference cost of ₹ 70,000 would be expensed off

In this situation, direct cost after establishment of technical feasibility of ₹ 7,00,000, testing cost of ₹ 2,00,000 and cost of producing product masters for training material of ₹ 3,00,000 will be capitalised.

The cost of software capitalised is = ₹ (7,00,000 + 2,00,000 + 3,00,000) = ₹ 12,00,000.

**PROBLEM : 38**

**X Ltd. has started developing a new production process in financial year 20X1-20X2. Total expenditure incurred till September 30, 20X3, was ₹ 1,00,00,000 . The expenditure on the development of the production process meets the recognition criteria on July 1, 20X1. The records of X Ltd. show that, out of total ₹ 1,00,00,000, ₹ 70,00,000 were incurred during to September 20X1. X Ltd. publishes its financial results quarterly. How X Ltd. should account for the development expenditure?**

**SOLUTION : 38**

X Ltd. should recognise the intangible asset at ₹ 70,00,000 and ₹ 30,00,000 which was already recognised as an expenses in first quarter should not be capitalised.

**PROBLEM : 39**

**X Ltd. decides to revalue its intangible assets on April 1, 20X1. On the date of revaluation, the intangible assets stand at a cost of ₹ 1,00,00,000 and accumulated amortisation is ₹ 40,00,000. The intangible assets are revalued at ₹ 1,50,00,000. How should X Ltd. account for the revalued intangible assets in its books of account?**

**SOLUTION : 39**

The intangible assets are revalued to ₹ 1,50,00,000 on an amortised replacement cost basis, which is a 150% increase from its original cost. Thereby applying the existing ratio of accumulated depreciation to the cost the revalued gross amount would be ₹ 2,50,00,000 gross and ₹ 1,00,00,000 on amortisation.

# IAS 36 — IMPAIRMENT OF ASSETS

## 1. INTRODUCTION

In certain situations, the value at which assets are carried in the books may not be reflective of true value of the assets. This is because the economic environment would have changed, newer technology would have replaced older once, the asset may not be producing the same level of output it normally does. In these situations, the asset may have been impaired and its value should be written down. This standard provides guidance on the same.

## 2. SCOPE

This Standard shall be applied in accounting for the impairment of all assets, other than:

1. Inventories: IAS 2
2. Deferred Tax Assets; IAS 12
3. Assets arising from Employee Benefits; IAS 19
4. Financial assets that are within the scope of IFRS 9
5. Biological assets related to agricultural activity that are measured at fair value less costs to sell; IAS 41
6. Non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5

## 3. THIS STANDARD APPLIES TO FINANCIAL ASSETS CLASSIFIED AS:

Subsidiaries, as defined in IFRS 10 Consolidated Financial Statements, Associates, as defined in IAS 28 Investments in Associates and Joint Ventures Joint ventures, as defined in IFRS 11 Joint Arrangements.

## 4. DEFINITIONS

An **active market** is a market in which all the following conditions exist:

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

**Carrying amount** is the amount at which an asset is recognized after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

| Cost | xxx |
|---|---|
| Less : accumulated depreciation | xxx |
| Less : Accumulated impairment loss | xxx |

**PROBLEM : 1**

**ASF Ltd purchased a machine for Rs 5,00,000. The accumulated depreciation is Rs 1,50,000. Calculate the carrying amount.**

**SOLUTION : 1**

A **cash-generating unit** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

***Examples on CGU***

a. A hotel has several restaurants, rooms, conference halls, health club and other facilities; since each of these facilities are not capable of generating revenues independently the entire hotel and not the individual facilities would be treated as a CGU.
b. A huge multiplex has a bowling alley, theatres, hotel, shopping mall, etc; since each of these facilities are not capable of generating revenues independently the entire multiplex and not the individual units would be treated as a CGU.
c. An enterprise has several retail stores spread across various locations that are centrally managed in terms of purchases, pricing, advertising etc. Each of these stores would be a separate CGU, since they are in different locations and probably have different customer bases. Though the stores are managed centrally, each of them generates cash inflows that are largely independent.
d. A company has three factories at different locations in Mumbai manufacturing the same type of colour televisions. Each of these factories would be a separate CGU. If however the colour picture tubes to manufacture the televisions are in short supply and the capacity utilisation of each of these factories completely based on allocation of the colour tubes by management, all the three factories together would constitute a CGU. This is because none of the three factories could be deemed to be generating cash flows independent of each other.
e. A building is predominately used by an enterprise for its switchboard manufacturing division, through the excess 40% not required is rented out. In this case, the building cannot be considered to generate cash inflows that are largely independent of the cash inflows from the switchboard manufacturing division. So it is likely that the building itself is not the CGU but the switchboard manufacturing divisions the CGU. Since the building is not held as an investment, it would not be appropriate to determine the value in use of the building based on projections of future market related rents.

**Corporate assets** are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

Examples - Divisional buildings, EDP equipment, Research centreetc.

**Costs of disposal** are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

**Depreciable amount** is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

**Depreciation (Amortisation)** is the systematic allocation of the depreciable amount of an asset over its useful life.

**Fair value less costs to sell** is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

**PROBLEM : 2**

**ASF Ltd has a machine, which is fixed to the ground. The cost of unfastening the machine is Rs 2,500. The fair value of machine is Rs 40,000. Calculate fair value less cost of disposal.**

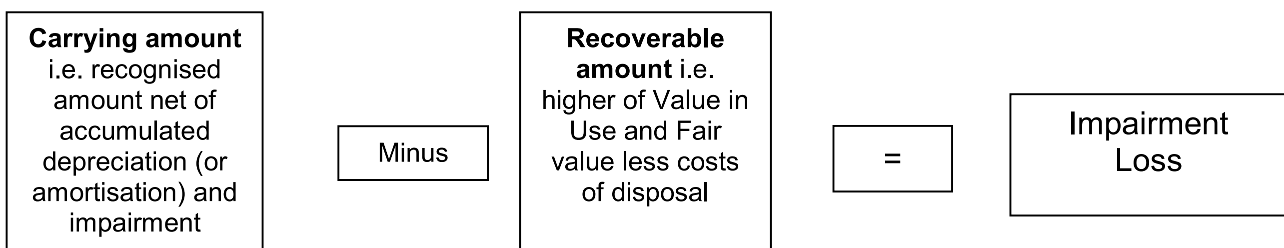
**SOLUTION : 2**

**PROBLEM : 3**

**X operates in leased premises. It owns a bottling plant which is situated in a single factory unit. Bottling plants are sold periodically as complete assets.Professional valuers have estimated that the plant might be sold for Rs 100,000. X would need to dismantle the asset and ship it to any buyer. Dismantling and shipping would cost Rs 5,000. Specialist packaging would cost a further Rs 4,000 and legal fees Rs 1,500. Calculate fair value less cost of disposal.**

SOLUTION : 3

An **impairment loss** is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.




The **recoverable amount** of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.

**Useful life** is either:

(a) the period of time over which an asset is expected to be used by the entity; or

(b) the number of production or similar units expected to be obtained from the asset by the entity.

**Value in use** is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

**PROBLEM : 4**

**The cash inflows from the use of a plant during the next 6 years are Rs. 10,00,000 each for first three years and Rs. 8,00,000 each for next three years. The discount rate is 15%. Find out the value in use.**

SOLUTION : 4

## 5. WHEN IS AN ASSET IMPAIRED

**An asset is said to be impaired only when the carrying amount of the asset exceeds the recoverable amount.** The test of impairment is carried out for all assets only when there are indications that there might be impairment.

## 6. FOLLOWING ASSETS ARE TESTED FOR IMPAIRMENT ANNUALLY

**As an exception to this principle the following assets are tested for impairment annually regardless of the indications:**

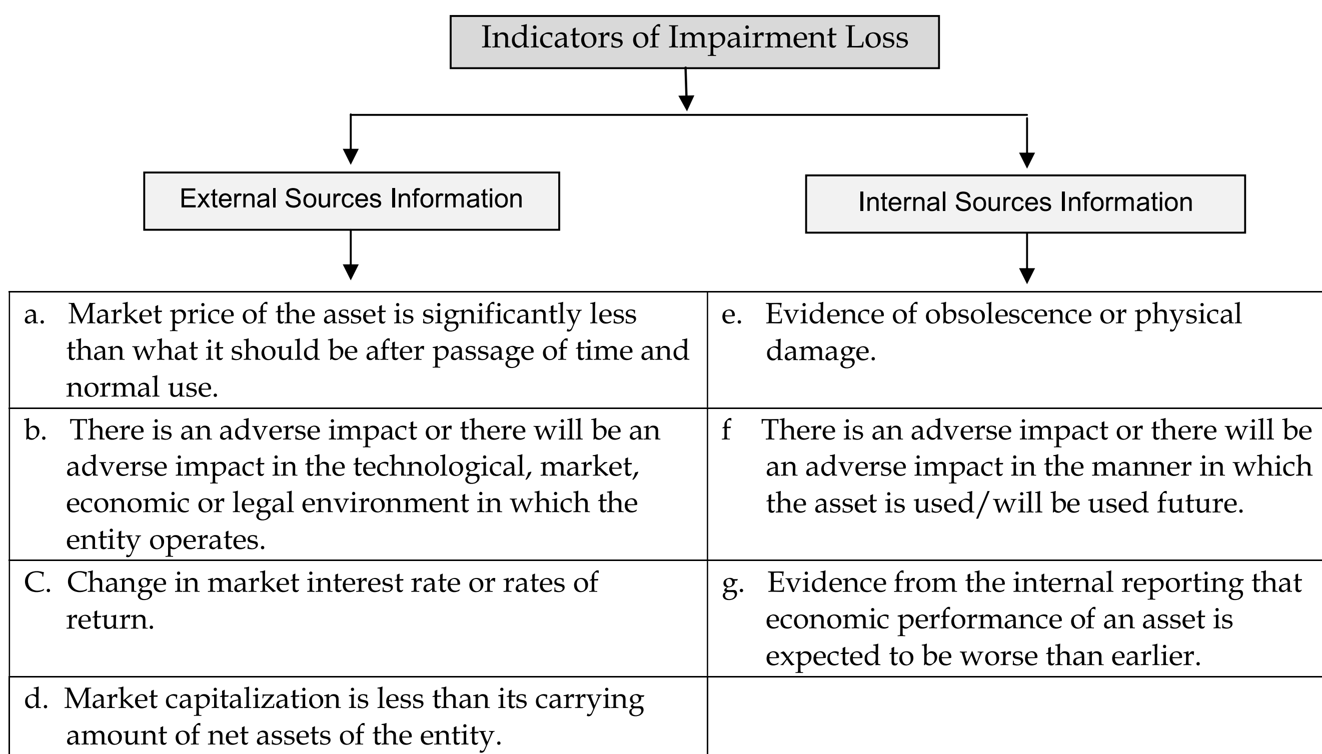
a) An intangible asset with indefinite useful life

b) An intangible asset not yet available for use, reason being an asset's ability to generate future economic benefits to recover its carrying amount is more uncertain before the asset is available for use than after an asset is available for use. An asset available but not put to use is different from asset not yet available for use.

c) Goodwill acquired in a business combination.

Entity should assess at the end of each reporting period whether there is any indication that an asset may be impaired.

## 7. INDICATIONS OF IMPAIRMENT




| External Sources Information | Internal Sources Information |
|---|---|
| a. Market price of the asset is significantly less than what it should be after passage of time and normal use. | e. Evidence of obsolescence or physical damage. |
| b. There is an adverse impact or there will be an adverse impact in the technological, market, economic or legal environment in which the entity operates. | f There is an adverse impact or there will be an adverse impact in the manner in which the asset is used/will be used future. |
| C. Change in market interest rate or rates of return. | g. Evidence from the internal reporting that economic performance of an asset is expected to be worse than earlier. |
| d. Market capitalization is less than its carrying amount of net assets of the entity. | |

The assets are tested for impairment if there are indications of impairment.

**PROBLEM : 5**

**The following information is available as regards the PPE of a company. Is there any indication of Impairment of assets?**

1. **Carrying amount in the SOFP net of accumulated depreciation Rs. 340 lacs. Assets are 2 years old. The present market price of the assets is Rs. 300 lacs. The company charges 10% SLM depreciation assuming 10 years useful life.**
2. **Estimated useful life of the assets has been reduced to 5 years henceforth (instead of remaining eight years) because of technological changes.**
3. **Market rate of interest has increased. Accordingly there is increase in the discount factor from 14% to 15%.**
4. **Book Value to market Capitalisation of the company is 0.80.**

**SOLUTION : 5**

Yes decline in market price and technological conditions.

## 8. STEPS INVOLVED IN QUANTIFYING THE IMPAIRMENT ARE AS FOLLOWS.

1. **Measuring the Carrying amount**

   Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

2. **Measuring the Recoverable Amount**

   The recoverable amount is **the higher of**

   - fair value less cost to sell and
   - value in use.

   The fair value is the reflection of the market participants' expectation of the discounted future economic benefits from the asset.

   Value in use is entity specific, and reflects the ability of the entity to earn future economic benefits from the usage of the asset

   As impairment is provided only when carrying amount is in excess of its recoverable amount, if any one component (fair value less cost to sell or value in use) of the recoverable amount is higher than the carrying amount, there is no need to compute the other component.

| | | |
|---|---|---|
| | | |
| | | |
| | | |

## 9. FAIR VALUE LESS COSTS TO SELL

The Fair value less costs to sell is usually arrived at as:

- The price in a binding sale agreement in an arm's length transaction.
- Current bid price if the asset is traded in an active market
- The recent market transaction price of the similar assets within the same industry if current bid prices are unavailable.
- The amount based on the best information available to the entity if neither of the above data are available.
- Cost of disposal, which is the direct consequence (incidental costs are not considered) of the disposal of the asset, should be deducted from the identified fair value.

## 10. VALUE IN USE

Value in use is the entity's expectation of recovering futureeconomic benefits from the usage of the asset. In order to determine this, the entity shall estimate the future cash flows from the asset considering all the following factors:

## 11. CASH FLOWS

- The assumptions used in projections shall be based on management's best estimate of the economic condition that is expected to prevail during the life of the asset, more weight given to external evidence.
- Cash flows shall be based on the recent financial budget approved by the management or like data with adjustments to be in consistent with past actual outcomes.
- The projections shall not exceed five years which is rebuttable.
- Normally for estimates beyond the recent budgets, extrapolation should be based on a steady or

declining growth unless increasing rate is justified. This growth rate should not exceed long term average growth rate for the country.

- Cash flows should include, cash flows from continuing use of the asset, cash flows necessary to generate the inflow and net cash flow on disposal.
- Future restructuring not yet committed and cash outflow to improve or enhance performance is not considered. Financing cash flows and tax flows should not be considered.
- If the asset generates cash flow in foreign currency, the future cash flows are projected in the foreign currency and discounted using appropriate rate prevailing in the concerned economic environment. The present value thus arrived is translated into the functional currency at the spot rate. **In this process it is possible that, in terms of foreign currency there may be impairment but not in terms of functional currency and vice-versa.**

## 12. DISCOUNT RATE

The cash flows shall be discounted at a **pre-tax discount rate** which reflects the market participants' assessment of the risk factor involved.

The current market risk free discount rate shall be adjusted for the time value of money, the risk profile of the asset used in the business.

If market rate is not available, then the entity may adopt the following rates and adjust for the various risk factors, such as country risk, currency risk:

- Entity's weighted average cost of capital
- Entity's incremental borrowing rate
- Other market borrowing rates

The entity may use different discount rate for different period, if the future periods risk factors affect the cash flow of the asset.

## 13. RECOGNISING AND MEASURING IMPAIRMENT LOSS

**Individual Asset**

An individual asset is impaired if its carrying amount exceeds its recoverable amount.

- **In case of non-revalued asset**

  An impairment of a non-revalued asset is recognized in profit or loss immediately. Subsequent depreciation or amortisation is provided based on the value after impairment provision.

- **In case of revalued asset**

  An impairment loss is treated as a revaluation decrease and accordingly reduced first from the revaluation surplus and excess, if any is recognized in profit or loss account. Subsequent depreciation or amortisation is provided based on the value after impairment provision.

**PROBLEM : 6**

**A Ltd. purchased an asset for Rs. 8,00,000 and the life of the asset was expected 10 years. The company provides depreciation @ 10% SL method. At present, the remaining life is 3 years, and the recoverable amount of the asset has been estimated at Rs. 90,000. Find out the amount of impairment loss. Also show the Asset A/c in the SOFP.**

**SOLUTION : 6**

**Calculation of impairment loss**

| | | **Rs.** | **Rs.** |
|---|---|---|---|
| a. | Carrying amount . | | |
| | Original cost | | |

(-) Depreciation For 7 years $\frac{8,00,000}{10}$ x 7 ________

b. Recoverable amount ________

c. Impairment loss a – b ________

**SOFP** (Asset side)

| **Asset** | **Rs.** | **Rs.** |
|---|---|---|
| <u>Fixed Asset</u> | | |
| Original Cost | | |
| (-) Accumulated depreciation | ________ | |
| (-) Impairment loss | | |

**PROBLEM : 7**

**A plant is being shown in the SOFP at the carrying amount of Rs. 42,00,000. Its remaining life is expected for 6 years after which it would be scrapped away for Rs. 6,00,000. The net cash inflows from the use of the plant during the next 6 years are Rs. 10,00,000 each for first three years and Rs. 8,00,000 each for next three years. The discount rate applicable to the company is 15%. The net selling price of the asset is Rs. 40,00,000. Find out the following :**

**a. The value in use (of the plant),**

**b. The impairment loss, if any.**

**c. The recoverable amount, of the plant**

**d. The impairment loss if the net selling price is Rs. 35,00,000.**

**SOLUTION : 7**

(i) **Value in use**

Calculation of P.V.

| Year | Cash flow | Dis. Factor @ 15% | P.V. (Rs.) |
|---|---|---|---|
| 1 | 10,00,000 | 0.8696 | |
| 2 | 10,00,000 | 0.7561 | |
| 3 | 10,00,000 | 0.6575 | |
| 4 | 8,00,000 | 0.5718 | |
| 5 | 8,00,000 | 0.4972 | |
| 6 | 14,00,000 | 0.4323 | |
| | | | |

(ii) **Recoverable amount**

Higher of **Rs.**

a. Net selling price

b. Value in use

∴ Recoverable amount

(iii) **Calculation of impairment loss** **Rs.**

a. Carrying amount

b. Recoverable amount (W.N. 2) ____________

c. Impairment Loss (a – b)

____________

(iv) **Calculation of impairment loss if net selling price is Rs. 35,00,000.**

| | | Rs. | Rs. |
|---|---|---|---|
| A. | Carrying amount | | |
| B. | Recoverable amount-higher of | | |
| | i. Net selling price | | |
| | ii. Value in use | | ____________ |
| C. | Impairment loss | | |

**PROBLEM : 8**

**The following information is available in respect of an asset :**

| | |
|---|---|
| **Cost of the asset** | **Rs. 28,00,000** |
| **Life (Salvage NIL)** | **10 years** |
| **Life remaining** | **3 years** |
| **Upward revaluation done last year** | **Rs. 7,00,000** |
| **Current carrying amount** | **13,65,000** |
| **Recoverable cost of the asset** | **6,00,000** |

**The asset is impaired at the end of the year and then the depreciation for the current year is charged. Find out the impairment loss and the depreciation for the current year. Also give the treatment of impairment loss.**

SOLUTION : 8

**Calculation of impairment loss and its treatment**

| | | **Rs.** |
|---|---|---|
| a. | Carrying amount | |
| b. | Recoverable Amount | |
| c. | Impairment loss (a – b) | |
| d. | Impairment loss to be charged against revaluation reserve | |
| e. | Impairment loss to be charged to P&L | |
| f. | Depreciation for the current year 6,00,000/3 | |

**PROBLEM : 9**

**A Ltd. purchased an asset on 1-1-22 for Rs. 12,00,000 with expected life of 8 years and no salvage value. For the first 3 years i.e., upto 31-12-24, the asset has been depreciated as usual. During the January 2025, there is an indication of impairment loss, the company has procured the following information :**

**Net selling price of the asset Rs. 6,70,000**

**Cash flow per annum (for 2025-2029) 1,80,000**

**Rate of Discount 15%**

**Find out the value in use, recoverable amount, impairment loss, revised carrying amount and the depreciation for the year 2025, given that there is no change in expected life of the asset.**

**SOLUTION : 9**

(i) **Calculation of value in use** **Rs.**

a. Annual cash flow for 2025-2029

b. PVAF (15%, 5 years)

c. P.V.

(ii) **Recoverable amount**

Higher of **Rs.**

a. Net selling price

b. Value in use

∴ Recoverable amt.

(iii) **Calculation of impairment loss**

| | **Rs.** | **Rs.** |
|---|---|---|
| a. Carrying amount | | |
| Original cost | 12,00,000 | |
| (-) Depreciation $\frac{12,00,000}{8} \times 3$ | 4,50,000 | |
| b. Recoverable amount (W.N. ii) | | |
| c. Impairment loss (a – b) | | |
| d. Revised carrying amount | | |
| e. Depreciation for year 2025 $\frac{6,70,000}{5}$ | | |

## 14. CASH GENERATING UNIT (CGU)

If an individual asset's recoverable amount is not determinable then the smallest unit (group of assets, i.e. cash generating unit) to which the individual asset belongs is identified and the CGU is tested for impairment. An individual asset's recoverable amount cannot be determined due to the following reasons:

- The asset's value in use cannot be estimated to be close to its fair value less costs to sell; and
- The asset does not generate cash inflows that are largely independent of those from other assets.

CGU is impaired only if the carrying amount of the CGU exceeds the recoverable amount of the CGU.

## 15. CARRYING AMOUNT OF CGU

The carrying amount of CGU shall include all and only those assets which are directly attributable or allocated to the CGU. Inclusion of other assets or exclusion of includible assets will fetch a different result as regards impairment of the CGU.

**The carrying amount of CGU shall include liabilities only if the recoverable amount is determinable after considering the recognized liabilities.**

## 16. RECOVERABLE AMOUNT OF CGU

Recoverable amount of CGU is the higher of fair value less costs to sell the CGU and its value in use.

- **Fair value** less costs to sell CGU is the net of fair value of all assets as considered to determine the carrying amount and the fair value of liabilities, less the cost to sell.
- **Value in use** of the CGU is the discounted cash flows of the CGU from the entity's perspective adjusted for all the associated risks, if not adjusted already in arriving the discount rate.

**PROBLEM : 10**

**A mining company has been given permission to carry out excavating operations for five years, at the end of which the mine has to be filled up again, and the entire land has to be landscaped. The cost of the landscaping is expected to be Rs 200,000 and the liability has been provided for.**

**The cash-generating unit of the mine is the whole mine itself. The carrying amount of the mine is Rs 1,000,000. The approach road to the mine has a carrying amount of Rs 25,000. The value in use is Rs 8,50,000 (excluding landscaping costs) and the fair value less costs to sell is Rs 830,000.**

**Required:**

**Calculate the carrying amount of the mine**

**SOLUTION : 10**

## 17. GOODWILL

**Goodwill has to be tested for impairment annually irrespective of any indications for impairment.**

The goodwill acquired in a business combination is allocated to the cash generating units that is expected to benefit from the synergies of the combination irrespective of whether other assets and liabilities of the acquiree are assigned to those groups.

Each unit or group of units to which goodwill is allocated shall:

- Represent the lowest level within the entity at which goodwill is monitored
- Not be larger than an operating segment determined in accordance with IFRS 8.

Since goodwill cannot be segregated from other assets and cannot generate cash flows independently from other assets, the smallest cash generating unit to which the goodwill is allocated is tested for impairment as mentioned earlier.

If there are indications of impairment for assets other than goodwill in a CGU, then the CGU is tested for impairment for the assets indicative of impairment before testing the related goodwill for impairment.

In case of reorganization of CGUs the goodwill shall also be reallocated to the CGUs based on relative value approach unless other methods are justifiable.

**PROBLEM : 11**

**A cash-generating unit consists of the following assets:**

| | **Rs** |
|---|---|
| | |

| | |
|---|---|
| | |

This cash-generating unit suffered an impairment loss of Rs 40,000. It is not practicable to estimate the recoverable amount of each individual asset. Show how the impairment loss is to be allocated

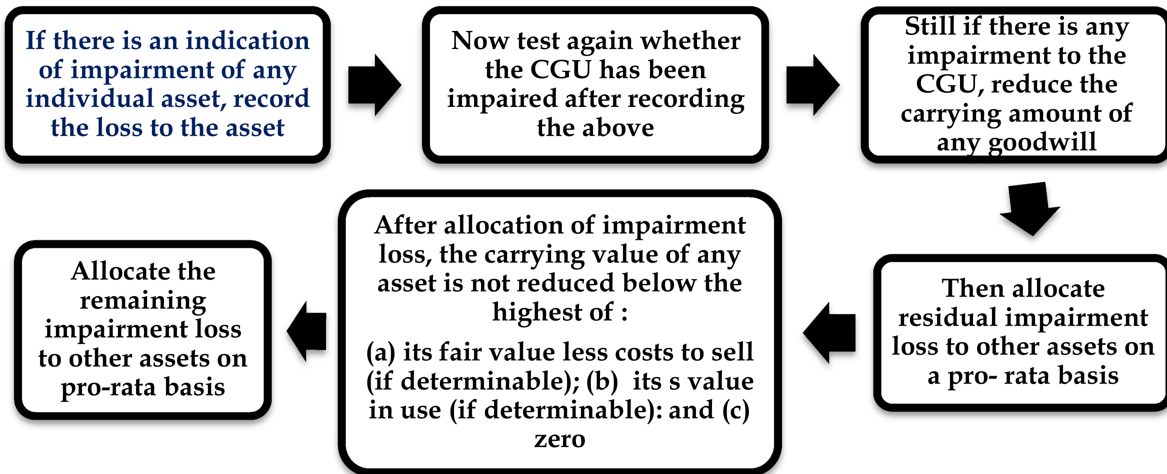
**PROBLEM : 12** A cash-generating unit has these net assets:

| | |
|---|---|
| | |
| | |
| | |
| | |

**The recoverable amount has been determined as Rs 45 million.**

*Required :***Allocate the impairment loss to the net assets of the entity.**

## 18. IF IT IS PRACTICABLE TO ESTIMATE THE RECOVERABLE AMOUNT OF ANY INDIVIDUAL ASSET OF A CASH-GENERATING UNIT




## 19. ALLOCATION OF IMPAIRMENT LOSS OF A CGU

The impairment loss being the excess of carrying amount of the CGU over the recoverable amount of the CGU shall be allocated to the CGU in the following order:

- first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
- then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

An impairment loss is provided for only when the asset's carrying amount exceeds the recoverable amount.

**While allocating an impairment loss, an entity shall not reduce the carrying amount of an asset <u>below the highest of:</u>**

- **its fair value less costs to sell (if determinable);**
- **its value in use (if determinable); and**
- **zero.**

**PROBLEM : 13 Continuing with above Example, but with more information**

The CGU suffered an impairment loss of Rs 40,000. Some more information about the impairment of individual assets

Required: Determine how the impairment loss is allocated. Calculate the revised carrying values of the assets of the cash generating unit.

**PROBLEM : 14**

**There are three assets in a CGU with Carrying Amounts of Rs. 6 lakhs, Rs. 12 lakhs and Rs. 9 lakhs respectively. The Recoverable Amount of the CGU as a whole is Rs. 18 lakhs. Impairment Loss be treated in this case?**

**SOLUTION : 14**

| Particulars | Computation | Rs. Lakhs |
|---|---|---|
| | | |

**The above Impairment Loss will be debited to P&L Account as an expense, if these assets were not revalued. In case of revalued assets, these amounts will be treated as a Revaluation Decrease and adjusted against Revaluation Reserve.**

## 20. CORPORATE ASSETS

Corporate assets in general, indirectly assist the CGU in its cash generation and they do not generate cash flows independently. Therefore, when there is an indication that corporate assets may be impaired, the CGU to which the corporate assets relate shall be identified and tested for impairment.

If the corporate assets can be reasonably allocated to the CGU, then the carrying amount and the recoverable amount of the CGU is compared and impairment loss is provided if the former exceeds the later.

**PROBLEM : 15**

An entity has two cash-generating units, X and Y. There is no goodwill within the units carrying values. The carrying values are X Rs10 million and Y Rs15 million. The entity has an office building that has not been included in the above values and can be allocated to the units on the basis of their carrying values. The office building has a carrying value of Rs 5 million. The recoverable amounts are based on value-in-use of Rs 9 million for X and Rs19 million for Y. ***Required :*** Determine whether the carrying values of X and Y are impaired.

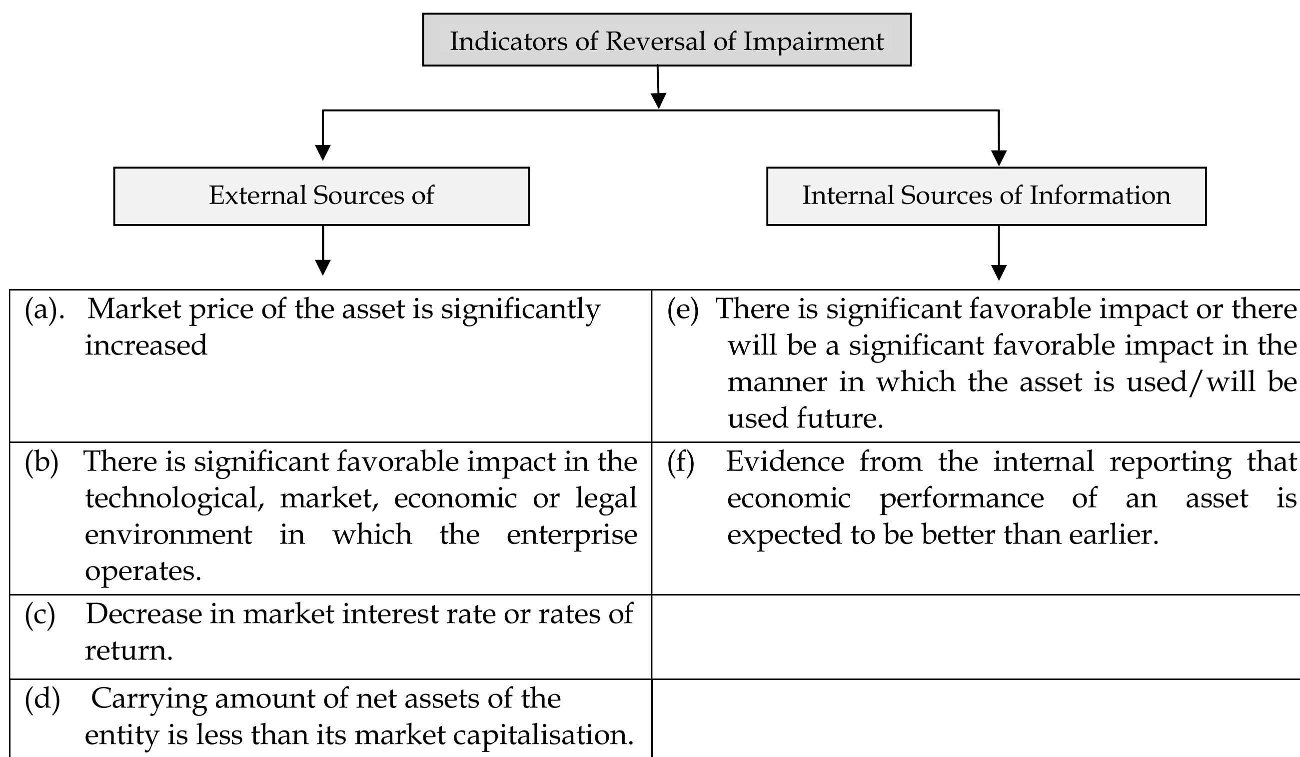
**SOLUTION : 15**

| | *X* | *Y* | *Total* |
|---|---|---|---|
| **Carrying value** | | | |
| **Office building (10:15)** | | | |
| | | | |
| **Recoverable amount** | | | |
| **Impairment loss** | | | |

If the corporate assets cannot be reasonably allocated to the particular related CGU, then

- The related CGU shall be tested for impairment excluding the corporate assets, and
- The group of CGUs to which the corporate assets can be reasonably allocated are identified and the group is tested for impairment.

## 21. INDICATIONS OF REVERSAL OF IMPAIRMENT LOSS




| External | Internal |
|---|---|
| (a). Market price of the asset is significantly increased | (e) There is significant favorable impact or there will be a significant favorable impact in the manner in which the asset is used/will be used future. |
| (b) There is significant favorable impact in the technological, market, economic or legal environment in which the enterprise operates. | (f) Evidence from the internal reporting that economic performance of an asset is expected to be better than earlier. |
| (c) Decrease in market interest rate or rates of return. | |
| (d) Carrying amount of net assets of the entity is less than its market capitalisation. | |

## 22. REVERSAL OF IMPAIRMENT LOSS FOR AN INDIVIDUAL ASSET

The reversal of impairment loss shall be subject to a **maximum of carrying amount (net of amortization or depreciation) of the concerned individual asset had there been no impairment.**

The reversal is recognized in profit or loss in case of an asset that is not revalued previously.

In case of an asset previously revalued, the reversal is first used to recover the amount previously debited to profit or loss on providing the impairment loss, if any, and the remaining is treated as increase in revaluation surplus. Subsequent depreciation or amortisation is adjusted according to the revised amounts.

## 23. REVERSING AN IMPAIRMENT LOSS FOR CASH GENERATING UNIT

An impairment reversal shall be allocated to the assets other than goodwill of the CGU on pro rata basis in relation to the carrying amount of the assets.

In allocating a reversal of an impairment loss for a cash-generating unit, the carrying amount of an asset shall not be increased above the lower of:

- its recoverable amount (if determinable); and
- the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognized for the asset in prior periods.

**Reversal of impairment loss for goodwill IS PROHIBITED by the standard.**

**PROBLEM : 16**

**X Ltd. acquired plant on 1.4.2010.**

**Cost: Rs. 200 lakhs, useful life 20 years, residual value Rs. 20 lakhs. Depreciation policy: straight line method.**

**As on 31.3.2013, the company determined recoverable amount of the plant as Rs. 100 lakhs. Impairment loss was recognised.**

**As on 31.3.2016, based on positive information the entity reviewed recoverable amount and re-determined at Rs. 150 lakhs.**

**Find out impairment loss and reversal of impairment loss.**

**SOLUTION : 16**

**PROBLEM : 17**

The calculation refers to an impairment loss suffered by Z Ltd at December 31, 20X4:

| | Goodwill | Net assets | Total |
|---|---|---|---|
| | Rs in million | Rs in million | Rs in million |
| December 31, 20X4—carrying value | 300 | 900 | 1200 |
| Impairment | (300) | (200) | (500) |
| | - | 700 | 700 |

**There has been a favourable change in the estimates of the recoverable amount of Zen's net assets since the impairment loss was recognized. The recoverable amount is now Rs 800 million at December 31, 20X5. The net assets' carrying value could have been Rs 720 million at December 31, 20X5. Assets are depreciated at 20% reducing balance.**

**Required :Show the accounting treatment for the reversal of the impairment loss as of December 31, 20X5.**

**SOLUTION : 17**

The carrying amount of Z Ltd can be increased up to the lower of the recoverable amount (Rs 800 million) and the carrying value (Rs 720 million) of the net assets.

**Carrying amount of Zen's net assets at December 31, 20X5:**

| | Goodwill | Net assets | Total |
|---|---|---|---|
| | Rs in million | Rs in million | Rs in million |
| Carrying amount (700 – 20% of 700) | | | |
| Reversal of impairment loss | | | |
| Carrying amount after reversal of impairment loss | | | |

**Note :Reversal of impairment loss for goodwill IS PROHIBITED by the standard.**

**PROBLEM : 18**

**At the end of year 2020, A Ltd. acquired assets of B Ltd. at a price of Rs. 90,00,000. The fair value of the assets was estimated to be Rs. 75,00,000 to be depreciated over 10 years from the year 2021 onward. Goodwill was to be amortized over a period of 5 years. In the beginning of 2023, a new government was voted to power. This government immediately announced some policies by which the main activities of A Ltd. were severely affected. By the end of year 2023, the company identified the indications for impairment and the recoverable amount of the assets was estimated at Rs. 49,00,000.**

**During the year 2025, the government adopted liberal policies which are expected to improve the working position and profitability of A Ltd. the recoverable amount at the end of year 2025, is estimated at Rs. 40,00,000.**

**Find out the impairment loss in year 2023 and the reversal of impairment loss and its treatment in the year 2025.**

**SOLUTION : 18**

**Calculation of impairment loss in the year 2023**

| S.No. | Particulars | Goodwill (Rs.) | Asset (Rs.) | Total (Rs.) |
|---|---|---|---|---|
| A | Cost of Acquisition | | | |
| B | Depreciation / Amortisation * $\frac{15,00,000}{5}$ x 3 | | | |
| C | Carrying amount at the end of year 2023 | | | |
| D | Recoverable amount | | | |
| E | Impairment loss | | | |
| F | Revised carrying amount | | | |
| G | Depreciation for year 2024 & 2025* ($\frac{49}{7}$ x 2) | | | |
| H | Carrying amount (end of 2025) | | | |

**Reversal of impairment loss**

Calculation of carrying amount had there been no impairment. **Rs.**

A. Carrying amount (2023)

B. Less : Depreciation 7,50,000 x 2

C. Carrying amount had there been no impairment

D. Recoverable amount at the end of the year 2025

E. Carrying amount after recognising impairment loss at the end of year 2025

F. Reversal of impairment loss [37,50,000 – 35,00,000]

G. ∴ **Revised carrying amount**

## 24. DISCLOSURES

**In the financial statements**

- The impairment losses and reversals recognized in profit or losses and other comprehensive income for each item. This disclosure shall also be given for each reportable segment for entities that report segment information.

**In the notes to accounts**

- With regard to CGU, the allocation of goodwill,
- indefinite useful life assets
- assumptions involved in estimating recoverable amount,
- methodology used to determine fair value less costs to sell.
- any goodwill or intangible with indefinite useful lives allocated to multiple CGU

## 25. MAJOR CHANGE IN IND AS 36 VIS-À-VIS IAS 36

***Impairment of Investment Property:*** Paragraph 2(f) of IAS 36 provides that this standard is not applied to the accounting for impairment of investment property that is measured at fair value. Paragraph 2(f) is deleted in Ind AS 36 as Ind AS 40 requires cost model for measurement of investment property.

## PROBLEMS FOR SELF-PRACTICE

**PROBLEM 19 :**

**On 1-1-03, A Ltd. acquired net assets of B Ltd. for Rs. 70,00,000. The fair value of net assets was estimated at Rs. 60,00,000. The goodwill, if any, was to be amortized over a period of 8 years, whereas the net assets were to be depreciated over 10 years (with no salvage value). During the year 2006, there was an indication of the impairment loss in respect of these assets. So, the cash inflows for the remaining life of the assets were estimated to be Rs. 12,00,000; Rs. 9,50,000; Rs. 8,00,000; Rs. 8,30,000; Rs. 8,00,000; Rs. 8,50,000 and Rs. 6,00,000 respectively. The discount rate applicable to the company is 12%.**

**Find out impairment loss to be recognized by the company. How should it be treated?**

**SOLUTION : 19**

(i) **Calculation of carrying amount of Assets and Goodwill.** **(Rs.)**

| Sr. No. | Particulars | Asset | Goodwill | Total |
|---|---|---|---|---|
| A. | Cost of acquisition | 60,00,000 | 10,00,000 | 70,00,000 |
| B. | Depreciation / Amortisation for 3 years<br>* $\frac{60,00,000}{10} \times 3$ ** $\frac{10,00,000}{8} \times 3$ | 18,00,000* | 3,75,000** | 21,75,000 |
| C. | Carrying amount (A – B) | 42,00,000 | 6,25,000 | 48,25,000 |

(ii) **Calculation of value in use**

| Year | Cash flow (Rs.) | D.F @ 12% | D.C.F. (Rs.) |
|---|---|---|---|
| 1 | 12,00,000 | 0.8929 | 10,71,480 |
| 2 | 9,50,000 | 0.7972 | 7,57,340 |
| 3 | 8,00,000 | 0.7118 | 5,69,440 |
| 4 | 8,30,000 | 0.6355 | 5,27,465 |
| 5 | 8,00,000 | 0.5674 | 4,53,920 |
| 6 | 8,50,000 | 0.5066 | 4,30,610 |
| 7 | 6,00,000 | 0.4523 | 2,71,380 |
| | | **Total** | **40,81,635** |

**Impairment loss** Rs.

| | | Rs. |
|---|---|---|
| A. | Total carrying amount (W.N. 1) | 48,25,000 |
| B. | Recoverable Amount | 40,81,635 |
| C. | Impairment Loss A – B | 7,43,365 |

This impairment loss of Rs. 7,43,365 should be first applied to write off goodwill and then to other assets as follows :-

| | **Rs.** |
|---|---|
| Impairment loss | 7,43,365 |
| Less : Goodwill | 6,25,000 |
| Amount written off the assets | 1,18,365 |

Revised carrying amount of the assets = 42,00,000 – 1,18,365
= Rs. 40,81,635

**PROBLEM 20 :**

**X Ltd. is having a plant (asset) carrying amount of which is Rs. 100 lakhs on 31.3.2004. Its balance useful life is 5 years and residual value at the end of 5 years is Rs. 5 lakhs. Estimated future cash flow from using the plant in next 5 years are:-**

| ***For the year ended on*** | ***Estimated cash flow (Rs. in lakhs)*** |
|---|---|
| **31.3.2005** | **50** |
| **31.3.2006** | **30** |
| **31.3.2007** | **30** |
| **31.3.2008** | **20** |
| **31.3.2009** | **20** |

**Calculate "value in use" for plant if the discount rate is 10% and also calculate therecoverable amount if fair value less cost to sell of plant on 31.3.2004 is Rs. 60 lakhs.**

**SOLUTION : 20**

**Present value of future cash flow** **(Rs. in lakhs)**

| *Year ended* | *Future Cash Flow* | *Discount @ 10% Rate* | *Discounted cash flow* |
|---|---|---|---|
| 31.3.2005 | 50 | 0.909 | 45.45 |
| 31.3.2006 | 30 | 0.826 | 24.78 |
| 31.3.2007 | 30 | 0.751 | 22.53 |
| 31.3.2008 | 20 | 0.683 | 13.66 |
| 31.3.2009 | 20 | 0.620 | 12.40 |
| | | 118.82 | |
| Present value of residual price on 31.3.2009 = 5 x 0.620 | | | 3.10 |
| Present value of estimated cash flow by use of an asset and residual value, which is called "value in use". | | | 121.92 |

If **fair value less cost to sell** of plant on 31.3.2004 is Rs. 60 lakhs, the recoverable amount will be higher of Rs. 121.92 lakhs (value in use) and Rs.60 lakhs (net selling price), hence recoverable amount is Rs.121.92 lakhs.

**PROBLEM 21 :**

**From the following details of an asset**

**(i) Find out impairment loss**

**(ii) Treatment of impairment loss**

**(iii) Current year depreciation**

| **Particulars of asset:** | |
|---|---|
| **Cost of asset** | **Rs.56 lakhs** |
| **Useful life period** | **10 Years** |
| **Salvage value** | **Nil** |
| **Current carrying value** | **Rs.27.30 lakhs** |
| **Useful life remaining** | **3 Years** |
| **Recoverable amount** | **Rs.12 lakhs** |
| **Upward revaluation done in last year** | **Rs.14 lakhs** |

**SOLUTION : 21**

| **Impairment Loss and its treatment** | **Rs.** |
|---|---|
| Current carrying amount (including revaluation amount of Rs.14 lakhs) | 27,30,000 |
| Less: Current recoverable amount | 12,00,000 |
| Impairment Loss | 15,30,000 |
| Impairment loss charged to revaluation reserve | 14,00,000 |
| Impairment loss charged to profit and loss account | 1,30,000 |

In the given case, the carrying amount of the asset will be reduced to Rs.12,00,00 after impairment. The amount is required to depreciated over remaining useful life of 3 years (including current year). Therefore, the depreciation for the current year will be Rs.4,00,000.

**PROBLEM : 22**

**Venus Ltd. has an assets, which is carried in the SOFP on 31.3.2005 at Rs. 500 lakhs. As at that date the value in use is Rs. 400 lakhs and the net selling price is Rs. 375 lakhs.**

**From the above data :**

(i) **Calculate impairment loss.**

(ii) **Prepare journal entries for adjustment of impairment loss.**

(iii) **Show, how impairment losswill be shown in the SOFP.**

**SOLUTION : 22**

**(i) Recoverable amount is higher of value in use Rs.400 lakhs and net selling price Rs.375 lakhs.**

Recoverable amount = Rs.400 lakhs

Impairement loss = Carried Amount – Recoverable amount

= Rs.500 lakhs – Rs.400 lakhs = Rs.100 lakhs.

**Journal Entries**

| | **Particulars** | **Dr. Amount Rs. in lakhs** | **Cr. Amount Rs. in lakhs** |
|---|---|---|---|
| (i) | Impairment loss account Dr.<br>To Asset<br>(Being the entry for accounting impairment loss) | 100 | 100 |
| (ii) | Profit and loss account Dr.<br>To Impairments loss<br>(Being the entry to transfer impairment loss to profit and loss account) | 100 | 100 |

**(ii) SOFP of Venus Ltd. as on 31.3.2005**

| | Rs. in lakhs |
|---|---|
| Asset less depreciation | 500 |
| Less: Impairment loss | 100 |
| | 400 |

**PROBLEM 23 :**

**Ergo Industries Ltd. gives the following estimates of cash flows relating to fixed asset on 31.12.2010.**

**The discount rate is 15%**

| Year | Cash Flow (Rs.in lakhs) |
|---|---|
| 2011 | 4,000 |
| 2012 | 6,000 |
| 2013 | 6,000 |
| 2014 | 8000 |
| 2015 | 4,000 |
| Residual value at the end of 2015 | = Rs.1,000 lakhs |
| Fixed Asset purchased on 1.1.2008 | = Rs.40,000 lakhs |
| Useful Life | = 8 years |
| Net Selling price on 31.12.2010 | = Rs.20,000 lakhs |

**Calculate on 31.12.2010:**

(i) Value in use on 31.12.2010;
(ii) Carrying amount at the end of 2010;
(iii) Recoverable amount on 31.12.2010;

**SOLUTION : 23** **Calculation of value in use**

| Year | Cash Flow | Discount as per 15% | Discounted cash flow |
|---|---|---|---|
| 2011 | 4,000 | 0.870 | 3,480 |
| 2012 | 6,000 | 0.756 | 4,536 |
| 2013 | 6,000 | 0.658 | 3,948 |
| 2014 | 8,000 | 0.572 | 4,576 |
| 2015 | 4,000+1000 | 0.497 | 2485 |
| | | | 19025 |

Value in use = Rs.19025 lakhs

**Calculation of carrying amount:**

Original cost = Rs.40,000 lakhs

Depreciation for 3 years = [(40,000 – 1000) x 3/8] = Rs.14,625

Carrying amount on 31.12.2010 = [40,000 – 14,625] = Rs.25,375

Recoverable amount = Rs.20,000 lakhs (higher of value in use and net selling price)

Impairment Loss = Rs.(25,375-20,000) = Rs.5,375 lakhs

**PROBLEM 24 :**

**Earth Infra Ltd has two cash-generating units, X and Y. There is no goodwill within the units' carrying values. The carrying values of the CGUs are CGU A for ₹ 20 million and CGU B for ₹ 30 million. The company has an office building which it is using as a office headquarter has not been included in the above values and can be allocated to the units on the basis of their carrying values. The office building has a carrying value of ₹ 10 million. The recoverable amounts are based on value-in-use of ₹ 18 million for CGU A and ₹ 38 million for CGU B.**

**Required: Determine whether the carrying values of CGU A and B are impaired.**

**SOLUTION : 24**

The office building is a corporate asset which needs to be allocated to CGU A and B on a reasonable and consistent basis:

| | **A** | **B** | **Total** |
|---|---|---|---|
| Carrying value of CGUs | 20 | 30 | 50 |
| Allocation of office building<br>(office building is allocated in the ratio of<br>Carrying value of CGU's<br>Carrying value of CGU after | 4 | 6 | 10 |
| Allocation of corporate asset | 24 | 36 | 60 |
| Recoverable Amount | 18 | 38 | 56 |
| Impairment Loss | 6 | - | |

The impairment loss will be allocated on the basis of 4/24 against the building (₹ 1 million) and 20/24 against the other assets (₹ 5 million).

**PROBLEM 25 :**

**A machine has suffered physical damage but is still working, although not as well as before it was damaged. The machine's fair value less costs of disposal is less than its carrying amount. The machine does not generate independent cash inflows. The smallest identifiable group of assets that includes the machine and generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.**

**Assumption 1: budgets/forecasts approved by management reflect no commitment of management to replace the machine.**

**Assumption 2: budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible**

**SOLUTION : 25**

1. The recoverable amount of the machine alone cannot be estimated because the machine's value in use:
   a) may differ from its fair value less costs of disposal; and
   b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

   The production line is not impaired. Therefore, no impairment loss is recognised for the machine. Nevertheless, the entity may need to reassess the depreciation period or the depreciation method for the machine. Perhaps a shorter depreciation period or a faster depreciation method is required

to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are expected to be consumed by the entity.

2. The machine's value in use can be estimated to be close to its fair value less costs of disposal. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (i.e. the production line). Because the machine's fair value less costs of disposal is less than its carrying amount, an impairment loss is recognised for the machine.

After the allocation procedures have been applied, a liability is recognised for any remaining amount of an impairment loss for a cash-generating unit if, and only if, that is required by another Indian Accounting Standard

**PROBLEM 26 :**

**On 1st April 20X1, Venus ltd acquired 100% of Saturn ltd for ₹ 4,00,000. The fair value of the net identifiable assets of Saturn ltd was ₹ 3,20,000 and goodwill was ₹ 80,000. Saturn ltd is in coal mining business. On 31st March 20X3 the government has cancelled licenses given to it in few states.**

**As a result Saturn's ltd revenue is estimated to get reduce by 30%. The adverse change in market place and regulatory conditions is an indicator of impairment. As a result, Venus ltd has to estimate the recoverable amount of goodwill and net assets of Saturn ltd on 31st March 20X3.**

**Venus ltd uses straight line depreciation. The useful life of Saturn's ltd assets is estimated to be 20 years with no residual value. No independent cash inflows can be identified to any individual assets. So the entire operation of Saturn ltd is to be treated as a CGU. Due to the regulatory entangle it is not possible to determine the selling price of Saturn ltd as a CGU. Its value in use is estimated by the management at ₹ 2,12,000.**

**Suppose by 31st March 20X5 the government reinstates the licenses of Saturn ltd. The management expects a favourable change in net cash flows. This is an indicator that an impairment loss may have reversed. The recoverable amount of Saturn's ltd net asset is reestimated. The value in use is expected to be ₹ 3,04,000 and net selling price is expected to be ₹ 2,90,000.**

**SOLUTION : 26**

Since the fair value less costs of disposal is not determinable the recoverable amount of the CGU is its value in use. The carrying amount of the assets of the CGU on 31st March 20X3 is as follows:

**Calculation of Impairment loss**

| | | | **INR** |
|---|---|---|---|
| | **Goodwill** | **Other assets** | **Total** |
| Historical Cost | 80,000 | 3,20,000 | 4,00,000 |
| Accumulated Depreciation (3,20,000/20) x 2 | - | (32,000) | (32,000) |
| Carrying Amount | 80,000 | 2,88,000 | 3,68,000 |
| Impairment Loss | (80,000) | (76,000) | (1,56,000) |

**Revised Carrying Amount**

- Impairment Loss = Carrying Amount – Recoverable Amount (₹ 3,68,000 - ₹ 2,12,000) = ₹ 1,56,000 is charged in statement of profit and loss for the period ending 31st March 20X3 as impairment loss.
- Impairment loss is allocated first to goodwill ₹ 80,000 and remaining loss of ₹ 76,000 (₹ 1,56,000 – ₹ 80,000) is allocated to the other assets.

**Reversal of Impairment loss**

Reversal of impairment loss is recognised subject to:-

- The impairment loss on goodwill cannot be reversed.

  The increased carrying amount of an asset after reversal of an impairment loss not to exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

**Calculation of carrying amount of identifiable assets had no impairment loss is recognised**

| | *INR* |
|---|---:|
| Historical Cost | 3,20,000 |
| Accumulated Depreciation for 4 years (3,20,000/20) x 4 | (64,000) |
| Carrying amount had no impairment loss is recognised on 31st March 20X5 | 2,56,000 |

**Carrying amount of other assets after recognition of impairment loss**

| | *INR* |
|---|---:|
| Carrying amount on 31st March 20X3 | 2,12,000 |
| Accumulated Depreciation for 2 years (2,12,000/18) x 2 [ rounded off to nearest thousand for ease of calculation] | (24,000) |
| Carrying amount on 31st March 20X5 | 1,88,000 |

- The impairment loss recognised previously can be reversed only to the extent of lower of re-estimated recoverable amount is ₹ 2,56,000 (higher of fair value less costs of disposal ₹ 2,90,000 and value in use ₹ 3,04,000)
- Impairment loss reversal will be ₹ 68,000 i.e. (₹ 2,56,000 – ₹ 1,88,000). This amount is recognised as income in the statement of profit and loss for the year ended 31st March 20X5.
- The carrying amount of other assets at 31st March 20X5 after reversal of impairment loss will be ₹ 2,56,000.
- From 1st April 20X5 the depreciation charge will be ₹ 16,000 i.e. (₹ 2,56,000/16)

**PROBLEM 27 :**

**From the following details of an asset, find out:**

*(a)* **Impairment loss and its treatment.**

*(b)* **Current year depreciation.**

**Particulars of assets:**

| | |
|---|---:|
| **Cost of asset** | **₹ 56 lakhs** |
| **Useful life** | **10 years** |
| **Salvage value** | **Nil** |
| **Current carrying value** | **₹ 27.30 lakhs** |
| **Remaining useful life** | **3 years** |
| **Recoverable amount** | **₹ 12 lakhs** |
| **Upward revaluation done in last year** | **₹ 14 lakhs** |

**SOLUTION : 27**

**Impairment loss**

Impairment loss = Carrying amount of the asset – Recoverable amount

= ₹ 27.30 lakhs – ₹ 12 lakhs

= ₹ 15.30 lakhs

**Treatment of impairment loss**

As per IAS 36, impairment loss (whether of an individual asset of a CGU) is recognised in the following manner:

(a) *Impairment loss of a revalued asset*: It is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. The balance, if any, is recognised as an expense in the statement of profit and loss.

(b) *Impairment loss of other assets*: Impairment loss of any other asset should be recognised as an expense in the statement of profit and loss.

Since, the asset in question has been revalued upwards, the impairment loss will be adjusted first against the revaluation surplus of ₹ 14 lakhs. The balance amount of ₹ 1.30 lakhs will be recognised as an expense in the profit and loss account.

**Current year depreciation**

| | |
|---|---|
| Revised carrying amount (after recognising impairment loss) | ₹ 12 lakhs |
| Remaining useful life | 3 years |
| Salvage value | Nil |
| Annual depreciation (12/3) | ₹ 4 lakhs |

**PROBLEM 28 :**

**Venus Ltd. has an asset, which is carried in the Balance Sheet on March 31, 20X1 at ₹ 500 lakhs. As at that date the value in use is ₹ 400 lakhs and the fair value less costs to sells is ₹ 375 lakhs.**

**From the above data:**

(a) **Calculate impairment loss.**

(b) **Prepare journal entries for adjustment of impairment loss.**

(c) **Show, how impairment loss will be shown in the Balance Sheet.**

**SOLUTION : 28**

According to IAS 36, *Impairment of Assets*, impairment loss is the excess of 'Carrying amount of the asset' over 'Recoverable Amount'.

In the present case, the impairment loss can be computed in the following manner:

Step 1: Fair value *less* costs to sell: ₹ 375 lakhs

Step 2: Value in use: ₹ 400 lakhs

Step 3: Recoverable amount, i.e., higher of 'fair value *less* costs to sell' & 'value in use'.

Thus, recoverable amount is ₹ 400 lakhs

Step 4: Carrying amount of the asset ₹ 500 lakhs

Step 5: Impairment loss, i.e., excess of amount computed in step 4 over amount computed in Step 3.

₹ 100 lakhs (being the difference between ₹ 500 lakhs and ₹ 400 lakhs).

According to IAS 36, an impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard. Assuming, that the asset is not carried at revalued amount, the impairment loss of ₹ 100 lakhs will be charged to Profit & Loss Account.

**Journal Entries**

| Date | Particulars | | Dr. Amt. | Cr. Amt. |
|---|---|---|---|---|
| | | | ₹ in Lakhs | |
| 31.3.20X1 | Impairment Loss A/c | Dr. | 100 | |
| | To Assets A/c | | | 100 |
| | (Being impairment loss on an asset recognised) | | | |
| 31.3.20X1 | Statement of Profit & Loss A/c | Dr. | 100 | |
| | To Impairment Loss A/c | | | 100 |
| | (Being impairment loss transferred to statement of profit and loss) | | | |

**PROBLEM 29 :**

**A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment. What is the cash-generating unit for an individual magazine title?**

**SOLUTION : 29**

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis. Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent of each other and that each magazine title is a separate cash-generating unit.

**PROBLEM 30 :**

**A mining entity owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine. Should the entity determine the recoverable amount for the private railway or for the mining business as a whole?**

**SOLUTION : 30**

It is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, i.e., the mine as a whole.

**PROBLEM 31 :**

**A bus company provides services under contract with a municipality that requires minimum service on each of seven separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss. Should the company determine the recoverable amount for an individual asset or for a cash generating unit?**

**SOLUTION : 31**

Because the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the

cash inflows generated by the seven routes together. The cash- generating unit for each route is the bus company as a whole.

**PROBLEM 32 :**

**A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same entity. X's products are sold to Y at a transfer price that passes all margins to X. 80% of Y's final production is sold to customers outside of the entity.**

**60% of X's final production is sold to Y and the remaining 40% is sold to customers outside of the entity. For each of the following cases, what are the cash-generating units for X and Y?**

(a) **If X could sell the products it sells to Y in an active market and internal transfer prices are higher than market prices, what are the cash-generating units for X and Y?**

(b) **If there is no active market for the products X sells to Y, what are the cash-generating units for X and Y?**

**SOLUTION : 32**

**(a)** **Cash-generating unit for X:** X could sell its products in an active market and, so, generate cash inflows that would be largely independent of the cash inflows from Y. Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y.

**Cash-generating unit for Y:** It is likely that Y is also a separate cash-generating unit. Y sells 80% of its products to customers outside of the entity. Therefore, its cash inflows can be regarded as largely independent.

**Effect of internal transfer pricing:** Internal transfer prices do not reflect market prices for X's output. Therefore, in determining value in use of both X and Y, the entity adjusts financial budgets/forecasts to reflect management's best estimate of future prices that could be achieved in arm's length transactions for those of X's products that are used internally.

**(b)** **Cash-generating units for X and Y:** It is likely that the recoverable amount of each plant cannot be assessed independently of the recoverable amount of the other plant because:

(i) the majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y.

(ii) the two plants are managed together.

As a consequence, it is likely that X and Y together are the smallest group of assets that generates cash inflows that are largely independent.

**PROBLEM 33 :**

**XYZ Limited produces a single product and owns plants 1, 2 and 3. Each plant is located in a different country. Plant 1 produces a component that is assembled in either Plant 2 or Plant 3. The combined capacity of Plant 2 and Plant 3 is not fully utilised. XYZ Limited's products are sold worldwide from either Plant 2 or Plant 3, e.g., Plant 2's production can be sold in Plant 3's country if the products can be delivered faster from Plant 2 than from Plant 3. Utilisation levels of Plant 2 and Plant 3 depend on the allocation of sales between the two sites. If there is no active market for Plant 1's products, what are the cash-generating units for Plant 1, Plant 2 and Plant 3?**

**SOLUTION : 33**

It is likely that the recoverable amount of each plant cannot be assessed independently because:

(a) There is no active market for Plant 1's products. Therefore, Plant 1's cash inflows depend on sales of the final product by Plant 2 and Plant 3.

(b) Although there is an active market for the products assembled by Plant 2 and Plant 3, cash inflows for Plant 2 and Plant 3 depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for Plant 2 and Plant 3 can be determined individually.

As a consequence, it is likely that Plant 1, Plant 2 and Plant 3 together (i.e., XYZ Limited as a whole) are the smallest identifiable group of assets that generates cash inflows that are largely independent.

**PROBLEM 34 :**

**A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is ₹ 500, which is equal to the present value of the restoration costs.**

**The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around ₹ 800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately ₹ 1,200 excluding restoration costs. The carrying amount of the mine is ₹ 1,000.**

**Is the mine required to be impaired?**

**SOLUTION : 34**

The cash-generating unit's fair value *less* costs to sell is ₹ 800. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cashgenerating unit is determined after consideration of the restoration costs and is estimated to be ₹ 700 (₹ 1,200 *less* ₹ 500). The carrying amount of the cash-generating unit is ₹ 500, which is the carrying amount of the mine (₹ 1,000) *less* the carrying amount of the provision for restoration costs (₹ 500). Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount. Thus, there is no impairment loss.

**PROBLEM 35:**

**An entity sells for ₹ 100 crores an operation that was part of a cash-generating unit to which goodwill has been allocated. The goodwill allocated to the unit cannot be identified or associated with an asset group at a level lower than that unit, except arbitrarily. The recoverable amount of the portion of the cash-generating unit retained is ₹ 300 crores. How the goodwill should be allocated to the operation sold?**

**SOLUTION : 35**

Since goodwill allocated to the cash-generating unit cannot be non-arbitrarily identified or associated with an asset group at a level lower than that unit, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the unit retained. Therefore, 25% of the goodwill allocated to the cash-generating unit is included in the carrying amount of the operation that is sold.

**PROBLEM 36 :**

**Goodwill had previously been allocated to cash-generating unit A. The goodwill allocated to A cannot be identified or associated with an asset group at a level lower than A, except arbitrarily. A is to be divided and integrated into three other cash-generating units, B, C and D. How the goodwill should be reallocated to B, C and D?**

**SOLUTION : 36**

Since goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to units B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D.

**PROBLEM 37 :**

**XYZ Limited has a cash-generating unit 'Plant A' as on April 1, 20X1 having a carrying amount of ₹ 1,000 crores. Plant A was acquired under a business combination and goodwill of ₹ 200 crores was allocated to it. It is depreciated on straight line basis. Plant A has a useful life of 10 years with no residual value. On March 31, 20X2, Plant A has a recoverable amount of ₹ 600 crores. Calculate the impairment loss on Plant A. Also, prescribe its allocation as per IAS 36.**

**SOLUTION : 37**

| Particulars | Goodwill (₹ in crores) | Identifiable assets (₹ in crores) | Total (₹ in crores) |
|---|---|---|---|
| Historical cost | 200 | 1,000 | 1,200 |
| Depreciation (20X1-20X2) | - | (100) | (100) |
| Carrying amount | 200 | 900 | 1,100 |

Since, the recoverable amount is ₹ 600 crores, there is an impairment loss of ₹ 500 crores. The impairment loss of ₹ 500 crores should be allocated to goodwill first, and then to the other identifiable assets, i.e., ₹ 200 crores to goodwill and ₹ 300 crores to identifiable assets of Plant A

| | | | (₹ in crores) |
|---|---|---|---|
| **Particulars** | **Goodwill** | **Identifiable assets** | **Total** |
| Impairment loss | (200) | (300) | (500) |
| Carrying amount after impairment loss | - | 600 | 600 |

**PROBLEM 38 :**

**Sun ltd is an entity with various subsidiaries. The entity closes its books of account at every year ended on 31st March. On 1st July 20X1 Sun ltd acquired an 80% interest in Pluto ltd. Details of the acquisition were as follows:**

- **Sun ltd acquired 800,000 shares in Pluto ltd by issuing two equity shares for every five acquired. The fair value of Sun Ltd's share on 1st July 20X1 was ₹ 4 per share and the fair value of a Pluto's share was ₹ 1·40 per share. The costs of issue were 5% per share.**
- **Sun ltd incurred further legal and professional costs of ₹ 100,000 that directly related to the acquisition.**
- **The fair values of the identifiable net assets of Pluto Ltd at 1st July 20X1 were measured at ₹ 1·3 million. Sun ltd initially measured the non-controlling interest in Pluto ltd at fair value. They used the market value of a Pluto ltd share for this purpose. No impairment of goodwill arising on the acquisition of Pluto ltd was required at 31st March 20X2 or 20X3.**

**Pluto ltd comprises three cash generating units A, B and C. When Pluto ltd was acquired the directors of Sun ltd estimated that the goodwill arising on acquisition could reasonably be allocated to units A:B:C on a 2:2:1 basis. The carrying values of the assets in these cash generating units and their recoverable amounts are as follows:**

| *Unit* | *Carrying value (before goodwill allocation)* | *Recoverable amount* |
|---|---|---|
| ₹ '000 | ₹ '000 | |
| A | 600 | 740 |
| B | 550 | 650 |
| C | 450 | 400 |

**Required:**

i. **Compute the carrying value of the goodwill arising on acquisition of Pluto Ltd in the consolidated Balance Sheet of Sun ltd at 31st March 20X4 following the impairment review.**

ii. **Compute the total impairment loss arising as a result of the impairment review, identifying how much of this loss would be allocated to the non-controlling interests in Pluto ltd**

**SOLUTION : 38**

**1. Computation of goodwill on acquisition**

| Particular | Amount (₹ '000) |
|---|---|
| Cost of investment (8,00,000 x 2/5 x ₹ 4) | 1,280 |
| Fair value of non-controlling interest (2,00,000 x ₹ 1 ·4) | 280 |
| Fair value of identifiable net assets at date of acquisition | (1,300) |
| So goodwill equals | 260 |

Acquisition costs are not included as part of the fair value of the consideration given under IFRS 3, Business Combination.

**2. Calculation of impairment loss**

| Unit | Carrying value | | | Recoverable Amount | Impairment Loss |
|---|---|---|---|---|---|
| | Before Allocation | Allocation of goodwill (2:2:1) | After Allocation | | |
| A | 600 | 104 | 704 | 740 | Nil |
| B | 550 | 104 | 654 | 650 | 4 |
| C | 400* | 52 | 452 | 400 | 52 |

* After writing down assets in the individual CGU to recoverable amount.

**3. Calculation of closing goodwill**

| | |
|---|---|
| Goodwill arising on acquisition (W1) | 260 |
| Impairment loss (W2) | (56) |
| So closing goodwill equals | 204 |

**4. Calculation of overall impairment loss**

| | |
|---|---|
| on goodwill (W3) | 56 |
| on assets in unit C (450 – 400) | 50 |
| So total loss equals | 106 |

₹ 21 ·2 (20%) of the above is allocated to the NCI with the balance allocated to the shareholders of Sun ltd.

**PROBLEM 39 :**

**Apex Ltd. is engaged in manufacturing of steel utensils. It owns a building for its headquarters. The building used to be fully occupied for internal use. However, recently the company has undertaken a massive downsizing exercise as a result of which 1/3rd of the building became vacant. This vacant portion has now been given of on lease for 6 years. Determine the CGU of the building.**

**SOLUTION : 39**

CGU of the building is Apex Ltd. as a whole as the primary purpose of the building is to serve as a corporate asset.

**PROBLEM 40 :**

**ABC Ltd. has three cash-generating units: A, B and C, the carrying amounts of which as on March 31, 20X1 are as follows:**

| Cash-generating units | Carrying amount | (₹ in crores) Remaining useful life |
|---|---|---|
| A | 500 | 10 |
| B | 750 | 20 |
| C | 1,100 | 20 |

**ABC Ltd. also has two corporate assets having a remaining useful life of 20 years.**

(₹ in crores)

| Corporate asset | Carrying amount | Remarks |
|---|---|---|
| X | 600 | The carrying amount of X can be allocated on a reasonable basis (i.e., pro rata basis) to the individual cash-generating units. |
| Y | 200 | The carrying amount of Y cannot be allocated on a reasonable basis to the individual cash- generating units. |

**Recoverable amount as on March 31, 20X1 is as follows:**

| Cash-generating units | Recoverable amount (₹ in crores) |
|---|---|
| A | 600 |
| B | 900 |
| C | 1,400 |
| ABC Ltd. | 3,200 |

**Calculate the impairment loss, if any. Ignore decimals.**

**SOLUTION : 40**

**Allocation of corporate assets**

The carrying amount of X is allocated to the carrying amount of each individual cash- generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

(₹ in crores)

| Particulars | A | B | C | Total |
|---|---|---|---|---|
| Carrying amount | 500 | 750 | 1,100 | 2,350 |
| Useful life | 10 years | 20 years | 20 years | — |
| Weight based on useful life | 1 | 2 | 2 | — |
| Carrying amount (after assigning weight) | 500 | 1,500 | 2,200 | 4,200 |
| Pro-rata allocation of X | 12% | 36% | 52% | |
| | (500/4,200) | (1,500/4,200) | (2,200/4,200) | |
| Allocation of carrying amount of X | 72 | 216 | 312 | 100% |
| Carrying amount (after allocation of X) | 572 | 966 | 1,412 | 600 |

**Calculation of impairment loss**

**Step I: Impairment losses for individual cash-generating units and its allocation**

**(a) Impairment loss of each cash-generating units**

| (₹ in crores) | | | |
|---|---|---|---|
| **Particulars** | A | B | C |
| Carrying amount (after allocation of X) | 572 | 966 | 1,412 |
| Recoverable amount | 600 | 900 | 1400 |
| Impairment loss | - | 66 | 12 |

**(b) Allocation of the impairment loss**

| (₹ in crores) | | | | |
|---|---|---|---|---|
| **Allocation to** | B | | C | |
| X | 15 | (66 x 216/966) | 3 | (12 x 312/1,412) |
| Other assets in cash generating Units | 51 | (66 x 750/ 966) | 9 | (12 x 1,100/ 1,412) |
| Impairment loss | 66 | | 12 | |

**Step II: Impairment losses for the larger cash-generating unit, i.e., ABC Ltd. as a whole**

| ( in crores) | | | | | | |
|---|---|---|---|---|---|---|
| **Particulars** | A | B | C | X | Y | ABC Ltd. |
| Carrying amount | 500 | 750 | 1,100 | 600 | 200 | 3,150 |
| Impairment loss (Step I) | - | (51) | (9) | (18) | - | (78) |
| Carrying amount (after Step I) | 500 | 699 | 1,091 | 582 | 200 | 3,072 |
| Recoverable amount | | | | | | 3,200 |
| Impairment loss for the 'larger' cash-generating unit | | | | | | Nil |

**PROBLEM 41 :**

**Parent acquires an 80% ownership interest in Subsidiary for ₹ 2,100 on April 1, 20X1. At that date, Subsidiary's net identifiable assets have a fair value of ₹ 1,500. Parent chooses to measure the non-controlling interests as the proportionate interest of Subsidiary's net identifiable assets. The assets of Subsidiary together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Because other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of ₹ 500 related to those synergies has been allocated to other cash-generating units within Parent. On March 31, 20X2, Parent determines that the recoverable amount of cash-generating unit Subsidiary is ₹ 1,000. The carrying amount of the net assets of Subsidiary, excluding goodwill, is ₹ 1,350. Allocate the impairment loss on March 31, 20X2.**

**SOLUTION : 41**

Non-controlling interests is measured as the proportionate interest of Subsidiary's net identifiable assets, i.e., ₹ 300 (20% of ₹ 1,500). Goodwill is the difference between the aggregate of the consideration transferred and the amount of the non-controlling interests (₹ 2,100 + ₹ 300) and the net identifiable assets (₹ 1,500), i.e., ₹ 900.

Since, the assets of Subsidiary together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets, therefore, Subsidiary is a cash-generating unit. Because other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of ₹ 500 related to those synergies has been allocated to other cash-generating units within Parent. Because the cash-generating unit comprising Subsidiary includes goodwill within its carrying amount, it should be tested for impairment annually, or more frequently if there is an indication that it may be impaired.

### Testing Subsidiary (cash-generating unit) for impairment

Goodwill attributable to non-controlling interests is included in Subsidiary's recoverable amount of ₹ 1,000 but has not been recognised in Parent's consolidated financial statements. Therefore, the carrying amount of Subsidiary should be grossed up to include goodwill attributable to the non-controlling interests, before being compared with the recoverable amount of ₹ 1,000. Goodwill attributable to Parent's 80% interest in Subsidiary at the acquisition date is ₹ 400 after allocating ₹ 500 to other cash-generating units within Parent. Therefore, goodwill attributable to the 20% non-controlling interests in Subsidiary at the acquisition date is ₹ 100.

### Testing subsidiary for impairment on March 31, 20X2

| On March 31, 20X2 | Goodwill of Subsidiary (₹ ) | Net identifiable Assets ( ₹) | Total ( ₹) |
|---|---|---|---|
| Carrying amount | 400 | 1,350 | 1,750 |
| Unrecognised non-controlling interests | 100 | - | 100 |
| **Adjusted carrying amount** | **500** | **1,350** | **1,850** |
| Recoverable amount | | | 1,000 |
| **Impairment loss** | | | **850** |

### Allocating the impairment loss

The impairment loss of ₹ 850 should be allocated to the assets in the unit by first reducing the carrying amount of goodwill.

Therefore, ₹ 500 of the ₹ 850 impairment loss for the unit is allocated to the goodwill. If the partially-owned subsidiary is itself a cash-generating unit, the goodwill impairment loss should be allocated to the controlling and non-controlling interests on the same basis as that on which profit or loss is allocated. In this case, profit or loss is allocated on the basis of relative ownership interests. Because the goodwill is recognised only to the extent of Parent's 80% ownership interest in Subsidiary, Parent recognises only 80% of that goodwill impairment loss (i.e., ₹ 400).

The remaining impairment loss of ₹ 350 is recognised by reducing the carrying amounts of Subsidiary's identifiable assets.

### Allocation of the impairment loss for Subsidiary on March 31, 20X2

| On March 31, 20X2 | Goodwill of Subsidiary (₹) | Net Identifiableassets (₹) | Total (₹) |
|---|---|---|---|
| Carrying amount | 400 | 1,350 | 1,750 |
| Impairment loss | (400) | (350) | (750) |
| **Carrying amount after impairment loss** | **-** | **1,000** | **1,000** |

**PROBLEM 42 :**

**A Ltd. purchased a machinery of ₹ 100 crores on April 1, 20X1. The machinery has a useful life of 5 years. It has nil residual value. A Ltd. adopts straight line method of depreciation for depreciating the machinery. Following information has been provided as on March 31, 20X2:**

| Financial year | Estimated future cash flows (₹ in crores) |
|---|---|
| 20X2-20X3 | 15 |
| 20X3-20X4 | 30 |
| 20X4-20X5 | 40 |
| 20X5-20X6 | 10 |

**Discount rate applicable : 10%**

**Fair value less costs to sell as on March 31, 20X2 : ₹ 70 crores**

**Calculate the impairment loss, if any**

**SOLUTION : 42**

Value in use of the machinery as on March 31, 20X2 can be calculated as follows:

| Financial year | Estimated cash flows ( in crores) | Present value factor @ 10% | Present value |
|---|---|---|---|
| 20X2-20X3 | 15 | 0.9091 | 13.64 |
| 20X3-20X4 | 30 | 0.8264 | 24.79 |
| 20X4-20X5 | 40 | 0.7513 | 30.05 |
| 20X5-20X6 | 10 | 0.6830 | 6.83 |
| | | | **75.31** |

The recoverable amount of the machinery is ₹ 75.31 crores (higher of value in use of ₹ 75.31 crores and fair value *less* costs to sell of ₹ 70 crores). Carrying amount of the machinery is ₹ 80 crores (after providing for one year depreciation @ ₹ 20 crores). Therefore, the impairment loss of ₹ 4.69 crores should be provided in the books.

**PROBLEM 43:**

**Assuming in the above example, as on March 31, 20X3, there is no change in the estimated future cash flows and discount rate. Fair value less costs to sell as on March 31, 20X3 is ₹ 40 crores. How should it be dealt with under IAS 36 ?**

| Financial year | Estimated cash flows (₹ in crores) | Present value factor @ 10% | Present value |
|---|---|---|---|
| **20X3-20X4** | **30** | **0.9091** | **27.27** |
| **20X4-20X5** | **40** | **0.8264** | **33.06** |
| **20X5-20X6** | **10** | **0.7513** | **7.51** |
| | | | **67.84** |

**SOLUTION : 43**

The recoverable amount of the machinery is ₹ 67.84 crores (higher of value in use of ₹ 67.84 crores and fair value *less* costs to sell of ₹ 40 crores). Carrying amount of the machinery is ₹ 60 crores (after providing for two years depreciation @ ₹ 20 crores per annum).

However, as per paragraph 116 of IAS 36, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

Therefore, the impairment loss of ₹ 4.69 crores should not be reversed.

**PROBLEM 44 :**

**A Ltd. purchased an asset of ₹ 100 lakhs on April 1, 20X0. It has useful life of 4 years with no residual value. Recoverable amount of the asset is as follows:**

| As on | Recoverable amount |
|---|---|
| **March 31, 20X1** | **₹ 60 lakhs** |
| **March 31, 20X2** | **₹ 40 lakhs** |
| **March 31, 20X3** | **₹ 28 lakhs** |

**Calculate the amount of impairment loss or its reversal, if any, on March 31, 20X1, March 31, 20X2 and March 31, 20X3.**

**SOLUTION : 44**

**As on March 31, 20X1**

| | |
|---|---|
| Carrying amount of the asset (opening balance) | ₹ 100 lakhs |
| Depreciation (₹ 100 lakhs/4 years) | ₹ 25 lakhs |
| Carrying amount of the asset (closing balance) | ₹ 75 lakhs |
| Recoverable amount (given) | ₹ 60 lakhs |

Therefore, an impairment loss of ₹ 15 lakhs should be recognised as on March 31, 20X1. Depreciation for subsequent years should be charged on the carrying amount of the asset (after providing for impairment loss), i.e., ₹ 60 lakhs.

**As on March 31, 20X2**

| | |
|---|---|
| Carrying amount of the asset (opening balance) | ₹ 60 lakhs |
| Depreciation (₹ 60 lakhs/3 years) | ₹ 20 lakhs |
| Carrying amount of the asset (closing balance) | ₹ 40 lakhs |

Therefore, no impairment loss should be recognised as on March 31, 20X2.

**As on March 31, 20X3**

| | |
|---|---|
| Carrying amount of the asset (opening balance) | ₹ 40 lakhs |
| Depreciation (₹ 40 lakhs/2 years) | ₹ 20 lakhs |
| Carrying amount of the asset (closing balance) | ₹ 20 lakhs |
| Recoverable amount (given) | ₹ 28 lakhs |

Since, the recoverable amount of the asset exceeds the carrying amount of the asset by ₹ 8 lakhs, impairment loss recognised earlier should be reversed. However, reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

Carrying amount as on March 31, 20X3 had no impairment loss being recognised would have been ₹ 25 lakhs. Therefore, the reversal of an impairment loss of ₹ 5 lakhs should be done as on March 31, 20X3.

**PROBLEM 45 :**

**On March 31, 20X1, XYZ Ltd. makes following estimate of cash flows for one of its asset located in USA:**

| Year | Cash flows |
|---|---|
| 20X1-20X2 | US $ 80 |
| 20X2-20X3 | US $ 100 |
| 20X3-20X4 | US $ 20 |

**Following information has been provided:**

| Particulars | India | USA |
|---|---|---|
| Applicable discount rate | 15% | 10% |

**Exchange rates are as follows:**

| As on | Exchange rate |
|---|---|

| March 31, 20X1 | ₹ 45/US $ |
|---|---|

| As on | Expected Exchange rate |
|---|---|
| March 31, 20X2 | ₹ 48/US $ |
| March 31, 20X3 | ₹ 51/US $ |
| March 31, 20X4 | ₹ 55/US $ |

**value in use as on March 31, 20X1.**

**SOLUTION : 45**

| Year | Cash flows (US $) | Present value factor @10% | Discounted cash flows(US $) |
|---|---|---|---|
| 20X1-20X2 | 80 | 0.9091 | 72.73 |
| 20X2-20X3 | 100 | 0.8264 | 82.64 |
| 20X3-20X4 | 20 | 0.7513 | 15.03 |
| Total Discounted cash flows in US $ | | | 170.40 |
| Exchange rate as on March 31, 20X1, i.e., date of calculating value in use | | | ₹ 45/US $ |
| Value in use as on March 31, 20X1 | | | ₹ 7,668 |

**PROBLEM 46 :**

**Cash flow is ₹ 100, ₹ 200 or ₹ 300 with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows.**

**SOLUTION : 47**

| Cash flow | Probability | Expected cash flow |
|---|---|---|
| 100 | 10% | 10 |
| 200 | 60% | 120 |
| 300 | 30% | 90 |
| Total | | 220 |

The expected cash flow is ₹ 220.

**PROBLEM 47 :**

**Cash flow of Rs 1,000 may be received in one year, two years or three years with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows assuming applicable discount rate of 5%, 5.25% and 5.5% in year 1, 2 and 3, respectively.**

**SOLUTION : 47**

| Years | Cash flow | P.V.F. | Present value | Probability | Expected cash flow |
|---|---|---|---|---|---|
| 1 | 1,000 | 0.95238 | 952.38 | 10% | 95.24 |
| 2 | 1,000 | 0.90273 | 902.73 | 60% | 541.64 |
| 3 | 1,000 | 0.85161 | 851.61 | 30% | 255.48 |
| Total | | | | | 892.36 |

The expected present value is ₹ 892.36.

**PROBLEM 48 :**

**Calculate expected cash flows in each of the following cases:**

**(a) the estimated amount falls somewhere between Rs 50 and Rs 250, but no amount in the range is more likely than any other amount.**

**(b) the estimated amount falls somewhere between Rs 50 and Rs 250, and the most likely amount is Rs 100. However, the probabilities attached to each amount are unknown.**

**(c) the estimated amount will be Rs 50 (10 per cent probability), Rs 250 (30 per cent probability), or Rs 100 (60 per cent probability).**

**SOLUTION : 48**

(a) the estimated expected cash flow is ₹ 150 [(50 + 250)/2].

(b) the estimated expected cash flow is ₹ 133.33 [(50 + 100 + 250)/3].

(c) the estimated expected cash flow is ₹ 140 [(50 × 0.10) + (250 × 0.30) + (100 × 0.60)].

# IAS 41 AGRICULTURE

## 1. INTRODUCTION

IAS 41 prescribes accounting treatment and disclosures related to agricultural activity. The Standard provides that entities shall apply this Standard to account for the following when they relate to agricultural activity:

- Biological assets
- Agricultural produce at the point of harvest and
- Government grants relating to agricultural activity

IAS 16 (Property, Plant and Equipment) or IAS 40 (Investment Properties) shall be applied in accounting for Land used for agricultural activity, and if an entity carries intangible assets attributable to agricultural activity, it shall apply IAS 38 (Intangible Assets).

Lessors of biological assets under operating lease and lessees of biological assets under finance lease shall apply IAS 41 and not IAS 17.

## 2. DEFINITIONS

**Agricultural Activity** is the management by an entity of the biological transformation and harvest of biological assets for sale or conversion, into agricultural produce, or into additional biological assets.

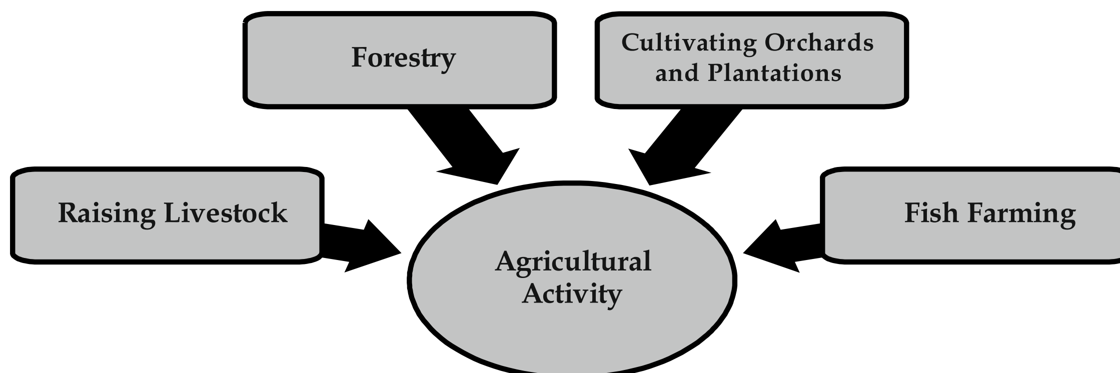
**Agricultural produce** is the harvested product of the entity's biological assets.

A **biological asset** is a living animal or plant.

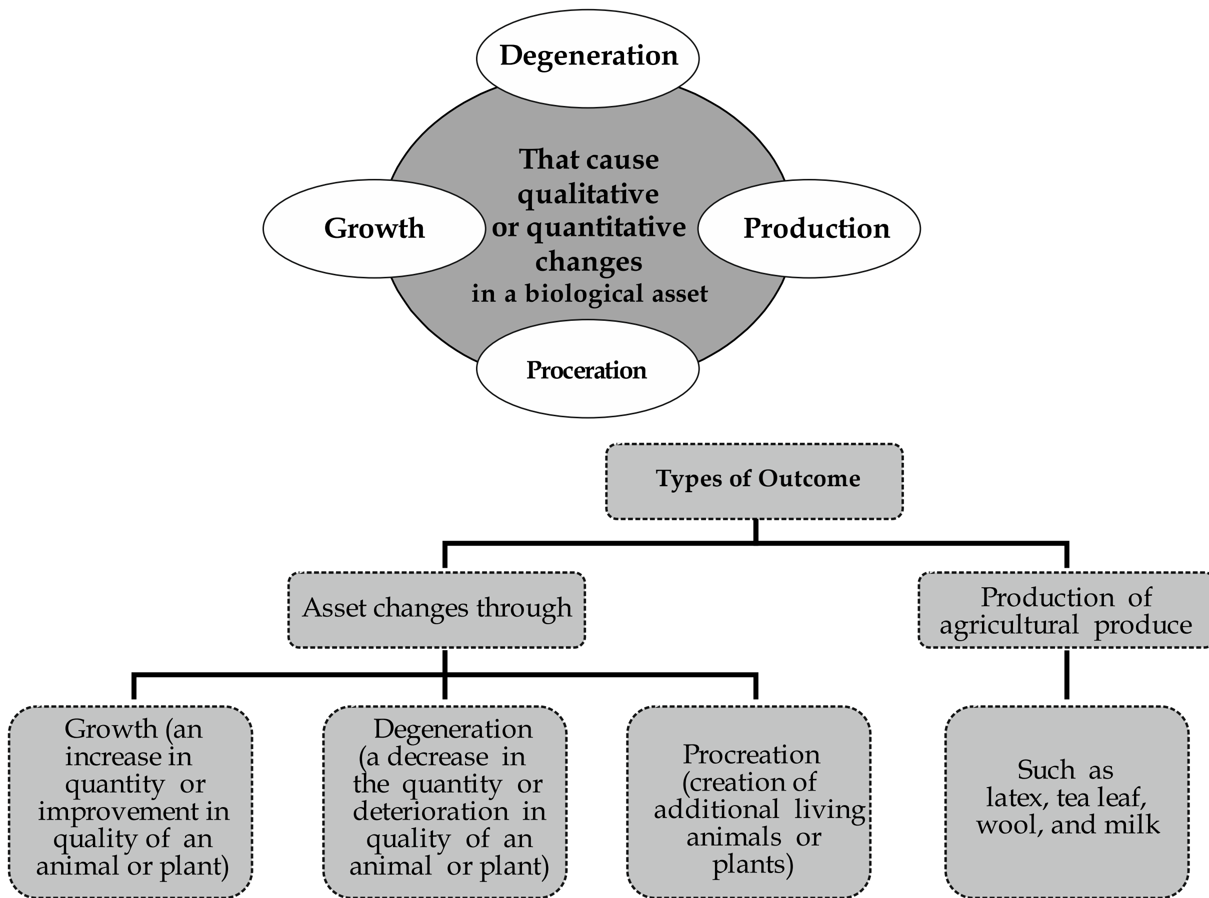
## 3. EXAMPLES OF BIOLOGICAL ASSETS

| Biological assets | Agricultural produce | Products that are the result of processing after harvest |
|---|---|---|
| Sheep | Wool | Yarn, carpet |
| Trees in a plantation forest | Felled trees | Logs, lumber |
| Plants | Cotton | Thread, clothing |
| | Harvested cane | Sugar |
| Dairy cattle | Milk | Cheese |
| Pigs | Carcass | Sausages, cured hams |
| Bushes | Leaf | Tea, cured tobacco |
| Vines | Grapes | Wine |
| Fruit trees | Picked fruit | Processed fruit |
| Oil palms | Picked fruit | Palm oil |
| Rubber trees | Harvested latex | Rubber products |

**Biological transformation** comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.A group of **biological assets** is an aggregation of similar living animals or plants.



**Biological transformation comprises the processes of:**




2. **A biological asset** is a:

**Harvest** is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

Agricultural activity covers a wide range of activities, such as raising livestock, forestry, annual or perennial cropping, cultivating orchards, floriculture, aquaculture, etc. There are certain common features to such diverse activities, such as:

(a) Living animals and plants are capable of biological transformation

(b) Biological transformation of these assets can be facilitated by enhancing, or stabilising the conditions necessary, e.g., nutrient levels, temperature, fertility and light, for the transformation process to take place.

(c) The change in the quality and quantity of transformation is measured and monitored as a routine management function.

It is necessary to bear in mind the distinction between agricultural activity and others, namely, harvesting from unmanaged resources such as ocean fishing or deforestation, are not agricultural activities.

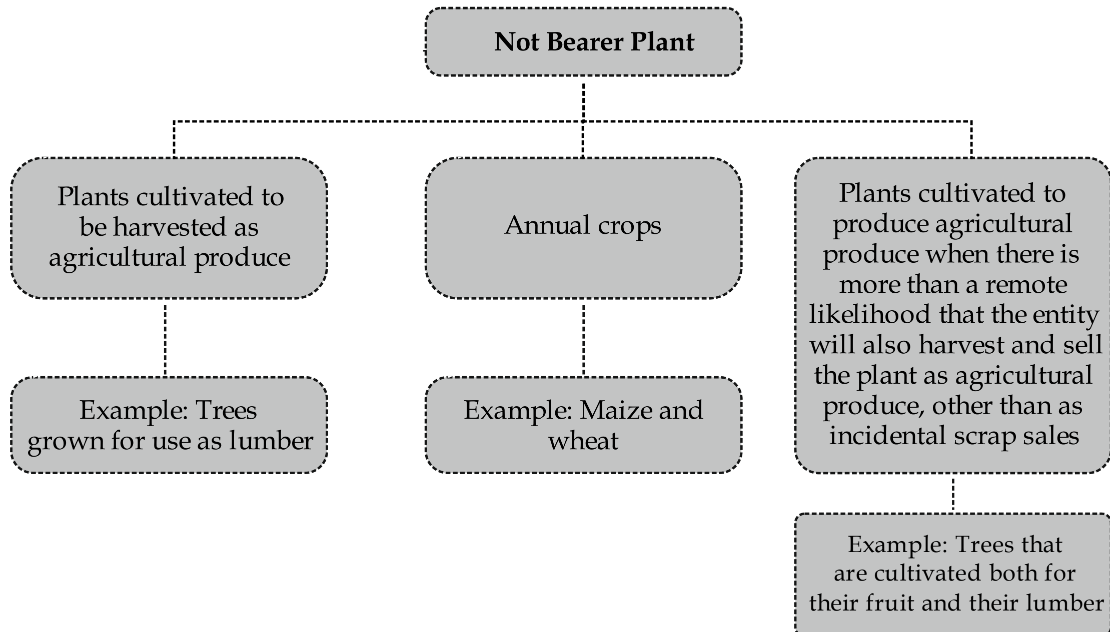
## 4. CLASSIFICATION OF BIOLOGICAL ASSETS

Biological assets are popularly classified into consumables and bear biological assets (see Figure)

A **bearer plant** is a living plant that:

- Is used in the production or supply of agricultural produce
- Is expected to bear produce for more than one period
- Has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales

The following are **NOT** bearer plants:




IAS 41 is applied to consumable biological assets and agricultural produce at the point of harvest. It does not apply to bearer biological asset. It means that any agricultural produce which is the harvested product of the entity's biological asset including bearer biological asset (like wool, logs and apples) falls under this standard for accounting purpose only at the point harvest not beyond that. Further processing of agricultural produce like grapes into wine or wheat into flour does not form part of agricultural activities.

**PROBLEM : 1**

**Is managing animal-related recreational activities agricultural activity?**

**Is the natural breeding of animals in zoos and game parks agricultural activity?**

**SOLUTION 1 :**

The answer to both questions are in negative. Managing recreational activities (for example, game parks and zoos) is not agricultural activity, as there is no management of the transformation of the biological assets. The activities simply involve control of the number of the animals.

The natural breeding that takes place in animals used in recreational activities is not a managed activity and is incidental to the main activity of providing a recreational facility. A managed breeding programme carried out to produce animals for sale would be considered agricultural activity.

**PROBLEM : 2**

**Check whether in the following cases IAS 41 applies:**

1. **Growing of plants to be used in the production of drugs;**
2. **Development of living organisms such as cultures, cells, bacteria and viruses for research purpose;**
3. **Ocean fishing; and**
4. **Fish farming.**

**SOLUTION 2 :**

(a) If a pharmaceutical or biotechnology entity grows plants from which particular drugs are produced, that activity will fall within the scope of IAS 41.

(b) The development of organisms for research purposes does not qualify as agricultural activity, as those organisms are not being developed for sale, or for transformation into agricultural produce or additional biological assets.

If the organisms are being developed for sale, the activity is agricultural activity within the scope of IAS 41. For example, the development of cultures for use in dairy products is with the scope of IAS 41.

(c) Harvesting biological assets from unmanaged sources, such as ocean fishing, is not agricultural activity.

(d) Managing the growth of fish for subsequent slaughter or sale is agricultural activity within the scope of IAS 41.

**PROBLEM : 3**

**Is the produce or harvest from a biological asset inventories or another biological asset? How should such asset be accounted for?**

**SOLUTION 3 :**

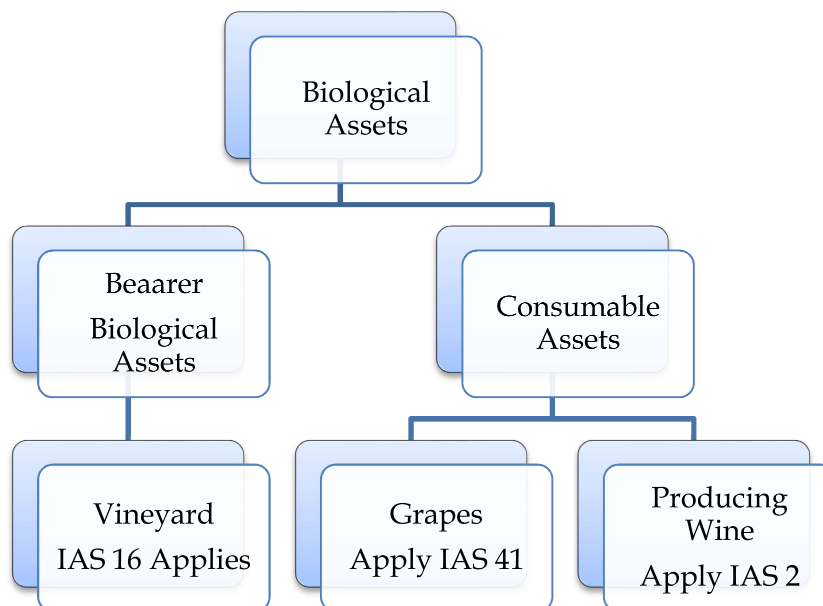
The produce or harvest from a biological asset like milk, tea leaves and lumber is treated as inventory. The harvested produce is transferred to Inventory at fair value less costs to sell; it is thereafter accounted for applying IAS 2 Inventories.

In case the produce is still growing or still attached to the biological asset, its value forms part of the value of the biological asset.

**PROBLEM : 4**

**B Ltd grows vines, harvests the grapes and produce wine. Which of these activities are with in the scope of IAS 41?**

**SOLUTION 4 :**




## 5. LEASE ARRANGEMENT OF BIOLOGICAL ASSETS

IAS 17 does not apply to lease arrangement of biological assets: biological assets may be subject to lease arrangements. Where the lease is finance lease, the lessee should recognise and measure the assets as biological assets rather than leased assets. Similarly, where the lease is an operating lease, the lessor recognises the leased assets as biological assets, because it is assumed to have the risks and benefits of the leased assets.

## 6. RECOGNITION

Principles laid down in the Framework for recognition of an asset will apply. The Standard provides that an entity shall recognise a biological asset or agricultural produce when and only when:

- The entity controls the asset as a result of past events;
- It is probable that future economic benefits associated with the asset will flow to the entity; and
- The fair value or cost of the asset can be measured reliability.

## 7. MEASUREMENT

A biological asset shall be recognised at fair value less costs to sell on initial recognition and at each subsequent reporting period.

The agricultural produce, harvested from an entity's biological assets, shall be measured at fair value less costs to sell at the point of harvest. This fair value measurement shall be the Cost at the date when applying IAS 2 (Inventories) or any other applicable Standard.

**A BIOLOGICAL ASSET SHALL BE RECOGNISED AT FAIR VALUE LESS COSTS TO SELL ON INITIAL RECOGNITION AND AT EACH SUBSEQUENT REPORTING PERIOD.**

## 8. DETERMINATION OF FAIR VALUE

While determining fair value, the biological asset or agricultural produce will be grouped according to significant attributes such as age or quality.

The Standard recognises that Fair value reflects the current market.

The contracts entered into by the entities to sell biological assets or agricultural produce at a future date shall not have any impact on determination of fair value.

The Standard also spells out certain principles regarding determination of fair value, as under:

**One : Where active market exists:** The quoted market price shall be the appropriate price for determination of fair value. If the entity has access to more than one active market, then the most relevant quote will be adopted for measuring fair value.

**Two: In the absence of active market:** The entity shall determine the fair value by considering one or more of the following:

- The most recent transaction provided that there had been no change in economic circumstances between the date of transaction and the date of determining the fair value.
- Market prices for similar assets with necessary adjustments.
- Sector benchmarks

**Three : Reasonable estimate of fair value:**

An entity should consider the reason for differences in order to derive a reasonable estimate of fair value, where the sources of information, listed above were to lead to different conclusions as to fair value.

**Four : Sale in combination with another asset:** Sometimes the biological assets may have active market only when sold in combination with other asset such as land. An entity my use the fair value of the combined assets to arrive at the fair value of the biological asset.

**Five : No active market in present condition:** Some biological assets may not have market prices in its present condition. In that case the present value of net cash flows expected from the asset, discounted at a pre tax current market rate, shall be the fair value of the biological asset.

**Six : Where cost is deemed as approximate fair value:** Cost may sometimes be the approximate fair value, particularly when:

- Little biological transformation has taken place since initial cost incurrence or
- The impact of the biological transformation on price is immaterial.

**Seven: Inability to measure fair value reliably:** There is a presumption that the fair value of a biological asset (or agricultural produce) can be measured reliably. This presumption can be rebutted.

- only at the time of initial recognition, **and**
- for biological assets, in respect of which market-determined prices or values are not available and for which alternative methods of estimating the fair value **are clearly unreliable.**

If such be the case, the biological asset shall be measured at cost less accumulated depreciation and any accumulated impairment loss. Nevertheless, if at any subsequent date, the biological asset becomes measurable at fair value, then those assets shall be measured at fair value less costs to sell.

It is however presumed that fair value can be measured reliably in case of non-current biological assets, classified as held for sale in accordance with IFRS 5.

## 9. GAINS AND LOSSES AT INITIAL RECOGNITION

The gains or losses arising on initial recognition of biological assets and agricultural produce at fair value less costs to sell shall be recognised in profit or loss for the period in which it arises.

**For example,** a loss may arise if point of sale costs exceeds the fair value. Gain may arise when a calf is born.

## 10. GAINS AND LOSSES FROM SUBSEQUENT MEASUREMENT

The gains or losses arising from subsequent measurement of biological assets at fair value less costs to sell shall be included in profit or loss for the period in which it arises.

## 11. GOVERNMENT GRANTS RELATING TO BIOLOGICAL ASSETS - MEASURED AT FAIR VALUE LESS COST TO SELL

Government grants related to biological assets may be conditional or unconditional depending upon the terms and conditions governing the grant.

- If unconditional, the grant shall be recognized as income when it becomes receivable.

If conditional, the grant shall be recognized as income when and only when the attached conditions are fully met. For

**EXAMPLE : 1**

**if an entity is required to farm in a particular location for five years, and requires the entity to returnthe grant if it farms for less than five years, then, grant shall not be recognized as income until the completion of five years.**

**EXAMPLE : 2**

**Suppose the attached condition is a grant of Rs 1,00,000 will be given to those entities which will remain engage in herb farming for five years. Grant is required to be returned if this condition is not satisfied. In this type of condition grant, income is not recognised unless five years period is elapsed. However, the attached condition to the grant may allow retention of 25% of the grant after completion of two years of farming. In this case, Rs. 25,000 should be recognised as income after completion of two years of farming.**

## 12. GOVERNMENT GRANTS RELATING TO BIOLOGICAL ASSETS — MEASURED AT COST

If government grant relates to biological asset measured at cost less accumulated depreciation and impairment, then IAS 20 applies.

## 13. DISCLOSURES

The under-noted requirements relating to disclosures are mandatory.

- Gain or loss on initial and subsequent recognition of biological assets and agricultural produce at fair value less costs to sell.
- Description of each group of biological assets
- Nature of activities involving each group or each class of biological assets
- Non-financial measures or estimates of physical quantities of each group of biological assets at the end of the period, and output of agricultural produce during the period
- Methods and significant assumptions in determining fair value of each group of (i) agricultural produce at the point of harvest, and (ii) biological assets
- Fair value (less costs to sell) of agricultural produce harvested during the period, determined at point of harvest.
- Existence and carrying amounts of biological assets whose trade is restricted, and those that have been pledged as security for liabilities
- Amount of commitment for development or acquisition of biological assets
- **Financial risk management strategies** relating to agricultural activity
- **Reconciliation** :A reconciliation of changes in carrying amount of biological assets, between the beginning and end of the current period. Such a reconciliation to include
  - increases due to purchases, or business combinations,
  - decreases due to harvest, or due to classification as assets held for sale (IFRS 5),
  - gain or loss arising from fair value changes,
  - exchange gains or losses recognised, and
  - other changes.
- Description of biological assets not recognised at fair value, explanation of reasons as to why a reasonable estimate of fair value cannot be made, where possible range of estimates within which fair value is highly likely to be, useful lives, depreciation rates and depreciation method used, and the gross carrying amount less accumulated depreciation and accumulated impairment loss.

- Where fair value of assets that were previously measured at cost, becomes reliably measurable, description of assets, explanations as to why fair value has become measurable, and effect of change.
- **Impairment loss**:Impairment loss related disclosures would include, amount of impairment losses (or reversals thereof), and amount of depreciation included in the statement of profit and loss.
- **Government grants :** Nature and extent of government grants recognised, unfulfilled conditions and other contingencies attached to grants, and significant decreases expected in the level of government grants.

## 14. COMPARISON WITH IAS 41, AGRICULTURE

Different terminology is used in this standard, e.g., the term "balance sheet" is used instead of 'Statement of financial position', and 'Statement of profit and loss' is used instead of 'Statement of Profit and Loss and comprehensive income'.

## PROBLEM FOR SELF - PRACTICE

**PROBLEM : 5**

**A farmer owned a dairy herd, of three years old cattle as at April 1, 20X1 with a fair value of ₹ 13,750 and the number of cattle in the herd was 250.**

**The fair value of three year cattle as at March 31, 20X2 was ₹ 60 per cattle. The fair value of four year cattle as at March 31, 20X2 is ₹75 per cattle.**

**Calculate the measurement of group of cattle as at March 31, 20X2 stating price and physical change separately.**

**SOLUTION** : 5

| Particulars | Amount (₹) |
|---|---|
| Fair value as at April 1, 20X1 | 13,750 |
| Increase due to Price change [250 x {60 - (13,750/250)}] | 1,250 |
| Increase due to Physical change [250 x {75-60}] | 3,750 |
| Fair value as at March 31, 20X2 | 13,750 |

**PROBLEM : 6**

**XYZ ltd, on 1 December 20X3, purchased 100 sheep's from a market for Rs 500,000 with a transaction cost of 2%. Sheep's fair value increased from Rs 500,000 to Rs 600,000 on 31 March 20X4.**

**Determine the fair value on the date of purchase and pass necessary journal entries.**

**SOLUTION** : 6

The fair value less cost to sell of sheep's on the date of purchase would be Rs 4,90,000 (5,00,000-10,000). Expense of Rs 10,000 would be recognised in profit and loss.

On date of Purchase

| | | Dr. | Cr. |
|---|---|---|---|
| Biological Asset | Dr. | 4,90,000 | |
| Expense on Purchase | Dr. | 10,000 | |
| To Bank | | | 5,00,000 |

(Being biological asset purchased)

On 31 March 20X4 sheep's would be measured at ₹ 5,88,000 as Biological Asset (6,00,000-12,000) and gain of ₹ 98,000 (5,88,000-4,90,000) would be recognised in profit or loss.

At the end of reporting period

| | | Dr. | Cr. |
|---|---|---|---|
| Biological Asset | Dr. | 98,000 | |
| To Gain – Change in fair value | | | 98,000 |

(Being change in fair value recognised at the end of reporting period)

**PROBLEM : 7**

**Moon Ltd prepares financial statements to 31 March each year. On 1 April 20X1 the company carried out the following transactions:**

-- Purchased a land for ₹ 50 Lakhs.

-- Purchased 200 dairy cows (average age at 1 April 20X1 two years) for ₹ 10 Lakhs.

-- Received a grant of ₹ 1 million towards the acquisition of the cows. This grant was nonrefundable.

For the year ending 31 March 20X2, the company has incurred following costs:

-- ₹ 6 Lakh to maintain the condition of the animals (food and protection).

-- ₹ 4 Lakh as breeding fee to a local farmer.

On 1 October 20X1, 100 calves were born. There were no other changes in the number of animals during the year ended 31 March 20X2. As of 31 March 20X2, Moon Ltd had 3,000 litres of unsold milk in inventory. The milk was sold shortly after the year end at market prices.

**Information regarding fair values is as follows:**

| Item | Fair Value less cost to sell | | |
|---|---|---|---|
| | 1 April 20X1 | 1 October 20X1 | 31 March 20X2 |
| | ₹ | ₹ | ₹ |
| Land | 50 Lakhs | 60 Lakhs | 70 Lakhs |
| New born calves (per calf) | 1,000 | 1,100 | 1,200 |
| Six month old calves (per calf) | 1,100 | 1,200 | 1,300 |
| Two year old cows (per cow) | 5,000 | 5,100 | 5,200 |
| Three year old cows (per cow) | 5,200 | 5,300 | 5,500 |
| Milk (per litre) | 20 | 22 | 24 |

**Prepare extracts from the SOFP and Statement of Profit & Loss that would be reflected in the financial statements of the entity for the year ended 31 March 20X2.**

**SOLUTION** : 7

**Extract from the Statement of Profit & Loss**

| Income | WN | Amount |
|---|---|---|
| Change in fair value of purchased dairy cow | WN 2 | 1,00,000 |
| Government Grant | WN 3 | 10,00,000 |
| Change in the fair value of newly born calves | WN 4 | 1,30,000 |
| Fair Value of Milk | WN 5 | 72,000 |
| Total Income | | **13,02,000** |
| Less: Expenses | | |
| Maintenance Costs | WN 2 | 6,00,000 |
| Breeding Fees | WN 2 | 4,00,000 |
| Total Expense | | **(10,00,000)** |
| Net Income | | **3,02,000** |

**Extracts from SOFP**

| **Property, Plant and Equipment:** | | Rs. |
|---|---|---|
| Land | WN 1 | 50,00,000 |
| Dairy Cow | WN 2 | 11,00,000 |
| Calves | WN 4 | 1,30,000 |
| | | 62,30,000 |
| **Inventory** | | |
| Milk | WN 5 | 72,000 |

| | | 72,000 |
|---|---|---|

**Working Notes:**

1. **Land:** The purchase of the land is not covered by IAS 41. The relevant standard which would apply to this transaction is IAS 16. Under this standard the land would initially be recorded at cost and depreciated over its useful economic life. This would usually be considered to be infinite in the case of land and so no depreciation would be appropriate. Under Cost Model no recognition would be made for post-acquisition changes in the value of land. The allowed alternative treatment under Revaluation Model would permit the land to be revalued to market value with the revaluation surplus taken to the other comprehensive income. We have followed the Cost Model.
2. **Dairy Cows:** Under the 'fair value model' laid down in IAS 41 the mature cows would be recognised in the Balance Sheet at 31 March 20X2 at the fair value of 200 x ₹ 5,500 = ₹11,00,000.

   Increase in price change 200 x (5,200-5,000) = 40,000

   Increase in physical change 200 x (5,500-5,200) = 60,000

   The total difference between the fair value of matured herd and its initial cost (₹ 11,00,000 – ₹ 10,00,000 = a gain of ₹ 1,00,000) would be recognised in the profit and loss along with the maintenance costs and breeding fee of ₹ 6,00,000 and ₹ 4,00,000 respectively.
3. **Grant:** Grant relating to agricultural activity is not subject to the normal requirement of IAS 20. Under IAS 41 such grants are credited to income as soon as they are unconditionally receivable rather than being recognised over the useful economic life of the herd. Therefore, ₹ 10,00,000 would be credited to income of the company.
4. **Calves:** They are a biological asset and the fair value model is applied. The breeding fees are charged to income and an asset of 100 x ₹ 1,300 = ₹ 1,30,000 recognised in the SOFP and credited to Profit and loss.
5. **Milk:** This is agricultural produce and initially recognised on the same basis as biological assets. Thus the milk would be valued at 3,000 x ₹ 24 = ₹ 72,000. This is regarded as 'cost' for the future application of IAS 2 to the unsold milk

# IFRS 8 OPERATING SEGMENTS

## 1. INTRODUCTION

IFRS 8 Operating Segments sets out requirements for disclosure of information about an entity's

- operating segments and also
- about the entity's products and services,
- the geographical areas in which it operates, and
- its major customers.

The standard requires the whole entity's financial information to be segmented and reported on the basis of principles laid down for identification of Operating Segments, and for measurement of items to be reported.

## 2. DEFINITIONS

**1. Operating segment -** An operating segment is a component of an entity:

- that engages in business activities
- from which it may earn revenues and incur expenses
- (including revenues and expenses relating to transactions with other components of the same entity),
- whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
- for which discrete financial information is available.

**OPERATING SEGMENTS INCLUDE**

- segments engaged in in-house trade,
- segments having both internal and external sales and segments having only external sales.
- The Operating Segments also include even start up activities provided they meet the definition criteria.

**WHO IS CHIEF OPERATING DECISION MAKER (CODM)**

In an organization, normally the hierarchy of authority and responsibility would include an individual (irrespective of the designation) exercising the function of reporting the operating activities, performance, forecasts of the segments etc. in respect of one or more segments to a higher authority. This individual may be called a segment manager.

**The authority to whom the segment managers furnish the report can be referred to as Chief Operating Decision Maker (CODM).** CODM is vested with the responsibility of reviewing the operating results of segments, and the authority for allocating resources and assessing the performance of one or more segments.

A given set of activities of an organization qualifies as an operating segment when it bears all the characteristics set out in the definition criteria.

Nevertheless there may be situations where the organizational structure is so designed that Management Information System permits up-stream flow of information based on products

orservices as also with an overlapping set of information based on geography (both of which are reported independently).

In such cases, the entity's decision for selection of an operating segment would depend on 'the basis adopted by the entity for assessing and evaluating the performance and also on the basis of decision on the allocation of resources'.

If decisions are made on the basis of geographical reporting bases, the geographical area would be termed as an Operating Segment and if decisions were to be made on the basis of products and services, that area of activity would be termed as an Operating Segment.

## 2. Reportable segments

The standard prescribes a step by step process for the identification of an operating segment.

Two or more Operating Segments may be aggregated into a single segment. If they have similar economic characteristics and are similar in each of the following parameters:

- the nature of the products and services;
- the nature of the production processes;
- the type or class of customer for their products and services;
- the methods used to distribute their products or provide their services; and
- if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

The Operating Segments so identified (either a single segment, or two or more segments aggregated into one segment, based on similarity of economic and other characteristics) are subjected to the test of quantitative thresholds to determine the reportable segments:

- Its reported revenue, including both sales to external customers and inter-segment sales or transfers, is 10 per centor more of the combined revenue, internal and external, of all Operating Segments.
- The absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of (i) the combined reported profit of all Operating Segments thatdid not report a loss and (ii) the combine reported loss of all Operating Segments that reported a loss.
- Its assets are 10 per cent or more of the combined assets of all Operating Segments.It is worthwhile to note that the 10% threshold tests prescribed above are identical to those prescribed in AS 17 (Segment Reporting).

### 2.1. Other situations

IFRS 8 lays down three other situations, in which an operating segment that does not qualify to be a reportable segment on the basis of 10% threshold tests can be included as a reportable segment.

**First:** The Operating Segments which have not passed through the above test may be reported by the management, if in its judgment, the disclosure is useful to the users to understand the financial statements better.

**Second:** Some of the Operating Segments that did not qualify as reportable segments can be combined if they have similar economic characteristics and share a majority of the aggregation criteria stated above.

**Third:**If the aggregate revenue of all the identified reportable operating segment is less than 75% of the entity's external revenue, additional Operating Segments shall be reported irrespective of the Operating Segments passing the quantitative threshold test.

### 2.2. Residual category: All Other Segments

Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an 'all other segments' category separately from other reconciling items

### 2.3. Continuity

If management concludes that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment shall continue to be reported separately in the current period even if it no longer meets the criteria for reportability.

### 2.4. Newly identified Reportable Operating Segments

If the business activities which did not qualify either · as an Operating Segment or as a reportable segment in the prior periods qualify as reportable segments through the quantitative threshold tests in the current period, the comparative figures for the prior periods of such reportable segment shall be disclosed.

### 2.5. Flexibility in the area or detailed disclosures

Considering the cost-benefit aspect of gathering and reporting segment data, the Standard requires the entities to review whether a practical limit is reached, if the number of reportable segments exceeds ten in number (rebuttable).

## 3. DISCLOSURE

The entity shall disclose

- the basis of factors considered for identifying the reportable segment
- types of products &Services from which each reportable segment derives its revenues
- information on the following lines about each reportable segment if these are regularly viewed by CODM:
  - revenues from external customers;
  - revenues from transactions with other
  - Operating Segments of the same entity;
  - interest revenue;
  - interest expense;
  - depreciation and amortisation;
  - material items of income and expense disclosed in accordance with IAS 1;
  - the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;
  - income tax expense or income; and
  - material non-cash items other than depreciation and amortisation.

### 3.1. Measurement for the purposes of disclosures

All the items of reportable segments shall be stated at the measure reported to the CODM irrespective of the measure used in entity's financial statements. The accounting policies used to measure the line items of reportable segments may be different from that of entity's accounting policies. This standard requires that an entity shall provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity shall disclose the following:

### 3.2. Descriptive Disclosures

- The basis of accounting for transactions between reportable segments,

- The nature of any difference between the measure adopted for reporting the profit or loss, assets, liabilities, and the measure adopted for reporting profit or loss, assets, liabilities, in the entity's financial statements.
- The nature of any changes relative to prior periods in the measurement methods including its effect on determining profit or loss
- The nature and effect of any asymmetrical allocations to reportable segments.

### 3.3. Quantitative reconciliation

The entity shall present a reconciliation statement, analyzing the difference between segmental revenue, profit, assets and liabilities with the entity's revenue, profit, assets, and liabilities respectively.

### 3.4. Restatement of previously reported information

When there is a change in the entity's internal organization resulting in the change of composition of reportable segments, the entity shall restate the earlier period amounts or disclose the fact whether restatement has been done or not if information is not available or cost to develop that information is excessive.

If restatement is not done due to above stated reasons, the entity shall disclose amounts for the current period on both old basis and new basis unless if information is not available or cost to develop that information is excessive.

### 3.5. Entity-wide disclosures

The standard requires disclosure of revenues attributable to external customers. The disclosure of amounts in this area shall be shall be based on financial information used to produce the entity's financial Statements.

**a) On the basis of product or services**

The entity shall disclose the revenue from external customers for each product or services or group of products or services.

**b) On the basis of geographical areas.**

**The entity shall disclose the revenue from external customers**

(i) attributed to the entity's country of domicile and

(ii) attributed to all foreign countries with separate disclosures about individual foreign country from which revenues considered to be significant and/ or material are generated.

**Non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts**

(i) located in the entity's country of domicile and

(ii) located in all other foreign countries with separate reference to individual foreign country in which material non-current assets are located.

If information in respect of (a) and (b) above is not available or the cost to develop the same is excessive then, the entity shall disclose that fact and explain the reason why the information is not being disclosed.

**c) Information about major customers**

If 10 percent or more of the external revenue of the entity is generated from a single customer, the same shall be disclosed with details of source segments for those revenues.

There may be transactions between reporting entity and entities which are under common control. In such cases all the entities which are under common control shall be treated as single customer. Government and its controlled entities are treated as single customer.

## 4. MAJOR CHANGE IN IND AS 108 VIS-À-VIS IFRS 8 NOT RESULTING IN CARVE OUT

Paragraph 2 of IFRS 8 requires that the standard shall apply to :

a) The separate or individual financial statements of an entity:
   i. whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
   ii. that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

b) The consolidated financial statements of a group with a parent:
   i. whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
   ii. that files, or is in the process of filing, the consolidated financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

The above have been deleted in the Ind AS 108 as the applicability or exemptions to the Indian Accounting Standards are governed by the Companies Act and the Rules made thereunder.

## PROBLEM FOR SELF- PRACTICE

**PROBLEM : 1**

**ABC Ltd. manufactures and sells healthcare products, and food and grocery products. Three products namely A, B & C are manufactured. Product A is classified as healthcare product and product B & C are classified as food and grocery products. Products B & C are similar products. Discrete financial information is available for each manufacturing locations and for the selling activity of each product. There are two line managers responsible for manufacturing activities of products A, B & C. Manager X manages product A and Manager B manages products B & C. The operating results of health care products (product A) and food and grocery products (products B & C) are regularly reviewed by the CODM. Identify reportable segments of ABC Ltd.**

**SOLUTION : 1**

In this situation both the healthcare, and food and grocery product line meet the criteria for operating segments set out above. Therefore, it is likely that ABC Ltd.'s operating segments would be classified as being (i) healthcare and (ii) food and grocery segments.

Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments. For the purposes of IFRS 8, an entity's post-employment benefit plans are not operating segments.

The term 'chief operating decision maker' (CODM) identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the CODM of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.

For many entities, the three characteristics of operating segments clearly identify its operating segments. However, an entity may produce reports in which its business activities are presented in a variety of ways. If the CODM uses more than one set of segment information, other factors may identify a single set of components as constituting an entity's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

Generally, an operating segment has a segment manager who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment. The term 'segment manager' identifies a function, not necessarily a manager with a specific title. The chief operating decision maker also may be the segment manager for some operating segments. A single manager may be the segment manager for more than one operating segment. If the characteristics apply to more than one set of components of an organisation but there is only one set for which segment managers are held responsible, that set of components constitutes the operating segments.

The characteristics may apply to two or more overlapping sets of components for which managers are held responsible. That structure is sometimes referred to as a matrix form of organisation. For example, in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. The CODM regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity should determine which set of components constitutes the operating segments by reference to the core principle.

**PROBLEM : 2**

**X Ltd. is engaged in the manufacture and sale of two distinct type of products A & B. X Ltd. supplies the product in the domestic market in India as well as in Singapore. There are two regional managers responsible for manufacturing activities of product A & B worldwide and also two other managers responsible for different geographical areas. For internal reporting purposes, X Ltd. provides information product-wise and as per the geographical location of the company. The CODM regularly reviews the operating results of both sets of components. How should X Ltd. identify its operating segments?**

**SOLUTION : 2**

In this situation, both the geographical sales areas and product areas may meet the criteria for operating segment. However, in such situation, it is more difficult to determine clearly which set of components should be identified as the entity's operating segments. In such situation the entity should determine which set of components constitutes the operating segments by reference to the core principle. The core principle is that the entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. The entity should also assess whether the identified operating segments could realistically represent the level at which the CODM is assessing performance and allocating resources.

Therefore, X Ltd. should consider all the above factors and apply judgement to determine which component should be disclosed as operating segment.

**PROBLEM : 3**

**X Ltd. is engaged in the business of manufacturing and selling papers. Varieties of paper like adhesive paper, anti-rust paper, antique paper, art paper etc., are manufactured and sold by X Ltd. Should X Ltd. classify these papers into different segments?**

**SOLUTION : 3**

Two or more operating segments may be aggregated into a single operating segment if the segments have similar economic characteristics, and the segments are similar with respect to various factors like nature of the product and production process, type of customers, method of distribution and regulatory requirement.

In case of X Ltd., so far as varieties of paper concerned, if all factors such as nature of the product and production process, type of customers, method of distribution and regulatory requirement are common, there is no need to create different segments for each type of paper.

**PROBLEM : 4**

**X Ltd. has identified the following business components.**

| Segment | Revenue (₹ ) | | Profit (₹ ) | Assets (₹ ) |
|---|---|---|---|---|
| | External | Internal | | |
| **Pharma** | **97,00,000** | **Nil** | **20,00,000** | **55,00,000** |
| **FMCG** | **Nil** | **4,00,000** | **2,50,000** | **25,00,000** |
| **Ayurveda** | **3,00,000** | **Nil** | **2,00,000** | **4,00,000** |
| **Others** | **8,00,000** | **41,00,000** | **5,50,000** | **6,00,000** |
| **Total for the entity** | **1,08,00,000** | **45,00,000** | **30,00,000** | **90,00,000** |

**Which of the segments would be reportable as per the criteria prescribed in IFRS 8?**

**SOLUTION : 4**

Quantitative thresholds are calculated below:

| Segments | Pharma | FMCG | Ayurveda | Others |
|---|---|---|---|---|
| % segment sales to total sales | 63.40 | 2.61 | 1.96 | 32.03 |
| % segment profit to total profits | 66.67 | 8.33 | 6.67 | 18.33 |
| % segment assets to total assets | 61.11 | 27.78 | 4.44 | 6.67 |

Segment Pharma would separately reportable since they meet all three size criteria, though any one criteria is required. FMCG segment does not satisfy the revenue and profit test but does satisfy the asset test. So it would be separately reportable. Ayurveda segment does not meet any threshold. It may not be classified as reportable segment.

**PROBLEM : 5**

**X Ltd. has identified 4 operating segments for which revenue data is given below:**

| | External Sale (₹) | Internal Sale (₹) | Total (₹) |
|---|---|---|---|
| **Segment A** | **30,00,000** | **Nil** | **30,00,000** |
| **Segment B** | **6,50,000** | **Nil** | **6,50,000** |
| **Segment C** | **8,50,000** | **1,00,000** | **9,50,000** |
| **Segment D** | **5,00,000** | **49,00,000** | **54,00,000** |
| **Total Sales** | **50,00,000** | **50,00,000** | **1,00,00,000** |

**Additional information:**

**Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years.**

**Which of the segments would be reportable under the criteria identified in IFRS 8?**

**SOLUTION : 5**

Threshold amount is ₹ 10,00,000 (₹ 1,00,00,000 × 10%).

Segment A exceeds the quantitative threshold (₹ 30,00,000 > ₹ 10,00,000) and hence reportable segment.

Segment D exceeds the quantitative threshold (₹ 54,00,000 > ₹ 10,00,000) and hence reportable segment.

Segment B & C do not meet the quantitative threshold amount and may not be classified as reportable segment.

However, the total external revenue generated by these two segments A & D represent only 70% (₹ 35,000/50,000 x 100) of the entity's total external revenue. If the total external revenue reported by operating segments constitutes less than 75% of the entity total external revenue, additional operating segments should be identified as reportable segments until at least 75% of the revenue is included in reportable segments.

In case of X Ltd., it is given that Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years. In accordance with the requirement of IFRS 8, X Ltd. designates this start-up segment C as a reportable segment, making the total external revenue attributable to reportable segments 87% (₹ 43,50,000/ 50,00,000 x 100) of total entity revenues.

**QUESTION : 6.**

**X Ltd. is operating in coating industry. Its business segment comprise coating and others consisting of chemicals, polymers and related activities. Certain information for financial year 20X1-20X2 is given below : (₹ in lakhs)**

| Segments | External sale | Tax | Other operating income | Result | Asset Liabilities |
|---|---|---|---|---|---|
| Coating | 2,00,000 | 5,000 | 40,000 | 10,000 | 50,000 30,000 |
| Others | 70,000 | 3,000 | 15,000 | 4,000 | 30,000 10,000 |

**Additional information:**

1. **Unallocated revenue net of expenses is ₹ 30,00,00,000**
2. **Interest and bank charges is ₹ 20,00,00,000**
3. **Income tax expenses is ₹ 20,00,00,000 (current tax ₹ 19,50,00,000 and deferred tax ₹ 50,00,000)**
4. **Investments ₹ 1,00,00,00,000 and unallocated assets ₹ 1,00,00,00,000.**
5. **Unallocated liabilities, Reserve & surplus and share capital are ₹ 2,00,00,00,000, ₹ 3,00,00,00,000 & ₹ 1,00,00,00,000 respectively.**
6. **Depreciation amounts for coating & others are ₹ 10,00,00,000 and ₹ 3,00,00,000 respectively.**
7. **Capital expenditure for coating and others are ₹ 50,00,00,000 and ₹ 20,00,00,000 respectively.**
8. **Revenue from outside India is ₹3,00,00,00,000 and segment asset outside India ₹ 1,00,00,00,000.**

**Based on the above information, how X Ltd. would disclose information about reportable segment revenue, profit or loss, assets and liabilities for financial year 20X1-20X2?**

**SOLUTION : 6**

**Segment information**

(A) **Information about operating segment**

(1) the company's operating segments comprise : Coatings: consisting of decorative, automotive, industrial paints and related activities. Others: consisting of chemicals, polymers and related activities.

**(2) Segment revenues, results and other information.** (₹ in Lakhs)

| | Revenue | Coating | Others | Total |
|---|---|---|---|---|
| 1. | **External sales (gross)** | **2,00,000** | **70,000** | **2,70,000** |
| | Tax | (5,000) | (3,000) | (8,000) |
| | External sales (net) | 1,95,000 | 67,000 | 2,62,000 |
| | Other operating income | 40,000 | 15,000 | 55,000 |
| | **Total Revenue** | **2,35,000** | **82,000** | **3,17,000** |

| 2. | **Results Segment results** | **10,000** | **4,000** | **14,000** |
|---|---|---|---|---|
| | Unallocated income (net of unallocated expenses) | | | 3,000 |
| | Profit from operation before | | | 17,000 |
| | interest, taxation and exceptional items | | | |
| | Interest and bank charges | | | 2,000 |
| | **Profit before exceptional items** | | | **15,000** |
| | Exceptional items | | | Nil |
| | **Profit before taxation**<br>Income Taxes<br>-Current taxes | | | <br>15,000<br>1,950 |
| | -Deferred taxes | | | 50 |
| | **Profit after taxation** | | | **13,000** |
| 3. | **Other Information** | | | |
| (a) | **Assets** | | | |
| | Segment Assets | 50,000 | 30,000 | 80,000 |
| | Investments | | | 10,000 |
| | Unallocated assets | | | 10,000 |
| | Total Assets | | | 1,00,000 |
| (b) | **Liabilities/Shareholder's funds** | | | |
| | Segment liabilities | 30,000 | 10,000 | 40,000 |
| | Unallocated liabilities | | | 20,000 |
| | Share capital | | | 10,000 |
| | Reserves and surplus | | | 30,000 |
| | Total liabilities/shareholder's funds | | | 1,00,000 |
| (c) | **Others** | | | |
| | Capital Expenditure | 5,000 | 2,000 | 70,000 |
| | Depreciation | 1,000 | 300 | 1,300 |
| | Geographical Information | | | **(₹ in lakhs)** |
| | | **India (₹ )** | **Outside India (₹ )** | **Total (₹ )** |
| | Revenue | 2,87,000 | 30,000 | 3,17,000 |
| | Segment assets | 70,000 | 10,000 | 80,000 |
| | Capital expenditure | 7,000 | | 7,000 |

Notes:

I. The operating segments have been identified in line with the IFRS 8, taking into account the nature of product, organisation structure, economic environment and internal reporting system.

II. Segment revenue, results, assets and liabilities include the respective amounts identifiable to each of the segments. Unallocable assets include unallocable fixed assets and other current assets. Unallocable liabilities include unallocable current liabilities and net deferred tax liability.

III. Corresponding figures for previous year have not been provided. However, in practical scenario the corresponding figures would need to be given.

**QUESTION : 7.**

**The following information is available in respect of RST Ltd. Identify the reportable segments.**

| Segments | External Sales | Inter segment Transfers | Total Revenue | Total Profit | Total Assets |
|---|---|---|---|---|---|
| A | 200 | 60 | 260 | - 85 | 48 |
| B | -- | 100 | 100 | 10 | 20 |
| C | 35 | 30 | 65 | 15 | 6 |
| D | 10 | -- | 10 | - 25 | 4 |
| E | 15 | 5 | 20 | 12 | 2 |
| F | 55 | -- | 55 | 5 | 6 |
| G | 50 | 5 | 55 | 7 | 5 |
| H | 45 | 5 | 50 | 23 | 9 |
| Total | 410 | 205 | 615 | - 38 | 100 |

**SOLUTION : 7**

According to IFRS 8, three criteria to identify reportable segment are :

1. Revenue from internal and external sales should be 10% or more of total revenue of all segments

   10% of total revenue = 10% x 615

   = 61.50

   Reportable segments are A, B, C

2. Segment result, profit/loss should be 10% or more of the total absolute profit or total absolute loss of all segments in profit or all segment in loss whichever is higher.

   10% of total profit = 10% (10 + 15+12+5+7+23)

   = 7.2

   10% of total loss = 10% (85 +25) = 11

   Reportable segments is A, C, D, E,H

3. Segment asset should be 10% or more of total asset

   10% of total asset = 10% x 100

   = 10

   Reportable segments is A & B

   Reportable segment = A,B,C,D,E,H

   Sales to external customer of these reportable segments as a % of total external sales

   $= \frac{305}{410} \times 100 = 74.39\%$

   As the result of external sales of reportable segment is less than 75% of total external sales the management should identify more segment either F or G.

**QUESTION : 8.**

**Identify, with working notes, the reportable segment in respect of PQR Ltd. whose information regarding different operating divisions is as follows :**

| Division | Sales external | Inter-Div Sales | Total Sales | Operating Profits | Total Assets |
|---|---|---|---|---|---|
| I | Rs. 6,60,000 | Rs. 2,20,000 | 8,80,000 | 2,00,000 | Rs. 5,00,000 |
| II | 7,00,000 | 10,000 | 7,10,000 | 1,70,000 | 5,50,000 |
| III | 1,80,000 | 1,80,000 | 3,60,000 | 25,000 | 1,40,000 |
| IV | 2,20,000 | 40,000 | 2,60,000 | - 45,000 | 2,00,000 |
| V | 2,40,000 | -- | 2,40,000 | 20,000 | 1,00,000 |
| VI | 4,00,000 | -- | 4,00,000 | -- | 3,00,000 |
| Total | 24,00,000 | 4,50,000 | 28,50,000 | - 30,000 | 17,90,000 |

**SOLUTION : 8**

In order to identify the reportable segment IFRS 8 has laid down 3 criteria :

1. Total revenue from internal and external sales should be 10% or more of total revenue of all segment.

   10 % of total sales = 2,85,000

   ∴ The reportable segments I, II, III & VI

2. Segment result, profit/loss, should be 10% or more of the total absolute profit or total absolute loss of all segments in profit or all segments in loss, whichever is high.

   Total of segment in profit = 2,15,000

   Total of segment in losses = 2,45,000

   Higher of the two 2,45,000

   Minimum profit/loss required

   10% x 2,45,000 24,500

   ∴ Reportable segments are I, II, III and IV

3. Segment assets should be 10% or more of the total assets of all the segments.

   ∴ Reportable segment are I, II, IV & VI

   ∴ The reportable segment are I, II, III, IV & VI

   Sales to external customer of these reportable segment as a % of total external sales

   $= \frac{21,60,000}{24,00,000}$

   = 90%

   As the sales to external customers exceeds 75% these are the reportable segments.

**QUESTION : 9.**

**Identify the reportable and reconciling segments from the following information :**

| Segments | Total Revenue | Profit | Total Assets |
|---|---|---|---|
| I | Rs. 37,500 | Rs. 4,500 | Rs. 60,000 |
| II | 1,06,250 | 13,500 | 1,40,000 |
| III | 75,000 | 11,000 | 1,50,000 |
| IV | 1,50,000 | 24,000 | 2,50,000 |
| V | 2,00,000 | 28,000 | 3,50,000 |
| VI | 25,00,000 | 35,000 | 4,00,000 |
| Total | 30,68,750 | 1,16,000 | 13,50,000 |

**SOLUTION : 9**

In order to identify reportable segment IFRS 8 has laid down three criteria :-

1. Revenue from internal and external sales should be 10% or more of total revenue of all segments

   10% of total revenue = 10% x 30,68,750

   = 3,06,875

   Reportable segment VI

2. Segment result, profit/loss should be 10% or more of the total absolute profit or total absolute loss of all segment in loss, whichever is higher.

   10% of total profit = 10% x 1,16,000

   = 11,600

   Reportable segment II, IV, V, VI

3. Segment asset should be 10% or more of the total assets of all the segments

   Minimum level of asset = 10% x 13,50,000

   = 1,35,000

   Reportable segment = II, II, IV, V, VI

   Reportable segments are = II, III, IV, V & VI

   Sale to external customers of these repostable segments as a % to total external sales

$$= \frac{30,31,250}{30,68,750} \times 100$$

= 98.78%

**QUESTION : 10.**

**A Ltd. has Business segments A, B, C, D, E, F. The following data pertains to financial year 2011-2012.**

**Amt. In rs. ₹ 000**

| Segment | Revenue External | Inter-segment Revenue | Total | Operating profit (loss) | Asset |
|---|---|---|---|---|---|
| **A** | **9000** | **9000** | **18000** | **2000** | **7000** |
| **B** | **12000** | **--** | **12000** | **1000** | **5000** |
| **C** | **11000** | **2000** | **13000** | **(4000)** | **9000** |
| **D** | **20000** | **--** | **20000** | **0** | **14000** |
| **E** | **33000** | **11000** | **44000** | **(10000)** | **23000** |
| **F** | **38000** | **--** | **38000** | **6000** | **26000** |

**In the segment information for year ended on 31/03/2002, how many reportable segments do A Ltd. have?**

**SOLUTION : 10**

Three criteria to determine reportable segment are :

a. Revenue from internal of external sales should be 10% or more of the total revenue

   10% of total revenue = 10% x 1,45,000

   = 14,500

   Reportable segment = A,D,E,F

b. Segment result, profit/ loss should be 10% or more of the total absolute loss of all segments in profit or all segments in loss whichever is higher:

   10% of total profit = 10% x(2,000+1,000+6,000)

= 900

10% of total loss = 10% (4,000+10,000)

= 1400 whichever is higher

Reportable segments = A,C,E,F,

c. Segment assets should be 10% or more of the total asset

10% x total asset = 10% (84,000)

= 8,400

Reportable segments = C,D,E,F

Reportable segments are A, C,D,E,F

Sales to external customers of these reportable segments as a % of total external sales

$= \frac{1,11,000}{1,23,000}$

= 90.24%

# IAS - 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

## 1. INTRODUCTION

It is irrefutable to conclude that accountancy is an art of recording historical (past) transactions. But it is well recognized that in order to ensure true and fair view in the preparation and presentation of financial statements it becomes essential to take cognizance of financial effect of what might happen at a future date.

## 2. SCOPE

This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:

(a) those resulting from executory contracts, except where the contract is onerous; and

(b) those covered by another Standard.

(c) This Standard does not apply to financial instruments (including guarantees) that are within the scope of IFRS 9 Financial Instruments.

**Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous.**

When another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard.

For example, some types of provisions are addressed in Standards on:

(a) income taxes (see IAS 12 Income Taxes);

(b) leases (see IFRS 16 Leases).

However, this Standard applies to any lease that becomes onerous before the commencement date of the lease as defined in IFRS 16.

This Standard also applies to short-term leases and leases for which the underlying asset is of low value accounted for in accordance with paragraph 6 of IFRS 16 and that have become onerous;

(c) employee benefits (see IAS 19 Employee Benefits);

(d) insurance contracts and other contracts within the scope of IFRS 17 Insurance Contracts;

(e) contingent consideration of an acquirer in a business combination (see IFRS 3 Business Combinations); and

(f) revenue from contracts with customers (see IFRS 15 Revenue from Contracts with Customers).

However, as IFRS 15 contains no specific requirements to address contracts with customers that are, or have become, onerous, this Standard applies to such cases.

This Standard applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

## 3. DEFINITIONS

**Provisions** are liabilities of uncertain timing or amount.

A **liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An **obligating event** is an event that creates an obligation that results in an enterprise having no alternative to settling that obligation.

**Present obligation** - an obligation is a present obligation if, based on the evidence available, its existence at the reporting date is considered probable, i.e., more likely than not.

**Possible obligation** - an obligation is a possible obligation if, based on the evidence available, its existence at the reporting date is considered not probable.

## 4. PROVISIONS AND OTHER LIABILITIES

Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement.

By contrast:

(a) **trade payables are liabilities to pay for goods or services** that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) **accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid**, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay).

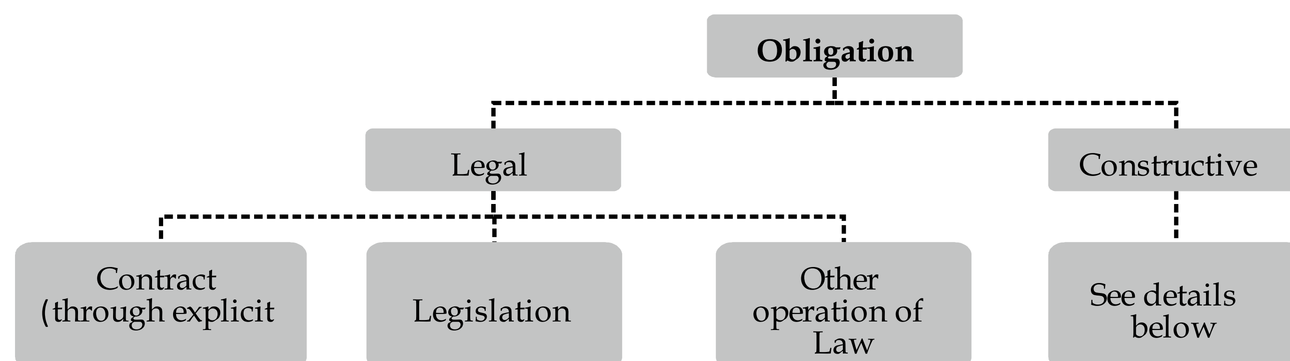
Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

## 5. WHEN SHOULD PROVISION BE RECOGNISED ?

A provision should be recognized when, and only when:

- It is a liability representing a **"present obligation"** (legal or constructive)
- due to past events
- it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation
- Reliable estimate can be made of the amount of obligation.

If these conditions are not met, no provision shall be recognised.




## 6. PAST EVENT

A past event that leads to a present obligation is called an obligating event.

For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event.

This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions.

**EXAMPLES : 1**

**Penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.**

**A provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused.**

**PROBLEM : 1**

**Provision for product warranty**

**A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within a specified period from the date of sale. Is provision required ?**

SOLUTION : 1

**Present obligation as a result of a past obligating event-** the obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

**An outflow of resources** embodying economic benefits in settlement

Probable for the warranties as a whole. **Reliable estimate** of the provision can be made.

The company is required to recognise provision.

**PROBLEM : 2**

**Provision for Site Restoration**

**A chemical company causes contamination of land but cleans up only when required to do so under I he laws of the country in which it operates. The country in which it operates did not have any legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At 31 March 2024 it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end with retrospective effect. Is provision required ?**

SOLUTION : 2

Present obligation as a result of a past obligating event the obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement Probable

The company is required to recognise provision.

## 7. MEASUREMENT OF PROVISION

**BEST ESTIMATE -**The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

In other words, the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

EXAMPLE : 2

**An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase.**

**If minor defects were detected in all products sold, repair costs of 1 million would result. If major defects were detected in all products sold, repair costs of 4 million would result.**

**The entity's past experience and future expectations indicate that, for the coming year, 75 per cent of the goods sold will have no defects, 20 per cent of the goods sold will have minor defects and 5 per cent of the goods sold will have major defects.**

**An entity assesses the probability of an outflow for the warranty obligations as a whole.**

**The expected value of the cost of repairs is: (75% of nil) + (20% of 1m) + (5% of 4m) = 400,000**

The amount of provision should be shown as an **expense in P&L net of any reimbursement.**

Amount of outstanding **provision** should be shown in the **liability side without netting off reimbursement.**

## 8. IMPORTANT POINTS

The following points are to be noted:

- **Future operating losses** - Provision should not be recognized for **future operating losses.** This is because expectation of future operating losses is an indication of impairment of certain assets for which the entity should test these assets under IAS36 Impairment of Assets.

- **Review** - A **provision** should be reviewed at each B/S date. If it is no longer probable that outflow of resources will be required to settle obligation, the provision is to be reversed.
- **Future events** that may affect the amount required to settle an amount of obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

**EXAMPLE : 3**

**An entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up.**

- The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.
- The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted.

## 9. GAINS FROM EXPECTED DISPOSAL OF ASSETS

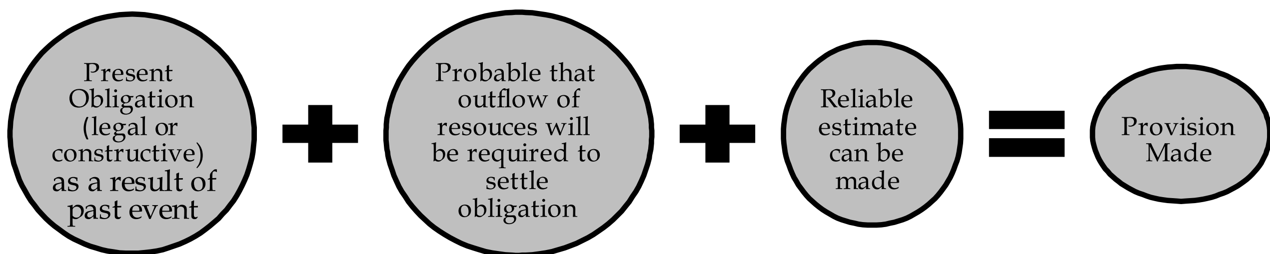
- **Gains from expected disposal of assets** shall not be taken into account in measuring a provision.

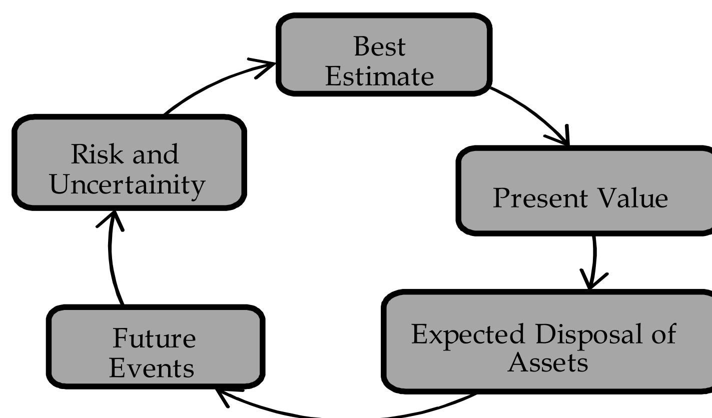
## 10. PRESENT VALUE:

At the reporting date the provisions are discounted to reflect the present value of the future cash outflow, if and only if the discounting is material.

The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.




**PROBLEM : 3**

**[Obligation to fit smoke filters]**

**Under a new rule, an entity is required to fit smoke filters to its factories by 30 June 2014. The entity did not, fit smoke filters during the accounting period 2014-15. As per law, the annual fine for not fitting smoke filter is Rs. 1,00,000. The cost of the smoke filter is Rs. 20,00,000.**

**Should the entity provide for fine and the cost of the smoke filter?**

**SOLUTION : 3**

There is no obligation to purchase the smoke filter, and so the entity shall not provide for the cost of the smoke filter.

However, a fine may be levied for non-compliance with the Rule. So the entity shall provide for the fine of Rs. 1,00,000.

**PROBLEM : 4**

**Requirement of retraining of staff because of change in accounting regulation**

**Because of introduction of new accounting system, a company is required to retrain its staff, and change in accounting software. The estimated retraining cost is Rs. 5,00,000 and cost of change in software is Rs. 15,00,000. The company proposes to undertake the staff retraining and change in software over next 2 years.**

**Should the company create any provision?**

**SOLUTION : 4**

No provision is required for staff retaining and software change as there is no obligating event.

**PROBLEM : 5**

**Dry-docking expenses of ship**

**A ship requires dry-docking every 3 years for renewal of sailing license. Dry-docking expenses is Rs. 40,00,000.**

**Should the ship-owner provide for 1/3rd of the dry-docking expense every year?**

**SOLUTION : 5**

There is no present obligation of dry-docking, and so no provision is required.

**PROBLEM : 6**

**A court case**

**Twenty people died possibly as a result of food poisoning from product sold by the entity in a conference. Legal proceeding has been initiated seeking damages from the entity but it disputes liability. Up to the date of approval of the financial statements for the year to 31 March 2014 for issue. The entity's lawyer advised that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 March 2015, its lawyer advised that, owing to developments in the case, it is probable that the entity will be found liable.**

**Should the entity create provision in 2013-14 & 2014-15?**

**SOLUTION : 6**

There was no obligating event in 2013-14, so no provision was required.

However, by virtue of IAS 37 a past event is deemed to give rise to a present obligation if, taking into account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period 31 March 2015. So there is an obligation event and the provision shall be created.

**PROBLEM : 7**

**Contaminated Land - Legislation Virtually Certain to be EnactedAn enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.**

**SOLUTION : 7**

**Present obligation as a result of a past obligating event -** The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

**An outflow of resources embodying economic benefits in settlement-** Probable.

**Conclusion -** A provision is recognised for the best estimate of the costs of the clean-up

**PROBLEM : 8**

**Refunds PolicyA retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.**

SOLUTION : 8

**Present obligation as a result of a past obligating event -** The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

**An outflow of resources embodying economic benefits in settlement-** Probable, a proportion of goods are returned for refund.

**Conclusion -** A provision is recognised for the best estimate of the costs of refunds

**PROBLEM : 9**

**Refunds Policy A company follows a policy of refunding money to the dissatisfied customers if they claim within thirty days from the date of purchase and return the goods. It appears from the past experience that in a month only 0.25% of the customers claim refunds. The company sold goods amounting to Rs. 10 lacs during the last month of the financial year. Is there any contingency?**

SOLUTION : 9

Company should make a provision of 10,00,000 x 0.25% = Rs. 2500

**PROBLEM 10 :**

**Sun Ltd. has entered into a sale contract of Rs.5 crores with X Ltd. during 2009-10 financial year. The profit on this transaction is Rs.1 crore. The delivery of goods to take place during the first month of 2010-11 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of Rs.1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2009-10 financial year. As on** reporting **date (31.3.2010), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.**

**i. Should Sun Ltd. provide for contingency as per IAS 37?**

**ii. Should provision be measured as the excess of compensation to be paid over the profit?**

SOLUTION 10 :-

(i) When an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting Rs.1.5 crores as per IAS 37.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2010 and no profit had accrued for the financial year 2009-2010. Therefore, provision should be made for the full amount of compensation amounting Rs.1.50 crores.

## 11. ONEROUS CONTRACTS

Onerous contracts are contracts in which the lower of the below exceeds the flow of economic benefits from a contract

- Costs of meeting the obligations under the contract; or
- Penalties, compensation arising from non-fulfillment of the obligation

If an entity has a contract that is onerous, the present obligation under the contract shall be recognized and measured as a provision.

**PROBLEM : 11**

**Mini Ltd. took a factory premises on lease on 1.4.07 for Rs.2,00,000 per month. The lease is operating lease. During March, 2008, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2010. The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2010 should be provided in the accounts for the year ending 31.3.2008. Mini Ltd. seeks your advice.**

**SOLUTION : 11**

If an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous as the economic benefit of lease contract for next 33 months up to 31.12.2010 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of Rs. 66,00,000 (i.e.2,00,000 p.m. for next 33 months).

Therefore, provision on account of Rs.66,00,000 is to be provided in the accounts for the year ending 31.03.08.

**PROBLEM 12 :**

**An entity operates profitably from a factory that it has taken under an operating lease. On December 1, 2014, the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be sub-let to another user. To cancel the lease it has to pay present value of annual lease rental of Rs. 5,00,000 discounted @ 10% p.a. Analyse the case and identify the obligating event. Should the entity create provision under IAS 37?**

**SOLUTION 12 :**

Signing the lease agreement was the obligating event.

If an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous as the economic benefit of lease contract will be nil. The entity shall recognize provision to the extent of the unavoidable lease payment.

**PROBLEM 13 :**

**An entity has a contract to purchase one million units of gas at Rs 2,30,000. The current market price for a similar contract is Rs 1,60,000. The company has a sales contract with a third party to sell gas at Rs 1,80,000. Should the entity create provision under IAS 37?**

**SOLUTION 13 :**

**PROBLEM 14 :**

**An entity has a contract to purchase one million units of gas at Rs 2,30,000. The current market price for a similar contract is Rs 1,60,000. The gas will be used in generating electricity and electricity will be sold at a profit. Should the entity create provision under IAS 37?**

**SOLUTION 14 :**

## 12. REIMBURSEMENTS

An entity may expect, reimbursement of some or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties).

An entity should recognize such reimbursement when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.

Also, the amount recognized for the reimbursement should not exceed the amount of the provision.

The entity should recognise the reimbursement as a separate asset in the statement of comprehensive income, the expense relating to a provision may be presented net of the amount recognized for a reimbursement.

**PROBLEM : 15**

**Shyam Ltd. (a Public Sector Company) provides consultancy and engineering services to its clients. In the year 2010-11, the Government has set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2006 based on the recommendations of the commission. The company makes the provision of Rs. 680 lakhs for pay revision in the financial year 2010-11 on the estimated basis as the report of the commission is yet to come. As per the contracts with the client on cost plus job, the billing is done on the actual payment made to the employees and allocated to jobs based on hours booked by these employees on each job.**

**The company discloses through notes to accounts**

**"Salaries and benefits include the provision of Rs. 680 lakhs in respect of pay revision. The amount chargeable from reimbursable jobs will be billed as per the contract when the actual payment is made".**

**The accountant feels that the company should also book/recognise the income by Rs. 680 lakhs in Profit and Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit.**

**SOLUTION 15 :-**

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

Accordingly, potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists.

In this case, the provision of salary to employees of Rs. 680 lakhs will be ultimately collected from the client, as per the terms of the contract. Therefore, the liability of Rs. 680 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be made reducing the claim to be made from the client. It appears that the whole amount of Rs. 680 lakhs is recoverable from client and there is no significant uncertainty about the collection. Hence, the net charge to profit and loss account should be nil.

The opinion of the accountant regarding non-recognition of income of Rs. 680 lakhs is not as per IAS 37. However, the concept of prudence will not be followed if Rs.680 lakhs is simultaneously recognized as income. Rs. 680 lakhs is not the revenue at present but only reimbursement of claim. However the accountant is correct to the extent as that non- recognition of Rs. 680 lakhs as income will result in the understatement of profit.

## 13. DISCLOSURES RELATING TO PROVISIONS

Disclosure aspects include:

**For each class of Provisions:**

- Opening balance, Addition to and use of the provision, closing balance
- Unused amount written back
- Brief description of the provision along with major assumptions made
- Expected reimbursement recognized as an asset.

- Effects of unwinding the provisions (e.g.: when provisions are created for dismantling PPE initially is unwound at each subsequent reporting period).

## 14. CONTINGENT LIABILITIES - DEFINITION

A **contingent liability** is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognized because:

 (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

 (ii) a reliable estimate of the amount of the obligation cannot be made.

## 15. CHARACTERISTICS OF CONTINGENT LIABILITIES

Characteristics of Contingent liabilities are:

- It is a liability representing a **"possible obligation"** due to past events
- Obligation existing at reporting date is **"not probable"**
- Existence of which will be confirmed only by the occurrence or non-occurrence of future uncertain events
- Future event is not wholly within the control of the enterprise.

## 16. WHEN IS PRESENT OBLIGATION ALSO CONSIDERED AS A CONTINGENT LIABILITY

Present obligation is also considered as a contingent liability if:

- It is not probable that an outflow of resources will be required to settle the obligation, or
- Reliable estimate of amount of present obligation cannot be made.

## 17. CONTINGENT LIABILITIES - RECOGNITION

A **contingent liability** should **not** be recognized.

It should be disclosed in the financial statements.

**An enterprise may be jointly and severally liable for an obligation**. Obligation required to be met by third parties are shown as contingent liability and disclosed. Entity's share is to be recognized as provision unless reliable estimate of amount cannot be made.

**Contingent liabilities** should be assessed continually assessed to determine whether the outflow of resources has become probable. If so, a provision is recognized.

## 18. DISCLOSURES RELATING TO CONTINGENT LIABILITIES

- Brief description of contingent liability
- Estimate of amount measured as per recognition criteria for provisions
- Indications of uncertainties relating to outflow
- Possibility of reimbursement.
- If above stated items cannot be disclosed, the fact should be disclosed.

**PROBLEM : 16**

**During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation. Advise disclosure.**

SOLUTION : 16

**(a)** <u>**At 31 March 2005**</u>

- **Present obligation as a result of a past obligating event -** The obligating event is the giving of the guarantee, which gives rise to an obligation.

- **An outflow of resources embodying economic benefits in settlement -** No outflow of benefits is probable at 31 March 2005.
- **Conclusion -** No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

**(b)** **At 31 March 2006**

- **Present obligation as a result of a past obligating event** - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.
- **An outflow of resources embodying economic benefits in settlement -** At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- **Conclusion -**Provision is recognised.

**PROBLEM 17 :** A COURT CASE

**The sales tax authority ordered an additional demand on the company for under payment of sales tax on the basis of under-invoicing of goods. The company contested the case. The lawyer advised the company as on 31-3-2004 that there would be no liability. As on 31-3-2005, the lawyer advised the company that on the basis of latest development in the case, a liability would arise. Advise disclosure.**

**SOLUTION : 17**

For the year ended 31 March 2004

There is no present obligation. The company should not make a provision but should disclose it as a contingent liability unless the probability of any outflow is regarded as remote.

FOR THE YEAR ENDED 31 MARCH 2005

On the basis of the evidence there is a present obligation and therefore a provision is recognised for the best estimate of amount to settle the obligation.

**PROBLEM : 18** A COURT CASE

**A Company has at its financial year ended 31st March, 2004 fifteen law suits outstanding, none of which has been settled by the time the accounts are approved by the directors. The directors have estimated that the possible out-comes are as below:**

| *Result* | *Probability* | *Amount of loss* |
|---|---|---|
| *For first ten cases:* | | *Rs.* |
| **Win** | **0.6** | **--** |
| **Lose-low damages** | **0.3** | **90,000** |
| **Lose-high damages** | **0.1** | **1,60,000** |
| *For remaining five cases:* | | |
| **Win** | **0.5** | **--** |
| **Lose-low damages** | **0.3** | **60,000** |
| **Lose-high damages** | **0.2** | **95,000** |

**The directors believe that the outcome of each case is independent of the outcome of all the others.**

**Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.**

**SOLUTION : 18**

Contingent liability should be disclosed in financial statements if following conditions are satisfied:-

- There should be present obligation arising out of past event but not recognized as provision.
- It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- The possibility of an outflow of resources embodying economic benefits is not remote.
- The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first 10 cases is 60% and for remaining, five cases 50%. In other words, the probability of losing is 40% or 50% respectively. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in first ten cases = Rs. 90,000 x 0.3 + Rs. 1,60,000 x 0.1

= Rs. 43,000 x 10

= Rs. 4,30,000

Expected loss in remaining five cases = Rs. 60,000 x 0.3 + Rs. 95,000 x 0.2

= Rs. 37,000 x 5

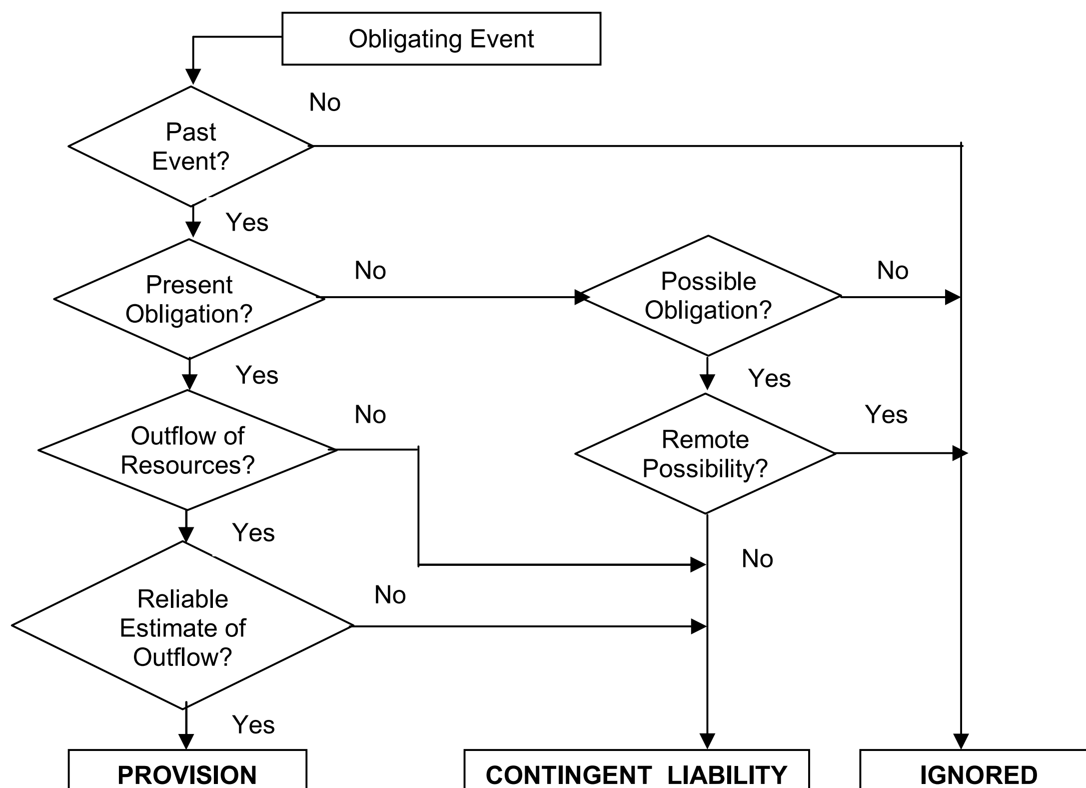
= Rs. 1,85,000

Total Contingent Liability = Rs. 4,30,000 + Rs. 1,85,000 = Rs. 6,15,000

## 19. PROVISIONS AND CONTINGENT LIABILITIES - SUMMARY

| **There is a present obligation that probably requires an outflow of resources and areliable estimate can be made of the amount ofobligation.** | **There is a possible obligation or a present obligation that may, but probably will not,require an outflow of resources.** | **There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.** |
|---|---|---|
| A provision is recognised. | No provision is recognised.<br>Disclosures are required for the contingent liability. | No provision is recognised.<br>No disclosure is required. |

## 20. FLOWCHART IDENTIFYING CONDITIONS FOR RECOGNITION OF PROVISION




## 21. CONTINGENT ASSETS - MEANING

Contingent assets are:

- Possible asset as a result of past events
- Existence of which will be confirmed only by the occurrence or non-occurrence of future uncertain events
- Future event is not wholly within the control of the enterprise.

## 22. CONTINGENT ASSETS - TREATMENT

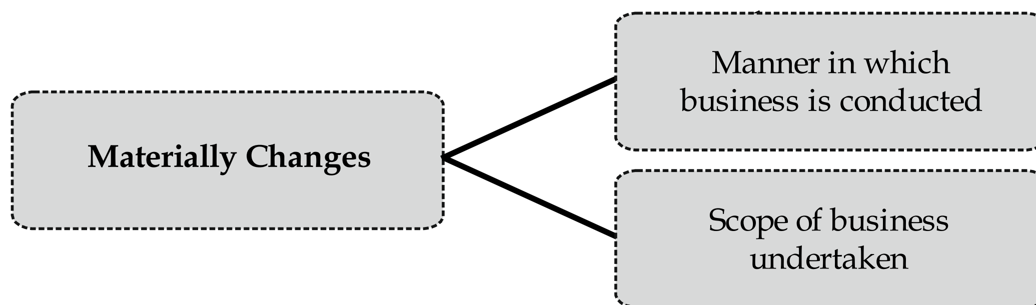
- A **contingent asset** should **not** be recognized. It is **disclosed in the notes** of financial statements.
- **Contingent assets** are continually assessed. If it becomes virtually certain that the economic benefits will arise, the asset and related income are recognized in the financial statements.
- **Example** -A claim that an entity is pursuing through legal processes, where the outcome is uncertain.
- **Disclosure requirements**- Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect. It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.

## 23. RESTRUCTURING

**A restructuring** is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.




The following **are examples of events that** may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

**A provision for restructuring costs is recognised only when the general recognition criteria for provisions discussed earlier are met.**

Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan.

## 24. PROVISION FOR RESTRUCTURING COST

| Should include : | Should not include : |
|---|---|
| • only direct expenditure arising from restructuring and not associated with the ongoing activities of the enterprise.<br>• A constructive obligation arises only when an entity has detailed formal plan for restructuring and has raised valid expectation that it will carry out restructuring. | 1. Retraining or Relocating continiung staff<br>2. Marketing or<br>3. Investment in new systems and distributionnetworks |

## PROBLEM FOR SELF PRACTICE

**PROBLEM 19 :**

**A company operates in an offshore oilfield. It is required to remove the oil rig at the end of production and restore the sea bed as per the licensing agreement. Is there any contingency requiring provisioning?**

**SOLUTION : 19**

A provision is required to be recognized for the removal of the oil rig and restoration of damage caused by building it because.

a) There is a present obligation i.e. to remove the rig as a result of past obligating event.

b) An outflow of resources embodying economic benefits in settlement.

**PROBLEM 20 :**

**A company offers product warranty. Past experience shows that the company had to expend 6% of sales value of the last accounting year during the current accounting period to fulfil the warranty obligation. Should the company recognise any provision for warranty against sales of the current accounting year?**

**SOLUTION : 20**

Company should make a provision for warranty based on 6% of sales as there is a present obligation arising out of past events.

**PROBLEM 21:**

**Raghav Ltd. had a major break down in its plant in the month of February. In the month of March it entered into an agreement with an Engineering Firm for the purpose of repairing its plant for a consideration of Rs. 180 lakhs. The Engineering Firm started the repairing work in the month of April and completed it in the same month. Raghav Ltd. made the Provision for said expenditure on repairs in its books of account for the financial year ended 31st March on the plea that the event of break down leading to repair expenditure had taken place in that financial year, binding contract for repairs was entered into during the same financial year and repair work was also completed before the Financial Statements were approved by the Company's Board of Directors. Comment.**

**SOLUTION : 21**

1. **Recognition :** Provision should be recognized if the following conditions for satisfied –

| Condition (1) | Condition (2) | Condition (3) |
|---|---|---|
| **Present** obligation as a result of past event. | **Outflow of resources** to settle the obligation is probable. | Reliable **estimate** of the amount. |
| Break down of the plant and binding contract for repairs is entered into, during the financial year ending 31st March but the Engineering Firm has **not started** performing the work of repair until the date of SOFP. Hence, there is **nopresent obligation**. | Payment should be made to the Engineering Firm as per the Binding Contract on completion of the repairs and hence outflow of resources is probable. | Sum payable on account of repairs is Rs. 180 lakhs. |

2. **Treatment and Conclusion :**
   a. Since all the conditions for recognition of a Provision are not satisfied, a Provision should **not** be recognized for the year ending 31st March.
   b. Hence, Provision made by Raghav Ltd. for expenditure on repairs in its books of account for repair work to be done in the next Financial Year is wrong, as there was no obligation.

**PROBLEM 22 :**

**Rajeev Ltd. was under audit for the year-ended 31st March. An appeal filed by Rajeev Ltd. against the demand of Excise Duty of Rs. 26 Crores was pending before the Supreme Court for which neither Provision was made nor was disclosed in the Notes to the Financial Statements. On 12th July (i.e. subsequent to the** SOFP **date), the Auditor came to know through paper reports that the point involved in the appeal of Rajeev Ltd. was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the Department of Excise Duty. The Auditor insisted that Provisions be made of Rs. 26 Crores in the Financial Statements. The Management was of the view that since its own case is still pending, no Provision is called for. It was also of the view that the event does not have any effect on the financial position of the Company on the SOFP date. Is the Management's view correct?**

SOLUTION : 22

1. **Recognition :** Provision should be recognized if the following conditions for satisfied –

| Condition (1) | Condition (2) | Condition (3) |
|---|---|---|
| **Present** obligation as a result of past event. | **Outflow of resources** to settle the obligation is **probable**. | **Reliableestimate** of the amount. |
| Excise Duty demand is already made on the Company. Hence present obligation exists at the SOFP date. | Additional evidence arising after SOFP date lead to the conclusion that the outflow is probable i.e. more likely than not. | Rs. 26 crores is the amount of the liability. (Given) |

2. **Treatment and Conclusion :**Since all the conditions for recognition of a Provision are satisfied, the Provision should be recognized for the year ending 31st March. If the amount is material, separate disclosure is also required. The Management's contention is not tenable.

**PROBLEM 23 :**

**AS Ltd. was involved in wage negotiations with trade unions of their organization as on 31st March 2007. Wage revision proposals could be finalized only after obtaining the final approval from the Head Office of the Company located at Mumbai. The final approval was granted on 9th April 2007 w.e.f. from 1st April 2005. The settlement covered period from 1.4.2005 to 31.3.2008. The liability upto 31st March 2007 was disclosed on account of the above settlement in the Notes forming part of the Accounts. As an Auditor, you may advise whether such disclosure is proper.**

SOLUTION : 23

1. **Recognition :** Provision should be recognized if the following conditions for satisfied –

| Condition (1) | Condition (2) | Condition (3) |
|---|---|---|
| **Present** obligation as a result of past event. | **Outflow of resources** to settle the obligation is probable. | Reliable **estimate** of the amount. |
| Wage revision is for the period covered by Financial Statements, i.e. 2006-2007, and consists of the Company's present obligation. | Post SOFP date events (i.e. sanction from HO) that the payment of revised wages is probable, i.e. more often than not. | Though not quantified in the question, wage payable on the revised scale can be estimated reliably. |

2. **Treatment and Conclusion :**Since all the conditions for recognition of a Provision are satisfied, a Provision should be recognized for the year ending 31st March 2007.

**PROBLEM 24 :**

**A claim for damages of Rs. 10 lakhs for breach of patents and copyrights had been served on ASF Ltd. in January. The Directors sought competent legal advice on the eligibility of the claim and were advised that the claim was highly frivolous, without any basis and would not survive even in the first trial court. The Company, however, anticipates a long drawn legal battle and huge legal costs. The Company's accounts for the year ended 31st March were considered and approved by the Board of Directors on 15th May. How will you treat the above in the accounts for the year ended 31st March?**

**SOLUTION : 24**

1. **Analysis :**
   a. The Company's liability for damages, if any, will be confirmed only after the occurrence of future events, i.e. hearing by the Court. Hence, the given situation is a **Possible Obligation**.
   b. At the SOFP date, it was not probable that events subsequent thereto would confirm that a liability has been incurred. Also, in the given case, there is no question of estimation of probable loss.
2. **Conclusion :**
   a. The Liability for Damages is a Contingent Liability and should be disclosed .
   b. However, a long legal battle is anticipated even before the SOFP date, for which a reasonable estimate of expenses should be made and that should be provided for in the accounts.

**PROBLEM 25 :**

**As on 31st March, there was a claim for damage from one of the customers against the Company engaged in selling of accounting software for an alleged failure to provide satisfactory after-sales services in relation to the software purchased from it. Before finalization of the accounts for the year ended 31st March (the accounts were finalized on 14th June), the Company won the case and had no liability whatsoever in this regard. The Company has made a Provision for this Contingent Liability in its accounts for the year ended 31st March, which, it says, will be reversed in the next year. Comment.**

**SOLUTION : 25**

1. **Post B/S events :** As per facts of the case, on the SOFP date, there was a claim against the Company for damages by a customer for not providing after sales service. The winning of the case by the Company in its favour (before the accounts were approved) after the SOFP date, constitutes additional evidence that will help in deciding the treatment of the matter in the accounts .
2. **Nature of Liability :** As on the B/S date, the Company may have provided for the Contingent Liability perhaps in view of expectation that such a claim may crystallize as liability against it. However, no Provision would be required as the case had been won by the Company, confirmed by the event happening after the SOFP date.
3. **Treatment :** The provisioning for non-existent liability is not proper. However, disclosure of facts of the case is, necessary with a view to keeping users of Financial Statements informed about the nature of event as well as the fact that no Provision is necessary.

**PROBLEM 26 :**

**Included under sundry creditors was a fee payable to the legal counsel for suits field against the company. The company in not aware of the status of the suits and hence did not want to provide for the same. Advise.**

**SOLUTION : 26**

The status of each suit would have to be assessed very carefully and accordingly provision would have to be made if warranted by the circumstances.

**PROBLEM 27 :**

**VV Ltd. had announced a voluntary retirement plan for its employees on January 1, 2000. The scheme is scheduled to close on June 30, 2000. The scheme envisaged on initial lump sum payment of maximum of Rs. 2 lakhs and monthly payments over the balance period of service of employees coming under the plan. 200 employees opted for the scheme as on March 31, 2000. The total lump sum payment for these employees would be Rs. 250 lakhs and the aggregate of future payments to them would amount to Rs. 1,500 lakhs. However no payment had been made to the employees under the scheme upto March 31, 2000. Not the company made any provision in its accounts towards any liability under the scheme.**

**SOLUTION : 27**

Condition existed on the SOFP date (31st March, 2000) regarding the liability towards the Voluntary Retirement Plan (VRP) since the management started the VRP in the month of January, 2000 and 200 employees opted for the VRP as on March 31, 2000. Since it was probable that future events will confirm that a liability has been incurred on the SOFP date and that the amount could be estimated on reasonable basis, a provision for payments under the VRP would be required to be made for an appropriate amount for the aforesaid number of employees.

**PROBLEM 28 :**

**As an Auditor, state your views on the following situation : In the course of audit of manufacturing company, it comes to light that it has outstanding forward contacts for purpose of raw materials at a price, which is higher than the current market price. However, there is no mention of this in the financial statement of the year.**

**SOLUTION : 28**

If it is likely that the contingency will result in a loss to the enterprise, then it is prudent to provide for that loss. Otherwise a mere disclosure is required unless the possibility of the loss is very remote.

**PROBLEM 29 :**

**A Company gives cash rebate to customers for prompt payment of bills. At the end of the year, sales are made in respect of which cash is expected to be recovered in the following month (next financial year), which will entitle the customer to a rebate. At the end of the year is the company required to make a provision for expected liability on account of cash rebate. The Company believes that from a matching concept expenditure on cash rebate should be matched with the sales revenue.**

**SOLUTION : 29**

At the end of the year, there is no present obligation arising out of a past obligating event and hence no provision should be made in respect of the expected rebate. The obligating event occurs when the customer makes the payment within the due date, which entitles the customer to a rebate. The Company's contention is not correct since cash rebate for prompt payment are matched with the saving of interest that is effected to the enterprise due to early receipt from customers and cannot be matched with sales.

**PROBLEM 30 :**

**EXOX Ltd. is the process of finalizing its accounts for the year ended 31st March, 2008. The company seeks your advice on the following:**

**(a) The Company's sales tax assessment for assessment year 2005-06 has been completed on 14th February, 2008 with a demand of Rs.2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.**

**(b) The Company has entered into a wage agreement in May, 2008 whereby the labour union has accepted a revision in wage from June, 2007. The agreement provided that the hike till May, 2008 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2008.**

**SOLUTION :- 30**

(a) Since the company is not appealing against the addition of Rs.0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 2008. The amount paid under protest can be kept under the heading 'Advances' and disclosed along with the contingent liability of Rs.2.10 crore.

(b) The arrears for the period from June, 2007 to March, 2008 are required to be provided for in the accounts of the company for the year ended on 31st March, 2008.

**PROBLEM 31 :**

**An airline is required by law to overhaul its aircraft once in every three years. A company which operates aircrafts does not provide any provision as required by law in its final account. Discuss.**

**SOLUTION:- 31**

A provision should be recognised only when an enterprise has a present obligation as a result of a past event. In the given case, there is no present obligation, therefore no provision is recognized as per IAS 37.

The cost of overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts. Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts. Further, the enterprises can avoid the future expenditure by its future action, for example by selling the aircraft. However, an obligation might arise to pay fines or penalties under the legislation after completion of three years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than three years.

**PROBLEM 32 :**

**X Shipping Ltd. is required by law to overhaul its shipping fleet once in every 3 years. The company's finance team was of the view that recognising the costs only when paid would prevent matching of revenue earned all the time with certain costs of large amounts which are incurred occasional. Thereby, it has formulated an accounting policy of providing in its books of account for the future cost of maintenance (overhauls, annual inspection etc.) by calculating a rate per hours sailed on sea and accumulating a provision over time. The provision is adjusted when the expenditure is actually incurred. Is the accounting policy of X Shipping Ltd. correct?**

**SOLUTION : 32**

A provision is made for a present obligation arising out of a past event. Overhauling does not arise out of past event. Even a legal requirement to overhaul does not make the cost of overhaul a liability, because no obligation exists to overhaul the ships independently of the company's future actions - the company could avoid the future expenditure by its future actions for example by selling the ships. So there is no present obligation.

As per the standard, financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's SOFP are those that exist at the end of the reporting period.

Therefore, the accounting policy of X Shipping Ltd. is not correct. The company should adopt the component approach in IAS 16, *Property, Plant and Equipment*, for accounting for the refurbishment cost.

**PROBLEM 33 :**

**X Chemical Ltd. is operating in the vicinity of a river since 20 years. A community living near X Chemical Ltd. claims that its operations has caused contamination of drinking water. X Chemical Ltd. has received notice from the governmental environmental agency that official investigations will be made into claims of pollution caused by the entity. If it is found that X Chemical Ltd. has caused contamination, then penalties and fine would be levied on it.**

**X Chemical Ltd. believes that it has implemented all environmental safety measures to an extent that it is unlikely to cause pollution. Management is not sure whether it has all the information about the entire 20 years. Therefore, neither management nor external experts are able to assess X Chemical Ltd.'s responsibility until the investigation has completed.**

**In such situation, how should management of X Chemical Ltd. account for a liability?**

**SOLUTION : 33**

As per the standard, in the present case, the available evidence does not support a conclusion that a present obligation exists. However, there is a possible obligation which exists and will be confirmed upon completion of investigations. Therefore, management should disclose the contingent liability for potential penalties and fines that may be imposed if contamination is proved.

**PROBLEM 34 :**

**X Ltd. has entered into an agreement with its selling agent Y, in accordance with which X Ltd. has to pay a base percentage of commission on export sales and an additional commission is to be paid if the export incentives are received. As per the accounting policy of X Ltd., it recognises export incentives when actually realised, on account of the uncertainty in realising such incentives. Export incentives have not been received for the year 20X1-20X2, however X Ltd. is hopeful of receiving the export incentives in the year 20X2-20X3. In the financial statements for 20X1-20X2, should X Ltd. provide for both base commission and additional commission?**

**SOLUTION : 34**

So far as the base percentage of sales commission is concerned, it is a present obligation arising out of past events. The obligating event takes place when the sales are made and also since commission is based on percentage of sale, reliable estimation can also be made. Therefore, the base percentage of sales commission should be provided.

However, in respect of additional commission, it is to be paid when the export incentives are recognised and export incentives are recognised only when it is received. Therefore, the obligating event will arise only when export incentives are received. Hence, no provision for additional commission is to be made in financial year 20X1-20X2. The expectation of X Ltd. to receive the export incentives in next year would not make any difference as on 31 March 20X2.

**PROBLEM 35 :**

**X Sugars Ltd. has entered into a sale contract of ₹ 3,00,00,000 with Y Choclates Ltd. for the supply of sugar during 20X1-20X2. As per the contract the delivery is to be made within 2 months from the date of contract. In case of failure to deliver within the schedule, X Sugars Ltd. has to pay a compensation of ₹ 30,00,000 to Y Chocolates Ltd.**

**During the transit, the vehicle carrying the sugar met accident and X Sugar Ltd. lost the entire consignment. It is, however covered by an insurance policy. According to the report of the surveyor, the amount is collectible, subject to the deductible clause [i.e., 15% of the claim] in the insurance policy. The cost of goods lost was ₹ 2,50,00,000.**

**Before the financial year end, X Sugars Ltd. received informal information from the insurance company that their claim had been processed and the payment had been dispatched for 85% of the claim amount. Meanwhile Y Chocolates Ltd. has made demand of ₹ 30,00,000 since the goods were not delivered on time.**

**What provision or disclosure would X Ltd. need to make at year end?**

**SOLUTION : 35**

As per the standard, where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out in IAS 37.

So X Sugars Ltd. would need to disclose the contingent asset of ₹ 2,12,50,000 (₹ 2,50,00,000 x 85%) at the end of the financial year 20X1-20X2.

It would also need to make a provision of ₹ 30,00,000 towards the claim of Y Chocolates Ltd.

**PROBLEM 36 :**

**An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of ₹ 1 million would result. If major defects were detected in all products sold, repair costs of ₹ 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects. In accordance with the standard, an entity assesses the probability of an outflow for the warranty obligations as a whole.**

**SOLUTION : 36**

The expected value of the cost of repairs is:

(75% of nil) + (20% of 1m) + (5% of 4m) = ₹ 4,00,000

**PROBLEM 37 :**

**X Solar Power Ltd., a power company, has a present obligation to dismantle its plant after 35 years of useful life. X Solar Power Ltd. cannot cancel this obligation or transfer to third party. X Solar Power Ltd. has estimated the total cost of dismantling at ₹ 50,00,000, the present value of which is ₹ 30,00,000. Based on the facts and circumstances, X Solar Power Ltd. considers the risk factor of 5% i.e., the risk that the actual outflows would be more from the expected present value. How should X Solar Power Ltd. account for the obligation?**

**SOLUTION : 37**

The obligation should be measured at the present value of outflows i.e., ₹ 30,00,000. Further a risk adjustment of 5% i.e., ₹ 1,50,000 (₹ 30,00,000 x 5%) would be made.

So, the liability will be recognised at = ₹ 30,00,000 + ₹1,50,000 = ₹ 31,50,000.

**PROBLEM 38 :**

**X Chemicals Ltd. engaged in the chemical industry causes environmental damage by dumping waste in the river near its factory. It does not clean up because there is no environmental legislation requiring cleaning up and X Chemicals Ltd. is causing damage for last 40 years. As at March 31, 20X2, the State Legislature has passed a path breaking legislation requiring all polluting factories to clean-up the river water already contaminated. The formal Gazette notification of the law is pending. How should X Chemicals Ltd. deal with this situation?**

**SOLUTION : 38**

The obligating event is the contamination of water and because of the virtually certainty of legislation requiring cleaning up, an outflow of resources is certain. It is possible to arrive at best estimated cost for the cleanup activity. So, a provision should be recognised in the books of X Chemicals Ltd. for 20X1-20X2.

**PROBLEM 39 :**

**X Beauty Solutions Ltd. is selling cosmetic products under its brand name 'B', but it is getting its product manufactured from Y Ltd. It has an understanding with Y Ltd. that if the company becomes liable for any damage claims, due to any injury or harm to the customer of the cosmetic products, 30% will be reimbursed to it by Y Ltd. During the financial year 20X1-20X2, a claim of ₹ 30,00,000 becomes payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?**

**SOLUTION : 39**

X Beauty Solutions Ltd. will get reimbursement of ₹ 9,00,000 (₹ 30,00,000 x 30%) from Y Ltd. So, X Beauty Solutions Ltd. should make a provision of ₹ 21,00,000 (₹ 30,00,000 - ₹ 9,00,000) in financial year 20X1-20X2 and disclose a contingent liability of ₹ 9,00,000. The contingent liability is recognised keeping in view the fact that in case Y Ltd. does not pay, then X Beauty Solutions Ltd. will be liable for the whole claim.

**PROBLEM 40 :**

**X Telecom Ltd. has income tax litigation pending before appellate authorities. Legal advisor's opinion is that X Telecom Ltd. will lose the case and estimated that liability of ₹ 1,00,00,000 may arise in two years. The liability is recognised on a discounted basis. The discount rate at which the liability has been discounted is 10% and it is assumed that discount rate does not change over the period of 2 years. How should X Telecom Ltd. calculate the amount of borrowing cost?**

**SOLUTION : 40**

The discount factor of 10% for 2 years is 0.827. X Telecom Ltd. will initially recognise provision for ₹ 82,70,000 (₹ 1,00,00,000 x 0.827).

The discount factor of 10% at the end of year 1 is 0.909. At the end of year 1, provision amount would be ₹ 90,90,000 (₹ 1,00,00,000 x 0.909).

As per the standard, the difference between the two present values i.e., ₹ 8,20,000 is recognised as a borrowing cost in year 1.

At the end of the Year 2, the liability would be ₹ 1,00,00,000.

The difference between the two present values i.e., ₹ 9,10,000 (₹ 1,00,00,000 - ₹ 90,90,000) is recognised as borrowing cost in year 2.

**PROBLEM 41 :**

**X Packaging Ltd. has two segments, packaging division and paper division. In March 20X1, the board of directors approved and announced a formal plan to sell the paper division in June 20X1. Operating losses of the paper division are estimated to be approximately ₹ 50,00,000 during the period from April 1, 20X1 to the expected date of disposal. Management of X Packaging Ltd. wants to include the future operating loss of ₹ 50,00,000 in a provision for restructuring in the financial statements for the period ended March 31, 20X1. Can X Packaging Ltd. include these operating losses in a provision for restructuring?**

**SOLUTION : 41**

Standard states that provision should not be made for future operating losses. Since IAS 37 prohibits the recognition of future operating losses, so X Packaging Ltd. should

not include these future operating losses in a provision for restructuring even though these losses relate to the disposal group.

**PROBLEM 42 :**

**X Metals Ltd. had entered into a non-cancellable contract with Y Ltd. to purchase 10,000 units of raw material at ₹ 50 per unit at a contract price of ₹ 5,00,000. As per the terms of contract, X Metals Ltd. would have to pay ₹ 60,000 to exit the said contract. X Metals Ltd. has discontinued manufacturing the product that would use the said raw material. For that X Metals Ltd. has identified a third party to whom it can sell the said raw material at ₹ 45 per unit.**

**How should X Metals Ltd. account for this transaction in its books of account in respect of the above contract?**

**SOLUTION : 42**

These circumstances do indicate an onerous contract. The only benefit to be derived from the purchase contract costing ₹ 5,00,000 are the proceeds from the sale contact, which are ₹ 4,50,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of cost of fulfilling the contract and the penal cost of cancellation of ₹ 60,000.

**PROBLEM 43 :**

**X Cements Ltd. has three manufacturing units situated in three different states of India. The board of directors of X Cements Ltd., in their meeting held on January 10, 20X1, decided to close down its operations in one particular state on account of environmental reasons. A detailed formal plan for shutting down the above unit was also formalised and agreed by the board of directors in that meeting, which specifies the approximate number of employees who will be compensated and expenditure expected to be incurred. Date of implementation of plan has also been mentioned. Meetings were also held with customers, suppliers, and workers to communicate the features of the formal plan to close down the operations in the said state, and representatives of all interested parties were present in those meetings. Do the actions of the board of directors create a constructive obligation that needs a provision for restructuring?**

**SOLUTION : 43**

As per IAS 37, the conditions prescribed are:

(a) there should be detailed formal plan of restructuring;

(b) which should have raised valid expectations in the minds of those affected that the entity would carry out the restructuring by announcing the main features of its plans to restructure.

The board of directors did discuss and formalise a formal plan of winding up the operation in the above said state. This plan was communicated to the parties affected and created a valid expectation in their minds that X Cements Ltd. would go ahead with its plans to close down operations in that state. Thus, there is a constructive obligation that needs to be provided at year-end.

**PROBLEM 44 :**

**A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the end of the reporting period, a provision of ₹ 60,000 has been recognised. The provision has not been discounted as the effect of discounting is not material. Draft the Note.**

**SOLUTION : 44**

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years after the reporting period.

**PROBLEM 45 :**

**In 2017, an entity involved in nuclear activities recognises a provision for decommissioning costs of ₹ 300 million. The provision is estimated using the assumption that decommissioning will take place in 60–70 years' time. However, there is a possibility that it will not take place until 100–110 years' time, in which case the present value of the costs will be significantly reduced. Draft the note.**

**SOLUTION : 45**

A provision of ₹ 300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2077 and 2087; however, there is a possibility that decommissioning will not take place until 2117–2127. If the costs were measured based upon the expectation that they would not be incurred until 2117–2127 the provision would be reduced to ₹ 136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2%.

**PROBLEM 46 :**

**An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of ₹ 100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by the standard. Draft the note.**

**SOLUTION : 46**

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of ₹ 100 million.

The information usually required by IAS 37, Provisions, Contingent Liabilities and Contingent Assets, is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.

**PROBLEM 47 :**

**X Ltd. is operating in the telecom industry. During the Financial Year 20X1-20X2, the Income Tax authorities sent a scrutiny assessment notice under Section 143(2) of the Income-tax Act, 1961, in respect to return filed under Section 139 of this Act for Previous Year 20X0-20X1 (Assessment Year 20X1-20X2) and initiated assessment proceedings on account of a deduction claimed by the company which in the view of the authorities was inadmissible.**

**During the financial year 20X1-20X2 itself, the assessment proceedings were completed and the assessing officer did not allow the deduction and raised a demand of ₹ 1,00,00,000 against the company. The company contested such levy and filed an appeal with the Appellate authority. At the end of the financial year 20X1-20X2, the appeal had not been heard. The company is not confident whether that the company would win the appeal. However, the company was advised by its legal counsel that on a similar matter, two appellate authorities of different jurisdictions had given conflicting judgements,**

**one in favour of the assessee and one against the assessee. The legal counsel further stated it had more than 50% chance of winning the appeal. Please advise how the company should account for these transactions in the financial year 20X1-20X2.**

**The information usually required by IAS 37, Provisions, Contingent Liabilities and Contingent Assets, is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.**

**SOLUTION : 47**

IAS 37 provides that in rare cases it not clear whether there is a present obligation, for example, in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity should determine whether a present obligation exits at the end of the reporting period by taking account of all available evidence, for example, the opinion of experts.

In the present case, the company is not confident that whether it would win the appeal. By taking into account the opinion of the legal counsel, it is not sure that whether the company would win the appeal. On the basis of such evidence, it is more likely than not that a present obligation exists at the end of the reporting period. Therefore, the entity should recognise a provision. The company should provide for a liability of ₹ 1,00,00,000.

**PROBLEM 48 :**

**An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31st March 2012, it is virtually certain that a law requiring a cleanup of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary?**

**SOLUTION : 48**

| Analysis | Conclusion and Treatment |
|---|---|
| **Present Obligation:** Obligating Event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.<br>**Outflow of Resources:** Probable.<br>**Estimate:** Best Estimate of the liability can be made. | Provision is recognized for the best estimate of the costs of the clean up. |

# IAS 33 EARNINGS PER SHARE

## 1. INTRODUCTION

Earnings per Share (EPS) is a crucial tool to analyze the performance of an enterprise between different reporting periods and between different entities in the same reporting period, thus enabling a prospective investor to make investment decisions.

The determination of earnings (Numerator) is subject to accounting policies adopted by enterprises.

The standard thus **focuses on the denominator of EPS calculation.**

## 2. DEFINITIONS

**Anti-dilution** is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

**A contingent share agreement** is an agreement to issue shares that is dependent on the satisfaction of specified conditions.

**Contingently issuable ordinary shares** are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

**Dilution** is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

**Options, warrants and their equivalents** are financial instruments that give the holder the right to purchase ordinary shares.

**An ordinary share** is an equity instrument that is subordinate to all other classes of equity instruments.

**A potential ordinary share** is a financial instrument or other contract that may entitle its holder to ordinary shares. (Potential Ordinary shares are the same as potential equity shares).

**Put options** on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.

## 3. EARNINGS

EPS is the ratio of earnings to weighted number of ordinary shares outstanding during a period.

**"Earnings" refers to, net profit after tax attributable to ordinary equity holders of parent entity.**

After tax amounts of preference dividends, differences on settlement of preference shares and other similar effects on preference shares classified as equity, are adjusted in the determination of earnings attributable to ordinary equity holders.

## 4. PREFERENCE SHARES (IF NOT CLASSIFIED AS LIABILITY)

The following aspects relating to preference shares (if not classified as liability) would warrant adjustments in computing profits attributable to ordinary equity holders.

- Preference shares may be issued at a discount and on which a low initial dividend may be declared; conversely a higher-than- market dividend may be declared for preference shares issued at a premium (at times referred to as increasing rate preference shares). Such premium or discount is amortised to retained earnings using effective interest method and shall be treated as preference dividend.
- Excess of fair value of consideration paid and carrying amount of preference shares in a repurchase offer by the entity is deducted in calculating profit or loss attributable to ordinary equity holders.
- Early conversion of preference shares may be induced by an entity, through favorable changes to the original-conversion terms, or by paying additional consideration. The excess of fair value of ordinary shares or other consideration paid over fair value of ordinary shares issuable up under original terms is

deducted in calculating profit or loss attributable to ordinary equity holders. Conversely, in situations where settlement of preference holders results in excess of carrying amount over fair value of consideration being paid, such excess is added back to profit or loss.

**PROBLEM 1 :** **Calculate basic EPS.**

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**PROBLEM 2 :** **Calculate basic EPS.**

- **On 1.04.14, ASF Ltd issued 10,000 11% cumulative preference shares of Rs 100 each at Rs 102.**
- **Maturity – 5 Years**
- **The company offered early redemption of pref shares at the end of 1st year at Rs 104.**
- **DDT is 17%**
- **PAT 300 (Rs thousand)**
- **No. of Equity shares - 100 Thousand**
- **Implicit rate = 10.47%**
- **Calculate basic EPS.**

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## 5. WEIGHTED AVERAGE NUMBER OF ORDINARY EQUITY SHARES (WANOES)

WANOES is calculated by adjusting for the changes (shares bought back and issued) in the number of ordinary shares. Weightage is assigned taking into account the time-period or the "number of days" for the shares were outstanding during the period.

**PROBLEM 3 :** **[Computation of Basic EPS with weighted average number of shares]**
**Given below are equity shares information and net profit of X Ltd. as on 31.3.2015 & 31.3.2016**

| | No. of Shares (in Millions) |
|---|---|
| Equity Share Capital as on 1.4.2014 | 100 |
| New Issue of Shares on 1.10.2014 | 100 |
| Buy back as on 1.10.2015 | (20) |
| Net profit after tax for the year 2014-15 | 1000 |
| Net profit after tax for the year 2015-16 | 1300 |

**Compute Basic EPS of the company as on 313.2015 & 31.3.2016 showing notes of computation of weighted average equity shares.**

## 6. DATE FROM WHICH THESE EQUITY SHARES ARE INCLUDED IN THE WEIGHTED AVERAGE

In most cases the shares are included in the weighted average no. of equity shares from the date the consideration is receivable.

| Sr. No. | Issue of equity shares | Date from which these equity shares are included in the weighted average |
|---|---|---|
| 1. | Ordinary shares issued in exchange for cash | When cash is receivable |
| 2. | Ordinary shares issued as a result of conversion of debt into equity shares | As of the date interest ceases to accrue. |
| 3. | Ordinary shares issued in lieu of interest or principal on other financial instruments | As of the date interest ceases to accrue. |
| 4. | Ordinary shares issued in exchange for the settlement of liability of the enterprise | As of the date the settlement becomes effective |
| 5. | Ordinary shares issued as consideration for the acquisition of an asset other than cash | As of the date on which the acquisition is recognized |
| 6. | Ordinary shares issued for rendering services to the enterprise. | As the date the services are rendered |
| 7. | Contingently issuable ordinary shares | From the date on which the necessary conditions under the contract have been satisfied (i.e. the events have accured), whether shares have been issued or not. |
| 8 | Ordinary shares issued as a part of consideration transferred in a business comination | From the acquisition date. |
| 9 | Ordinary shares that will be issued upon the conversion of a mandatorily convertible instrument | From the date the contract is entered into. |
| 10 | Ordinary shares issued on a voluntary reinvestment of dividend on ordinary or preference shares | When dividends are re-invested |
| 11. | Contingently issuable ordinary shares solely after the passage of time | Are not Contingently issuable ordinary shares because the passage of time is certainty. They are included from the date of contract. |

## 7. WHERE ORDINARY SHARES ARE NOT FULLY PAID:

In situations where ordinary shares are not fully paid:

- To the extent they can participate in dividends the concept of equivalent units is applied.
- If not entitled to participate in dividends, accounting treatment for such party paid shares would be on the same lines as warrants or options in the computation of diluted earnings (discussed later).

**PROBLEM : 4 Calculate Weighted Average Number of Equity Shares- Partly Paid Shares**

| Date | Particulars | No. of shares Issued | Face value per share | Paid up value per share |
|---|---|---|---|---|
| 1.4.11<br>30.6.11 | 1.4.11<br>30.6.11 | 10,000<br>5,000 | Rs. 10<br>Rs.10 | Rs. 10<br>Rs. 5 |

**SOLUTION : 4**

**PROBLEM : 5** **Calculate Basic EPS for 2016-17**

| **PAT** | |
|---|---|
| **No. of Shares on 1.4.16** | |
| **Public Issue on 1.07.2016** | |
| **Received Calls on 1.10.16** | |
| **Received calls on 01.11.16** | |

**PROBLEM : 6**

**The equity share are of two types:**

**A. Voting equity shares 3000 shares of Rs 100 each;**

**B. Non-voting equity shares 2000 shares of Rs100 each entitled for dividend at 50% more than on 'A' type share.**

**Net profit attributable to equity shareholders- Rs. 1,40,000.**

**Calculate EPS for both class of shares.**

## 8. INCREASE OR DECREASE IN NUMBER OF SHARES HAVING NO IMPACT ON RESOURCES

Increase in number of shares without corresponding increase in resources shall be treated as issued at the beginning of the earliest comparative period. Such a change is considered in calculating EPS even if the change occurs after the reporting period but before the financial statements are authorized for issue and is to be disclosed appropriately.

## 9. BONUS SHARES

**Bonus issue** affects the number of shares without generating new earnings. Hence the number of shares is to be adjusted from the beginning of the earliest reporting period, without considering the time of issue.

**PROBLEM : 7** **Bonus Shares**

| **Net profit 2013-14** | |
|---|---|
| **Net profit 2014-15** | |
| **No. of equity shares till 31.12. 2014** | |
| **Bonus issue as on 1.1. 2015** | |
| **EPS 2013-14 (Restated)** | |
| **EPS 2014-15** | |

**PROBLEM : 8** **Bonus Shares**

| | |
|---|---|
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**PROBLEM : 9**

**ABC Ltd. has 10,000 equity shares outstanding on 1-1-16. Find out the weighted average number of equity shares for the year 2016, for the purpose of calculation of Basic EPS in each of the following cases :**

**a. The company issued 2,000 equity shares as Bonus shares on 1-4-16**

**b. The company issued 2,000 equity shares for cash on 1-7-16 and 3,000 Bonus shares on 1-10-16.**

**PROBLEM : 10**

**Find out the Basic EPS for the year 2004 from the following particulars :**

| | |
|---|---|
| **Shares outstanding on 1-1-04** | **5,00,000** |
| **Issue of shares for cash on 1-7-04, fully paid up** | **1,70,000** |
| **Bonus shares on 1-4-04 in the ratio 1 : 2** | |
| **Profit for the year** | **Rs. 15,00,000** |

**SOLUTION : 10** **Calculation of EPS**

| | Particulars | Rs. |
|---|---|---|
| A | Profit for the year | |
| B | No. of equity shares in the beginning | |
| | Add: Fresh issue of shares for cash 1,70,000 x 6/12<br>Bonus shares 5,00,000 / 2 | |
| | | |
| C | EPS A/B | |

**PROBLEM : 11**

**Calculate Basic EPS for the year from the following information :**

| | |
|---|---|
| **No. of Equity Shares in the beginning** | **6,00,000** |
| **12% Preference Share capital in the beginning** | **Rs. 15,00,000** |
| **10% Debentures** | **Rs. 20,00,000** |
| **Fresh Issue of shares at the end of 3rd month** | **1,20,000** |
| **Profit for the year (after Tax)** | **Rs. 21,00,000** |

**SOLUTION : 11** **Calculation of EPS**

| | Particulars | Rs. |
|---|---|---|
| A | Profit for the year (after tax) | |
| | Less : Preference dividend<br>15,00,000 x 12% | |
| | Profit available to equity shareholders | |
| B | No. of equity shares in the beginning | |
| | Add: Fresh issue of shares at the end of 3rd month<br>1,20,000 x 9/12 | |
| | | |
| C | EPS A/B | |

**PROBLEM : 12**

**Calculate Basic EPS from the following :**

| | |
|---|---|
| **Net Profit before tax for the year** | **Rs. 15,00,000** |
| **Number of shares outstanding on Jan. 1** | **1,00,000** |
| **10% Preference Share Capital** | **Rs. 5,00,000** |
| **Issue of Bonus Shares to Equity Shareholders on (Oct. 1)** | **50,000** |
| **Fresh issue of equity shares fully paid on Nov. 1** | **60,000** |
| **Buy-back of Equity shares on Dec. 1 (Number)** | **12,000** |
| **Tax rate** | **30%.** |

**Note : Calendar year has been adopted as financial year by the company.**

**SOLUTION : 12** **Calculation of EPS**

| | **Particulars** | **Rs.** |
|---|---|---|
| A | Net profit before tax | |
| | Less : Tax @ 30% | |
| | Profit after tax | |
| | Less : Preference dividend | |
| | 10% x 5,00,000 | |
| | Profit available to equity shareholders | |
| B | No. of equity shares on 1st January | |
| | Issue of Bonus shares | |
| | Issue of equity shares 60,000 x 2/12 | |
| | Less : Buy back of equity shares | |
| | 12,000 x 1/12 | |
| C | EPS A/B | |

## 10. RIGHT SHARES

**Right issues** are generally made at a price lower than fair value. This may involve some bonus element. This bonus element is ascertained by multiplying the number of shares outstanding prior to issue by **rights factor.**

**Number of equity shares to be used for calculating Basic EPS for all periods prior to right issue**

**= No. of equity shares outstanding prior to issue x Adjustment factor**

**Adjustment factor =**

$$\frac{\text{FAIR VALUE PER SHARE IMMEDIATELY PRIOR TO THE EXERCISE OF RIGHTS}}{\text{THEORETICAL EX-RIGHTS FAIR VALUE PER SHARE}}$$

**Theoretical Ex-right fair value per share =**

$$\frac{\textit{Fairvalue of the shares prior to right} + \textit{amount received from excercise of right}}{\textit{no. of shares outstanding prior to right issue} + \textit{no. of shares issued on the excercise of right}}$$

**PROBLEM : 13**

**R Ltd. has 100,000 equity shares outstanding in the beginning of the year. After 3 months, it issued Right shares in the ratio of 1 : 5 @ Rs. 20 per share. The fair value of shares before Right issue was Rs. 30 per share. Net profit for the current year is Rs. 18,00,000 and for the previous year was Rs. 14,00,000. Find out the Basic EPS for the current year and restate Basic EPS for the previous year.**

**PROBLEM : 14**

**PQR Ltd. has 5,00,000 shares outstanding in the beginning of the year. The fair value of the share was Rs. 45. It issued Right shares in the ratio of 2 : 5 @ Rs. 36 per shares midway during the year. Find out the Basic EPS for the year given that the company earned a net profit of Rs. 25,00,000 for the year.**

**SOLUTION : 14**

Theoretical ex-right price $= \dfrac{\text{F.V. of existing shares + amount realized on right shares}}{\text{Total no of shares}}$

$= \dfrac{5,00,000 \times 45 + 2,00,000 \times 36}{5,00,000 + 2,00,000}$

**= 42.43**

Adjustment Factor $= \dfrac{\text{F.V}}{\text{Theoretical ex-right price}}$

$= \dfrac{45}{42.43}$

**= 1.06**

Basic EPS = $\frac{\text{Net profit}}{\text{Weighted average no of shares}}$

= $\frac{25,00,000}{(5,00,000 \times 1.06 \times 6/12) + (7,00,000 \times 6/12)}$

= $\frac{25,00,000}{6,15,000}$

= **4.06**

## 11. SHARE SPLIT AND CONSOLIDATION

**Share split and consolidation** does not affect the earnings but changes the number of shares. Number of shares is to be calculated "after" the split or consolidation assuming as though the event of share split or consolidation had occurred at the beginning of the earliest reporting period.

However, when the overll effect is a share repurchase at fair value, the reduction in number of ordinary shares outstanding is the result of corresponding reduction in resources.

An example is a share consolidation with a special dividend. The weightage average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognized.

**In all these cases prior year figures will also be adjusted appropriately.**

**PROBLEM : 15**

M Ltd. consolidated 10 shares into one stock as on 1.5.15 coupled with specia dividend @200 per share. As on 30.4.15, average market price per share based on simple average closing price over immediately preceding three months was Rs 20 per share. The relevant information relating to basic EPS computation is as follows:

| | 2014-15 | 2015-16 |
|---|---|---|
| No. of ordinary shares (in million) | 500 | 50 |
| Reduction in shares by consolidation | | 450 |
| Special dividend per share | | 200 |
| Net profit for the year ( in million) | 800 | 900 |
| Average share price on 30.4.15 | | 20 |

Find out basic and diluted EPS.

## 12. CONTINGENTLY ISSUABLE SHARES

**Impact on basic EPS — Contingently issuable shares**

- Will be considered for basic EPS **only from date of fulfillment of condition.**
- These are included from the beginning of the period or from the date of contingent share agreement if it is entered into during the period.
- **Example - Performance based employee share options are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time.**

**PROBLEM : 16**

**As on 01.04.15, X Ltd offers 10 share based payment to each of the employees if PAT for the year 2015-16 exceeds Rs 5,000 crores. Shares shall be issued by 31.12.16. As on 31/3/16, PAT works out to be Rs 5,100 crores and share based payment works to be 50 Lakhs shares. Outstanding shares on 31.3.16 was 100 crores. Find basic EPS.**

## 13. POTENTIAL ORDINARY SHARES

These are financial instruments that entitle or may entitle its holder to ordinary shares.

**Examples include** convertible preference shares, convertible debentures, share warrants, etc. They are further classified into:

- **Dilutive shares:** Conversion into ordinary shares leads to reduction in EPS or increase in loss per share.
- **Antidilutive shares:** Conversion increases EPS or reduces loss per share.

It is a requirement in the Standard that when computing Diluted EPS, Potential Equity Shares that are anti-dilutive should be ignored.

## 14. WHY DILUTED EPS IS DISCLOSED?

Diluted EPS is disclosed because future dilution in EPS can affect the interests of the shareholder and the decisions of prospective investors.

## 15. DILUTED EARNINGS

This is the amount derived by making adjustments to basic earnings to incorporate the after-tax effect of,

- dividends, if any, on dilutive potential equity shares
- interest recognized on dilutive potential ordinary shares and
- other changes in income or expenses that can be attributed to and result from their conversion. **For example, the reduction of interest expense relating to potential ordinary shares and the resulting increase in profit may lead to increase in expense relating to a non-discretionary profit-sharing plan.**

## 16. REVISED WEIGHTED AVERAGE NUMBER OF ORDINARY EQUITY SHARES (WANOES)

This number is the aggregate of basic WANOES and the weighted average of additional ordinary shares which **"would have been"** outstanding assuming conversion of all potential ordinary equity shares.

If potential ordinary shares are allowed to lapse or are cancelled during the period, the period for which they were outstanding should be considered.

**Diluted earnings per share =**

$$\frac{\text{Net profit or loss for the period attributable to the equity shareholders duly adjusted with dividend,interest and other related expenses on dilutive potential equity shares}}{\text{Weighted avg no. of shares outstanding during the period plus diluted no. of equity shares}}$$

## 17. POTENTIAL ORDINARY SHARES ISSUED BY SUBSIDIARY, JOINT VENTURE, OR ASSOCIATE

The dilutive effect of potential ordinary shares issued by subsidiary, joint venture, or associate that may be converted into parent's ordinary shares or ordinary shares of subsidiary, joint venture or associate on the basic EPS of the reporting entity should be considered.

**PROBLEM : Find Basic And Diluted EPS in SFS and CFS of P Ltd**

**As on 31.03.16, P Ltd has following investment.**
**S Ltd (Subsidiary) - % Holding : 60%**
**Other details (figures in crores):**

| | | |
|---|---|---|
| | | |
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| | | |

**PROBLEM : 17**

**Convertible Debentures- Diluted / Antidiluted EPS**

| S. No. | PARTICULARS | SITUATION 1 | SITUATION 2 |
|---|---|---|---|
| A | Net profit for 2014-15 (Rs)<br>No. of equity shares outstanding | 7,50,000<br>1,50,000 | 7,50,000<br>1,50,000 |
| B | Basic EPS | | |
| C | No. of 10% convertible debentures of Rs.100 each | | |
| D | Conversion ratio | | |
| E | No. of equity shares on conversion | | |
| F | Interest expenses (Rs.) | | |
| G | Income Tax relating to interest @ 35% (Rs) | | |
| H | Adjusted net profit for the year (Rs). | | |
| I | Total No. of equity Shares | | |
| J | Revised EPS (Rs) | | |
| K | Effect | | |
| L | Reported EPS 2014 - 15<br>Basic EPS<br>Diluted EPS (Rs) | | |

**PROBLEM : 18**

**ASF Ltd. provides the following information for the year :**

**No. of shares outstanding** **5,00,000**

**Net Profit for the year (after tax)** **Rs. 11,00,000**

**The company had 1,00,000 15% Debentures of Rs. 100 each. These debentures are compulsorily convertible into 4 equity shares per debenture. Find out the Basic EPS and Diluted EPS given that the tax rate is 35%.**

**SOLUTION : 18**

Basic EPS $= \frac{11,00,000}{5,00,000}$

**= 2.2**

**Calculation of Diluted EPS**

Saving in debenture interest = (1,00,000 x 100) x 15%

= 15,00,000

Loss of Tax shield on interest = 15,00,000 x 35%

= 5,25,000

Effective profit = 11,00,000 + 15,00,000 – 5,25,000

= 20,75,000

Diluted EPS $= \frac{20,75,000}{5,00,000 + (1,00,000 \times 4)}$

**= 2.31**

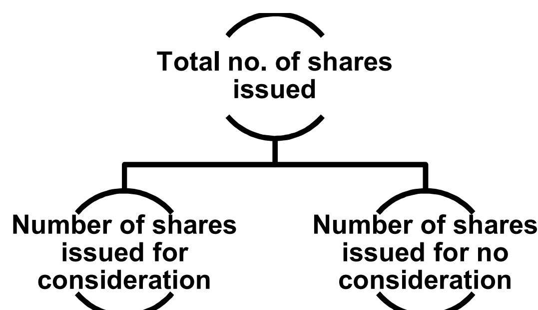
In the given problem the potential equity shares are anit-dilutive as the diluted EPS i.e. 2.31 is more than the basic EPS i.e. Rs. 2.20. The company should not disclose anti-dilutive EPS. Therefore, Company will disclose 2.20 as basic as well as diluted EPS

## 18. DILUTED EPS IN CASE OF OPTIONS AND WARRANTS

Options, warrants and other similar instruments shall be considered first since there is no increase in earnings and hence most dilutive. In determining the extent of dilution, the essential factors to be kept in view are:

- Employee share options with service based conditions are treated as options. Options with performance based conditions are considered as contingently issuable shares.
- **Options are considered dilutive only when exercise price is less than the average market price of the shares.**
- The amount of dilution is the difference between the number of ordinary shares actually issued against warrants (or options) and that would have been issued at average market price. This differential number is considered as shares issued for no consideration. Rest is considered as issued at average market price and hence it is neither dilutive nor anti-dilutive.

Number of shares issued for consideration = $\frac{\textbf{Expected issue proceeds}}{\textbf{Fair value per share}}$




The terms of conversion' stipulates the number of ordinary shares to be issued on conversion of dilutive potential ordinary shares. If more than one such conversion basis exist, the one that would be most advantageous to the holder shall be considered.

**PROBLEM : 19**

**ASF Ltd. has given option to its employees to subscribe 1,00,000 Equity Shares @ Rs. 15 within a period of one year. At present, the fair value of the share is Rs. 25. The company has 5,00,000 Equity Shares outstanding and the net profit for the current year is Rs. 16,00,000. Find out the Basic EPS and the Diluted EPS for the year.**

**SOLUTION: 19 BASIC EPS**

| | Rs |
|---|---|
| Net Profit | |
| Weighted average no of shares | |
| EPS | |

**Calculation of diluted EPS**

No of shares issued without consideration

A No. of shares to be issued under option

B No. of shares that would have been issued at FV 1,00,000x15/25

C Shares issued without consideration

Diluted EPS =

## 19. SEQUENCE IN WHICH POTENTIAL ORDINARY SHARES ARE CONSIDERED

Each series of potential ordinary share shall be considered separately for determination of dilutive effect. The **sequence of considering such potential ordinary shares** may affect the determination of dilution. Hence the standard prescribes a sequence. The sequence considers those items which have the most dilutive effect to least dilutive effect.

**QUESTION 20 :**

**XYZ Ltd. has 10,00,000 Equity Shares outstanding and the net profit attributable to these shares is Rs. 35,00,000. The average fair value of the share during the year is Rs. 75. The company had issued the following potential equity shares :**

**a. 1,00,000 10% Preference Shares of Rs. 100 each to be converted into 2 Equity Shares.**

**b. Options to subscribe 2,50,000 Equity shares at Rs. 60 each**

**c. 2,00,000 12% Convertible Debentures of Rs. 100 each to be converted into 3 shares.**

**Find out the Basic EPS and Diluted EPS given that the Corporate Dividend Tax is 10% and the income tax applicable to the company is 30%.**

**SOLUTION : 20**

**Increase in earnings available to equity share holders on conversion of Potential Equity Shares.**

| Particulars | Increase in Earnings | Increase in No. of Equity shares | EPS incremental | Rank |
|---|---|---|---|---|
| 10% Preference shares (1,00,000 x 100) x 10% + 10,00,000 x 10% | | | | |
| Options [2,50,000 – (2,50,000 x $\frac{60}{75}$ )] | | | | |
| 12% Convertible Debentures [(2,00,000 x 100) x 12%] – 30% | | | | |

**Calculation of Diluted EPS**

| Particulars | Net profit | No. of Equity shares | EPS (Rs.) | Remarks |
|---|---|---|---|---|
| Net Profit as Reported | | | | |
| Option | | | | |
| | | | | |
| 12% Convertible Debentures | | | | |
| | | | | |
| 10% Pref. shares | | | | |
| | | | | |

## 20. CONTINGENTLY ISSUABLE SHARES

- **Contingently issuable shares** are considered for inclusion in the computation of **dilutive EPS** if the conditions attached to it are **not** satisfied.
- The number of dilutive shares is calculated based on the assumption that **end of the reporting period is the end of period for such conditions to be satisfied.**
- **The conditions that existed at the end of reporting period should be treated as conditions that existed on the date the conditions are required to be fulfilled under the terms of issue.**

**Problem:**

**On 1.4.14, X ltd acquired Y Ltd in a business combination of a share settled deal. It issued 200 thousand shares. On the date of business combination, works of certain retail outlets were pending. It was agreed to issue additional shares once these retail outlet are ready. Retail outlets were opened on 1.10.15. Assume for example that any additional share issue arising out of the aggrement shall be made on the 1st April next year.**

**Relevant details (Rupees in thousand):**

| | 31.3.16 | 31.3.15 | 31.3.14 |
|---|---|---|---|
| **PAT** | **2250** | **2000** | **1200** |
| **No. of shares outstanding** | **1000** | **1000** | **1000** |
| **Shares issued in business combination** | | **200** | |
| **Contingently issuable shares** | | **100** | |

**Find out the basic and diluted EPS of X Ltd as on 31.3.14, 31.3.15 and 31.3.16.**

## 21. CONTRACTS THAT MAY BE SETTLED EITHER IN CASH OR IN ORDINARY SHARES

In case of **contracts that may be settled either in cash or in ordinary shares,** the treatment depends on the party vested with the option.

**If the entity is vested with that option**, it is presumed that contract will be settled in **ordinary shares** and the resulting potential equity shares shall be included in Diluted Earnings per share, if dilutive.

**If the option is with the counter party**, either the cash option or share option — **whichever is more dilutive** — is considered.

## 22. PURCHASED PUT OPTIONS AND PURCHASED CALL OPTIONS

**Purchased put options** (right to sell own shares) and **purchased call options** (right to buy back own shares) are considered as anti-dilutive because the option will be exercised only if the exercise prices are favorable to the entity.

**PROBLEM – 21 Put option on own shares :**

**Put option is excercised when market price < Exercise price.**

**Suppose an entity has entered into put option on 10,000 shares at exercise price of Rs 100. Market price is Rs 90. Find out potential shares.**

**PROBLEM – 22 call option on own shares**

**Call option on own shares will result in negative potential shares as it is in effect buyback of shares.**

**Call option is excercised when market price > Exercise price.**

**Suppose an entity has entered into call option on 10,000 shares at exercise price of Rs 100. Market price is Rs 110. Find out potential shares.**

## 23. WRITTEN PUT OPTIONS OR FORWARD PURCHASE CONTRACT

If the entity has **written put options** (obligation to buy back own shares) or forward purchase contract for buying back own shares, then potential dilutive effect, if any is considered.

The potential dilutive effect on EPS is calculated as follows:

- It shall be assumed that at the beginning of the period sufficient number of shares will be issued to raise proceeds to satisfy the contract.
- The difference between shares assumed as issued and shares received from satisfying the contract is included for calculating dilutive EPS.

**PROBLEM : 23**

**X Ltd. has outstanding 10,000 written put options on its ordinary shares with an exercise price of Rs. 100. The average market price of its ordinary shares for the period is Rs. 78. Find out potential shares.**

## 24. RETROSPECTIVE ADJUSTMENTS

Basic and Diluted EPS shall be adjusted for:

- Increase in the number of ordinary or potential ordinary shares outstanding as a result of capitalization, bonus issue, stock split, reverse share split.
- If these changes occur after the reporting but before the date on which the financial statements are authorised by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per

share calculations reflect such changes in the number of shares, that fact should be disclosed.

- Effects of errors or adjustments resulting from changes in accounting policies accounted for retrospectively.

## 25. PRESENTATION AND DISCLOSURES IN THE FINANCIAL STATEMENT

In the Financial Statements

- Basic and diluted earnings per share (positive or negative) shall be presented on the face of income (comprehensive income) statement
- If separate Financial Statement is presented EPS should be disclosed for that Financial Statement as well
- Where the ordinary shares include shares with differential rights, EPS for each class of such shares shall be presented separately
- Both basic and diluted EPS shall be presented with equal prominence for all periods presented.
- Where an entity reports a discontinued operation, the entity shall disclose basic and diluted **amounts** per share for the discontinued operations separately, and disclose the same either in the statement of profit or loss or in the notes.

## 26. PRESENTATION AND DISCLOSURES IN THE NOTES TO ACCOUNTS

- A reconciliation of the Numerator used in basic and diluted EPS to the profit or loss attributable to the parent entity.
- A reconciliation of the denominators used in basic and diluted EPS to each other.
- Anti-dilutive instruments that were not considered for determining diluted EPS;
- Post balance sheet events that would have changed the number of ordinary shares or potential ordinary shares, had they occurred;

## 27. MAJOR CHANGES IN IND AS 33 VIS-À-VIS IAS 33 NOT RESULTING IN CARVE OUTS

1. ***Consolidated Financial Statements and Separate Financial Statements:*** IAS 33 provides that when an entity presents both consolidated financial statements and separate financial statements, it may give EPS related information in consolidated financial statements only, whereas, Ind AS 33 requires EPS related information to be disclosed both in consolidated financial statements and separate financial statements.
2. ***Applicability of the Standard:*** Paragraph 2 of IAS 33 requires that the entire standard applies to:
   (a) the separate or individual financial statements of an entity:
      (i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or
      (ii) that files, or is in the process of filing, its financial statements with a Securities Regulator or other regulatory organisation for the purpose of issuing ordinary shares in a public market; and
   (b) the consolidated financial statements of a group with a parent:
      (i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or
      (ii) that files, or is in the process of filing, its financial statements with a Securities Regulator or other regulatory organisation for the purpose of issuing ordinary shares in a public market.

   It also requires that an entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.

   The above requirements have been deleted in the Ind AS as the applicability or exemptions to the Ind ASs are governed by the Companies Act and the Rules made there under.

3. ***Usage of Information:*** Paragraph 4 has been modified in Ind AS 33 to clarify that an entity shall not present in separate financial statements, earnings per share based on the information given in consolidated financial statements, besides requiring as in IAS 33, that earnings per share based on the information given in separate financial statements shall not be presented in the consolidated financial statements.
4. ***Adjustment of Securities Premium:*** In Ind AS 33, a paragraph has been added after paragraph 12 on the following lines -

   "Where any item of income or expense which is otherwise required to be recognized in profit or loss in accordance with Indian Accounting Standards is debited or credited to securities premium account/other reserves, the amount in respect thereof shall be deducted from profit or loss from continuing operations for the purpose of calculating basic earnings per share."
5. ***Amortisation of Discount or Premium:*** In Ind AS 33 paragraph 15 has been amended by adding the phrase, „irrespective of whether such discount or premium is debited or credited to securities premium account" to further clarify that such discount or premium shall also be amortised to retained earnings.
6. ***Disclosure of Amounts of per Share using a Reported Component :*** IAS 33 requires disclosure of amounts of per share using a reported component, basic and diluted earnings per share and basic and diluted earnings per share for discontinued operations in the separate income statement, where separate income statement is presented. This requirement is not provided in Ind AS 33 consequential to the removal of option regarding two statement approach in Ind AS 1. Ind AS 1 requires that the components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

## PROBLEMS FOR SELF-PRACTICE

**PROBLEM 24 :**

**A.S Foundation Ltd. Supplied the following information. You are required to compute the basic earning per share :**

**Accounting year 1.1.2005 – 31.12.2005)**

| | | |
|---|---|---|
| **Net Profit** | : | **Year 2005 :Rs. 20,00,000** |
| | : | **Year 2006 :Rs. 30,00,000** |
| **No. of shares outstanding prior to Right Issue** | : | **10,00,000 shares** |
| **Right Issue** | : | **One new share for each four outstanding i.e., 2,50,000 shares. Right Issue Price – Rs. 20 Last date of exercise rights – 31.3.2006.** |
| **Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2006** | : | **Rs. 25 (Nov 2004)** |

**SOLUTION : 24** **Computation of Basic Earnings Per Share**

| | *Year 2005* | *Year 2006* |
|---|---|---|
| | *Rs.* | *Rs.* |
| EPS for the year 2005 as originally reported | | |
| $= \dfrac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$ | | |
| = (Rs. 20,00,000 / 10,00,000 shares) | 2.00 | |
| EPS for the year 2005 restated for rights issue | | |
| = [Rs. 20,00,000 / (10,00,000 shares x 1.04*)] | 1.92 (approx.) | |
| EPS for the year 2006 including effects of rights issue | | |

$$\frac{\text{Rs. }30{,}00{,}000}{(10{,}00{,}000\text{ shares} \times 1.04 \times 3/12) + (12{,}50{,}000\text{ shares} \times 9/12)}$$

$$\frac{\text{Rs. }30,00,000}{11,97,500\text{ shares}}$$ 2.51 (approx.)

**Working Notes:**

1. Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

$$= \frac{(\text{Rs. }25 \times 10,00,000\text{ shares}) + (\text{Rs. }20 \times 2,50,000\text{ shares})}{10,00,000\text{ shares} + 2,50,000\text{ shares}}$$

$$= \frac{\text{Rs. }3,00,00,000}{12,50,000\text{ shares}} = \text{Rs. }24$$

2. Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}}$$

$$= \frac{\text{Rs. }25}{\text{Rs. }24\text{ (Refer Working Note 1)}} = 1.04\text{ (approx.)}$$

**PROBLEM : 25**

| | |
|---|---|
| **Net profit for the current year** | **Rs. 1,00,00,000** |
| **No. of equity shares outstanding** | **50,00,000** |
| **Interest expense for the current year** | **Rs. 12,00,000** |
| **Rate of income tax** | **30%** |
| **No. of 12% debentures of Rs. 100 each** | **1,00,000** |

**Each debentures is convertible into 10 equity shares**

**Calculate Basic EPS and Diluted EPS.**

**SOLUTION : 25**

| | **Rs.** | **Rs.** |
|---|---|---|
| Net profit for the purpose of Basic EPS | | 1,00,00,000 |
| *Add:* Interest expense | 12,00,000 | |
| *Less:* Tax saving on interest expense | 3,60,000 | 8,40,000 |
| Adjusted net profit for the purpose of diluted EPS | | 1,08,40,000 |
| No. of equity shares used to compute Basic EPS | | 50,00,000 |
| *Add:* Dilutive Potential equity shares | | 10,00,000 |
| No. of equity shares used to compute diluted EPS | | 60,00,000 |

Basic EPS = 1,00,00,000/50,00,000 = Rs. 2.00

Diluted EPS = 1,08,40,000/60,00,000 = Rs. 1.81

**Note:** Interest is an expense deductible for tax purposes hence result into tax saving.

**PROBLEM : 26**

**On 01.01.2004 Induga Ltd. had 5,00,000 shares outstanding on 01.03.2004. It issued onenew share for each five shares outstanding at Rs. 15. Fair value of one equity shareimmediately before the right issue was Rs. 21. Net profit for the year 2003 was Rs.11,00,000 and for 2004 Rs. 15,00,000. Calculate the basic EPS for 2004 and restated EPSfor 2003.**

**SOLUTION : 26**

Computation of theoretical ex-right fair value per share.

$$= \frac{\text{Fair value of outstanding shares immediately prior to exercise of rights} + \text{total amount received from exercise of right}}{\text{Number of shares outstanding prior to exercise} + \text{number of shares issued in the exercise}}$$

$$= \frac{(\text{Rs. } 21.00 \times 5{,}00{,}000 \text{ shares}) + (\text{Rs. } 15 \times 1{,}00{,}000 \text{ shares})}{(5{,}00{,}000 + 1{,}00{,}000) \text{ Shares}}$$

Theoretical ex-right value per share = Rs. 20.00

$$\text{Computation of adjustment factor} = \frac{\textbf{Fair value per share prior to exercise of rights}}{\textbf{Theoretical ex - right value per share}}$$

$$= \frac{\text{Rs. } 21.00}{\text{Rs. } 20.00} = 1.05$$

Computation of earnings per share

EPS for the year 2003 as originally reported : Rs. 11,00,000/5,00,000 shares Rs.2.20

EPS for the year 2003 restated for rights issue: Rs. 11,00,000/(5,00,000 shares x 1.05) Rs.2.10 (approx.)

Basic EPS for the year 2004 including effects of Rights issue =

$$= \frac{\text{Rs. } 15{,}00{,}000}{(5{,}00{,}000 \times 1.05 \times 2/12) + (6{,}00{,}000 \times 10/12)} = \textbf{Rs. 2.55 (approx.)}$$

**PROBLEM 27 :**

**The Net Profit Before Tax of A.S. Ltd. was Rs. 100 lakhs and the Income Tax Rate was 37%. The Company's Preference Share Capital has the following classes –**

**12% Non Cumulative Preference Share Capital Rs. 100 lakhs**

**10% Cumulative Preference Share Capital Rs. 150 lakhs**

**In its accounts, A.S. Ltd. has provided / paid following dividends on Preference Capital :**

**On Non Cumulative Preference Shares – fully provided for the current year.**

**On Cumulative Preference Shares – fully provided for the past three years.**

**The Company also provided for Dividend Distribution Tax at 12.75% and transferred Rs. 5 Lakhs to General Reserve. You are required to calculate the Net Profit for the period, attributable to Equity Shareholders.**

**SOLUTION : 27 Calculation of Net Profit attributable to equity shareholders**

| | Particulars | Computation | Rs. Lakhs |
|---|---|---|---|
| | Profit Before Tax | Given | 100.00 |
| **Less :** | Tax Expense | 100.00 x 37% | 37.00 |
| | **Profit After Tax** | | 63.00 |
| **Less :** | Preference Dividend for the period | | |
| | On Non-Cumulative Preference Shares | 100.00 x 12% | 12.00 |
| | On Cumulative Preference Shares for the year only | 150.00 x 10% | 15.00 |
| | Dividend Distribution Tax payable | (12.00 + 15.00) x 12.75% | 3.44 |
| | **Net Profit for the period attributable to Equity Shareholders** | | **32.56** |

**Note :** (a) Dividend on Cumulative Preference Shares for prior years, and (b) Transfer to General Reserve should be ignored.

**PROBLEM : 28**

**A.S. Ltd. has the following different classes of Equity Shares of Rs. 10 each, outstanding as at 31st March, having disproportionate rights with respect to voting and dividends –**

| Number of Shares | Rights as to Share in Net Profit to the extent of Capital |
|---|---|
| **100,000 "A" Class Equity Shares** | **Proportionate to Capital** |
| **30,000 "B" Class Equity Shares** | **In the proportionate of 3:2 with respect to "A" Class Shares** |
| **30,000 "C" Class Equity Shares** | **In the proportionate of 5:2 with respect to "A" Class Shares** |
| **40,000 "D" Class Equity Shares** | **In the proportionate of 3:1 with respect to "A" Class Shares** |

**Profit for the year ended 31st March was Rs. 8,00,000. The Company believes that Net Profit is to be allocated to the Shares in the ratio of 2:3:5:6 as derived from their rights to Share Net Profit. The Company has calculated the Basic EPS in the following manner. You are required to confirm whether this calculation is correct.**

| Class | Apportionment of Net Profit | No. of Shares | Basic EPS |
|---|---|---|---|
| **Class A** | **Rs. 8,00,000 x 2 / 16 = Rs. 1,00,000** | **1,00,000** | **Rs. 1.00** |
| **Class B** | **Rs. 8,00,000 x 3 / 16 = Rs. 1,50,000** | **30,000** | **Rs. 5.00** |
| **Class C** | **Rs. 8,00,000 x 5 / 16 = Rs. 2,50,000** | **30,000** | **Rs. 8.33** |
| **Class D** | **Rs. 8,00,000 x 6 / 16 = Rs. 3,00,000** | **40,000** | **Rs. 7.50** |

**SOLUTION : 28**

**Note :** If an enterprise has more than one class of Equity Shares, Net Profit or Loss for the period is apportioned over the different classes of Shares in accordance with their dividend rights.

In the instant case, the Net Profit or Loss should first be apportioned to various classes of Equity Shares in accordance with their dividend rights. This is apportioned in the following manner –

| Class | No. of Shares | Ratio of rights in Net Profit | Adjusted Number of Shares | Apportioned Net Profit (in the ratio of adjusted number of Shares) |
|---|---|---|---|---|
| A | 1,00,000 | 1 : 1 | 1,00,000 x 1/1 = 1,00,000 | 8,00,000 x 100/340 = Rs. 2,35,294 |
| B | 30,000 | 3 : 2 | 30,000 x 3/2 = 45,000 | 8,00,000 x 45/340 = Rs. 1,05,882 |
| C | 30,000 | 5 : 2 | 30,000 x 5/2 = 75,000 | 8,00,000 x 75/340 = Rs. 1,76,471 |
| D | 40,000 | 3 : 1 | 40,000 x 3/1 = 1,20,000 | 8,00,000 x 120/340 = Rs. 2,82,353 |
| | | **Total** | **3,40,000** | **Rs. 8,00,000** |

The revised computation of Basic EPS, based on the above apportionment of Net Profit is as under –

| Class | Apportioned Net Profit | No. of Shares | Basic EPS |
|---|---|---|---|
| Class A | Rs. 2,35,294 | 1,00,000 | Rs. 2.35 |
| Class B | Rs. 1,05,882 | 30,000 | Rs. 3.53 |
| Class C | Rs. 1,76,471 | 30,000 | Rs. 5.88 |
| Class D | Rs. 2,82,353 | 40,000 | Rs. 7.06 |

**Conclusion :** The calculation made by the Company is **not correct**. The amounts presented above should be taken.

**PROBLEM6 : 29**

**A.S. Ltd. follows the calendar year for reporting purposes. During a year, it issued Rs. 80 Lakhs Equity Shares at par on 15th September. It had also bought back Rs. 20 lakhs Equity Capital (at par) on 1st December. The Equity Capital was Rs. 150 lakhs at the end of the year. Calculate the Weighted Average Number of Equity Shares outstanding during the period, if the price of each Share is Rs. 100. Also calculate Basic EPS if the Net Profit attributable to Equity Shareholders is Rs. 10 lakhs.**

**SOLUTION : 29**

Determination of Opening Balance of Equity Capital :

Opening Capital + Fresh Issue – Buy Back = Closing Capital.

Hence, Opening Capital = Closing Capital + Buy Back – Fresh Issue

= 150 + 20 – 80 = Rs. 90 lakhs

**Computation of Weighted Average Number of Shares outstanding during the period.**

| Date | Equity Capital (in Rs. Lakhs) | No. of Equity Shares | Period Outstanding (upto 31st Dec.) | Time Weighting Factor | Weighted Average Number of Shares |
|---|---|---|---|---|---|
| (1) | (2) | (3) = (2) ÷ 100 | (4) | (5) | (6) = (3) x (5) |
| 1st Jan. | 90.00 | 90,000 | 12 months | 12/12 | 90,000 |
| 15th Sep. | 80.00 | 80,000 | 3.5 months | 3.5/12 | 23,333 |
| 1st Dec. | 20.00 | 20,000 | 1 month | 1/12 | (1,667) |
| **Weighted Average Number of Shares outstanding during the period** | | | | | **1,11,666** |

Basic Earnings Per Share = $\frac{\text{Net Profit or Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$

Basic Earnings Per Share = Rs. 10,00,000 ÷ 1,11,666 = **Rs. 8.96 per Share**

Alternatively, the Weighted Avg. No. of Equity Shares outstanding during the period may be calculated as –

| Period | Period in Months | Time Weighting Factor | No. of Equity Shares | Weighted Average Number of Shares |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) = (3) x (4) |
| 1st Jan – 15th Sep. | 8.5 months | 8.5 / 12 | Opening Balance = 90,000 | 63,750 |
| 15th Sep – 1st Dec | 2.5 months | 2.5 / 12 | 90,000 + 80,000 = 1,70,000 | 35,416 |
| 1st Dec – 31st Dec | 1 month | 1 / 12 | 1,70,000 – 20,000 = 1,50,000 | 12,500 |
| **Weighted Average Number of Shares outstanding during the period** | | | | 1,11,666 |

**PROBLEM : 30**

**Computed Basic EPS for financial year ending 31st March from the following data :**

| | | |
|---|---|---|
| **1st April** | **Equity Shares outstanding – Face value Rs. 100 fully paid (Opening Balance)** | **10,000** |
| **1st June** | **Issue of Shares – Face value Rs. 100, paid up amount Rs. 70** | **10,000** |
| **1st July** | **Buy-back of Shares (fully paid)** | **4,000** |
| **1st Nov** | **Issue of Shares – Face Value Rs. 100 fully paid** | **6,000** |
| | **Net Profit before Tax for the year (Tax Rate = 35%)** | **Rs. 12 lakhs** |
| | **Preference Dividend (Dividend Distribution Tax = 12.5%)** | **Rs. 5 lakhs** |

**SOLUTION : 30**

Weighted Average Number of Equity Shares outstanding at the end of the year
= (10,000 x 12/12) + (10,000 x 70% x 10/12) – (4,000 x 9/12) + (6,000 x 5/12)
= 10,000 + 5,833 – 3,000 + 2,500 = 15,333 Shares

| | Particulars | Rs. |
|---|---|---|
| | Net Profit Before Tax | Rs. 12,00,000 |
| **Less :** | Tax at 35% | Rs. 4,20,000 |
| | Profit After Tax | Rs. 7,80,000 |
| **Less :** | Preference Dividend + 12.5% Tax thereon | Rs. 5,62,500 |
| | **Net Profit attributable to Equity Shareholders** | **Rs. 2,17,500** |

Basic Earnings Per Share = $\frac{\text{Net Profit or Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$

Basic Earnings Per Share = Rs. 2,17,500 ÷ 15,333 = **Rs. 14.19 per Share**

**PROBLEM : 31**

**At the beginning of a financial year, a Company issued 1,20,000 Equity Shares of Rs. 100 each, Rs. 50 per Share was called up on that date which was paid by all Shareholders. The remaining Rs. 50 was called up on 1st September. All Shareholders paid the sum in September, except one Shareholder having 24,000 Shares. The Net Profit for the relevant financial year is Rs. 2,64,000 after dividend on Preference Shares and Dividend Distribution Tax of Rs. 64,000. Compute basic EPS for the year.**

**SOLUTION : 31**

1. **Computation of Weighted Average No. of Shares**

| Date | Shares Outstanding | Proportion of Paid-up Value to Face Value | Period Outstanding | Weighted Average No. of Shares |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 = 2 x 3 x 4 /12 |
| 1st Apr. | 1,20,000 (Partly Paid) | Rs. 50 ÷ Rs. 100 = 50% | 5 Mths (Upto 31st Aug) | 25,000 |
| | 96,000 (Fully Paid) | Rs. 100 ÷ Rs. 100 = 100% | 7 Mths (Upto 31st Mar) | 56,000 |
| 1st Sep. | 24,000 (Partly Paid) | Rs. 50 ÷ Rs. 100 = 50% | 7 Mths (Upto 31st Mar) | 7,000 |
| **Weighted Average Number of Shares** | | | | **88,000** |

2. Basic EPS = $\frac{\text{Net Profit or Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$

= Rs. 2,64,000 ÷ 88,000 = **Rs. 3.00 per Share**

**PROBLEM : 32**

**Would completely vested options to purchase Shares of a Company be included in the computation of Basic EPS?**

**A.S. Ltd. has formulated a scheme for Employee Stock Options for its employees. During the year ended December 21, 20X2, the Company has granted options to purchase 36,000 Shares to its employees, out of which, options to purchase 15,000 Shares have vested by December 31, 20X2. However, no options have been exercised by December 31, 20X2. Would these 15,000 Shares that have vested, be included in the computation of Basic EPS for the year ended December 31, 20X2?**

**SOLUTION : 32**

1. **Principle :** For the purpose of calculating Basic EPS, the number of Equity Shares should be the Weighted Average Number of Equity Shares **outstanding** during the period. The vesting of Shares cannot be considered as Shares being **outstanding**. Hence, Shares that have vested **would not be included** in the computation of Basic EPS.
2. **Analysis :**For inclusion of Contingently Issuable Shares in the computation of Basic EPS, all necessary conditions under the contract should have been satisfied. As the employees are yet to exercise their option to purchase, which is one of the necessary conditions of the contract, these Shares would not be included in the computation of **Basic EPS**.
3. **Conclusion :** However, for the computation of Diluted EPS, the entire 36,000 Shares should be considered for inclusion.

**PROBLEM : 33**

**During the year ended March 31, 2008, A.S. Ltd. makes a public issue of 100,000 Equity Shares of Rs. 10 each. The issue was fully subscribed and the calls were made as –**

- **Rs. 5 on application and allotment made on July 1, 2007**
- **Rs. 2 on first call made on September 30, 2007**
- **Rs. 3 on second and final call made on January 1, 2008**

**Partly Paid Shares are entitled to participate in the dividend to the extent of amount paid. The Company had 5,00,000 Shares outstanding at the year and, apart from the public issue of Shares made above, there were no other additions to or reductions from Share Capital. Calculate the Weighted Average Number of Equity Shares for computation of Basic EPS.**

**SOLUTION : 33**

Weighted Average Number of Equity Shares outstanding during the period would be calculated as follows –

| Number of Shares | Time – Weighting Factor, i.e. months for which the Shares were outstanding | Paid-up Value Equivalent for Rs. 10 per Share | Weighted Average Number of Equity Shares |
|---|---|---|---|
| **(1)** | **(2)** | **(3)** | **(4) = (1) x (2) x (3)** |
| 5,00,000 | 12 / 12 | 10 / 10 = 1.00 | 5,00,000 |
| 1,00,000 | 9 / 12 | 5 / 10 = 0.50 | 37,500 |
| 1,00,000 | 6 / 12 | 2 / 10 = 0.20 | 10,000 |
| 1,00,000 | 3 / 12 | 3 / 10 = 0.30 | 7,500 |
| **Weighted Average Number of Equity Shares outstanding during the period** | | | **5,55,000** |

**PROBLEM : 34**

**A.S. Ltd. issued 8,00,000 Equity Shares of Rs. 100 each on 15th July. During the reporting period (calendar year), the Company purchased an asset on 1st September for Rs. 25 lakhs and issued 1,00,000 Equity Shares treated as Rs. 25 paid up. At the beginning of the year (1st January), A.S.'s Equity Capital was 5 lakh Shares of Rs. 100 each. Calculate Weighted Average Number of Equity Shares & Basic EPS if Net Profit for the period for the period is Rs. 37.50 lakhs.**

**SOLUTION : 34**

Computation of Weighted Average Number of Shares outstanding during the period :

| Date | No. of Equity Shares | Period Outstanding (upto 31st Dec.) | Time Weighting Factor | Weighted Average Number of Shares |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 = 2 x 4 |
| 1st Jan. | 5,00,000 | 12 months | 12 / 12 | 5,00,000 |
| 15th July | 8,00,000 | 5.5 months | 5.5 / 12 | 3,66,667 |
| 1st Sep. | 25,000 (1,00,000 x 25 / 100) | 4 months | 4 / 12 | 8,333 |
| **Weighted Average Number of Shares outstanding during the period** | | | | **8,75,000** |

**Note :** Shares issued for purchase of asset are included with effect from the date of recognising the acquisition.

$$\text{Basic Earnings Per Share} = \frac{\text{Net Profit or Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$$

= Rs. 37,50,000 ÷ 8,75,000 = **Rs. 4.29 per Share**

**PROBLEM : 35**

**A.S. Ltd. provides the following information. Compute Basic EPS.**

**Number of Equity Shares outstanding as at beginning of the period = 5,00,000.**

**Bonus Issue on 1st July of current year = 3 Shares for every 1 Share held.**

**Net Profit for current year and previous reporting period = Rs. 160 lakhs and Rs. 50 lakhs.**

**SOLUTION : 35**

| Step | Procedure |
|---|---|
| 1 | Number of Equity Shares outstanding at the beginning of the current period = 5,00,000 |
| 2 | Number of Additional Equity Shares issued by way of Bonus = 5,00,000 x 3 = 15,00,000 |
| 3 | Total Number of Equity Shares outstanding i.e. Step 1 + Step 2 = 20,00,000 |
| 4 | Basic EPS for Current Yr = Net Profit for the yr ÷ Total Shares = 1,60,00,000 ÷ 20,00,000 = **Rs. 8.00**. |
| 5 | Adjusted Basic EPS for the previous year = Net Profit for that year ÷ Total Shares<br>= 50,00,000 ÷ 20,00,000 = **Rs. 2.50** |

Since the Bonus Issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the previous reporting period, i.e. the earliest period reported.

**PROBLEM 36 :**

**As on 31-3-2007, the Equity Share Capital of A.S. Ltd. is Rs. 10 Crores divided into Shares of Rs. 10 each. During financial year 2007-08, it has issued Bonus Shares in the ratio of 1 : 1. The Net Profit after Tax for the years 31-3-2007 and 31-3-2008 are Rs. 8.50 Crores and Rs. 11.50 Crores respectively. EPS disclosed in the accounts for two years is Rs. 8.50 and Rs. 5.75 respectively. Comment on the above.**

**SOLUTION : 36**

1. Number of Shares as on 31-3-2007 = Rs. 10 Crores ÷ Rs. 10 = 1 Crore Shares = 100 lakhs Shares
2. Bonus Shares in the ratio 1 : 1 = 100 lakh Shares.
3. Bonus Shares are treated as the Number of Equity Shares outstanding as if the event occurred at the beginning of the earliest period reported. Hence, the number of Equity Shares includes Bonus Shares for both years, and is calculated as under –

| Financial year ending | Adjusted for 31.3.07 | Actual for 31.3.08 |
|---|---|---|
| a. Net Profit attributable to Equity Shareholders (Given) | Rs. 850 lakhs | Rs. 1150 lakhs |
| b. Weighted Average Number of Equity Shares | 200 lakhs Shares | 200 lakhs Shares |
| c. Basic EPS = (1) ÷ (2) | **Rs. 4.25** | **Rs. 5.75** |

4. In the instant case, the adjusted EPS for the previous year should be Rs. 4.25 after considering Bonus issue and not Rs. 8.50 as disclosed in the Accounts.

**PROBLEM 37 :**

**Compute Diluted Earnings Per Share with the following information of A.S. Ltd. Net Profit for the period attributable to Equity Shareholders = Rs. 50 lakhs.**

**Number of Equity Shares outstanding = 10 lakhs**

**Number of 12% Convertible Preference Shares of Rs. 100 each = 50,000 (Each Preference Share is convertible into 8 Equity Shares).**

**Corporate Income-Tax Rate is 30% while Dividend Distribution Tax Rate is 12.5%.**

SOLUTION : 37 **Calculation of Diluted EPS**

| Particulars | Computation | Rs. |
|---|---|---|
| **A. Adjusted Net Profit for Equity Shareholders** | | |
| Net Profit (after Tax Expenses) for the period | Given | Rs. 50,00,000 |
| **Add :** Dividend on Preference Share Capital | 50,000 x 100 x 12% | Rs. 6,00,000 |
| **Add :** Dividend Distribution Tax on Preference Dividend | 6,00,000 x 12.5% | Rs. 75,000 |
| Adjusted Net Profit attributable to Equity Shareholders | | **Rs. 56,75,000** |
| **B. Adjusted Weighted Average Number of Equity Shares** | | |
| Weighted Average Number of Equity Shares | Given | 10,00,000 |
| **Add :** Shares issuable on conversion of Preference Capital | 50,000 x 8 Shares | 4,00,000 |
| Adjusted Weighted Average Number of Equity Shares | | **14,00,000** |
| **C. Calculation of Basic and Diluted EPS** | | |
| Basic EPS = Net Profit ÷ No. of Equity Shares | 50,00,000 ÷ 10,00,000 | Rs. 5.00 |
| Diluted EPS = Adjusted Net Profit ÷ Adjusted No. of ES | 56,75,000 ÷ 14,00,000 | **Rs. 4.05** |

**Note :**

- First ascertain whether Preference Capital is dilutive or anti-dilutive.
- Diluted EPS generally cannot be higher than the Basic EPS.
- Corporate Income – Tax Rate is not relevant here since Pref. Dividend is not a **"Tax Deductible Expense".**

**PROBLEM 38 :**

**A.S. Ltd. has Equity Capital of Rs. 40,00,000 consisting of fully paid Equity Shares of Rs. 10 each. The Net Profit for the year ended 2004-2005 was Rs. 60,00,000. It has also issued 36,000, 10% Convertible Debentures of Rs. 50 each. Each Debenture is convertible into five Equity Shares. Tax rate applicable is 30%. Compute diluted EPS.**

SOLUTION : 38 **Calculation of Basic and Diluted EPS**

| Particulars | Computation | Rs. |
|---|---|---|
| **A. Adjusted Net Profit for Equity Shareholders** | | |
| Net Profit after Tax Expenses for the period (See Note) | Rs. 60 lakhs x (100% - 30%) | 42,00,000 |
| **Add :** Interest on Convertible Debentures | Rs. 50 x 36,000 x 10% | 1,80,000 |
| **Less :** Tax on Interest Expense | Rs. 1,80,000 x 30% | (54,000) |
| Adjusted Net Profit for Equity Shareholders | | **43,26,000** |
| **B. Adjusted Weighted Average Number of Equity Shares** | | |
| Weighted Average Number of Equity Shares | Rs. 40,00,000 ÷ Rs. 10 | 4,00,000 |
| **Add :** Shares issuable on conversion of Debentures | 36,000 x 5 Shares | 1,80,000 |
| Adjusted Weighted Average Number of Equity Shares | | **5,80,000** |

| | | |
|---|---|---|
| **C. Basic and Diluted EPS** | | |
| Basic EPS | 42,00,000 ÷ 4,00,000 | 10.50 |
| Diluted EPS | 43,26,000 ÷ 5,80,000 | **7.46** |

**Note :** It is assumed that the Net Profit of Rs. 60 lakhs as given in the question, is before Tax Expense at 30%. If PAT were taken at Rs. 60 lakhs, the basic and diluted EPS would be Rs. 15 and Rs. 10.56 respectively.

**PROBLEM 39 :**

**Calculate Basic and Diluted EPS of Marthanda Ltd., if –**

**Equity Shares (Rs. 10 each) as at the beginning of the financial year – 50,00,000 Shares,**

**Net Profit for the year – Rs. 2,00,00,000,**

**Issue of Shares for cash on 1st July – 10,00,000 Shares (Rs. 10 each)**

**Issue of Bonus Shares on 1st Oct = 1 : 5 as at the beginning of year, i.e. 10,00,000 Shares.**

**Convertible Debentures outstanding at beginning of the year = 10% Debentures for Rs. 1,00,00,000. Company's Tax Rate is 40%.**

**SOLUTION : 39**

**Computation of Weighted Average Number of Equity Shares :**

| | | | | |
|---|---|---|---|---|
| Opening Bal. | = 50,00,000 Shares for 12 months | = 50,00,000 x 12/12 | = | 50,00,000 |
| Fresh Issue | = 10,00,000 Shares for 9 months (1st Oct to 31st Mar) | = 10,00,000 x 9/12 | = | 7,50,000 |
| Bonus Issue | = 10,00,000 Shares for 12 months (deemed as from the Previous reporting period) | =10,00,000 x 12/12 | = | 10,00,000 |
| | | **Total** | | **67,50,000** |

**Calculation of Basic and Diluted EPS**

| Particulars | Computation | Rs. |
|---|---|---|
| **A. Adjusted Net Profit for Equity Shareholders** | | |
| Net Profit (after Tax Expenses) for the period | Given | Rs. 2,00,00,000 |
| **Add :** Interest on Convertible Debentures | 1,00,00,000 x 10% | Rs. 10,00,000 |
| **Less :** Tax on Interest added back | 10,00,000 x 40% | Rs. (4,00,000) |
| Adjusted Net Profit attributable to Equity Shareholders | | **Rs. 2,06,00,000** |
| **B. Adjusted Weighted Average Number of Equity Shares** | | |
| Weighted Average Number of Equity Shares | As computed above | 67,50,000 |
| **Add :** Shares issuable on conversion of Debentures | Rs. 1,00,00,000 ÷ Rs. 10 | 10,00,000 |
| Adjusted Weighted Average Number of Equity Shares | | **77,50,000** |
| **C. Calculation of Basic ad Diluted EPS** | | |
| **Basic EPS** = Net Profit ÷ No. of Equity Shares | 2,00,00,000 ÷ 67,50,000 | Rs. 2.96 |
| **Diluted EPS** = Adjusted Net Profit ÷ Adjusted No. of ES | 2,06,00,000 ÷ 77,50,000 | **Rs. 2.66** |

**PROBLEM 40 :**

**Should appropriation to mandatory reserves be excluded from net profit attributable to equity shareholders?**

**Kashyap Ltd. is engaged in manufacturing industrial packaging equipment. As per the terms of an agreement entered into with its debentureholders, the company is required to appropriate adequate portion of its profits to a specific reserve over the period of maturity of the debentures such that, at the redemption date, the Reserve constitutes at least half the value of such debentures. As such, appropriations are not available for distribution to the equity shareholders. Kashyap Ltd. has excluded this from the numerator in the computation of basis EPS. Is this treatment correct?**

**SOLUTION : 40**

For the purpose of calculating basic earnings per share, the netprofit or loss for the period attributable to Equity shareholders should be the net profit or loss forthe period after deducting preference dividends and any attributable tax thereto for the period.

With an emphasis on the phrase "attributable to equity shareholders", it may be construed thatamounts appropriated to Mandatory Reserves as described in this case, though not available fordistribution as dividend, are still attributable to equity shareholders.

Therefore, the appropriation made to mandatory reserve created for the redemption of debentureswould be included in the net profit attributable to equity shareholders for the computation of BasicEPS. The treatment made by the company is not correct.

**PROBLEM 41 :**

**A Ltd. had 6,00,000 equity shares on April 1,2007. The company earned a profit of Rs.15,00,000 during the year 2007-08. The average fair value per share during 2007-08 was Rs.25. The company has given share option to its employees of 1,00,000 equity shares at option price of Rs.15. Calculate basic EPS and diluted EPS.**

**SOLUTION : 41 Computation of earnings per share**

| | Earnings | Shares | Earnings per shares |
|---|---|---|---|
| Net profit for the year 2007-08 | Rs.15,00,000 | | |
| Weighted average number of shares outstanding during year 2007-08 | | 6,00,000 | |
| **Basic earnings per share** | | | **Rs.2.50** |
| Number of shares under option | | 1,00,000 | |
| Number of shares that would have been issued at fair value: (100,000 x 15.00)/25.00 | * | (60,000) | |
| **Diluted earnings per share** | Rs.15,00,000 | 6,40,000 | Rs.2.34 (approx) |

* The earnings have not been increased as the total number of shares has been increased only by the number of shares (40,000) deemed for the purpose of the computation to have been issued for no consideration.

**PROBLEM 42 : Compute Basic Earnings per share from the following information:**

| Date | Particulars | No. of shares |
|---|---|---|
| 1st April, 2008 | Balance at the beginning of the year | 1,500 |
| 1st August, 2008 | Issue of shares for cash | 600 |
| 31st March, 2009 | Buy back of shares | 500 |

Net profit for the year ended 31st March, 2009 was Rs.2,75,000.

**SOLUTION : 42**

**Computation of weighted average number of shares outstanding during the period**

| Date | No. of equity shares | Period outstanding | Weights (months) | Weighted average number of shares |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) = (2) x (4) |
| 1st April, 2008 | 1,500 (Opening) | 12 months | 12/12 | 1,500 |
| 1st August, 2008 | 600 (Additional issue) | 8 months | 8/12 | 400 |
| 31st March, 2009 | 500 (Buy back) | 0 months | 0/12 | - |
| | | | | **1,900** |

$$\text{Basic earnings Per Share} = \frac{\text{Net Profit or loss for the attributable to equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$$

$$= \frac{\text{Rs.2,75,000}}{\text{1,900 shares}} = \text{Rs.144.74}$$

**PROBLEM 43 :**

**Net profit after tax including extraordinary profit/losses for the year ended 31st December, 2009 = Rs.2,00,000**

**10% cumulative preference shares of Rs.5,00,000.**

**Number of equity shares = 5,000 shares, Equity shares of Rs.100 each = Rs.5,00,000.**

**Equity dividend declared @ 18%. Corporate dividend tax 15%.**

**Calculate EPS assuming that out of 5,000 equity shares, 2,000 equity shares were issued on 1.7.2009.**

**SOLUTION : 43**

| | | |
|---|---|---|
| Net profit | | Rs.2,00,000 |
| Less: Preference Dividend 5,00,000 x 10% | 50,000 | |
| Corporate Dividend tax 15% | 7,500 | Rs.57,500 |
| Net profit attributable to equity shareholders | | Rs.1,42,500 |

Equity Dividend and Corporate Dividend Tax thereon are not to be considered for calculating EPS. These are not deducted from net profit/loss for the period available for equity Shareholders.

Weighted average number of shares = $3000 \times \frac{12}{12} + 2000 \times \frac{6}{12} = 4,000$

$\therefore$ Basic EPS = $\frac{1,42,500}{4,000}$ = Rs.35.63

**PROBLEM 44:**

**From the following information relating to X Ltd., calculate Diluted Earnings Per Share as per IND AS 33:**

| | |
|---|---|
| Net Profit for the current year | Rs.2,00,00,000 |
| Number of equity shares outstanding | 40,00,000 |
| Basic earnings per share | Rs.5.00 |
| Number of 11% convertible debentures of Rs.100 each | 50,000 |
| Each debenture is convertible into 8 equity shares. | |
| Interest expense for the current year | Rs.5,50,000 |
| Tax saving relating to interest expense (30%) | Rs1,65,000 |

**SOLUTION : 44**

Adjusted Net profit for the current year

2, 00,00,000+5,50,000 - 1,65,000 = Rs.2,03,85,000

Number of equity shares resulting from conversion of debentures

= 50,000 x 8 = 4,00,000 (in number)

Total number of equity shares resulting from conversion of debentures

= 40,00,000 + 4,00,000= 44,00,000 Shares

$\therefore$ Diluted Earnings per share = $\frac{\text{Rs.2,03,85,000}}{44,00,000}$

= Rs.4.63 (Approximately)

**PROBLEM 45 :**

**From the following information compute diluted earnings per share.**

| | |
|---|---|
| **Net profit for the year 2008** | **Rs.12,00,000** |
| **Weighted average number of equity shares outstanding during year 2008** | **5,00,000 shares** |
| **Average fair value of one equity share during the year 2008** | **Rs.20** |
| **Weighted average number of share under option during the year 2008** | **1,00,000 shares** |
| **Exercise price per share under option during the year** | **Rs.15** |

**SOLUTION : 45 Computation of diluted earnings per share**

| | Earnings (Rs.) | Shares | Earning per share(Rs.) |
|---|---|---|---|
| Net profit for the year 2008 | 12,00,000, | | |
| Weighted average number of equity shares outstanding during the year 2008 | | 5,00,000 | |
| Basic earnings per share (12,00,000/5,00,000) | | | 2.40 |
| Weighted average number of shares under option | | 1,00,000 | |
| Number of shares that would have been issued at fair value (1,00,000 x 15.00)/20.00) | * | (75,000) | - |
| Diluted earnings per share (12,00,000/5,25,000) | 12,00,000 | 5,25,000 | 2.29 |

* The earnings have not been increased the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of computation to have issued for no consideration (Para 37(b) of AS 20.)

# IAS 7 STATEMENT OF CASH FLOWS

## 1. INTRODUCTION

The general purpose financial statements are prepared using the accrual basis of accounting.

As a consequence, the timing and certainty of generating cash flows are not considered.

Information about cash flows helps in assessing the ability of an entity to generate cash flows and the effectiveness of their utilization.

Cash flow statements serve the purpose and help the users of Financial Statements to comprehend the relationship between profitability of an entity and its cash generating ability.

## 2. DEFINITIONS

**Cash** comprises cash on hand and demand deposits.

**Cash equivalents** are short term, highly liquid investments that are readily convertible to into known amounts of cash and which are subject to an insignificant risk of changes in value.

**Cash flows** are inflows and outflows of cash and cash equivalents.

**Operating activities** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

**Investing activities** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

**Financing activities** are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

**Cash and cash equivalents**

Cash comprise cash on hand and demand deposits i.e., cash held at banks other than term deposits. Cash equivalents are usually held for the purpose of meeting the short-term cash commitments of the entity. Term deposits that are convertible to known amounts of cash and not subject to insignificant changes in value are cash equivalents.

An investment qualifies as a cash equivalent only when it has a short maturity, generally construed as a period of three months or less from the date of acquisition.

Any investments which can be liquidated within three months at the date of SOFP, acquired originally for holding for a period of more than three months will not be considered as cash and cash equivalents.

Equity instruments, unless acquired within a short period of their maturity and with a specified redemption date, are not cash equivalents.

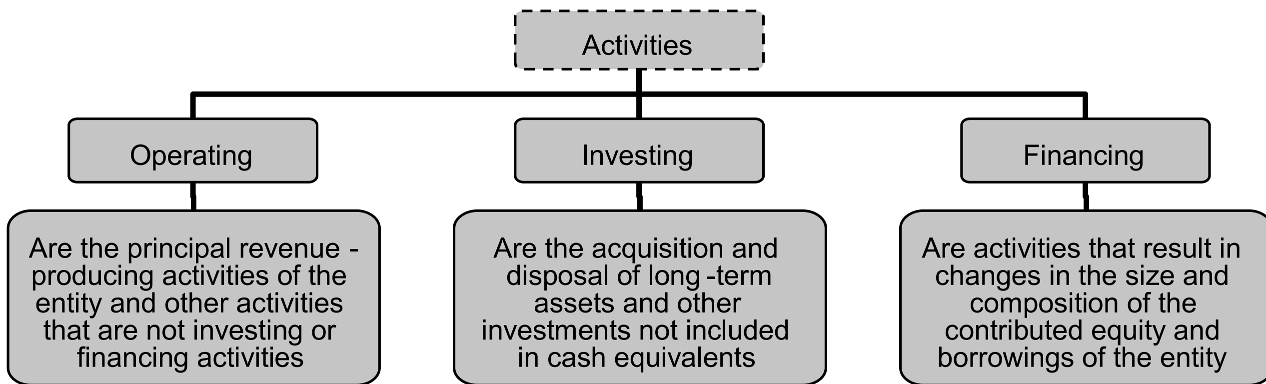
Cash flows exclude movements between items of cash and cash equivalents.

## 3. BANK OVERDRAFTS

Borrowings from banks are normally considered as financing activities. However, bank overdrafts, repayable on demand and forming an integral part of an entity's cash management activities, are classified as cash equivalents, a key feature of such borrowings being frequent fluctuation in balances from being positive to overdrawn.

## 4. PRESENTATION OF STATEMENT OF CASH FLOWS

Cash flows should be classified as cash flows from (i) operating activities, (ii) investing activities and (iii) financing activities.




## 5. OPERATING ACTIVITIES

Operating activities are the principal revenue generating activities of an entity. Cash flows from operating activities indicate the efficiency of operations of an entity to generate cash to repay loans, maintain operating facilities, pay dividends and make fresh investments without external financing.

Examples include

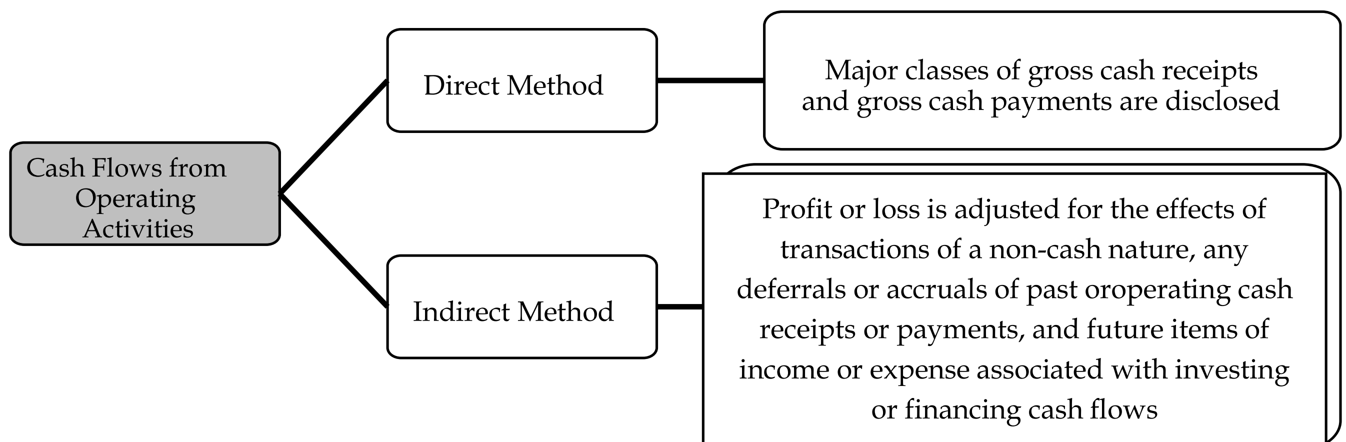
(i) receipts from sale of goods and rendering of services,

(ii) cash payments to suppliers for goods and services.

This classification differs between industries as securities may be held as stock in trade by certain entities making it operating activity whereas normally would be classified as investing activity.

Cash flows from operating activities may be reported either under

- Direct method **or**
- Indirect




## 6. DIRECT METHOD

Under **direct method,** major classes of gross cash receipts and gross cash payments are disclosed.

Details of these can be obtained either

1. From accounting records or
2. By adjusting sales, cost of sales and other items in the income statement for changes in inventories, receivables, payables, other non-cash items and other items of income and expenses classifiable as financing or investing activities.

## 7. INDIRECT METHOD

Under **indirect method,** profit or loss is adjusted for non-cash items, changes in working capital and other items of income and expense that are classifiable as financing or investing activities.

The standard encourages entities to report cash flows from operating activities under direct method since the information provided can be useful in making future projections.

## 8. INVESTING ACTIVITIES

Cash flows from investing activities provide an insight on the expending of the resources of the entity for future generation of cash flows and income.

**Examples include**

(i) cash payments and receipts relating to acquisition and disposal property, plant and equipment, intangibles,and

(ii) cash payments and receipts relating to acquisition and disposal of equity or debt instruments of other entities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

## 9. FINANCING ACTIVITIES

Cash flows from financing activities aids in prediction of claims on future cash flows by providers of capital to the entity.

**Examples include**

(i) cash proceeds from issue of shares or other equity instruments,

(ii) cash payments toowners to acquire or redeem the entity's shares.

## 10. REPORTING OF CASH FLOWS

Cash flows from financing and investing activities are reported on gross basis subject to certain exceptions, which are reported on net basis.

**Cash receipts and payments**

- On behalf of customers where such cash flows reflect the activities of the customer rather than that of the entity,
- For items on which turnover is quick, amounts are large and maturities are shortmay be reported on **net basis** for operating, investing and financing activities.

**Certain cash flows of financial institutions like**

- Cash receipts and payments for acceptance and repayment of deposits with fixed maturity,
- Placement and withdrawal of deposits with other financial institutions and
- Advances and loans made to and repaid by customers may also be reported on **net basis.**

## 11. FOREIGN CURRENCY CASH FLOWS

**Cash flows from foreign currency transactions and cash flows of foreign subsidiaries are translated into entity's functional currency at the reporting date**.

Unrealised gains or losses on account of changes in exchange rates are not cash flows.

However, the effect of changes in exchange rates on cash and cash equivalents held or due in a foreign currency are presented in order to facilitate reconciliation of cash and cash equivalents at the beginning and end of the period.

## 12. INCOME TAXES

Cash flows associated with taxes on income are classified as operating activity unless the cash flows can be directly identified with any financing or investing activity.

**For example, if dividend paid is classified as financing activity, the dividend transaction tax that is directly identifiable with the cash flow is classified under financing activity as well.**

## 13. INVESTMENTS IN SUBSIDIARIES, ASSOCIATES AND JOINT VENTURES

Financial statements in which investments in subsidiaries, associates and/or joint ventures are accounted as per equity method, only the cash flows between the entity and the investee will be shown in cash flow statement. E.g., Dividends from associates.

## 14. CHANGES IN OWNERSHIP INTEREST IN SUBSIDIARY AND OTHER BUSINESSES

- The cash flows that arise to an entity from obtaining or losing control in subsidiary or other businesses is classified as investing activity.
- If the change in ownership does not result in loss of control (i.e. sale of investments without loss of control), cash flows from such transactions shall be classified as financing activities.
- **If there is obtaining or losing control, disclosure of the following should be made:**
  - total consideration paid or received,
  - consideration that is in the form of cash and cash equivalents,
  - amount of cash and cash equivalents over which control is obtained or lost,
  - other assets and liabilities over which control is lost or obtained.

## 15. NON CASH TRANSACTIONS

Non-cash transactions relating to investing and financing activities are not included in the statement of cash flows.

## 16. COMPONENTS OF CASH AND CASH EQUIVALENTS

Components of cash and cash equivalents are presented with a reconciliation of amounts in statement of cash flows with the amount in the SOFP.

Any significant **cash and cash equivalent balances that are not available for use** by the group are also **disclosed** including a commentary on the reasons for non-availability by the management.

## 17. OPTIONAL DISCLOSURES

- The amount of undrawn borrowing facilities indicating restrictions on future use, if any.
- Cash flows representing increase in operating capacity and those required to maintain the operating capacity.
- Cash flows relating to each reportable segments reported

## 18. MAJOR CHANGES IN IND AS 7 VIS-À-VIS IAS 7 NOT RESULTING IN CARVE OUTS

1. ***Interest:*** In case of other than financial entities, IAS 7 gives an option to classify the interest paid and interest and dividends received as item of operating cash flows. Ind AS 7 does not provide such an option and requires these items to be classified as items of financing activity and investing activity, respectively.
2. ***Dividend:*** IAS 7 gives an option to classify the dividend paid as an item of operating activity. However, Ind AS 7 requires it to be classified as a part of financing activity only.

## 19. PROBLEMS FOR SELF-PRACTICE

**QUESTION 1 :**

**Company has provided the following information regarding the various assets held by company on 31st March 2017. Find out, which of the following items will be part of cash and cash equivalents for the purpose of preparation of cash flow statement as per the guidance provided in IAS 7:**

| Sr. No. | Name of the Security | Additional Information |
|---|---|---|
| 1. | Government Bonds | 5%, open ended, main purpose was to park the excess funds for temporary period |
| 2. | Fixed deposit with SBI | 12%, 3years maturity on 1st Jan 2020 |
| 3. | Fixed deposit with HDFC | 10%, original term was for 2 years, but due for maturity on 30.06.2017 |
| 4. | Redeemable Preference shares in ABC ltd | The redemption is due on 30th April 2017 |

| 6. | Cash balances at various banks | All international branches of Indian banks |
|---|---|---|
| 7. | Cash balances at various banks | Branches of foreign banks outside India |
| 8. | Bank overdraft of SBI Fort branch | Temporary O/d, which is payable on demand |
| 9. | Overdraft facility for working capital purpose | Maximum permissible limit sanctioned by the bank |
| 10. | Treasury Bills | 90 days maturity |
| 11. | Units in Mutual funds | Open ended scheme. Main purpose was to reap short term gains by leveraging the dip in the capital market. |

**SOLUTION : 1**

| S. No. | Name of the Security | Additional Information | Decision |
|---|---|---|---|
| 1. | Government Bonds | 5%, open ended, main purpose was to park the excess funds for temporary period | Included as intention is not to hold long term |
| 2. | Fixed deposit with SBI | 12%, 3years maturity on 1st Jan 2020 | Not to be considered – long term |
| 3. | Fixed deposit with HDFC | 10%, original term was for 2 years, but due for maturity on 30.06.2017 | Include as due in 90 days |
| 4. | Redeemable Preference shares in ABC ltd | The redemption is due on 30th April 2017 | Include as due in 90 days |
| 5. | Cash balances at various banks | All branches of all banks in India | Include |
| 6. | Cash balances at various banks | All international branches of Indian banks | Include |
| 7. | Cash balances at various banks | Branches of foreign banks outside India | Include |
| 8. | Bank overdraft of SBI Fort branch | Temporary O/d, which is payable on demand | Include |
| 9. | Overdraft facility for working capital purpose | Maximum permissible limit sanctioned by the bank | Do not include as it is credit facility |
| 10. | Treasury Bills | 90 days maturity | Include |
| 11. | Units in Mutual funds | Open ended scheme. Main purpose was to reap short term gains by leveraging the dip in the capital market. | Include as intention is not to hold for long period. |

**QUESTION 2 :**

**From the following transactions, identify which transactions will be qualified for the calculation of operating cash flows, if company is into the business of trading of mobile phones**

| Sr. No. | Nature of Transaction |
|---|---|
| 1 | Receipt from sale of mobile phones |
| 2 | Purchases of mobile phones from various companies |
| 3 | Employees expenses paid |

| | |
|---|---|
| **4** | **Advertisement expenses paid** |
| **5** | **Credit sales of mobile** |
| **6** | **Misc. charges received from customers for repairs of mobiles** |
| **7** | **Warranty claims received from the companies** |
| **8** | **Loss due to decrease in market value of the closing stock of old mobile phones** |
| **9** | **Payment to suppliers of mobile phones** |
| **10** | **Depreciation on furniture of sales showrooms** |
| **11** | **Interest paid on cash credit facility of the bank** |
| **12** | **Profit on sale of old computers and printers, in exchange of new laptop and printer** |
| **13** | **Advance received from customers** |
| **14** | **Sales Tax and excise duty paid** |
| **15** | **Proposed dividend for the current financial year** |

**SOLUTION : 2**

| Sr. No. | Nature of Transaction | Included / Excluded with reason |
|---|---|---|
| 1 | Receipt from sale of mobile phones | Include – main revenue generating activity |
| 2 | Purchases of mobile phones from various companies | Include – expenses related to main operations of business |
| 3 | Employees expenses paid | Include – expenses related to main operations of business |
| 4 | Advertisement expenses paid | Include – expenses related to main operations of business |
| 5 | Credit sales of mobile | Do not include – Credit transaction will not be included in cash flow (receipts from customers will be included) |
| 6 | Misc. charges received from customers for repairs of mobiles | Include – supplementary revenue generating activity |
| 7 | Warranty claims received from the companies | Include – supplementary revenue generating activity |
| 8 | Loss due to decrease in market value of the closing stock of old mobile phones | Do not include - Non cash transaction |
| 9 | Payment to suppliers of mobile phones | Include – cash outflow related to main operations of business |
| 10 | Depreciation on furniture of sales showrooms | Do not include – non cash item |
| 11 | Interest paid on cash credit facility of the bank | Do not include – cost of finance |
| 12 | Profit on sale of old computers and printers, in exchange of new laptop and printer | Do not include – non cash item |
| 13 | Advance received from customers | Include – Related to operations of business |
| 14 | Sales tax and excise duty paid | Include – related to operations of business |
| 15 | Proposed dividend for the current financial year | Do not include – cost of finance |

**QUESTION 3 :**

**From the following transactions taken from a private sector bank operating in India, identify which transactions will be classified as operating and which would be classified as Investing activity.**

| S. No. | Nature of transaction paid |
|---|---|
| 1 | Interest received on loans |
| 2 | Interest paid on Deposits |
| 3 | Deposits accepted |
| 4 | Loans given to customers |
| 5 | Loans repaid by the customers |
| 6 | Deposits repaid |
| 7 | Commission received |
| 8 | Lease rentals paid for various branches |
| 9 | Service tax paid |
| 10 | Furniture purchased for new branches |
| 11 | Implementation of upgraded banking software |
| 12 | Purchase of shares in 100% subsidiary for opening a branch in Abu Dhabi |
| 13 | New cars purchased from Honda dealer, in exchange of old cars |
| 14 | Provident fund paid for the employees |
| 15 | Issued employee stock options |

**SOLUTION : 3**

| Sr. No. | Nature of transaction paid | Operating / Investing / Not to be considered |
|---|---|---|
| 1 | Interest received on loans | Operating – Main revenue generating activity |
| 2 | Interest paid on Deposits | Operating – Main expenses of operations |
| 3 | Deposits accepted | Exclude – financing activity |
| 4 | Loans given to customers | Operating – in case of financial institutes |
| 5 | Loans repaid by the customers | Operating – in case of financial institutes |
| 6 | Deposits repaid | Exclude – Financing activity |
| 7 | Commission received | Operating – Main revenue generating activity |
| 8 | Lease rentals paid for various branches | Operating – Main expenses of operations |
| 9 | Service tax paid | Operating – Main expenses of operations |
| 10 | Furniture for new branches | Investing – Assets purchased |
| 11 | Implementation of upgraded banking software | Investing – Purchased for long term purpose |
| 12 | Purchase of shares in 100% subsidiary for opening a branch in Abu Dhabi | Investing – strategic investment |
| 13 | New cars purchased from Honda dealer, in exchange of old cars | Investing |
| 14 | Provident fund paid for the employees | Operating |
| 15 | Issued employee stock options | Not to be considered. No cash flow |

**QUESTION 4 :**

**From the following transactions taken from a parent company having multiple businesses and multiple segments, identify which transactions will be classified as operating Investing and Financing:**

| S. No. | Nature of transaction |
|---|---|
| 1 | Issued preference shares |
| 2 | Purchased the shares of 100% subsidiary company |
| 3 | Dividend received from shares of subsidiaries |
| 4 | Dividend received from other companies |
| 5 | Bonus shares issued |
| 6 | Purchased license for manufacturing of special drugs |
| 7 | Royalty received from the goods patented by the company |
| 8 | Rent received from the let out building (letting out is not main business) |
| 9 | Interest received from the advances given |
| 10 | Dividend paid |
| 11 | Interest paid on security deposits |
| 12 | Purchased goodwill |
| 13 | Acquired the assets of a company by issue of equity shares ( not parting any cash) |
| 14 | Interim dividends paid |
| 15 | Dissolved the 100% subsidiary and received the amount in final settlement |

**SOLUTION : 4**

| S. No. | Nature of transaction | Operating / Investing / Financing /Not to be considered |
|---|---|---|
| 1 | Issued preference shares | Financing |
| 2 | Purchased the shares of 100% subsidiary company | Investing |
| 3 | Dividend received from shares of subsidiaries | Investing / operating |
| 4 | Dividend received from other companies | Investing / operating |
| 5 | Bonus shares issued | No cash flow |
| 6 | Purchased license for manufacturing of special drugs | Investing |
| 7 | Royalty received from the goods patented by the company | Operating |
| 8 | Rent received from the let out building (letting out is not main business) | Investing |
| 9 | Interest received from the advances given | Operating |
| 10 | Dividend paid | Financing / operating |
| 11 | Interest paid on security deposits | Financing / operating |
| 12 | Purchased goodwill | Investing |
| 13 | Acquired the assets of a company by issue of equity shares ( not parting any cash) | Not to be considered |
| 14 | Interim dividends paid | Financing / operating |
| 15 | Dissolved the 100% subsidiary and received the amount in final settlement | Investing |

**QUESTION 5 :**

**Find out the cash from operations by direct method and indirect method from the following information:**

**Operating statement of ABC Co for the year ended 31.3.2017**

| Particular | INR |
|---|---|
| Sales | 500,000.00 |
| Less : Cost of goods sold | 350,000.00 |
| Administration & Selling Overheads | 55,000.00 |
| Depreciation | 7,000.00 |
| Interest Paid | 3,000.00 |
| Loss on sale of asset | 2,000.00 |
| Profit before tax | 83,000.00 |
| Tax | (30,000.00) |
| Profit After Tax | 53,000.00 |

**SOFP as on 31st March**

| | 2017 | 2016 |
|---|---|---|
| Equity and Liabilities | | |
| Shareholders' Funds | 60,000.00 | 50,000.00 |
| Non-current Liabilities | 25,000.00 | 30,000.00 |
| Current Liabilities | | |
| Creditors | 12,000.00 | 8,000.00 |
| Creditors for Expenses | 10,000.00 | 7,000.00 |
| Provisions | 8,000.00 | 5,000.00 |
| Total | 115,000.00 | 100,000.00 |
| Assets Fixed Assets | 75,000.00 | 65,000.00 |
| Investment | 12,000.00 | 10,000.00 |
| Current Assets | | |
| Inventories | 12,000.00 | 13,000.00 |
| Debtors | 10,000.00 | 7,000.00 |
| Cash | 6,000.00 | 5,000.00 |
| Total | 115,000.00 | 100,000.00 |

**SOLUTION : 5**

**1. Cash flow from Operations by Direct Method**

| Particulars | ₹ | See Note |
|---|---|---|
| Cash Sales | 497,000.00 | 1 |
| *Less:* Cash Purchases | 345,000.00 | 2 |
| Overheads | 52,000.00 | 3 |
| Interest | - | Financing |

| | | |
|---|---|---|
| Depreciation | - | Non cash item |
| Loss | - | Non cash item |
| ***Cash profit*** | **100,000.00** | |
| *Less:* Tax | 30,000.00 | |
| **Cash profit after tax** | **70,000.00** | |
| **Note No 1 - Cash Receipts from Sales and debtors** | | |
| **Particulars** | **₹** | |
| Sales | 500,000.00 | |
| *Add :* Opening Debtors | 7,000.00 | |
| *Less :* Closing Debtors | (10,000.00) | |
| **Cash Receipts** | **497,000.00** | |
| **Note No 2 :- Payment to creditors for Purchases** | | |
| **Particulars** | **₹** | |
| COGS | 350,000.00 | |
| Closing stock | 12,000.00 | |
| Less: Opening stock | (13,000.00) | |
| Purchases | 349,000.00 | |
| *Add:* Opening creditors | 8,000.00 | |
| *Less:* Closing creditors | (12,000.00) | |
| **Payment to creditors** | **345,000.00** | |
| **Note No 3 :- Payment to creditors for Expenses** | | |
| **Particulars** | **₹** | |
| Overheads | 55,000.00 | |
| *Add:* Opening | 7,000.00 | |
| *Less:* Closing creditors | (10,000.00) | |
| **Payment for O/Ds** | **52,000.00** | |

## 2. Cash flow from Operations by Indirect Method

| **Indirect Method** | **₹** |
|---|---|
| Profit After Tax | 53,000.00 |
| *Add/(Less) :* Depreciation | 7,000.00 |
| Loss on Asset | 2,000.00 |
| Interest paid | 3,000.00 |
| Decrease in Inventory | 1,000.00 |
| Increase in Debtors | (3,000.00) |
| Increase in Creditors | 4,000.00 |
| Increase in Creditors for expenses | 3,000.00 |
| **Total** | **70,000.00** |

**Note:** Cash flow derived from operations ₹ 70,000 is same both from Direct Method and Indirect Method.

**QUESTION 6 :**

**A firm invests in a five year bond of another company with a face value of ₹ 10,00,000 by paying ₹ 5,00,000. The effective rate is 15%. The firm recognises proportionate interest income in its income statement throughout the period of bond.**

**Based on the above information answer the following question:**

a) **How the interest income will be treated in cash flow statement during the period of bond?**

b) **On maturity, whether the receipt of ₹ 10,00,000 should be split between interest income and receipts from investment activity.**

**SOLUTION : 6**

Interest Income will be treated as income over the period of bond in the income statement. However, there will be no cash flow in these years because no cash has been received. On maturity, receipt of ₹ 10,00,000 will be classified as investment activity with a bifurcation of interest income & money received on redemption of bond.

**QUESTION 7 :**

**X Limited has paid an advance tax amounting to 5,30,000/- during the current year. Out of the above paid tax, 30,000 is paid for tax on long term capital gains.**

**Under which activity the above said tax be classified in the cash flow statements of X Limited?**

**SOLUTION : 7**

Cash flows arising from taxes on income should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. In the case of X Limited, the tax amount of 30,000 is specifically related with investing activities.

Rs 5,00,000 to be shown under operating activities. 30,000 to be shown under investing activities.

**QUESTION 8 :**

**X Limited acquires fixed asset of Rs 10,00,000 from Y Limited by accepting the liabilities of Rs 8,00,000 of Y Limited and balance amount it paid in cash. How X Limited will treat all those items in its cash flow statements?**

**SOLUTION : 8**

Investing and financing transactions that do not require the use of cash and cash equivalents shall be excluded from a statement of cash flows. X Limited should classify cash payment of Rs 2,00,000 under investing activities. The non-cash transactions – liabilities and asset should be disclosed in the notes to the financial statements.

**QUESTION 9 :**

**An entity has bank balance in foreign currency aggregating to USD 100 (equivalent to ₹ 4,500) at the beginning of the year. Presuming no other transaction taking place, the entity reported a profit before tax of ₹ 100 on account of exchange gain on the bank balance in foreign currency at the end of the year. What would be the closing cash and cash equivalents as per the SOFP?**

**SOLUTION : 9**

For the purpose of statement of cash flows, the entity shall present the following:

| | **Amount INR** |
|---|---:|
| Profit before tax | 100 |
| Less: Unrealised exchange gain | (100) |
| Cash flow from operating activities | Nil |
| Cash flow from investing activities | Nil |
| Cash flow from financing activities | Nil |
| Net increase in cash and cash equivalents during the year | Nil |

| | |
|---|---:|
| Add: Opening balance of cash and cash equivalents | 4,500 |
| Cash and cash equivalents as at the year end | 4,500 |
| **Reconciliation of cash and cash equivalents** | |
| Cash and cash equivalents as per statement of cash flows | 4,500 |
| Add: Unrealised gain on cash and cash equivalents | 100 |
| Cash and cash equivalents as per the SOFP | 4,600 |

**QUESTION 10 :**

**Use the following data of ABC Ltd. to construct a statement of cash flows using the direct and indirect methods:**

**(Amount in INR)**

| | 20X2 | 20X1 |
|---|---:|---:|
| Cash | 4,000 | 14,000 |
| Accounts Receivable | 25,000 | 32,500 |
| Prepaid Insurance | 5,000 | 7,000 |
| Inventory | 37,000 | 34,000 |
| Fixed Assets | 3,16,000 | 2,70,000 |
| Accumulated Depreciation | (45,000) | (30,000) |
| Total Assets | 3,42,000 | 3,27,500 |
| Accounts Payable | 18,000 | 16,000 |
| Wages Payable | 4,000 | 7,000 |
| Debentures | 1,73,000 | 1,60,000 |
| Equity Shares | 88,000 | 84,000 |
| Retained Earnings | 59,000 | 60,500 |
| Total Liabilities & Equity | 3,42,000 | 3,27,500 |
| | 20X2 | |
| Sales | 2,00,000 | |
| Cost of Goods Sold | (1,23,000) | |
| Depreciation | (15,000) | |
| Insurance Expense | (11,000) | |
| Wages | (50,000) | |
| Net Profit | 1,000 | |

**During the financial year 20X2 company ABC Ltd. declared and paid dividends of ` 2,500.**

**During 20X2, ABC Ltd. paid ` 46,000 in cash to acquire new fixed assets. The accounts payable was used only for inventory. No debt was retired during 20X2.**

**SOLUTION : 10**

## A. DIRECT METHOD

| **Cash flows from operating activities** | | **20X2** |
|---|---:|---:|
| Cash received from customers | 2,07,500 | |
| Cash paid for inventory | (1,24,000) | |
| Cash paid for insurance | (9,000) | |
| Cash paid for wages | (53,000) | |

| | | |
|---|---|---|
| *Net cash flow from operating activities* | | 21,500 |
| **Cash flows from investing activities** | | |
| Purchase of fixed assets | | (46,000) |
| **Cash flows from financing activities** | (2,500) | |
| Dividend paid | 13,000 | |
| Proceeds from issuance of debentures | 4,000 | |
| Proceeds from issue of equity | | |
| *Net cash flows from financing activities* | | 14,500 |
| **Net decrease in cash and cash equivalents** | | **(10,000)** |
| **Opening Cash Balance** | | **14,000** |
| **Closing Cash Balance** | | **4,000** |

**B. INDIRECT METHOD**

| **Cash flows from operating activities** | | **20X2** |
|---|---|---|
| Net Profit | 1,000 | |
| Adjustments for Depreciation | 15,000 | |
| | 16,000 | |
| Decrease in accounts receivable | 7,500 | |
| Decrease in prepaid insurance | 2,000 | |
| Increase in inventory | (3,000) | |
| Increase in accounts payable | 2,000 | |
| Decrease in wages payable | (3,000) | |
| *Net cash flow from operating activities* | | 21,500 |
| **Cash flows from investing activities** | | |
| Purchase of fixed assets | | (46,000) |
| **Cash flows from financing activities** | | |
| Dividend paid | (2,500) | |
| Proceeds from issue of debentures | 13,000 | |
| Proceeds from issue of equity | 4,000 | |
| *Net cash flows from financing activities* | | 14,500 |
| **Net decrease in cash and cash equivalents** | | **(10,000)** |
| **Opening Cash Balance** | | **14,000** |
| **Closing Cash Balance** | | **4,000** |

**Working notes:** **Fixed Assets Account**

| Particulars | Amount (₹) | Particulars | Amount (₹) |
|---|---|---|---|
| To balance b/d | 2,70,000 | By balance c/d | 3,16,000 |
| To Cash (Purchase of Fixed Assets) | 46,000 | | |
| | 3,16,000 | | 3,16,000 |

**Inventory Account**

| Particulars | Amount (₹) | Particulars | Amount (₹) |
|---|---|---|---|
| To balance b/d<br>To Creditors account (credit purchase) | 34,000<br>2,000<br>1,24,000 | By Cost of goods sold<br>By Balance c/d | 1,23,000<br>37,000 |
| To Purchase (Bal. Figure) | 1,60,000 | | 1,60,000 |

### Accounts Payable Account

| Particulars | Amount (₹) | Particulars | Amount (₹) |
|---|---|---|---|
| To Balance b/d | 18,000 | By Balance b/d<br>By Inventory Account (credit purchase) (Bal.Fig.) | 16,000<br>2,000 |
| | 18,000 | | 18,000 |

### Equity Share Capital Account

| Particulars | Amount (₹) | Particulars | Amount (₹) |
|---|---|---|---|
| To Bal. c/d | 88,000 | By Balance b/d<br>By Bank account (Proceeds from equity share issued) | 84,000<br>4,000 |
| | 88,000 | | 88,000 |

**QUESTION 11 :**

**From the following summary cash account of XYZ Ltd, prepare cash flow statement for the year ended March 31, 20X1 in accordance with IAS 7 using direct method.**

**Summary of Bank Account for the year ended March 31, 20X1**

| | ₹ '000 | | ₹ '000 |
|---|---|---|---|
| **Balance on 1.4.20X0** | **50** | **Payment to creditors** | **2,000** |
| **Issue of Equity Shares** | **300** | **Purchase of Fixed Assets** | **200** |
| **Receipts from customers** | **2,800** | **Overhead Expenses** | **200** |
| **Sale of Fixed Assets** | **100** | **Payroll** | **100** |
| | | **Tax Payment** | **250** |
| | | **Dividend** | **50** |
| | | **Repayment of Bank loan** | **300** |
| | | **Balance on 31.3.20X1** | **150** |
| | **3,250** | | **3,250** |

**SOLUTION : 11**

**XYZ Ltd.**

Cash Flow Statement for the year ended March 31, 20X1 (Using the Direct Method)

| **Cash flows from operating activities** | ₹ '000 | ₹ '000 |
|---|---|---|
| Cash receipts from customers | 2,800 | |
| Cash payments to suppliers | (2,000) | |
| Cash paid to employees | (100) | |
| Cash payments for overheads | (200) | |

| | | |
|---|---:|---:|
| Cash generated from operations | 500 | |
| Income tax paid | (250) | |
| Net cash from operating activities | | 250 |
| **Cash flow from investing activities** | | |
| Payments for purchase of fixed assets | (200) | |
| Proceeds from sale of fixed assets | 100 | |
| Net cash used in investing activities | | (100) |
| **Cash flows from financing activities** | | |
| Proceeds from issuance of equity shares | 300 | |
| Bank loan repaid | (300) | |
| Dividend paid | (50) | |
| *Net cash used in financing activities* | | (50) |
| **Net increase in cash** | | **100** |
| **Cash at the beginning of the period** | | **50** |
| **Cash at end of the period** | | **150** |

**QUESTION : 12**

**How would an entity apply IAS 7 in classifying the following :**

**A term deposit was made as on 15th December amounting to Rs. 10 crore for a period of 6 months. The reporting date is on 31st March**

**Remaining maturity of the fixed deposit is less than 3 months.**

**SOLUTION : 12**

An investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. [Paragraph 7, IAS 7]

Accordingly, the term deposit is classified as cash outflows from investment activities.

Investment in shares are normally excluded from cash equivalents since it does not satisfy insignificant risk feature. However, Paragraph 7 of IAS 7 states that preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preference shares acquired within a short period of their maturity and with a specified redemption date.

**QUESTION : 13**

**X Ltd purchased a tradable bond having a maturity period of 2 years (from the date of its issue) on 15 December 2015. The bond was due for maturity on 28 February 2016. In its cash flow statement presented for the quarter ended 31 December 2015, X Ltd included the same in cash and cash equivalent. Please give your views on the same.**

**SOLUTION : 13**

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Para 7 of the standard further states that cash equivalents are held for the purposes of meeting short-term cash commitments rather than for investment or other purposes.

In the given scenario, X Ltd has made the investment in bond for investment purposes. Though it meets the condition of a cash equivalent (ie, readily convertible into known amounts of cash), it is not held for the purposes of meeting short-term cash Commitments.

**QUESTION : 14**

**X Ltd had a cash balance of Rs 1,00,000 as on 30 September 2017. On 15 October 2017, X Ltd used the cash balance to purchase a short-term bank deposit with a maturity of 3 months. How should this be shown in the statement of cash flow to be prepared for the quarter ended 31 December 2017?**

**SOLUTION : 14**

As per Para 9, cash flows exclude movements between items that constitute cash or cash equivalents as these components are part of cash management of an entity, rather than part of its operating, investing and financing activities.

The purchase of the short-term bank deposit is therefore not shown in the statement of cash flows.

**QUESTION : 15**

**X Ltd acquired machinery under a finance lease costing Rs 10 lakh. During the year ended 31 March 2017, X Ltd paid an installment of Rs 3 lakh, comprising Rs 2 lakh of interest and Rs 1 lakh as repayment of the principal amount of the loan. How should the installment payment be reflected in the statement of cash flow for the period ended 31 March 2018?**

**SOLUTION : 15**

Para 12 of the standard recommends different classification of cash flows for a single transaction. In the instant case, in the statement of cash flows for the period ended 31 March 2018, X Ltd should classify the interest element as cash flows from financing activities and repayment of loan should be treated as investing activity (represents payments for purchase of the machinery).

**QUESTION : 16**

**X Ltd invested Rs 1,00,000 in the equity instruments of Y Ltd. Y Ltd is a listed entity and the equity instruments are actively traded in the stock exchanges and as a result they are easily and readily convertible into cash. In its cash flow statements, X Ltd classified this investment as cash equivalent. Please give your views on the same.**

**SOLUTION : 16**

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Equity instruments which are actively traded in market may be readily convertible into cash, but the cash is generally not known as these instruments are subject to significant risk in changes in value.

X Ltd should therefore not classify investments in equity instruments as cash equivalents.

**QUESTION : 17**

**How is bank overdraft and cash credit presented in the statement of cash flows under IAS 7?**

**SOLUTION : 17**

Bank overdraft facility is granted by bank usually for a short period to accommodate short-term fund requirement. Overdraft facilities are linked with the operations in current account. Overdraft facility may either be clean (unsecured) or may be secured by tangible assets.

Cash credit is a fund-based facility granted by a bank to its customer to finance working capital requirements on a continuing basis, It is a secured facility, usually secured by tangible assets or/ and hypothecation of receivables.

IAS 7 provides that bank borrowings are usually considered part of the financing activities. However, where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents.

Cash credit from bank, a facility on a continuing basis, is considered as a part of financing activities.

**QUESTION : 18**

**X Ltd purchased machinery for USD $10,000 and recognised the machinery the financial statements on the date when the machinery was delivered. The exchange rate on that date was $1 = Rs 40. Subsequently, when the payment was settled after 30 days, the exchange rate was $1 = Rs 50, thereby leading to an exchange loss $1 = Rs 10.**

**(a) How the transaction should be classified in the cash flow statement?**

**(b) Would your answer be different if X Ltd is in the business of purchasing and selling machinery?**

SOLUTION : 18

(a) Cash flows arising from transactions in a foreign currency shall be recorded in the entity's functional currency (in this case the 'INR') by applying to foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.

X Ltd should classify the payment of Rs 5,00,000 ($10,000 x Rs 50) in the statement of cash flows as an Investing activity.

(b) If the business of X Ltd is to purchase and sell machinery, then purchase of machinery will be an operating activity of X Ltd and accordingly the cash flows relating to the same will be classified as operating activities.

**QUESTION : 19**

**X Ltd has a foreign currency cash balance of USD 1,000 as on 31 March 2017, This foreign currency was purchased when the exchange rate was $1 —Rs 40. As on 31 March 2018, assuming the exchange rate to be $1=Rs 45, how would you account for this change in the statement of cash flow for the period ended 31 March 2018?**

SOLUTION : 19

As per Para 28, unrealised gains and losses arising from changes in foreign currency exchange rates are NOT cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and end of the period. This amount is presented separately from cash flows from operating, investing and financing activities.

X Ltd will prepare the cash flow statement as follows:

(Extracts of cash flow statement of X Ltd)

| | |
|---|---|
| Net cash flow from opera ting activities (a) | XX |
| Net cash flow from investing activities (b) | XX |
| Net cash flow from financing activities (c) | XX |
| Increase in cash and cash equivalents during the period (d=a+b+c) | XXX |
| Exchanges gain in respect of cash in foreign currency ($1,000 x Rs 5)(e) | Rs 5000 |
| Net increase in cash and cash equivalents during the period [d + e] | XXX |
| Add : opening balance of cash and cash equivalents | XX |
| Closing balance of cash and cash equivalents (including foreign currency cash balance at the closing rate $1 = Rs 45) | XXX |

**QUESTION : 20**

**X Ltd is a parent company of Y Ltd and holds 75% of the voting power of Y Ltd. During the year ended 31 March 2018, ie, 2017-18, X Ltd sold 15% of its stake in Y Ltd. thereby reducing its holding in Y Ltd to 60%.**

(a) **How will the proceeds received be classified in the cash flow statement of X Ltd for the period ended 31 March 2018?**

| | |
|---|---|
| (b) | **Would your answer be different if Y Ltd sold 30% of its stake in Y Ltd (instead of 15%), thereby reducing its holding in Y Ltd to 45%?** |
| (c) | **Would your answers to questions (a) and (b) above be different, if X Ltd were to be an investment entity as defined in IFRS 10 'Consolidated Financial Statements'?** |

**SOLUTION : 20**

(a) As per Paras 42A and 42B of IAS 7, changes in the cash flows that do not result in a loss of control, such as a subsequent purchase or sale by a parent of the subsidiary's equity instruments, are accounted for as equity transactions. Accordingly, the resultant cash flows are classified in the same way as other transactions with owners as financing activities.

Hence, cash proceeds received from sale of 15% stake in subsidiary Y Ltd, not leading to loss of control, shall be classified as financing activities in the statement of cash flows prepared by X Ltd for the period ending 31 March 2018.

(b) As per Para 39 of the Standard, the aggregate cash flows arising from obtaining or losing control of subsidiaries or other business shall be presented separately and classified as investing activities.

Hence, cash proceeds received, from sale of 30% stake in subsidiary Y Ltd leading to loss of control, shall be classified as investing activities in the statement of cash flows prepared by X Ltd for the period ending 31 March 2018.

(c) Para 39 of the Standard requiring cash proceeds received from sale of stake leading to loss of control in a subsidiary to be classified as investing activity whether or not the parent entity is an investment entity.

Similarly Paras 42A and 42B requiring cash proceeds received from sale of stake, not leading in a subsidiary to be classified as financing activity unless the subsidiary is held by an investment entity as defined in IFRS10 and is required to be measured at fair value through profit and loss.

Hence, if the X Ltd were to be an investment entity, then sale of stake in Y Ltd, whether or not leading to loss of control, shall be classified as an investment activity.

**QUESTION : 21**

**What are the examples of cash flows arising from taxes on income to be separately disclosed under cash flows from investing or financing activities?**

**SOLUTION : 21**

Cash flows arising from taxes on income shall be separately disclosed and classified as cash flow from operating activities, unless they can be specifically identified with financing and investing activities. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in the statement of cash flows. While tax expense may be identified with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of underlying transaction. Therefore, taxes paid are usually classified as cash flows from operating activities.

Example: If we strictly go by classification of taxes in accordance with the nature of the related transaction, tax impact of short-term capital gain should be classified as investing activity. Suppose, the entity is incurring business losses, the same gets adjusted against short-term capital gain for tax purposes. Accordingly, showing tax impact of short-term capital gain and business losses separately is impracticable. Therefore, tax paid is usually classified as cash flows from operating activity. However, where it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows, tax cash flows are classified as investing or financing activities. Examples: tax pavement by way of long-term capital gain on sale of land which was used as property, plant and equipment (PPE), tax payment on dividend received from a foreign company shall be classified as investing activity. Similarly, dividend distribution tax under section 1 15-0 of Income Tax Act, 1961 viz., and preference and equity dividend distribution tax is considered as an integral part of financing activities.

**QUESTION : 22**

**A Ltd. purchased fixed assets from USA for $ 50,000 on 1-10-2017. It entered into currency option contract for purchase of foreign exchange to pay for fixed assets and paid a premium of Rs. 25,000. How will you classify such premium in cash flow statement of A Ltd.**

**(a) Operating Activities**

**(b) Investing Activities**

**(c) Financing Activities**

**(d) None of the these**

**SOLUTION : 22**

Investing Activities

# IAS 34 — INTERIM FINANCIAL REPORTING

## 1. INTRODUCTION

In view of increasing density in the transactions and size of business organisations, the need for reporting of financial and operating activities at regular intervals becomes indispensable.

Many jurisdictional authorities also require listed companies to submit unaudited interim financial reports. In order to bring uniformity in such reports; the standard prescribes certain procedures vis-a- vis minimum components to be reported along with the content, form and the recognition criteria.

## 2. DEFINITIONS

- **Interim period** is a financial reporting period shorter than a full financial year.
- **Interim financial report** means a financial report containing either a complete set of financial statements (as described in IAS 1) or a set of condensed financial statements (as described in this standard) for an interim period

## 3. RECOGNITION AND MEASUREMENT

Interim period is a financial reporting period shorter than a full financial year. The recognition and measurement should be done on a **"year to date basis",** i.e. from the first day of the fiscal year to given interim date.

The recognition criteria should be similar to that of annual accounts except that the measurement for IFR should be on a **"year to date"** basis.

## 4. ACCOUNTING POLICIES

The accounting policies adopted for preparation of **Interim Financial Report (IFR)** cannot be different from that adopted for annual accounts. If the entity does not comply with IAS 34 then the same shall be disclosed.

The same accounting policies applied for annual financial statements should be applied in preparation of interim financial statements. To achieve this objective, measurement for interim reporting purposes shall be made on a year-to-date basis.

An entity is not prohibited to make out interim financial statements without compliance of some IFRS, but shall state that it complies with all IFRS **only** when it meets all the requirements of all of the IFRSs.

## 5. RECOGNITION OF TAX EXPENSE

One exception is in recognition of tax expense which requires recognition based on best estimate of the weighted average effective Income tax rate expected for the full financial year.

**PROBLEM 1 :**

**At the end of quarter 1, a company estimated that 20% of its annual profit would be earned and taxed in USA. Tax rates in USA and India are 30% and 40% respectively. The proportion of US income was re-estimated at 25% at the end of quarter 2. Company's profit before tax for quarter 1 and quarter 2 were Rs. 50 lakh and Rs. 30 lakh respectively. Compute after tax profits for the quarters.**

**SOLUTION 1 :**

Average annual effective tax rate = Weighted average of US and Indian tax rate

Quarter 1 (Effective annual tax rate) = 0.80 x 40 + 0.20 x 30 = 38%

Tax expense for quarter 1 = 38% of Rs. 50 lakh = Rs 19 lakh

Quarter 2 : (Effective annual tax rate re-estimated on year to date basis

= 0.75 x 40 + 0.25 x 30 = 37.5%

Tax expense for quarter 2

= 37.5% of (Rs. 50 lakh + Rs. 30 lakh) – Tax expense recognized in quarter 1

= Rs. 30 lakh – Rs. 19 lakh = Rs. 11 lakh

| | Quarter 1 | Quarter 2 |
|---|---|---|
| | **Rs. Lakh** | **Rs. Lakh** |
| Profit before tax | 50 | 30 |
| Less : Tax | 19 | 11 |
| Profit after tax | 31 | 19 |

**PROBLEM 2 :**

**An enterprise reports quarterly. At the end of quarter 1 estimate of pre-tax annual profit was Rs. 6 lakh and aggregate of deductions from gross total income under tax laws was estimated at Rs. 1 lakh.**

**At the end of quarter 2 estimate of pre-tax annual profit was Rs. 6.30 lakh and aggregate of deductions from gross total income under tax laws was estimated at Rs. 84,000.**

**The pre-tax earning for quarters 1 and 2 were is Rs. 1.20 lakh and Rs. 1.3 lakh respectively. The tax rate is 30%. Compute profits after tax for the quarters.**

**SOLUTION 2 :**

Annual tax liability (as estimated at the end of quarter 1)

= 30% of (Rs. 6 lakh – Rs. 1 lakh) = Rs. 1.5 lakh

Effective annual tax rate (as estimated at the end of quarter 1)

= Rs. 1.5 lakh / Rs. 6 lakh = 25%

Tax expense for quarter 1 = 25% of Rs. 1.2 lakh = Rs. 0.30 lakh

Annual tax liability (as estimated at the end of quarter 2)

= 30% of (Rs. 6.3 lakh – Rs. 0.84 lakh) = Rs. 1.638 lakh

Effective annual tax rate (as estimated at the end of quarter 2)

= Rs. 1.638 lakh / Rs. 6.30 lakh = 26%

Tax expense for quarter 2

= 26% of (Rs. 1.2 lakh + Rs. 1.3 lakh) – Tax expense recognized in quarter 1

= Rs. 0.65 lakh –Rs. 0.30 lakh = Rs. 0.35 lakh

| | Quarter 1 | Quarter 2 |
|---|---|---|
| | **Rs. Lakh** | **Rs. Lakh** |
| Profit before tax | 1.20 | 1.30 |
| Less : Tax | 0.30 | 0.35 |
| Profit after tax | 0.90 | 0.95 |

**PROBLEM 3 :**

**An enterprise that reports quarterly, earned Rs. 1 lakh before tax at the end of quarter 1 and Rs. 1.5 lakh before tax at the end of quarter 2. The annual pre-tax profit estimated at the end of quarter 1 was Rs. 4 lakh and that at the end of quarter 2 was Rs. 5 lakh. The company had a carry-forward balance of loss amounting to Rs. 1 lakh at the beginning of the year. No deferred tax asset was recognized in respect of the loss carried forward. The applicable tax rate is 40%.**

**Compute profits after tax for the quarters.**

**SOLUTION 3 :**

Annual tax liability (as estimated at the end of quarter 1)

= 40% of (Rs. 4 lakh – Rs. 1 lakh) = Rs. 1.2 lakh

Effective annual tax rate (as estimated at the end of quarter 1)

= Rs. 1.2 lakh / Rs. 4 lakh = 30%

Tax expense for quarter 1 = 30% of Rs. 1 lakh = Rs. 0.30 lakh

Annual tax liability (as estimated at the end of quarter 2)

= 40% of (Rs. 5 lakh – Rs. 1 lakh) = Rs. 1.6 lakh

Effective annual tax rate (as estimated at the end of quarter 2)

= Rs. 1.6 lakh / Rs. 5 lakh = 32%

Tax expense for quarter 2

= 32% of (Rs. 1.0 lakh + Rs. 1.5 lakh) – Tax expense recognized in quarter 1

= Rs. 0.80 lakh – Rs. 0.30 lakh = Rs. 0.50 lakh

| | **Quarter 1 Rs. Lakh** | **Quarter 2 Rs. Lakh** |
|---|---|---|
| Profit before tax | 1.00 | 1.50 |
| Less : Tax | 0.30 | 0.50 |
| Profit after tax | 0.70 | 1.00 |

**PROBLEM 4 :**

**An enterprise reports quarterly, estimates an annual income of Rs.10 lakhs. Assume tax rates on 1st Rs. 5,00,000 at 30% and on the balance income at 40%. The estimated quartery income are Rs. 75,000, Rs.250000,Rs. 3,75,000 and Rs.3,00,000.Calculate the tax expense to be recognized in each quarter.**

**SOLUTION 4 :**

As per IAS 34 "Interim Financial Reporting", Income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

| | **Rs.** |
|---|---|
| Estimated Annual Income | 10,00,000 |
| Tax expense: | |
| 30% of **Rs.** 5,00,000 | 1,50,000 |
| 40% of remaining **Rs.** 5,00,000 | 2,00,000 |
| | 3,50,000 |

**Weighted average annual income tax rate =** $\frac{3,50,000}{10,00,000} = 35\%$

| **Tax expense to be recognized in each of the quarterly reports** | **Rs.** |
|---|---|
| Quarter I - **Rs.**75,000 x 35% | |
| Quarter II – **Rs.**2,50,000 x 35% | 26,250 |
| Quarter III – **Rs.**3,75,000 x 35% | 87,500 |
| Quarter IV – **Rs.**3,00,000 x 35% | 1,31,250 |
| 10,00,000 | 1,05,000 |
| | 3,50,000 |

**PROBLEM 5 :**

To comply with listing requirements and other statutory obligations Quaker Ltd. prepares interim financial reports at the end of each quarter. The company has brought forward losses of Rs. 700 lakhs under Income Tax Law, of which 90% is eligible for set off as per the recent verdict of the Court, that has attained finality. The company has reported quarterly earnings of Rs. 700 lakhs and Rs. 300 lakhs respectively for the first two quarters of Financial year 2013-14 and anticipates a net earning of Rs. 800 lakhs in the coming half year ended March 2014 of which Rs. 100 lakhs will be the loss in the quarter ended Dec. 2013. The tax rate for the company is 30% with a 10% surcharge. You are required to calculate the amount of Tax Expense to be reported for each quarter of financial year 2013-14.

**SOLUTION 5 :**

Estimated tax liability on annual income = [Income Rs.1,800 lakhs less b/f losses Rs. 630 lakhs (90% of 700)] x 33%

= 33% of Rs. 1,170 lakhs = Rs. 386.10 lakhs

As per IAS 34'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

Thus, estimated weighted average annual income tax rate = Rs. 386.10 lakhs divided by Rs. 1,800 lakhs=21.45%

| Tax expense to be recognised in each quarter | Rs.in lakhs |
|---|---|
| Quarter I–Rs. 700 lakhs x 21.45% | 150.15 |
| Quarter II–Rs. 300 lakhs x 21.45% | 64.35 |
| Quarter III –(Rs.100 lakhs) x 21.45% | (21.45) |
| Quarter IV –Rs. 900 lakhs x 21.45% | 193.05 |
| | 386.10 |

**PROBLEM 6 :**

**An enterprise that reports quarterly has an operating loss carry forward of Rs. 100 lakhs for income-tax purposes at the start of the current financial year for which a deferred tax asset has not been recognized. The enterprise earns Rs. 100 lakhs in the first quarter of the current year and expects to earn Rs. 100 lakhs in each of the three remaining quarters. Excluding the loss carry forward, the estimated average annual effective income-tax rate is expected to be 40 percent.**

**SOLUTION 6 :**

The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs {(Rs. 400 lakhs – Rs. 100 lakhs) x 40%}. Considering the loss carry forward, the estimated average annual effective income-tax rate would be 30% {(Rs. 120 lakhs / Rs. 400 lakhs) x 100}. This average annual effective income-tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows :

**Amount in Rs. Lakhs**

| 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter | Annual Tax Expense |
|---|---|---|---|---|
| 30 | 30 | 30 | 30 | 120 |

**QUESTION : 7**

**Company A expects to earn 15,000 pre-tax profit each quarter and has a corporate tax slab of 20 percent on the first 20,000 of annual earnings and 40 per cent on all additional earnings. Actual earnings match expectations. Calculate the amount of income tax to be shown in each quarter.**

**SOLUTION 7 :**

The following table shows the amount of income tax expense that is reported in each quarter:

Expected Total Income = 15,000 x 4 = 60,000

Expected Tax as per slabs = 20,000 x 20% + 40,000 x 40% = 20,000

Average Annual Income tax rate = 20,000/60,000 x 100 = 33.33%

**Amt (Rs)**

| | Q1 | Q2 | Q3 | Q4 |
|---|---|---|---|---|
| Profit before tax | 15,000 | 15,000 | 15,000 | 15,000 |
| Tax expense | 5,000 | 5,000 | 5,000 | 5,000 |

## 6. SEASONAL, OCCASIONAL OR CYCLICAL REVENUES

Revenues that are received seasonally, occasionally or cyclically are recognized only when they occur and not in anticipation of the revenue receipt.

**Example 1:** Sale of air-conditioner may be maximum during the quarter ended 30th June. It is not wise to defer this revenue & spread to all quarters.

**Example 2 :** Similarly, sale of woolen garments will maximum for the quarter ended 31st Dec . Such sale should be recognized in the appropriate quarter. It is not proper to anticipate revenue in the first & second quarter of the financial year.

**PROBLEM 8 :**

**A Ltd. expects to receive dividend income of Rs. 100 corers on its investments in the quarter October to December 2021. It proposes to recognize Rs. 25 crore dividend income in interim financial statement of each quarter. Is this justified.**

**SOLUTION 8 :**

Revenues received seasonally / occasionally should be recognized as they occur and not be anticipated / deferred. Hence, entire 100 crore to be recognized in October – December 2021, quarterly statement.

**PROBLEM 9 :**

**X Ltd holds Equity shares worth Rs.1,00,000/- in Y Ltd. Y Ltd. is doing well and is sure to declare dividend for the current year. While preparing the Interim financial statements, X Ltd. recognises the pro-rata dividend income, which has not been received by it actually. Is the treatment right? Discuss.**

**SOLUTION : 9**

**IAS 34** lays down principles of recognition and measurement of revenues received seasonally or occasionally. Dividend income from a subsidiary falls within the ambit of these principles. Such revenues should not be anticipated, or deferred, if anticipation or deferral is not appropriate at the end of the year of the enterprise Dividend is recognized when the "right to receive" is established. Right to receive does not emerge until the dividend is approved and declared. Accordingly, it would not be in order for X Ltd., to recognise dividend income, even though it may be sure of declaration.

## 7. COSTS THAT ARE INCURRED UNEVENLY

Costs that are incurred unevenly during the year can be deferred or anticipated if appropriate.

**PROBLEM 10 :**

**Your client a listed company is in the process of preparing first quarter accounts as required by its stock exchange. Advise your client on its following position.**

**a. Training expenses incurred in the first quarter will be allocated equally over the four quarters because the benefit is spread over the entire year.**

**b. Training expenses expected to be incurred in the last quarter will be estimated and equally allocated to all the four quarters.**

**c. A donation of Rs. 5 million is expected to be made in the second quarter, provision will be made in the first quarter.**

**d. Since historically there has been an immaterial variance between budgets and actual, depreciation charge each quarter will be determined by the budgeted figures.**

**e. Incentives are provided to customers if they purchase I million kg of urea on an annual basis. It is expected that atleast 30 customers would be able to achieve this target before the end of the third quarter. No provision is made for the incentive in the first quarter, since the client believes that the provision has not yet fructified**

**f. 70% of the clients revenue comes in the second quarter. The client wants to spread this revenue to all the four quarters, else the quarterly accounts will fluctuate significantly.**

**g. A major repair is planned of the plant in the forth quarter, which is absolutely certain. The estimated repair expenditure will be accounted for in the first quarter itself.**

**h. Over the years the client has been unfailingly giving bonus to staff in the third quarter. This has become its constructive obligation. The client does not wish to charge a proportionate amount of bonus in the current quarter.**

**SOLUTION 10 :**

a) Not correct

b) Not correct

c) Not correct

d) Not correct

e) The company should make provision (liability has incurred in cash)

f) Not correct

g) Not correct( Liability has not incurred)

h) It should be charged in current quarter.

## 8. CHANGE IN ACCOUNTING POLICIES

On change in accounting policies the prior interim periods of the current period and comparative periods shall be restated.

**PROBLEM 11 :**

**ASF India Ltd. has Rs. 1,02,000 net income for the quarter ended 31st December, 2023 including the following items:-**

**a. Rs. 60,000 gain on sale of investment received on July 30 2023, was allocated equally to the second, third and fourth quarter of financial year 2023-2024.**

**b. Rs. 16,000 cumulative effect loss resulting from change in method of inventory valuation method was recognized on November 2, 2023. Out of this loss Rs. 10,000 relates to the previous quarters.**

**Compute the profit as per IAS 34 for the quarter ended 31st December, 2023 of ABC India Ltd.**

**SOLUTION : 11**

**Statement showing computation of the correct amount of profit attributable for the quarter**

| | *Amount (Rs.)* |
|---|---|
| Net income for the quarter as shown by the company | 1,02,000 |
| **Gain on sale of investment** should be recognized in the quarter in which it is accrued. Hence, allocation of Rs. 20,000 for the current quarter should be adjusted | (20,000) |
| Effect of change in the method of inventory valuation pertaining to earlier period, to be adjusted | 10,000 |
| Net profit for the period | 92,000 |

**Note:** It is also required to restate the result of previous quarter, based on the above adjustments.

**PROBLEM 12 :**

**ASF Ltd. shows the net profit of Rs. 5,40,000 for quarter III after incorporating the following:**

**i. Bad debt of Rs. 30,000 incurred during the year. 50% of the bad debts have been deferred to next quarter.**

**ii. Loss on sale of investment of Rs. 28,000 incurred during the quarter has been fully recognized in this quarter.**

**iii. Additional depreciation of Rs. 36,000 resulting from the change of method of, depreciation.**

**Do you agree with the treatment adopted by the company? If not, find out correct quarterlyincome as per IAS 34 ?**

**SOLUTION 12 :**

In the above case, the quarterly income has not been correctly stated. As per IAS 34, thequarterly income should be adjusted and restated as follows:

Bad debt of Rs. 30,000 have been incurred during the current quarter. Out of this, thecompany has deferred 50% i.e., Rs. 15,000 to next quarter. This is not correct. Rs. 15,000 therefore, should be deducted from Rs. 5,40,000.

The treatment of **Loss on sale of investment** of Rs. 28,000 being recognized in the same quarter and recognizing the additional depreciation of Rs. 36,000 in the same quarter is correct and intune with IAS 34. So, no adjustment required for these two items.

The company should report the quarterly income as Rs. 5,25,000 (i.e., Rs. 5,40,000 – Rs.15,000).

## 9. MINIMUM COMPONENTS OF AN INTERIM FINANCIAL REPORT (IFR)

Interim financial report of an entity can be a **complete set** of financial statements as the entity presents for the annual period or it can be a **condensed set** of financial statements. Taking cognizance of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared to its annual financial statements.

This Standard defines the minimum content of an interim financial report as including condensed financial statements and selected explanatory notes. These are:

- **Condensed SOFF (incl. Statement of changes in equity)**
- **Condensed statement of Profit or Loss**
- **Condensed statement of cash flows**
- **Selected explanatory notes**

## 10. CONDENSED SET OF FINANCIAL STATEMENTS

Condensed set would mean that each of the headings and subtotals that were included in the most recent annual financial statements would be presented at the minimum. Additional line items shall be included if their exclusion would make the condensed interim financial statements misleading.

## 11. SELECTED EXPLANATORY NOTES

**Selected explanatory notes** would require the following items to be mentioned:

- Statement that same accounting policies and methods of computation are followed as in most recent annual financial statements
- Explanatory comments about seasonality or cyclicality of operations
- Nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual
- Nature and amount of changes in estimates
- Issuances, repurchases and repayment of debt and equity securities
- Dividends paid
- **Segment information —** revenue from external customers, intersegment revenues, segment profit or loss, total assets with material change, differences, reconciliation
- Material events that are not reflected in the financial statements
- Effect of changes of composition of equity
- Changes in contingent liabilities or assets

## 12. ROLE OF ESTIMATES

- The role of **"estimates"** is predominant in interim financial reporting.
- Hence the report should be designed to ensure reliability and appropriate disclosure of all material information.
- While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.
- If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate shall be disclosed in a note to the annual financial statements for that financial year.

## 13. PERIODS FOR WHICH IFR IS REQUIRED TO BE PRESENTED

| COMPONENTS OF FINANCIAL STATEMENTS | INTERIM PERIOD | COMPARATIVES |
|---|---|---|
| SOFP | At the end of the current Interim period. | Comparative SOFP at the end of immediately preceding financial year. |
| SOPL and OCI | For the current interim period and cumulatively for for the current financial year to date | Comparable interim period and year to date in immediately preceding financial year. |
| Cash flow | Cumulatively for the current | Comparable year to date for the immediately |

| | | |
|---|---|---|
| statement | financial year to date | preceding year. |
| SOCIE | Cumulatively for the current financial year to date | Comparable year to date for the immediately preceding year. |
| For seasonal enterprises: interim financial statements (Read note below) | For the 12 months ending on the interim reporting date. | Comparative information for the prior twelve months period. |

Note : In case of highly seasonal business **the enterprise is encouraged (i.e. it is no mandatory)** to give financial information for 12 month period ending on the interim reporting date and corresponding 12 month ending in previous year

**PROBLEM 13 :**

**A company is carrying out operations which are seasonal by nature. It has to prepare first quarter interim financial statements for the period ended on 30th June, 2020. As per IAS 34 describe the periodicity of its interim financial statements along with comparatives.**

**SOLUTION 13 :**

| COMPONENTS OF FINANCIAL STATEMENTS | INTERIM PERIOD | COMPARATIVES |
|---|---|---|
| SOFP | | |
| SOPL and OCI | | |
| Cash flow statement | | |
| SOCIE | | |

**PROBLEM 14 :**

**A company is carrying out operations which are seasonal by nature. It has to prepare quarter interim financial statements for the period ended 31st December ,2013. As per IAS 34 describe the periodicity of its interim financial statements along with comparatives.**

**SOLUTION 14 :**

| COMPONENTS OF FINANCIAL STATEMENTS | INTERIM PERIOD | COMPARATIVES |
|---|---|---|
| SOFP | | |
| SOPL and OCI | | |

| Cash flow statement | | |
|---|---|---|
| SOCIE | | |

## 14. RESTATEMENT OF PREVIOUSLY REPORTED INTERIM PERIODS

A change in accounting policy, other than one for which the transition is specified by a new IFRS, shall be reflected byrestating the financial statements of prior interim periods of the current financial year and the comparable interim periods of any prior financial years that will be restated in the annual financial statements in accordance with IAS 8 or,

- when it is impracticable to determine the cumulative effect at the beginning of the financial year of applying a new accounting policy to all prior periods, adjusting the financial statements of prior interim periods of the current financial year, and comparable interim periods of prior financial years to apply the new accounting policy prospectively from the earliest date practicable.

## 15. MAJOR CHANGES IN IND AS 34 VIS-À-VIS IAS 34 NOT RESULTING IN CARVE OUTS

***(i)*** **Addition of a footnote regarding Unaudited Financial Results:** A footnote has been added to paragraph 1 of IND AS 34, "Interim Financial Reporting" that Unaudited Financial Results required to be prepared and presented under Clause 41 of Listing Agreement with stock exchanges is not an "Interim Financial Report" as defined in paragraph 4 of this Standard.

***(ii)*** **Single Statement Approach:** IAS 34 provides option either to follow single statement approach or to follow two statement approaches. IND AS 34 allows only single statement approach on the lines of Ind AS 1, "Presentation of Financial Statements", which also allows only single statement approach.

**PROBLEM 15 :**

**Priyanshi Ltd. is dealing in seasonal products. The quarterly sales pattern of the product is given below:**

| Quarter I | II | III | IV |
|---|---|---|---|
| 15% | 15% | 30% | 40% |

**For the First quarter ending 31st March, 2010, Priyanshi Ltd. gives you the following information:**

| | Rs. in lakhs |
|---|---|
| Sales | 70 |
| Salary and other expenses | 20 |
| Administrative and selling expenses | 02 |

**While preparing interim financial report for the first quarter Priyanshi Ltd wants to defer Rs.10 lakhs expenditure to third quarter on the argument that third quarter is having more sales, therefore third quarter should be debited by higher expenditure, considering the seasonal nature of business. The expenditures are uniform throughout all quarters.**

**Calculate the results of first quarter as per IAS 34 and comment on the company's view.**

SOLUTION 15 :

**Result of the first quarter ended 31st March, 2010**

| | | Rs. in lakhs |
|---|---|---|
| Turnover | | 70 |
| Add: Other Income | | Nil |
| Total | | 70 |
| Less: Change in inventories | Nil | |

| | | |
|---|---|---|
| Salaries and other cost | 20 | |
| Administrative and selling expenses | 2 | 22 |
| | | 48 |

As per **IAS 34**on Interim Financial Reporting, the income and expense should be recognized when they are earned and incurred respectively.

Therefore, the argument given by Priyanshi Ltd. relating to deferment of Rs.10 lakhs is not tenable as expenditures are uniform throughout all quarters.

**PROBLEM 16 :**

**On 30,6.2009, Asmitha Ltd. incurred Rs. 2,00,000, net loss from disposal of a business segment.**

**Also, on 30.7.2009, the company paid Rs. 60,000 for property taxes assessed for the calendar year 2009. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interim period ended on 30.9.2009.**

**SOLUTION 16 :**

According to IAS 34"Interim Financial Reporting", If an enterpriseprepares and presents a complete set of financial statements in its interim financialreport, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. As on 30.9.2009, Asmitha Ltd., would report the entire Rs.2,00,000 loss on the disposal ofits business segment since the loss was incurred during interim period.

A costcharged as an expense in an annual period should be allocated to Interim periodson accrual basis. Since Rs.60,000 Property Tax payment relates to entire calendaryear 2009, Rs.30,000 would be reported as an expense for six months ended on 30th September, 2009 while remaining Rs.30,000 would be reported as prepaid expenses.

**PROBLEM 17 :**

Saurav Limited reported a Profit before Tax of Rs. 8.00 Lakhs for the 2nd quarter ending on 30th September 2014. On enquiry, following issues were noticed:

(i) Property Tax of Rs. 60,000 paid during the quarter for the full year has been recognized in full.

(ii) 1/5th of Rs. 15 Lakhs being Marketing Promotional Expenses incurred on 23rd September, 2014 has been recognized based on past experience of higher sales in the last quarter of the year.

(iii) 50% of the Loss of Rs. 2 Lakhs incurred on disposal of a Business Segment has been allocated to this quarter.

(iv) Cumulative Loss of Rs. 3 Lakhs resulting from the change in the method of Valuation of Inventory was recognised in the 2nd quarter, which included Rs. 2 Lakhs related to earlier quarters.

(v) Gain of Rs. 15 Lakhs from Sale of Investments sold in the 1st quarter was apportioned equally over the full year.

You are required to give proper treatment as required by IAS 34on Interim Financial Reporting and to recast the adjusted Profit before Tax for the 2nd quarter.

**SOLUTION : 17**

| Item | Treatment |
|---|---|
| **Property Taxes** | Property Taxes of Rs. 60,000 relatable to the entire calendar year should be apportioned on time basis, i.e. 3 months period expense Rs. 15,000 will be reported as Expense. |
| **Marketing Promotional Expenses** | Costs should be anticipated or deferred only when – |
| | • It is appropriate to anticipate that type of cost at the end of the fin.year, and |
| | • Costs are incurred unevenly during the financial year of an |

| | |
|---|---|
| | Enterprise. |
| | In this case, recognition of 1/5th of Expense is not proper. |
| **Loss on Disposal of Business Segment** | Net Loss on Disposal of Business Segment Rs. 2,00,000 should be **reported in full**, since the loss was incurred during the Interim Period. |
| **Loss due to change in method of Valuation** | The amount relating to earlier quarters to be taken and adjusted against those respective periods |
| **Gain on Investment Sale** | Apportioned Gain on Sale of Investments in first quarter to be reversed |

| | **Particulars** | **Rs. Lakhs** |
|---|---|---|
| | PBT as reported | 8.00 |
| Add: | Property Taxes to be recognised on time basis (0.60 – 0.15 to be recognised) | 0.45 |
| | Loss on change in method of Inventory Valuation relating to previous quarters | 2.00 |
| Less: | Sales Promotion Expenses relating to this Quarter (4/5th i.e. 80% × 15.00) | (12.00) |
| | Loss on Disposal of Business Segment to be reported in full (balance 50% of 2.00) | (1.00) |
| | Apportioned Gain on Sale of Investments in first quarter to be reversed (15.00 ÷ 4) | (3.75) |
| | Adjusted PBT for the Second Quarter (6.30) | |

**Note:** The Company should also re–state the results of the previous quarters based on the above adjustments.

**PROBLEM : 18**

**On 30-6-2011, X Limited incurred Rs.3,00,000 net loss from disposal of a business segment. Also on 31-7-2011, the company paid Rs. 80,000 for property taxes assessed for the calendar year 2011. How should the above transactions be included in determination of net income of X Limited for the six months interim period ended on 30-9-2011?**

SOLUTION 18 :

**IAS 34** "Interim Financial Reporting" states that revenues and gains should be recognised in interim reports on the same basis as used in annual reports. As at September 30, 2011, X Ltd. would report the entire Rs. 3,00,000 loss on the disposal of its business segment since the loss was incurred during the interim period.

A cost charged as an expense in an annual period should be allocated among the interim periods, which are clearly benefited from the expense, through the use of accruals and/or deferrals. Since Rs. 80,000 property tax payment relates to the entire 2011 calendar year, only Rs. 40,000 of the payment would be reported as an expense at September 30, 2011, while out of the remaining Rs. 40,000, Rs.20,000 for Jan. 2011 to March, 2011 would be shown as payment of the outstanding amount of previous year and another Rs. 20,000 related to quarter October, 2011 to December, 2011, would be reported as a prepaid expense.

## PROBLEMS FOR SELF-PRACTICE

**PROBLEM 19 :**

**An enterprise has sold 25,000 tons of particular material to a customer during April 2003 to June 2003. If this were the annual volume enterprise will give a rebate of 5% to the customer. Than annual value of sale expected during the year 2003-04 is 1,20,000 tons for which customer will give 8% discount. Whether to recognize discount on purchase of 25,000 tons @8% or 5%.**

SOLUTION 19 :

If it is probable, annual volume will touch 1,20,000 tons recognize discount @ 8%. Otherwise recognize discount @5% for the interim period April 2003 to June 2003.

**PROBLEM 20 :**

**In the last annual report, X Ltd, reported a contingent liability towards the Bills discounted to the extent of Rs.50,000/-. During the current interim period, the amount of bills that was discounted rose up to Rs.2,50,000/- should this be reported separately as part of Interim financial statements assuming that they have a material effect in the current interim period? Will your answer differ if the event does not have a material effect?**

**SOLUTION 20 :**

X Ltd., should ensure that the information on contingent liability is reported in the interim financial reports, on a year to date basis.

Assuming that the quantum of increase in contingent liability of bills discounted from Rs.50,000 in the first interim reporting period to Rs.2,50,000 in the subsequent interim reporting period has a material effect, this information ought to be reported separately.

If the volume and value of such discounted bills is not material, a separate disclosure is not necessary.

Nevertheless, in making assessment of materiality, it should be recognized that interim measurements has a greater reliance on estimates, than measurements of annual financial data.

# IFRS 2 — ACCOUNTING FOR SHARE BASED PAYMENT

## 1. INTRODUCTION

It is a payment based on price or value of shares. Entities often grant shares or share options to employees or other parties. Share plans and share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.

## 2. SHARE-BASED PAYMENT ARRANGEMENT

It is an agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive -

(a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or

(b) **equity instruments** (including shares or **share options**) of the entity or another group entity, provided the specified **vesting conditions**, if any, are met.

## 3. SHARE BASED PAYMENT TRANSACTION

It is a transaction in which the entity -

(a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

## 4. ANALYSIS OF SHARE BASED PAYMENT (SBP)

1. Share based payment should be formed with an **agreement** between an entity & a party (includes employees) which essentially means that a communication of the terms and conditions should be in place in order to have share based payment.

**PROBLEM 1 :**

**A management committee of an entity has initiated a plan to provide some stock options to its employees but there are some terms which are to be finalized and the plan is not yet communicated to the employee.**

**Will IFRS 2 be applicable?**

SOLUTION : 1

2. Share based payments should be made for goods/ services and should be with an external person e.g. supplier including employee.

**PROBLEM 2 :**

**A goods/service has been received by an entity for which it has issued its own equity shares to the counterparty (who has supplied the goods) at discount/ premium. The value of the goods received has been paid by using its own equity shares but if the fair value of the goods received are more / less than the value of share issued by an entity, then some un-identified goods / services will be received / or have been received. Will IFRS 2 be applicable?**

**SOLUTION : 2**

**PROBLEM 3 :**

**An entity issues its own shares for a charity without any consideration. Will IFRS 2 be applicable?**

**SOLUTION: 3**

3. Goods/services that are being received by an entity should be from a supplier. Person receiving it can also be an employee of the entity. The goods/services received from a counterparty who act in a capacity of shareholder will not be covered under **IFRS 2.**

**EXAMPLE 1**

**Service Maintenance Agreement has been entered by an entity with one of the supplier, outside the entity. The agreement requires to pay for these services by issuing equity shares of the entity. Such an agreement will be covered under IFRS 2. However, if such services are being provided by one of its own existing shareholder, then this will fall outside the scope of IFRS 2**.

4. A transaction with an employee (or other party) in his/her capacity as a holder of equity instruments of the entity is not a share-based payment transaction.

**PROBLEM 4 :**

**An entity issued right shares to all its shareholders which include employees of the company. Will IFRS 2 be applicable?**

**SOLUTION 4 :**

5. For receiving such goods/services by an entity, it needs to settle the transaction either by issuing its own equity shares/ or group entity's share (which is called "equity settled") or by paying cash equivalent to value of such shares (which is called "cash settled") or a combination of these two where settlement option rests either with an entity or with the counterparty.
6. Equity instruments, which means a residual interest in asset & liability of the company will include
   a) Ordinary shares
   b) Written call option or warrants over such ordinary shares.
7. Share based payment transaction may be settled by its own equity shares or one of group's entity shares which means that a parent of the reporting entity might issue shares on behalf of its subsidiary for providing goods/services to its subsidiary. This will also be covered under **IFRS 2**.

**PROBLEM 5 :**

**A parent issues share options to the employee of its subsidiary company or a subsidiary company issues share options to its employee based on the equity price of its parent company. Will IFRS 2 be applicable?**

**SOLUTION 5 :**

**PROBLEM 6 :**

**An entity issues certain benefits to its employee by <u>taking a reference of earnings</u> of next year. Will IFRS 2 be applicable?**

**SOLUTION 6 :**

**Vesting conditions** means the criteria which is to be fulfilled (if it is required as per the share based agreement) in order to get such Shared based payment.

**EXAMPLE 2**

**A stock option has been issued by an entity to its employees those who remains in service for next 4 years. Those who leave before 4 years will not get the stock option. The 4 years is a Vesting conditions in order to get the shared based payment**.

## 5. WHAT IS COVERED WITHIN IFRS 2?

Based on the analysis of the definitions, the scope of the standard are as follows:

Even if an entity is not able to identify all goods/ services that are being received by settling the transaction, either by **issuing its own equity/ group's equity or by paying a cash value equivalent to the equity prices**, still it will be covered under **IFRS 2**.

**Covers settlement in equity or in cash or alternative settlement option** i.e. to issue shares or by paying cash.

**Un-identified goods/ services that are being received** will be covered in the standard.

Such share based payment can be settled by another group entity or by using equity shares of group's entity.

Employee of a company, working as a service provider to an entity, receiving such share based payments (e.g. stock options, warrants etc.) will be covered under this standard.

Goods will include inventories, consumables, property, plant & equipment and other non-financial items.

**PROBLEM 7 :**

**An entity grants 10 shares to its employees who will remain in service for next 2 years. Will IFRS 2 be applicable?**

**SOLUTION 7 :**

**PROBLEM 8 :**

**An entity grants INR 1,000 to each employee which is based on its <u>current</u> equity price of the entity. Will IFRS 2 be applicable?**

**SOLUTION 8 :**

- An entity received services from a party who is acting as shareholder will not be covered under the standard. However, an employee who received additional payment from the entity for providing services other than its normal employment will be covered under this standard.
- An entity has agreed to provide bonus to its employees purely based on the share price of the entity. Since the benefit is with reference to the share price of the entity, hence it will be covered under **IFRS 2**.

## 6. WHAT IS NOT COVERED IN IFRS 2 ?

Transactions for providing goods/ services in a capacity of a shareholder is not covered.

**EXAMPLE: 3**

**If an entity grants all holders of a particular class of its equity instruments the right to acquire additional equity instruments of the entity at a price that is less than the fair value of those equity instruments, and an employee receives such a right because he/she is a holder of equity instruments of that particular class, the granting or exercise of that right is not subject to the requirements of this Standard.**

Entity shall not apply this standard to transactions in which the entity acquires goods as part of net assets acquired in business combinations as defined by IFRS 3 'Business Combinations', or contribution for Joint ventures as per IFRS 11 'Joint Arrangements'.

**EXAMPLE: 4**

**An entity has issued equity instruments in exchange for control of the acquiree is not within the scope of this standard. However, if the equity instruments are being issued to acquiree's employees in their capacity as employee, then it will be covered under this standard.**

**EXAMPLE : 5**

**An entity buys a business from an Individual to whom equity instruments are being issued. The Individual will be working as an employee in the combined new entity. Now, if the instruments that are being issued as part of business purchase consideration under IFRS 3- Business Combination, then this transaction will not be covered under this standard. However, if the Equity Instrument is being issued in a capacity of accepting employment in new company, then it will be covered within this standard.**

Financial instruments issued to buy/sell non-financial items which can be settled at net will be outside this standard.

**EXAMPLE : 6**

**Contracts to purchase and sale of goods/ services which are entered for settling in net amounts / or keep it for speculation purposes will be covered under IFRS 9- Financial Instruments and hence will not be covered under IFRS 2.**

## 7. RECOGNITION

An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it

- **obtains the goods or**
- **as the services are received.**

The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share based payment transaction".

## 8. ANALYSIS OF RECOGNITION OF SBP

- All such goods / services which are being received in share based payment will be recognized once such goods/ services are received.
- Goods are generally being received once risk and rewards has been transferred to the entity and it has control over it. Hence as soon as such goods are received, it will be recognized to increase assets / expense and to increase equity in case Equity Settled Share based payment.
- On the other side a liability will be created corresponding to an increase in asset/ expense in case of Cash Settled Share Based Payment.
- The recognition will depend on vesting conditions, if any (in certain cases there will not be any vesting condition). It means if there are certain conditions either service related or performance related which needs to be completed in order to be eligible for such Share based payments, then recognition will be based on the best estimate of the expected vesting value of such share based payments.

**QUESTION 9 :**

**An entity purchases some inventory from a supplier for which the entity will issue 100 shares as payment. The fair value of the shares was INR 15,000. When will purchases be recognized?**

**SOLUTION 9 :**

**QUESTION 10 :**

**An entity has given 100 stock options to each of its 1,000 employees for those who will remain in service for next 4 years. The grant date was 01 Jan 20X1. How will the transaction be recognized?**

**SOLUTION 10 :**

## 9. TYPES OF SHARE BASED PAYMENTS

(a) **Equity- settled:** e.g. ESOP

(b) **Cash-settled:** e.g. Stock Appreciation Rights (SAR).

(c) **Share- based payment plans with cash alternatives:** Under these plans, either the enterprise or the counterparty/employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

## 10. EQUITY SETTLED- SHARE BASED PAYMENTS

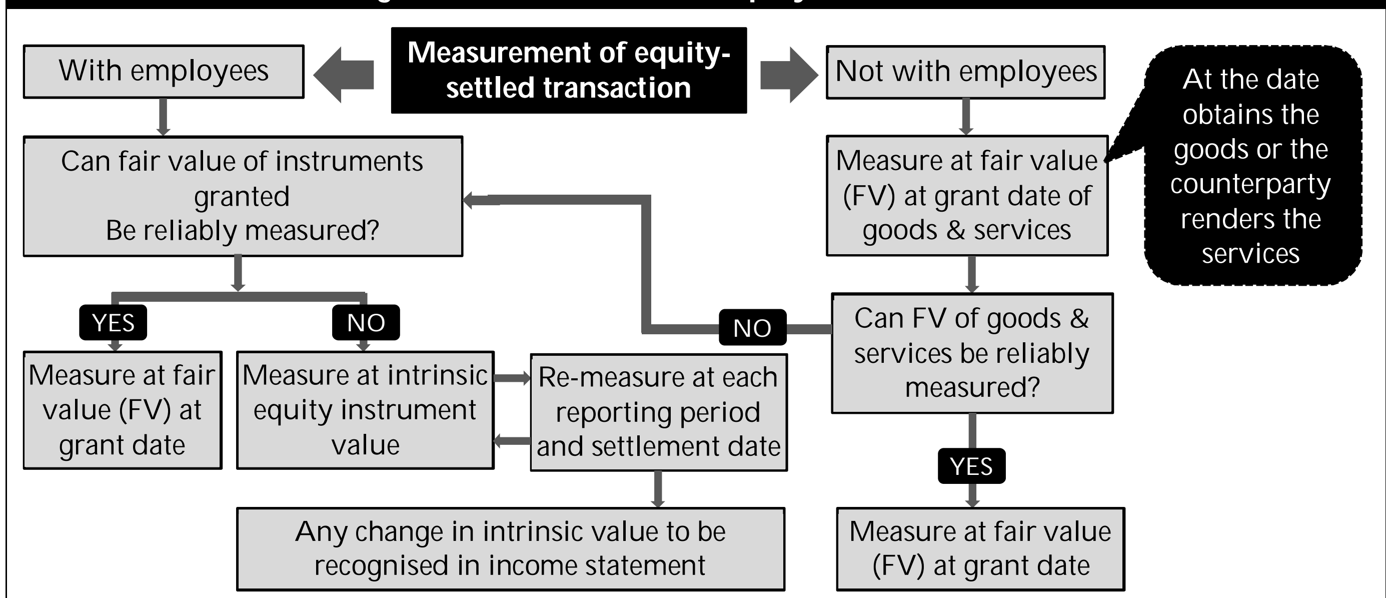
For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

## 11. ANALYSIS OF THE EQUITY SETTLED SHARE BASED PAYMENTS

- As per the standard, all Goods or Services which are being received by an Entity shall be measured at its **fair value** in order to arrive the transaction price.
- In the **absence of non-reliable information** to arrive at the fair value of such goods & services, **fair value of equity instrument** so issued will be used.
- It is a required by the standard to use **fair value** of equity granted in case of **employees** because it is practically not possible to identify the fair value of the services rendered by such employees.
- However, there is a rebuttable presumption that the fair value of goods/services received from any external supplier other than services of an employee, can be estimated. However, if this is not feasible, then an indirect reference can be used by taking fair value of instruments issued.

- **If the entity is unable to estimate the fair value of the equity instruments granted, the entity should initially, at the date of receipt of goods or services, measure at intrinsic value.**
- **In subsequent period, on each reporting date up to the date of final settlement, only the changes in intrinsic value is recognised in the SOPL**

**Diagram – 1 Measurement of equity-settled transaction**




**EXAMPLE : 7**

1. **An entity has agreed to issue 100 shares to each of its 500 employees if they remain in service for next 3 years. Next 3 years being a service period for which these share will be issued. The fair value of equity instruments will be used for calculating transaction value of the share based payments.**
2. **An entity agreed to issue 100 shares to a supplier for providing some consultancy services for next 2 years. There is similar contract in the market which has a value of INR 20,000. The similar value of the contract will be used as fair value of transaction unless there is no reliable fair value available.**

**QUESTION 11 :**

**Equity Settled Shared Based Payment- Service conditions**

**ABC limited granted to its employees, share options with a fair value of INR 5,00,000 on 1 April 20X0, if they remain in the organization upto 31st March 20X3. On 31st March 20X1, ABC limited expects only 91% of the employees to remain in the employment. On 31st March 20X2, company expects only 89% of the employees to remain in the employment. However, only 82% of the employees remained in the organisation at the end of March, 20X3 and all of them exercised their options. Pass the Journal entries?**

## 12. CASH SETTLED- SHARE BASED PAYMENTS

For cash-settled share-based payment transactions, the entity shall **measure the goods or services** acquired and the liability incurred at the **fair value of the liability.**

Until the liability is settled, the entity shall **remeasure the fair value of the liability at the end of each reporting period** and at the date of settlement, with any changes in fair value **recognized in profit or loss for the period.**

## 13. ANALYSIS OF THE CASH SETTLED SHARE BASED PAYMENTS

- When entity issues rights to its employees / suppliers upon which they will be entitled for a cash payment in future, based on the prices of the shares of an entity / or equity prices of group, and in which right to increase in equity prices will be provided, is called as Share Appreciation Rights (SAR)
- Once goods/ services are rendered against these share based payment to be settled in cash, then a liability is recognized by debiting expenses. This will be re-measured annually until it is actually paid off.
- There could be vesting conditions attached to such share based payments e.g. to remain in service for next 3 years etc., then the recognition of such share based payment will be done by recognizing the fair value (fair value at the closing period, and not the fair value of grant date) of such equity instrument as a liability with corresponding effect on expenses / asset etc. The liability so recognized will be fair valued at each reporting date by using fair value of such equity instruments and difference in value will be charged to profit and loss for the period.
- There could be some cases where no vesting period/ condition is required to be fulfilled, then the cash settled share based payment can be recognized in full at initial recognition only.

**EXAMPLES : 8**

1. **An entity issued share appreciation rights to its existing employees who remains in service for next 3 years and the benefit will then be settled in cash of an equivalent amount of share price.**
2. **Management of an entity decides to issue bonus amount to certain key employees for their past services based on share price of an entity. The amount equivalent to the shares will be recognized immediately as cost of employees because there are no conditions which are to be vested upon.**

**QUESTION 12 - Cash Settled Shared Based Payment-Service conditions**

**XYZ issued 10,000 Share Appreciation Rights (SARs) that vest immediately to its employees on 1 April 20X0. The SARs will be settled in cash. At that date it is estimated, using an option pricing model, that the fair value of a SAR is INR 95. SAR can be exercised any time upto 31 March 20X3. At the end of period on 31 March 20X1 it is expected that 95% of total employees will exercise the option, 92% of total employees will exercise the option at the end of next year and finally 89% will be vested only at the end of the 3rd year. Fair Values at the end of each period have been given below:**

| Fair value of SAR | INR |
|---|---|
| 31-Mar-20X1 | 112 |
| 31-Mar-20X2 | 109 |
| 31-Mar-20X3 | 114 |

**Pass the Journal entries?**

## 14. SHARE BASED PAYMENT WITH CASH ALTERNATIVES

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments,

- the entity shall account for that transaction, or the components of that transaction,
- as a cash settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or
- as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

## 15. ANALYSIS OF THE EQUITY SETTLED SHARE BASED PAYMENTS

The choice either to settle in Cash or Equity may be **by the entity** **or** **by its counterparty** which will define the way of recognizing the such alternatives either Equity settled or Cash settled. The choice to select the cash or Equity alternatives can be segregated in two parts –

**a) When Counterparty has a choice of settlement**

- ♦ When counterparty has a choice of settlement for such Share based payments, then this will be **treated as compound Instrument** which has debt & Equity components
- ♦ When such alternatives are being given in case of **transactions other than** **employees** where Goods/ Services will be used as fair values then the fair value of such Goods/ Services will be deducted from the fair value of debt component to arrive a fair value of Equity component
- ♦ In other cases, a separate fair value of Equity & Debt components will be calculated and accordingly the values of Goods/Services received will be accounted
- ♦ At the date of settlement, the entity shall remeasure the liability to its fair value. If the entity issues equity instruments on settlement rather than paying cash, the liability shall be transferred direct to equity, as the consideration for the equity instruments issued
- ♦ If the entity pays in cash on settlement rather than issuing equity instruments, that payment shall be applied to settle the liability in full. Any equity component previously recognised shall remain within equity. By electing to receive cash on settlement, the counterparty forfeited the right to receive equity instruments. However, this requirement does not preclude the entity from recognising a transfer within equity, i.e. a transfer from one component of equity to another

**EXAMPLE : 9**

1. **An entity issues stock options to its employees which can be claimed either in cash or equity instrument of an entity. Employees need to be in service for next 2 years. Entity needs to find fair value component of equity to be settled and fair value of cash amount to be settled. Each balance sheet date, these value needs to be updated. Upon the exercising of the option, if it is in Equity then fair value liability will be transferred to the Equity in full.**
2. **An entity buys some equipment from a supplier and the Entity provides an option to either take cash or equity instrument equivalent to the value of the share price of the entity. The entity will first find out the fair value of the goods received, then fair value of cash settlement will be valued. The difference of the fair value of the goods received and fair value of cash settlement option will be treated as fair value of equity component.**

### b) *When the Entity has a choice of settlement*

- Where an entity has **present obligation** to deliver cash as one of an alternative then it will create a liability for the settlement to treat it as cash settled share based payments.
- The assumption to consider present obligation would be in those cases where there is **no commercial substance to issue equity** (e.g. restriction to issue new share capital etc.) or there is past policy to settle such type of arrangement in cash only.
- In case, **no such obligation** exist to pay such arrangement in cash then the equity settled accounting treatment can be done.
- In case, equity settled accounting has been done but the settlement is to be paid in cash then the cash will be accounted for as repurchase of an equity interest.
- In case, cash alternative was accounted and actual settlement is to be made in Equity then any excess amount over the fair value of Equity instrument on initial recognition will be debited to Profit & Loss for the period.

**EXAMPLE : 10**

1. **An entity issues stock options to its employees which provides entity an option to settle either in cash or by entity's own shares. As per the past practice of the entity, these kind of stock options have been settled in cash only, hence the entity will create a liability assuming present obligation to settle the options in cash.**
2. **An entity has issued certain stock options to its employees where it has right to settle these options either in cash or by its own equity. Based on the past practices, the entity assumed the settlement will be done in equity only and accordingly the fair value of such options at grant date was credited to equity (based on expected vesting rights). However, the options were actually settled in cash, hence all such equity portion will be debited to the extent it was credited as re-purchasing the equity shares, and the portion above the equity portion so debited will be transferred to Profit and Loss of the period.**

**QUESTION 13 :** Share Based Payment-Cash Alternative

**On 1 January 20X1, ABC limited gives options to its key management employees to take either cash equivalent to 1,000 shares or 1,500 shares. The minimum service requirement is 2 years and shares being taken must be kept for 3 years.**

| Fair values of the shares are as follows: | INR |
|---|---|
| Share alternative fair value (with restrictions) | 102 |
| Grant date fair value on 1 Jan 20X1 | 113 |
| Fair value on 31 Dec 20X1 | 120 |
| Fair Value on 31 Dec 20X2 | 132 |

**The key management exercises his cash option at the end of 20X2. Pass the journal entries.**

**QUESTION 14 :**

**Indian Inc. issued 995 shares in exchange for a purchase of Office building. The title has been transferred in the name of Indian Inc. on Feb 20X1 and shares were issued. Fair value of the office building was INR 2,00,000 and face value of each share of Indian Inc was INR 100.**

**Pass the journal entries?**

**QUESTION : 15** - Share Based Payment- Services

Reliance limited hired a maintenance company for its oil fields. The services will be settled by issuing 1,000 shares of Reliance. Period for which the service is to be provided is 1 April 20X1 to 1 July 20X1 and fair value of the service was estimated using market value of similar contracts for INR 1,00,000. Nominal value per share is INR 10.

Record the transactions?

**QUESTION 16 :** Share Based Payment- Cash and Equity Alternative

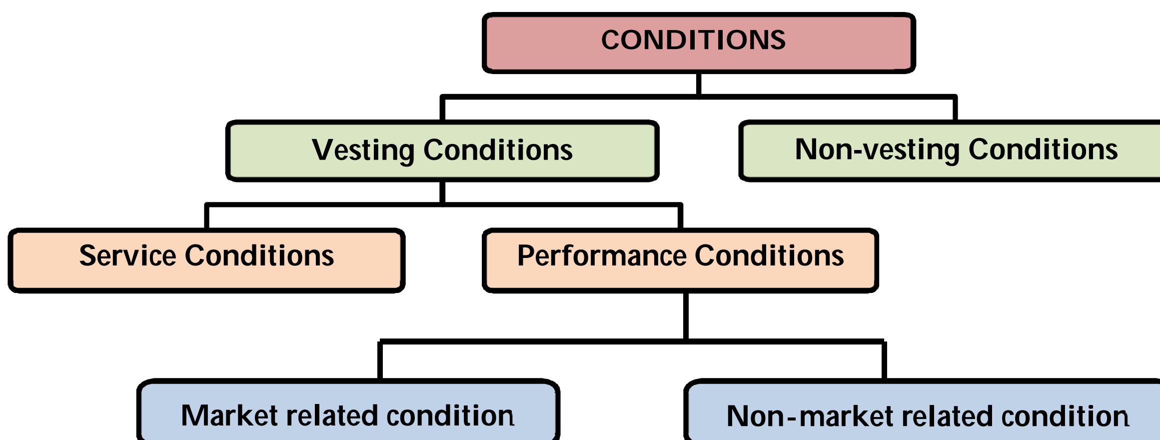
Tata Industries has incurred a share based option to one of its key management personnel which can be exercised either in cash or equity and it has following features:

| **Option 1** | **Period** | **INR** |
|---|---|---|
| Cash settled shares | | **74,000** |
| Service Condition | **3 years** | |
| Option 2 | | |
| Equity settled shares | | **90,000** |
| Service Condition | **3 years** | |

| **Restriction to sell** | **2 years** | |
|---|---|---|
| Fair values | | |
| **Equity price with a restriction of sale for 2 years** | | **115** |
| **Fair value grant date** | | **135** |
| **Fair value 20X0** | | **138** |
| **20X1** | | **140** |
| **20X2** | | **147** |

Pass the Journal entries?

## 16. DETERMINING TYPES OF CONDITIONS




## 17. VESTING CONDITIONS

**a) Service condition**

When share based payment is dependent upon the minimum term to be served in order to be eligible for employees share based payment, it is called service condition.

**EXAMPLE : 11**

**An entity has issued 100 shares each to its 1,000 employees under share based payment if they remain in the organization for next 3 years. Hence, 3 year period is a service condition.**

**b) Performance condition**

When some targeted performance is required in order to be eligible for Share Based Payment, it is called Performance condition. It may be market related or non-market related -

**i. *Market related condition***

In order to be eligible for Share Based Payment, when one of the conditions is to achieve target price/ value of the share by an Entity, it is called market related condition.

**EXAMPLE : 12**

1. **An entity issues stock option to its employees for those who will serve the organization for next 2 years and till the time the share price reaches to Rs. 100. The target price to reach Rs. 100 is one of the market related condition.**
2. **Achieving total shareholder return.**
3. **Outperforming a share price index**

**ii. *Non-market related condition***

When the parameter is not market driven but linked with some internal performance/ operation or activities of the Entity, it will be considered as non-market related conditions. Non- market related conditions do not have any impact on market price of the shares of the entity issuing such share based payments.

**EXAMPLE : 13**

1. **An entity has issued some stock options to employees with a condition that they have to remain in the organisation for next 2 years and EBITA of the entity will rise to 10 million. Here, the EBITA target is non-market related condition.**
2. **Completion of a project.**

## 18. NON-VESTING CONDITIONS

Such conditions which do not have any impact on eligibility to have share based payments. It has not been specifically defined by the standard. However, one can understand this as conditions which are other than vesting conditions.

**EXAMPLE : 14**

**An entity has issued some stock options to its employee in which it is required to serve minimum period of next 2 years and from the end of the 2nd year there will further be waiting time till of next 1 year within which the entity will achieve revenue of 100 million. However, if an employee leaves job after the end of 2nd year then the employee will not lose its entitlement to get such share based payment. Hence the condition of achieving revenue target is non-vesting condition**

## 19. DETERMINING IMPACT OF CONDITIONS ON SHARE BASED VALUATION

Once we understood the conditions attached with any share based payment, next question arises that about the implication of the conditions on valuation / accounting of such share based payments and why it is crucial to segregate them.

Let's have a tabular form of presentation to understand the impact of the conditions –

| Conditions | To include in fair value of SBP (refer note-1) | To include expected equity shares which meet conditions (refer note-2) |
|---|---|---|
| Service condition | No | Yes |
| Performance- Market related | Yes | No |
| Performance- Non-market related | No | Yes |
| Non- vesting conditions | Yes | No |

**Note 1** Share based payment will be measured at fair value on initial recognition which will include the effect of these conditions. Equity settled share based payment will be measured at fair value on grant date with no subsequent measurement, whereas cash settled share based payment shall be re-measured at each reporting date till its settlement in full.

**Note 2** These condition will have no impact on fair valuation of share based payments. However, they will be considered while estimating the expected number of equity shares at the end of each period for recognition of the share based payment.

**EXAMPLES : 15**

**An entity has issued 100 shares each to its 1000 employees under share based payment upon the condition to serve the organization at least for next 2-years subject to the below scenarios:**

1) **EBIDTA of the entity shall be INR 10 million in next 2 years**
2) **Share price of the Entity shall be INR 150 in next 2 years**
3) **Employee is required to serve additional 4 months from the end of 2 years but will have no impact on vesting the rights at the end of the 2nd year.**

Since 2 years to remain in service is a 'service related condition', it will be considered in the calculation of expected number of shares which will satisfy the conditions attached.

1) **EBIDTA** is one of the performance conditions which is non-market related, hence will be considered while making an estimation of number of shares which will satisfy the condition attached.
2) **Share price target** is one of the market related condition and hence it will be considered in the measurement of fair value at initial recognition (equity & cash settled) and at subsequent dates (in case of cash settled).
3) **Additional 4-months** requirement does not have any impact on eligibility to get share based payment. Therefore, it is a non -vesting condition and will be considered in fair value of the SBP

## 20. GRANT DATE

The date at which the entity and another party (including an employee) **agrees** to a share-based payment arrangement, being when the entity and the counterparty have a **shared understanding** of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an **approval process** (for example, by shareholders), grant date is the date when that approval is obtained.

## 21. ANALYSIS OF THE DEFINITION OF THE GRANT DATE

- It is crucial to determine grant date correctly like determination of fair value of share based payment and its accounting.
- There must be an agreement between the employee / supplier and the entity with clear communication of the terms and conditions of such share based payment. The date of such settlement of such agreement will be considered as Grant date.

- If the agreement is subject to the <u>approval of appropriate authorities,</u> then the grant date will be the date of approval.

**EXAMPLE: 16**

**Entity initiated a share based payment agreement in its board meeting and directed the supervisors to communicate the agreement to the employee, considering the following scenarios to arrive at grant date:**

1) **Employee has not yet given his/her consent either implicitly or explicitly. However, entity has taken approval of the agreement in its General Meeting.**
2) **Employee has agreed the terms implicitly/ explicitly. However, the approval process is under finalization.**
3) **Certain terms have not been specifically mentioned since they are based on some subjective conditions in future.**

**Now,**

1) **Even when the approval has been acquired, no consent has been given by an employee/ counterparty; therefore, grant date cannot be determined.**
2) **Even when the employee/ counterparty has agreed the terms but approval process is still not done, then grant date is not achieved.**
3) **Terms/ conditions mentioned in the agreement must be objectively defined and should not be based on subjective outcome. Mutual understanding is crucial which essentially means that all terms/ clauses and calculation related to the equity prices must be clear and objectively defined.**

**QUESTION 17 :** - Equity Settled – Non market conditions-

**A Holding Inc. grants 100 shares to each of its 500 employees at 1st January 20X1, provided the employees remain in service during the vesting period. The shares will vest at the end of the**

**First year** if the company's earnings is more than 12%;

**Second year** if the company's earnings is more than 20% over the two-year period;

**Third year** if the entity's earnings increase by more than 22% over the three-year period.

**The fair value of one share at the grant date is INR 122. In 20X1, earnings was 10%, and 29 employees left the organisation. The company expects that earnings will continue at a similar rate in 20X2 and expects that the shares will vest at the end of the year 20X2. The company also expects that additional 31 employees will leave the organisation in the year 20X2 and that 440 employees will receive their shares at the end of the year 20X2. At the end of 20X2, company's earnings was 18%. Therefore, the shares did not vest. Only 29 employees left the organization during 20X2. Company believes that additional 23 employees will leave in 20X3 and earnings will further increase so that the performance target will be achieved in 20X3. At the end of the year 20X3, only 21 employees have left the organization. Assume that the company's earnings increased to desired level and the performance target had been met.**

**Required:**

**Determine the expense for each year and pass appropriate journal entries?**

**QUESTION : 18** - Equity Settled – Non market conditions (Reversals)

**ACC limited granted 10,000 share options to one of its manager. In order to get the options, the manager has to work for next 3 years in the organization and reduce the cost of production by 10% over the next 3 years.**

**Fair value of the option at Grant date was** **95**

**Cost reduction achieved-**

| | | |
|---|---|---|
| Year 1 | 12% | Achieved |
| Year 2 | 8% | Not expected to vest in future |
| Year 3 | 10% | Achieved |

How the expenses would be recorded?

**QUESTION 19 :-** Equity Settled – Market based conditions

**Apple Limited has granted 10,000 share option to one of its directors for which he must work for next 3 years and the price of the share should be 20% on an average over next 3 years.**

The share price has moved as per below details –

| | | |
|---|---|---|
| Year 1 | 22% | |
| Year 2 | 19% | |
| Year 3 | 25% | |

At the grant date, the fair value of the option was INR 120.

How should we recognize the transaction?

## 22. SUBSEQUENT MEASUREMENT

**Equity settled Share Based Payment**

The entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates.

On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested.

**QUESTION 20:**

**An Entity issued 100 shares each to its 2,000 employees subject to service condition of next 3 years. Grant date fair value of the shares is INR 200 each. There is an expectation that employee will remain in service at the rate 95% at end of 1st year, however the expectation got revised at the end of 2nd year to 92% and again got revised to 88% at the end of the 3rd year. Calculate expense to be recognized each year.**

**QUESTION: 21**

The following particulars in respect of stock options granted by a company are available:

| | |
|---|---|
| Grant date | April 1,2006 |
| Number of employees covered | 525 |
| Number options granted per employee | 100 |
| Vesting condition: Continuous employment for 3 years | |
| Nominal value per share (Rs.) | 100 |
| Exercise price per share (Rs.) | 125 |
| Market price per share on grant date (Rs.) | 149 |
| Vesting date | March 31, 2009 |
| Exercise Date | March 31, 2010 |
| Fair value of option per share on grant date (Rs.) | 30 |

<u>Position on 31/03/07</u>

a. Estimated annual rate of departure 2%

b. Number of employees left = 15

Position on 31/03/08

a. Estimated annual rate of departure 3%

b. Number of employees left = 10

Position on 31/03/09

a. Number of employees left = 8

b. Number of employees entitled to exercise option = 492

Position on 31/03/10

a. Number of employees exercising the option = 480

b. Number of employees not exercising the option = 12

Compute expenses to recognise in each year and pass journal entries.

**QUESTION : 22** - (Variation in Vesting Period)

The following particulars in respect of stock options granted by a company are available:

| | |
|---|---|
| Grant date | April 1,2006 |
| Number of employees covered | 500 |
| Number options granted per employee | 100 |
| Fair value of option per share on grant date (Rs.) | 25 |

The vesting period shall be determined as below:

a. If the company earns Rs. 120 crore or above after taxes in 2006-07, the options will vest on 31/03/07.

b. If condition (a) is not satisfied but the company earns Rs. 250 crores or above after taxes in aggregate in 2006-07 and 2007-08, the options will vest on 31/03/08.

c. If conditions (a) and (b) are not satisfied but the company earns Rs. 400 crores or above after taxes in aggregate in 2006-07, 2007-08 and 2008-09, the options will vest on 31/03/09.

Position on 31/03/07

a. The company earned Rs. 115 crore after taxes in 2006-07

b. The company expects to earn Rs. 140 crores in 2007-08 after taxes

c. Expected vesting date: March 31, 2008

d. Number of employees expected to be entitled to option = 474

Position on 31/03/08

a. The company earned Rs. 130 crore after taxes in 2007-08

b. The company expects to earn Rs. 160 crores in 2008-09 after taxes

c. Expected vesting date: March 31, 2009

d. Number of employees expected to be entitled to option = 465

Position on 31/03/09

a. The company earned Rs. 165 crore after taxes in 2008-09

b. Number of employees on whom the option actually vested = 450

Compute expenses to recognise in each year.

**QUESTION : 23**

The following particulars in respect of stock options granted by a company are available:

| | |
|---|---|
| Grant date | April 1,2006 |
| Number of employees covered | 50 |
| Number options granted per employee | 1,000 |

Fair value of option per share on grant date (Rs.) 9

The options will vest to employees serving continuously for 3 years from grant date, provided the share price is Rs. 70 or above at the end of 2008-09.

The estimates of number of employees satisfying the condition of continuous employment were 48 on 31/03/07, 47 on 31/03/08. The number of employees actually satisfying the condition of continuous employment was 45.

The share price at the end of 2008-09 was Rs. 68

Compute expenses to recognise in each year and pass journal entries.

**QUESTION : 24**

Choice Ltd. grants 100 stock to each of its 1,000 employees on 1.4.2005 for Rs.20, depending upon the employees at the time of vesting of options. The market price of the share is Rs.50. These options will vest at the end of year 1 if the earning of Choice Ltd. increase 16%, or it will vest at the end of the year 2 if the average earnings of two years increase by 13%, or lastly it will vest at the end of the third year if the average earnings of 3 years will increase by 10%, 5,000 unvested options lapsed on 31.3.2006. 4,000 unvested options lapsed on 31.3.2007 and finally 3,500 unvested options lapsed on 31.3.2008.

Following is the earning of Choice Ltd.:

| Year ended on | Earning (in %) |
|---|---|
| 31.3.2006 | 14% |
| 31.3.2007 | 10% |
| 31.3.2008 | 7% |

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

**QUESTION : 25**

On April 1, 2006, a company offered 100 shares to each of its 500 employees at Rs. 40 per share. The employees are given a month to decide whether or not to accept the offer. The shares issued under the plan shall be subject to lock-in on transfers for three years from grant date. The market price of shares of the company on the grant date is Rs. 50 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at Rs. 48 per share.

On April 30, 2006, 400 employees accepted the offer and paid Rs. 40 per share purchased.

Nominal value of each share is Rs. 10.

Record the issue of shares in book of the company under the aforesaid plan.

## 23. CASH SETTLED SHARE BASED PAYMENT

After the initial recognition of a liability to settle SBP in cash, at the end of each subsequent period the liability would be fair valued till it is settled.

**QUESTION : 26 - (Stock Appreciation Rights)**

A company announced a Stock Appreciation Right on 01/04/06 for each of its 525 employees. The scheme gives the employees the right to claim cash payment equivalent to excess on market price of company's shares on exercise date over the exercise price Rs. 125 per share in respect of 100 shares, subject to condition of continuous employment for 3 years. The SAR is exercisable after 31/03/09 but before 30/06/09. The fair value of SAR was Rs. 21 in 2006- 07, Rs. 23 in 2007-08 and Rs. 24 in 2008-09. In 2006-07 the company estimates that 2% of the employees shall leave the company annually. This was revised to 3% in 2007-08. Actually, 15 employees left the company in

2006-07, 10 left in 2007-08 and 8 left in 2008-09. The SAR therefore actually vested to 492 employees. On 30/06/09, when the SAR was exercised, the intrinsic value was Rs. 25 per share.

**Show Provision for SAR A/c by fair value method.**

**Example**

An Entity issued 100 shares each to its 20 employees subject to service condition of next 3 years. The settlement is to be made in cash. Grant date fair value of the shares is INR 200 each However the fair value as at end of 1st year, 2nd year & 3rd year were INR 180, INR 190, INR 220 respectively.

| Year end | Vest | Expense (current period) | Cumulative expenses |
|---|---|---|---|
| First | 1/3 | 20 x 100 x 180 x 1/3 = 1,20,000 | 1,20,000 |
| Second | 2/3 | 20 x 100 x 190 x 2/3 – 1,20,000= 1,33,333 | 2,53,333 |
| Third | 3/3 | 20 x 100 x 220 x 3/3 – 2,53,333 =1,86,667 | 4,40,000 |

## 24. MODIFICATION, CANCELLATION AND SETTLEMENTS

An entity might modify the terms and conditions on which the equity instruments were granted.

For example, it might reduce the exercise price of options granted to employees (i.e. re-price the options), which increases the fair value of those options.

## 25. ANALYSIS OF THE REQUIREMENT OF MODIFICATION, CANCELLATION AND SETTLEMENTS

- An entity shall recognize as a minimum the services measured at the grant date fair value unless vesting conditions are not fulfilled. It means that any modification will be treated which reduce the fair value of the SPB will be recognized at original agreement value as if there was no modification happened, however if due to the modification there is an increase in fair value then the increased value will be spread over the remaining period of SBP.
- This requirement is applicable irrespective of any modification of terms, cancellation or early settlement, if any.
- **If there is a cancellation of SBP then an entity will immediately recognize all related amount which were due to be recognize in future.**
- **If any compensation is given for an early settlement** then the same will be recognized at **Profit & Loss immediately**.

**QUESTION 27 : - Modifications- Equity Settled Share based payment**

**Marathon Inc. has issued 150 share option to each of its 1,000 employees subject to the service condition of 3 years. Fair value of the option given was calculated at INR 129. the below are the details and activities related to the SBP plan-**

**Year 1: 35 left, further INR 60 are expected to leave**

**Share options re-priced (as MV of shares has fallen) as the FV had fallen to INR 50.**

**After the re-pricing they are now worth INR 80, hence expense is expected to increase by INR 30**

**Year 2: 30 left, further 36 expected to leave**

**Year 3: 38 left**

**How the modification/ re-pricing will be accounted?**

**QUESTION 28 :** - **Cancellation- Equity Settled Share based payment**

**A Ltd limited has issued 2000 Share options to its 10 directors for an exercise price of INR 100.The directors are required to stay with the company for next 3 years.**

| | |
|---|---|
| **Fair value of the option estimated** | **130** |
| **Expected Directors to vest the option** | **8** |

**During the year 2, there was a crisis in the company and Management decided to cancel the such scheme immediately, it was estimated further as below-**

| | |
|---|---|
| **Fair value of option at the time of cancellation was** | **90** |
| **Market price of the share at the cancellation date was** | **99** |

**There was a compensation which was paid to directors and since only 9 directors were currently in employment. During the date of cancellation of such scheme hence amount of 95 per option has been given to each of 9 directors.**

**How the cancellation would be recorded?**

## 26. FAIR VALUE CALCULATION

All the share based payment plans are recognized referring fair value at grant date and it is crucial to understand how the fair value is arrived and what are the specific guidance available in the standards.

Fair value which is required to be used is not just a quoted price of any security. There are some market related conditions and/ or non-vesting conditions that would be considered in the determination of fair value. Hence to determine such fair value, one has to use valuation techniques. However, there is nothing specific which has been defined by the standard. **Black-scholes pricing model and Binomial pricing model are being used widely and are also generally accepted.**

Standard specify minimum inputs to be used while calculating the fair value.

**Para B 6 of Appendix B**

All option pricing models take into account, as a minimum, the following factors:

(a) the exercise price of the option;

(b) the life of the option;

(c) the current price of the underlying shares;

(d) the expected volatility of the share price;

(e) the dividends expected on the shares (if appropriate); and (f) the risk-free interest rate for the life of the option.

Exercise price, Current price and life of the option is observable inputs and relatively easy to understand and value can be easily identified. However, other inputs which are required to be used as minimum can be detailed out as below:

1. **Expected early exercise**

   If a SBP has service/ performance conditions attached, then there is an underlying presumption that the SBP plan will vest and it is usually expected to settle/ exercise when the current market price crosses exercise price of the plan. Some senior level employees normally tends to exercise options later than lower level employee. Since all expected exercise will not happen at the same time and it is difficult to establish a linear function for such behavior, hence Binomial model is generally used in such situations.

2. **Expected Volatility**

   The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. Volatility is typically

expressed in annualised terms that are comparable regardless of the time period used in the calculation, for example, daily, weekly or monthly price observations.

3. **Expected Dividend**

   Whether expected dividend should be taken into account when measuring the fair value of shares or options granted depends on whether the counterparty is entitled to dividend or dividend equivalents.

**EXAMPLE : 17**

**If employees were granted options and are entitled to dividend on the underlying shares or dividend equivalents (which might be paid in cash or applied to reduce the exercise price) between grant date and exercise date, the options granted should be valued as if no dividend will be paid on the underlying shares, ie the input for expected dividend should be zero**

4. **Risk free Interest rate-**

   The risk-free interest rate is the implied yield currently available on zero-coupon government issues of the country in whose currency the exercise price is expressed, with a remaining term equal to the expected term of the option being valued.

## 27. GROUP SHARE BASED PAYMENT PLAN

It is a general practice to have a common share based programme among a group which has one or more subsidiary and one group entity receive goods/services and other entity might settle the same.

Let's understand the requirement by analyzing the following scenarios:

1. **Parent issue its own shares for the SBP issued by its subsidiary**

Space for Diagram

Since Subsidiary company do not have any obligation to settle the services/ goods which are being received against the plan, hence it will be treated as Equity Settled SBP (for Subsidiary).

- Parent would debit these shares as "Investment in Subsidiary" and credit its Equity.
- Subsidiary will treat the amount as Equity settled SBP and will debit its expenses (employee related cost) and credit the capital contribution from Parent.

**JOURNAL ENTRIES IN THE BOOKS OF SUBSIDIARY**

**Employee Benefits exp. A/c………….Dr**

**To Equity (Contribution from Parent)**

**JOURNAL ENTRIES IN THE BOOKS OF PARENT**

**Investment in Subsidiary A/C ……….Dr**

**To Share Options A/c**

**QUESTION : 29**

**A parent grants 200 share options to each of 100 employees of its subsidiary, conditional upon the completion of 2 years' service with the subsidiary. The fair value of the share options on grant date is Rs 30 each. At grant date, the subsidiary estimates that 80% of the employees will complete the 2-year service period. This estimate does not change during the vesting period. At the end of the vesting period, 81 employees complete the required 2-years' service. The parent does not require the subsidiary to pay for the shares needed to settle the grant of share options. Record the transactions in the books of subsidiary and parent.**

**SOLUTION : 29**

As per required by Ind AS, over the 2-year vesting period, the subsidiary measures the services received from the employees in accordance with the requirements applicable to equity-settled share-based payment transactions. Thus the subsidiary measures the services received from the employees on the basis of the fair value of the share options at grant date. An increase in equity is recognized as a contribution from the parent in the separate or individual financial statements of the subsidiary.

**Accounting Entries in the books of Subsidiary :**

2. **Subsidiary provide rights to its employees to get Equity Instruments of its parent**

   Subsidiary will account for this arrangement as Cash settled SBP since it has an obligation to settle the same in other than its own equity shares.

3. **Subsidiary grants an equity settled share based payment to employees of its parent**
   - Parent would consider the payment/ settlement which is being made by its subsidiary as credit to "Dividend Income" and debit to Expenses (employee related cost).
   - Subsidiary would debit its retained earnings as "Dividend distribution" and credit Equity (being share issued).

4. **Parent settle the transaction by paying cash value for SBP issued by its subsidiary**

   Irrespective of the cash which is settled either based on Parent's equity or Subsidiary Equity, it will be treated as Equity Settled SBP in case of separate financial of Subsidiary because the subsidiary does not have any obligation to settle the payments.

## 28. DISCLOSURES

Standard require an Entity to disclose the following-

- Type and scope of agreement existing during the reporting period
- Describing general terms & conditions of each type of SBP plans
- The number of weighted average price of share option as outstanding with a movement of granted, vested, expired, exercised, cancelled and closing balance of SBP
- The average share price of exercised options
- The range of exercise prices and weighted average remaining contractual life of options outstanding at the end of reporting period
- The valuation method used to estimate the fair value of the awards
- The impact on Statement of Profit and Loss and Balance Sheet for such SBP.

| IAS 32 | FINANCIAL INSTRUMENT PRESENTATION |
|---|---|

## 1. INTRODUCTION

**IFRS on financial instruments are comprehensive standards that deal with financial instruments.**

**The distinction between equity and liability itself will now need careful consideration with the substance rather than legal form driving the classification.**

**An entity will be required to classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.**

**Therefore, a substantial amount of judgment will now be required to determine the correct classification.**

Financial instruments to be classified as per substance rather than legal form.

All financial instruments are initially measured at fair value.

Subsequent to initial recognition, financial assets should be measured at

- **Amortized cost,**
- **Fair value through other comprehensive income (FVTOCI) or**
- **FVTPL.**
- For financial liabilities, two measurement categories exist:
- **FVTPL and**
- **Amortised cost.**

## 2. STANDARDS DEALING WITH FINANCIAL INSTRUMENTS UNDER IFRS

- Under IFRS, three standards deal with accounting for financial instruments.
- **IAS 32 FINANCIAL INSTRUMENTS: PRESENTATION** deals with the presentation and classification of financial instruments as financial liabilities or equity and sets out the requirements regarding offset of financial assets and financial liabilities in the SOFP.
- **IFRS 7 FINANCIAL INSTRUMENTS: DISCLOSURES** sets out the disclosures required in respect of financial instruments.
- **IFRS 9 FINANCIAL INSTRUMENTS** contains guidance on the recognition, de-recognition, classification and measurement of financial instruments, including impairment and hedge accounting.
- It may be noted that fair value of financial instruments should be determined in accordance with the principles enunciated in **IFRS 13 *Fair Value Measurement.***

## 3. OBJECTIVE OF IAS 32

1. **Classification of financial instruments into financial assets, financial liabilities and equity instruments.**
2. **Classification of related interest, dividends, losses and gains.**
3. **Offset of financial assets and financial liabilities**

## 4. FINANCIAL INSTRUMENTS (FI) - MEANING

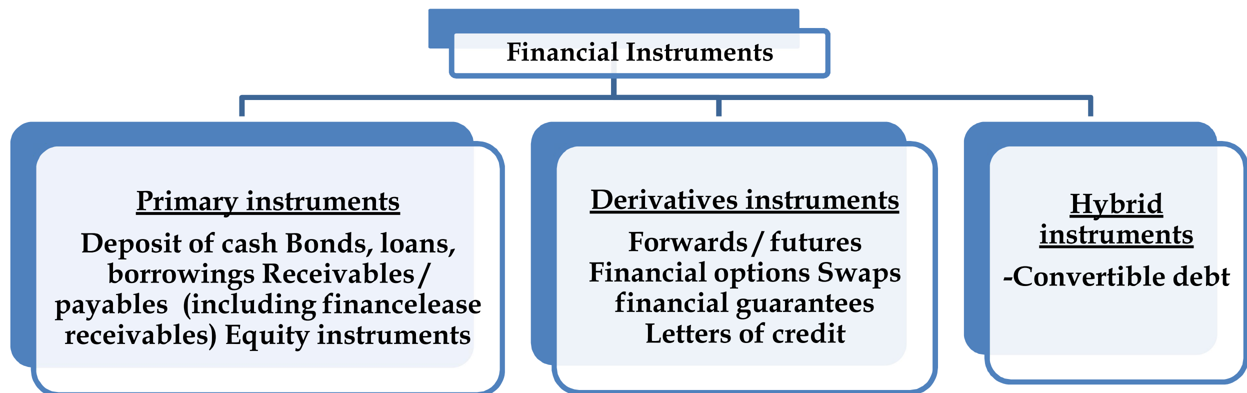
A financial instrument is defined as

- any **contract** that gives rise to
  - a **financial asset** of one entity and
  - a **financial liability** or **equity instrument** of another entity.

Thus, the basis of FI is a **contractual relationship.**

## 5. SOME OF THE EXAMPLES OF FINANCIAL INSTRUMENTS.

- Trade receivables and payables, bank loans and overdrafts, issued debt, equity and preference shares, investments in securities (e.g. shares and bonds) and various derivatives
- In addition, some contracts to buy or sell non-financial items that would not meet the definition of financial instruments are specifically brought within the scope of the financial instruments standards on the basis that they behave and are used in a similar way to financial instruments.




## 6. FINANCIAL ASSETS

A financial asset is any asset that is:

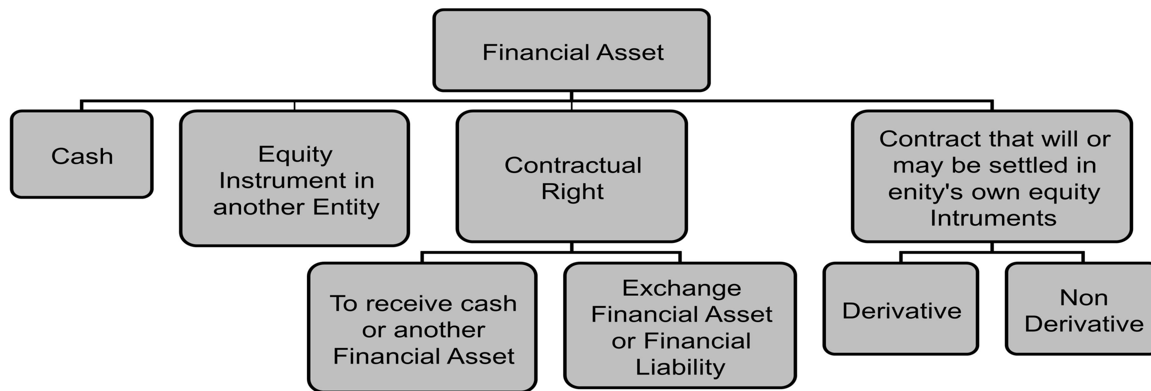
- cash;
- an equity instrument of another entity;
- a **contractual right**:
  - to receive cash (e.g., investment in bonds, Receivable, etc) or another financial asset from another entity (e.g., investment in convertible debentures); or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity ( derivatives like call option, put option, forward and future contracts); or

| *EXAMPLE : 1* |
|---|
| *X Ltd holds a call option to purchase the shares of a company for Rs 50 per share, when market price is Rs 60. X Ltd stands to gain if the option is exercised and therefore the option is a derivative financial asset.* |
| *EXAMPLE : 2* |
| *X Ltd holds a PUT option to purchase the shares of a company for Rs 50 per share, when market price is Rs 40. X Ltd stands to gain if the option is exercised and therefore the option is a derivative financial asset.* |

- a contract that will or may be settled in the entity's own equity instruments, and is.

  (i) a non-derivative for which the entity is or may be obliged to **receive a variable number of the entity's own equity instruments; or**

  (ii) a derivative that will or may be settled **other than by the exchange of a fixed amount of cash** or **another financial asset for a fixed number of the entity's own equity instruments.**




## 7. EXAMPLES OF FINANCIAL ASSETS

- Investments In Equity Instruments,
- Investments In Debt Instruments,
- Trade Receivables,
- Cash And Cash Equivalents,
- *Loans to other entities*
- Derivative Financial Assets.

## 8. FINANCIAL LIABILITIES

A financial liability is any liability that is:

- a **contractual** obligation
- to **deliver cash or another financial asset** to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments, and is.
  - (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

    **EXAMPLES – 3**

    - **A debt instrument of $ 10,000 to be repaid in 3 years by delivering as many equity shares as are equal to value of $ 11,500.**
    - **Contract to deliver as many of the entity's own equity instruments as are equal to Rs.100.**
    - **Contract to deliver as many of the entity's own equity instruments as are equal to value of 100 grams of gold.**

  - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

**QUESTION 1 :**

**If X Ltd. writes an option under which the counterparty can force the entity to sell equity shares in the listed company Y Ltd. for Rs. 5 per share at any time in the next 90 days.**

**SOLUTION 1:**

X Ltd. has a contractual obligation to exchange equity shares in another company for cash of Rs. 5 per share on potentially unfavourable terms if the holder exercises the option, because the market price per share exceeds the exercise price of Rs. 5 per share at the end of 90 day period. Since X ltd stands to loss if the option is exercised the exchange is potentially unfavourable and option is a derivative financial liability from the time the company becomes a party to the option contract.

**REASON:**

**If the settlement of the financial instrument is by using a variable number of own equity instruments, it is similar to using own shares as "currency" to settle, and in substance a financial liability. Such a contract does not evidence a residual interest in the entity's net assets. The holder of the instrument is not exposed to ownership risk.**

**QUESTION : 2**

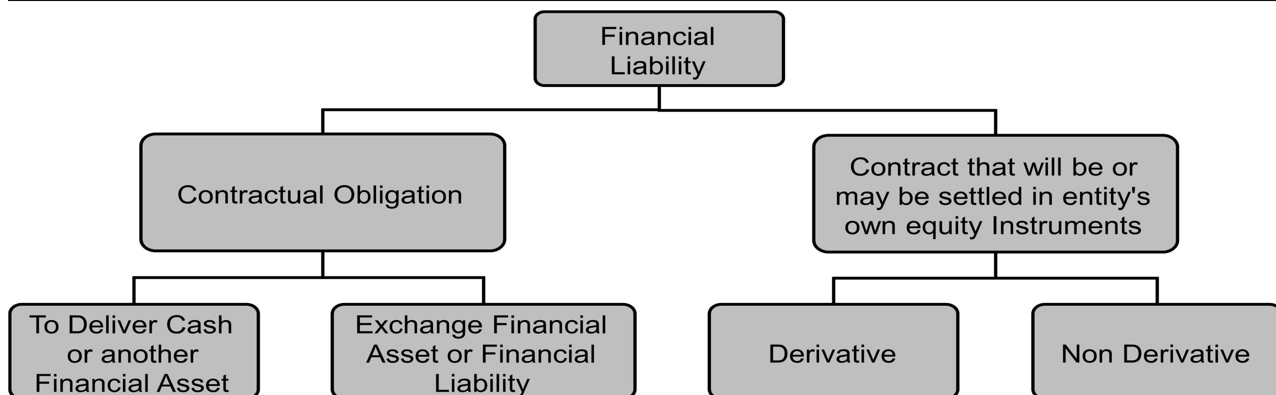
**X Ltd. issued debentures amounting to Rs. 10,00,000. As per terms of debenture issue it has been agreed to issue equity shares amounting to Rs. 15,00,000 to redeem these debentures at the end of 3rd year. Are debentures financial liabilities?**

**SOLUTION : 2**

**QUESTION : 3**

**X Ltd. issued 1,00,00 Zero Coupon Bond of Rs 10 each amounting to Rs 10,00,000. Debentures will be redeemed at the end of 3rd year issuing 1,45,000 own equity shares of Rs 10 each of the company. Should the equity-settled debentures be classified as an equity transaction or a liability?**

**SOLUTION : 3**




**EXAMPLES**

- **Payables (e.g., trade payables),**
- **Loans from other entities,**
- **Issued bonds and other debt instruments issued by the entity**
- **Redeemable preference shares (as there is contractual obligation to deliver cash)**
- **Derivative financial liabilities,**
- **Obligations to deliver own shares worth a fixed amount of cash,**
- **Some derivatives on own equity**

## 9. EQUITY

- An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
- The presentation by the issuer of a financial instrument or its component parts as liability or equity is determined based on principles of classification contained in IAS 32.

## 10. PUTTABLE FINANCIAL INSTRUMENTS

- A puttable instrument is a financial instrument that gives the holder of the instrument the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.
- As an **exception,** puttable instruments are classified as an equity instrument even if they meet the definition of financial liability.

## 11. PRINCIPLES OF LIABILITY/EQUITY CLASSIFICATION

**Principles of liability/equity classification**

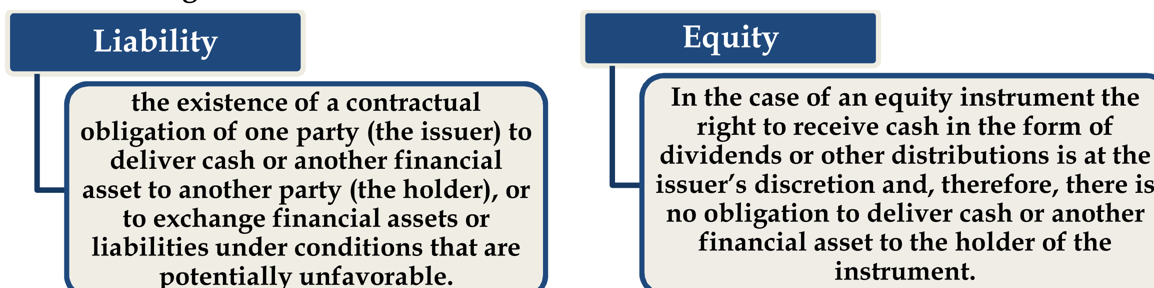
- A financial instrument or its component parts should be classified by the issuer upon initial recognition as a financial liability or an equity instrument according to the substance of the contractual arrangement, rather than its legal form, and the definitions of a financial liability and an equity instrument.
- For some financial instruments, although their legal form may be equity, the substance of the arrangements is that they are liabilities.
- A preference share, for example, may display either equity or liability characteristics depending on the substance of the rights attaching to it.
- The appropriate classification as a financial liability, equity or a combination of both, is determined by the entity when the financial instrument is initially recognised and
- That classification is not generally changed subsequently unless the terms of the instrument change.
- In addition, when the specific requirements for puttable instruments and instruments that contain an obligation to deliver a pro rata share of net assets at liquidation no longer apply or start to apply, reclassification may be appropriate.

## 12. PRINCIPLES OF LIABILITY/EQUITY CLASSIFICATION IN CONSOLIDATED FINANCIAL STATEMENTS

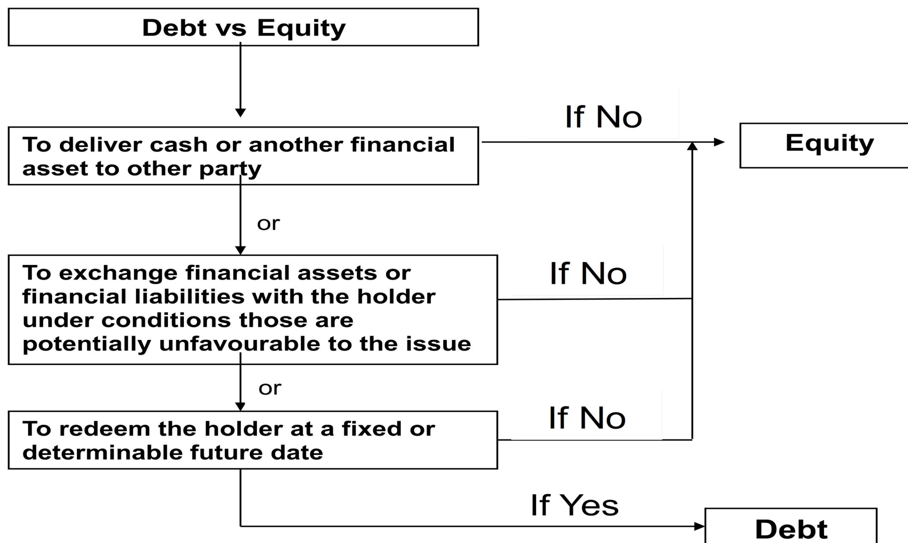
- When classifying a financial instrument in the consolidated financial statements, an entity should consider all of the terms and conditions agreed upon between members of the group and the holders of the instrument.
- For example, a financial instrument issued by a subsidiary could be classified as equity in the subsidiary's individual financial statements and as a liability in the consolidated financial statements if another group entity has provided a guarantee to make payments to the holder of the instrument.

## 13. FINANCIAL LIABILITY OR EQUITY ?

**Contractual obligation to deliver cash or another financial asset**



- There is an exception to this rule for certain puttable instruments and instruments with an obligation to deliver a pro rata share of net assets only at liquidations.




**QUESTION 4 :**

**Alpha Ltd. issued an option to buy or sell fixed number of shares at a specified exercise price. The terms of the option state that the specified exercise price varies with the share price of the Alpha Ltd.**

| Share Price | Conversion Ratio |
|---|---|
| 10 Rs. | 10 shares at Rs. 1 per share |
| 20 Rs. | 10 shares at Rs. 1.50 per share |

**Is the option a financial liability or equity ?**

SOLUTION : 4

**QUESTION : 5**

**Are deferred revenue and warranty obligations financial liabilities ?**

SOLUTION : 5

**QUESTION : 6**

**Are obligations to pay tax, company registration fees and other similar charges financial liabilities ?**

**SOLUTION : 6**

## 14. CHARACTERISTICS OF LIABILITY

**Mandatory redemption and/or mandatory interest payments**

- When an instrument requires mandatory redemption by the issuer for a fixed or determinable amount, a contractual obligation to deliver cash at redemption exists and, therefore, the instrument is presented as a liability.
- **Exceptions**
  - **certain puttable instruments and**
  - **certain instruments that contain an obligation to deliver a pro rata share of net assets at liquidation.**

**QUESTION 7 :**

**Are mandatorily redeemable preference shares financial liabilities ?**

- **Entity A issues preference shares that are mandatorily redeemable at par in 10 years.**

**SOLUTION 7 :**

**QUESTION 8 :**

**Are perpetual instruments financial liabilities ?**

- **Perpetual instruments provide the holder with no right to require redemption. However, the terms of such instruments often require the issuer to make coupon payments into perpetuity.**

**SOLUTION 8 :**

**QUESTION 9 :**

**Are perpetual coupon-bearing preference shares financial liabilities ?**

- **A perpetual instrument is issued at a par amount of Rs 100 million requiring coupon payments of 8 percent to be made annually.**
- **Provided that 8 percent is the market rate of interest for this type of instrument when issued, the issuer has assumed a contractual obligation to make a future stream of 8 percent interest payments.**
- **The net present value of the interest payments is Rs 100 million and represents the fair value of the instrument.**

**SOLUTION 9 :**

**QUESTION 10 :**

**Are mandatory distribution of a percentage of the profits of an entity financial liabilities ?**

**SOLUTION 10 :**

**QUESTION 11 :**

**X Ltd. issued 1,00,000 12% Perpetual Debentures of Rs.100 each on 1.4.2014. Classify this perpetual debenture as financial liability or equity. Explain accounting treatment.**

**SOLUTION : 11**

- Perpetual debentures (and other perpetual debts instruments like bonds and notes) having contractual obligation pay periodic interest over indefinite future does not satisfy 'no obligation to deliver cash or other financial asset' to be classified as equity. They are classified as financial liabilities of the issuer, and financial assets to the holders.
- Assume that market rate of interest at the time of issue is 11.5%, the fair value of the instrument is present value future cash flows at 11.5%.
- Present value of perpetuity = A / r = 12,00,000 / 11.5% = Rs. 104,34,783.
- Where A is the fixed periodic payment; and r is the interest rate or discount rate per compounding period.
- Accounting Entries

| Date | Particulars | | Dr. | Cr. |
|---|---|---|---|---|
| | | | Amount in Rs. | |
| 1.4.2014 | Bank Account | Dr. | 100,00,000 | |
| | Fair Value Loss Account | Dr. | 4,34,783 | |
| | Perpetual Debentures Account | Cr. | | 104,34,783 |
| | Fair value loss is charged to the Statement of Profit and Loss | | | |

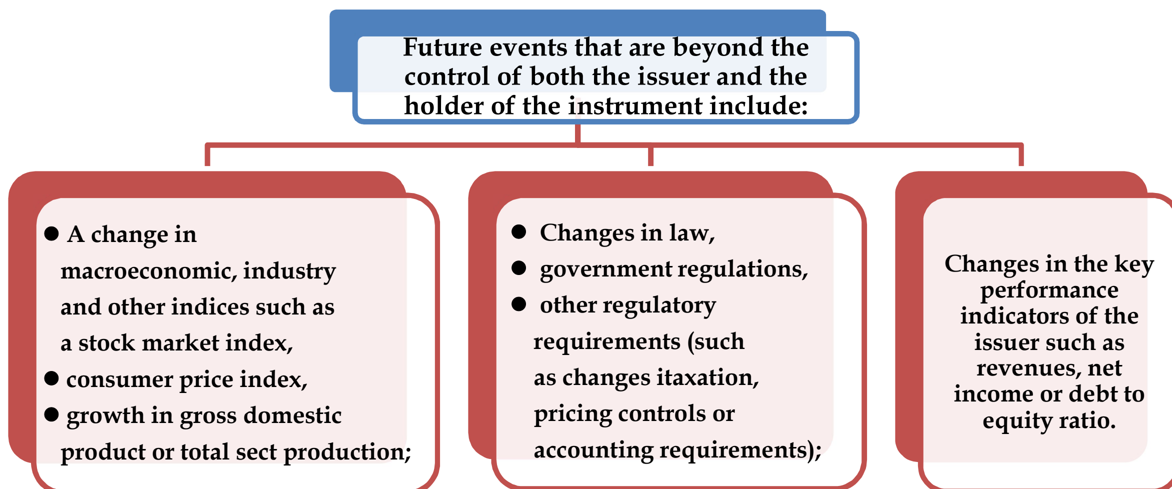
| Annual date | Interest Account Dr.<br>Bank Account Cr.<br>Assuming interest is paid on coupon date. | 12,00,000 | 12,00,000 |
|---|---|---|---|

## 15. CONTINGENT SETTLEMENT PROVISIONS

- Financial instruments may be structured such that the obligation to deliver cash or another financial instrument arises only on the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument.
- The issuer does not have an unconditional right to avoid the obligation to deliver cash or another financial instrument and, therefore, such instruments are financial liabilities of the issuer unless:
  - the contingent settlement provision that could require payment in cash or another financial asset is not genuine; or
  - settlement in cash or another financial asset can only be required in the event of liquidation of the issuer; or
  - the instrument meets the specified criteria for a puttable instrument or an obligation arising on liquidation to be classified as equity.

## 16. CONTINGENT SETTLEMENT PROVISIONS - WHAT IS GENUINE ?

- Genuine' is generally understood to be not counterfeit, i.e. a genuine provision is one that is authentic and has commercial substance.
- A provision that is extremely rare, highly abnormal and very unlikely to occur is not considered genuine.




**QUESTION 12 :**

**Contingent Settlement Provisions: Change In Accounting Or Tax Law :**

- **Entity A issues preference shares bearing 5 percent non-cumulative dividends that are at the discretion of the issuer.**
- **The shares will be redeemed if the applicable taxation or accounting requirements were to change.**
- **The contingent event of a change in taxation or accounting requirements is deemed to be genuine.**
- **The requirement for redemption on change of taxation or accounting requirements represents a contingent settlement provision (i.e. it is an uncertain future event beyond the control of both the issuer and the holder of the instrument).**
- **Is the instrument a financial liability ?**

**SOLUTION 12 :**

**QUESTION 13 :**

**Contingent settlement provisions: initial public offering**

- **Entity B issues shares for Rs 1 million. Dividends are discretionary. Entity B must redeem the shares for par in the event of a flotation/initial public offering (IPO) of the entity.**
- **Entity B cannot guarantee a successful flotation/IPO, but it does have discretion as to whether or not to instigate proceedings to float or to seek an IPO.**
- **Is the instrument a financial liability ?**

**SOLUTION : 13**

**QUESTION 14 :**

**Contingent settlement provisions: initial public offering**

- **Entity C issues shares for RS 1 million.**
- **Entity C must redeem the shares at par in the event that Entity C is not subject to a successful flotation/Initial Public Offering (IPO) within five years from the date of issue of the shares.**
- **Entity C cannot guarantee a successful flotation/IPO, but it does not have discretion as to whether or not to instigate proceedings to float or to seek an IPO.**
- **Is the instrument a financial liability ?**

**SOLUTION : 14**

- Given that the contingent event (a successful flotation/IPO) is not in the control of Entity C, it is a contingent settlement provision.
  - The contingent settlement provision is considered genuine,
  - it is potentially payable other than at liquidation, and
  - the shares do not meet the puttable exception in IAS 32.

Because Entity C cannot avoid redeeming the shares for cash, the instrument contains an obligation to pay cash that creates a financial liability.

## 17. EQUITY INSTRUMENTS

- A financial instrument is classified as equity only if the instrument fails the definition of a financial liability.
- The key requirement in determining whether an instrument is equity is the issuer's unconditional ability to avoid delivery of cash or another financial asset.

**THAT ABILITY IS NOT AFFECTED BY:**

- the history of making distributions;
- an intention to make distributions in the future;
- a possible negative impact on the price of ordinary shares of the issuer if the distributions are not made on the instrument concerned;
- the amount of the issuer's reserves;
- an issuer's expectations of a profit or loss for the period; or
- an ability or inability of the issuer to influence the amount of its profit or loss for the period.
  - Provided that dividends are at the discretion of the issuer, it is irrelevant whether dividends are cumulative or non-cumulative.
  - Once a dividend is properly declared and the issuer is legally required to pay it, a contractual obligation to deliver cash comes into existence and a financial liability for the amount of the declared dividend should be recognised.
  - Similarly, a liability arises upon liquidation to distribute to the shareholders the residual assets in the issuer.
  - The existence of an option whereby the issuer can redeem equity shares for cash does not trigger liability classification because the issuer retains an unconditional right to avoid delivering cash or another financial asset.
  - A contractual obligation would only arise at the point when the issuer exercised its right to redeem.

**QUESTION 15 :**

**X Ltd. issued 1,00,00 Zero Coupon Bond of Rs 10 each amounting to Rs 10,00,00. Debentures will be redeemed at the end of 3rd year issuing 1,45,000 own equity shares of Rs 10 each of the company.**

**Should the equity-settled debentures be classified as an equity transaction or a liability linked transaction ? Show necessary accounting entries.**

**SOLUTION 15 :**

- In this case both 'fixed test 'and 'no obligation test' are satisfied. Therefore, the underlying instrument is classified as equity. The difference between the issue price and redemption value of debentures i.e. Rs 4,50,000 is treated as dividend and adjusted against retained earnings.
- **Accounting Entries**

| Date | Particulars | | Dr. | Cr. |
|---|---|---|---|---|
| | | | **Amount in Rs.** | |
| 1.4.2014 | Bank Account | Dr. | 10,00,000 | |
| | Redemption Premium Account | Dr. | 4,50,000 | |
| | Equity Settled Bonds Account | Cr. | | 14,50,000 |
| | Debentures are recorded at par value of equity shares to be | | | |

| | | | |
|---|---|---|---|
| | issued - the difference of the issue price and redemption value is adjusted against retained earnings/share premium. | | |
| 31.3.2015 | No entry required | | |
| 31.3.2016 | No entry required | | |
| 31.3.2017 | Equity Settled Bonds Account Dr.<br>Equity Share Capital Account Cr.<br>Issue of equity shares to redeem debentures. | 14,50,000 | 1450,000 |

## 18. EQUITY INSTRUMENTS - DERIVATIVES OVER OWN EQUITY.

- Specific rules apply to derivatives over own equity.
- For example, a purchased call option over a fixed number of shares will allow the issuer to buy back shares at a fixed price in the future.
- The issuer always has a choice as to whether it wishes to pay cash, because it always has a choice as to whether it wishes to exercise its option.
- However, this instrument is only treated as equity if it is gross physically settled in all cases when the issuer chooses to exercise, i.e. the option can never be net settled.

**QUESTION 16 :**

**DIVIDEND STOPPER**

- **Entity Y issues 6 percent cumulative, non-redeemable preference shares with discretionary dividends that are subject to the availability of distributable reserves. The directors of Entity Y can decide at each period end whether and the extent to which a dividend will be paid on the preference shares. The terms of the instrument include a dividend stopper, i.e. if no dividend is paid on the preference shares, then no dividend is paid on Entity Y's ordinary shares.**
- **Is the financial instrument an equity or financial liability ?**

**SOLUTION 16 :**

**QUESTION 17 :**

**Dividend pusher**

- **Entity M issues non-redeemable preference shares bearing 6 percent discretionary non-cumulative dividends that are subject to the availability of distributable reserves. The directors of Entity M can decide at each period end whether and the extent to which a dividend will be paid on the preference shares. The payment of dividends on Entity M's ordinary shares is also discretionary. However, the terms of the instrument include a dividend pusher, i.e. if a dividend is paid on Entity M's ordinary shares, then a dividend must be paid on the preference shares.**
- **Is the financial instrument an equity or financial liability ?**

**SOLUTION 17 :**

## 19. COMPOUND INSTRUMENTS

- A financial instrument may be structured such that it contains both equity and liability components (i.e. the instrument is neither entirely a liability nor entirely an equity instrument).
- An example of a compound instrument
- A bond that is convertible, either mandatorily or at the option of the holder, into a fixed number of equity shares of the issuer.
- The liability and equity components of a compound instrument are required to be accounted for separately.
- A compound instrument takes the legal form of a single instrument, while the substance is that both a liability and an equity instrument exist.

## 20. WHY THERE IS A NEED TO SPLIT EQUITY AND FINANCIAL LIABILITY COMPONENT IN COMPOUND INSTRUMENTS ?

The requirement to separate out the equity and financial liability components of a compound instrument is consistent with the principle that a financial instrument must be classified in accordance with its substance, rather than its legal form.

## 21. EXAMPLE OF COMPOUND INSTRUMENTS

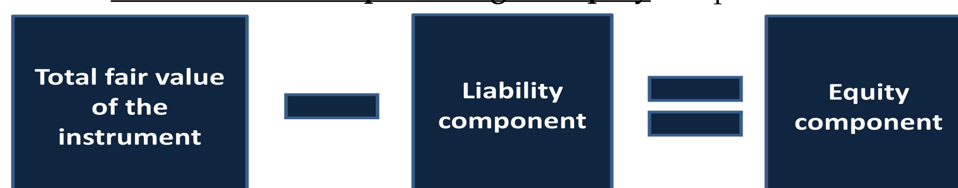
**Convertible Bond**

A convertible bond that pays fixed coupons and is convertible by the holder into a fixed number of ordinary shares of the issuer has the legal form of a debt contract; however, its substance is that of two instruments:

- a financial liability to deliver cash (by making scheduled payments of coupon and principal) which exists as long as the bond is not converted; and
- a written call option granting the holder the right to convert the bond into a fixed number of ordinary shares of the entity.

## 22. METHOD OF SEPARATING THE LIABILITY AND EQUITY COMPONENTS

- The **liability component** is fair valued **first,** and this provides the initial carrying amount of the liability components.
- The fair value of the liability component is then **deducted from the total fair value of the instrument** with the **residual amount representing the equity** component.




- Transaction costs are usually allocated to the liability and equity components based on proportion of the respective values. Transaction costs of an equity transaction are deducted from equity.

## 23. STEPS TO SPLIT COMPOUND FINANCIAL INSTRUMENT INTO FINANCIAL LIABILITY AND EQUITY

- **Step 1** : calculate cash outflow as per the contract, which could not be denied by the company.
- **Step 2** : identify interest rate on similar non – convertible financial instruments i.e. the market rate of interest that would have been applied to an instrument of comparable credit quality with substantially the same cash flows, on the same terms, but without the conversion option. Such rate is called effective rate of interest and is used for calculating present value of interest and redemption value.
- **Step 3** : Calculate PV of cash-flows of step 1 using discount rate in step 2. The value so arrived is called liability.
- **Step 4** : Equity = Proceeds – Financial Liability

## 24. SUBSEQUENT ACCOUNTING OF COMPOUND INSTRUMENT

- The financial liability component will be subsequently measured in accordance with the measurement requirements in IFRS 9 depending on its classification (either as a financial liability at FVTPL, or as an 'other' liability, measured at amortized cost using the effective interest method).
- The equity component will not be re-measured.
- No gain or loss arises from initially recognizing the components of the instrument separately.
- If the holder exercises the conversion option, the liability is derecognized and increase in equity of same amount is recognized.
- If the holder elects to receive cash, liability is derecognized along with a corresponding decrease in cash and bank.
- The original amount recognized in respect of the equity component remains in equity although it may be transferred from one line item to another within equity.

## 25. WHY EQUITY COMPONENTS IS THE RESIDUAL VALUE ?

- This method of allocating the liability and equity components is consistent with the definition of equity as a residual interest in the assets of an entity after deducting all of its liabilities.
- It ensures that no gain or loss arises on the initial recognition of the two components.

**QUESTION 18 :**

**CONVERTIBLE DEBT**

- **Entity A issues 2,000 convertible bonds on 1 January 20X5. The bonds have a 3-year term, and are issued at par with a face value of Rs 1,000 per bond, resulting in total proceeds of Rs 2 million. Interest is payable annually in arrears at an annual interest rate of 6 percent. Each bond is convertible, at the holder's discretion, at any time up to maturity into 250 ordinary shares. When the bonds are issued, the market interest rate for similar debt without the conversion option is 9 percent (i.e. the market interest rate for similar bonds with the same credit standing having no conversion rights).**
- **Being compound financial instrument, you are required to separate equity and debts portion**

**SOLUTION 18 : Calculation of Financial Liability and Equity**

| Year | Cashflow | PVF @ % | PV |
|---|---|---|---|
| 1 - 3 | | | |
| 3 | | | |
| | | | |
| Financial Liability | | | |

**Equity = Total Proceeds – Financial Liability**

In the financial statements of the issuer,

Journal entries :

| | | Rs | Rs |
|---|---|---|---|
| Dr | Cash | | |
| Cr | Financial liability | | |
| Cr | Equity | | |

**NOTE :**

**QUESTION 19 :**

**Entity A issues a bond with a principal amount of $100,000. The holder of the bond has the right to convert the bond into ordinary shares of Entity A. On issuance, Entity A receives proceeds of $100,000. By discounting the principal and interest cash flows of the bond using interest rates for similar bonds without an equity component, Entity A determines that the fair value of a similar bond without any equity component would have been $91,000. Therefore, the initial carrying amount of the liability component is $91,000. The initial carrying amount of the equity component is computed as the difference between the total proceeds (fair value) of $100,000 and the initial carrying amount of the liability component of $91,000. Thus, the initial carrying amount of the equity component is $9,000. Pass journal entry:**

**SOLUTION : 19**

| | | |
|---|---|---|
| | | |

**QUESTION 20 :**

**On October 31, 20X5, Entity A issues convertible bonds with a maturity of five years. The issue is for a total of 1,000 convertible bonds. Each bond has a par value of $100,000, a stated interest rate is 5% per year, and is convertible into 5,000 ordinary shares of Entity A. The convertible bonds are issued at par. The per-share price for an Entity A share is $15. Quotes for similar bonds issued by Entity A without a conversion option (i.e., bonds with similar principal and interest cash flows) suggest that they can be sold for $90,000.**

**Indicate how Entity A should account for the compound instrument on initial recognition.**

**SOLUTION : 20**

| | | |
|---|---|---|
| | | |

| | | |
|---|---|---|
| | | |

QUESTION 21 :

**Compound Financial Instruments :**

- **On 1st April, 2008 D Ltd. issued Rs.30,00,000, 6% convertible debentures of face value of Rs.100 per debentures at par. The debentures are redeemable at a premium of 10% on 31.03.12 or these may be converted into ordinary shares at the option of the holder the interest rate for equivalent debentures without conversion rights would have been 10%.**
- **Being compounded financial instrument, you are required to separate equity and debts portion as on 01.04.08.**
- **The present value of Re.1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:**

| End of year | 6% | 10% |
|---|---|---|
| 1 | 0.94 | 0.91 |
| 2 | 0.89 | 0.83 |
| 3 | 0.84 | 0.75 |
| 4 | 0.79 | 0.68 |

SOLUTION : 21 **Calculation of Financial Liability and Equity**

| Year | Cashflow | PVF @ 10% | PV |
|---|---|---|---|
| 1 - 4 | | 3.17 | |
| 4 | | 0.68 | |
| | | | |
| Financial Liability | | | |

**Equity =** Total Proceeds – Financial Liability

QUESTION 22 :

**Compound Financial Instruments :**

**On 1st April, 2008 Sigma Ltd. issued 6% Convertible debentures of face value of Rs.100 per debenture at par. The debentures are redeemable at a premium of 10% on 31-03-2012 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%. Being a compound financial instrument, you are required to separate equity and debt portions as on 01-04-2008. Equity portion is Rs.1,85,400. Find out the debt portion (Debenture amount). The present value of Re.1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:**

| End of year | 6% | 10% |
|---|---|---|
| 1 | 0.94 | 0.91 |
| 2 | 0.89 | 0.83 |
| 3 | 0.84 | 0.75 |
| 4 | 0.79 | 0.68 |

**SOLUTION : 22**

**QUESTION : 23**

**QUESTION FOR HOMEWORK**

**ASF Ltd., issued Rs 100,00,000 worth of 8% Debentures of face value Rs100 each on par value basis on 1st January, 2011. These debentures are redeemable at 12% premium at the end of 2014 or exchangeable for ordinary shares of Mega Ltd., on 1:1 basis. The interest rate for similar debentures that do not carry conversion entitlement is 12%. You are required to calculate the value of the debt portion of the above compound financial instrument.**

**SOLUTION : 23**

**QUESTION 24 :**

**ASF Ltd has issued 5000 convertible debentures with a face value of Rs. 100 per debentures. The interest rate on the debentures is 5%. The debenture holders have the option of converting these debentures into ordinary shares at the end of four years. The prevailing market rate for a similar debt which does not have a conversion right is 7%.**

**SOLUTION : 24**

**QUESTION 25 :**

**At the beginning of year 1, an enterprise issued 20,000 convertible debentures with face value Rs. 100 per debenture, at par. The debentures have six year term. The interest at annual rate of 9% is paid half-yearly. The bondholders have an option to convert half of the face value of debentures in to 2 ordinary shares at the end of year 3. The Bondholder not exercising the conversion option will be repaid at par to the extent of Rs. 50 per debenture at the end of year 3. The Non-convertible portion will be repaid at 10% premium at the end of year 6. At the time of issue, the prevailing market interest rate for similar debt without conversion option was 10%.**

**Calculation of Value of Debt and Equity**

**SOLUTION : 25**

**QUESTION : 26**

**On 1-4-2008 A Ltd. Issued 8% Debentures of Rs. 12,00,000. These are redeemable at 10% premium or to be converted into Equity Shares at choice of company on 31-3-2011. Rate of interest for Non Compound Financial Instrument is 14% Calculate value of liability and Equity.**

**ALTERNATIVELY, question can be presented like this :**

**On 1-4-2008 A Ltd. Issued 8% Debentures of Rs. 12,00,000. These are to be converted into Equity Shares on 31-3-2011. Rate of interest for Non Compound Financial Instrument is 14% Calculate value of liability and Equity.**

**SOLUTION : 26**

**QUESTION : 27**

**ASF Ltd. Issued 9% Convertible Debenture of Rs 7,00,000 at 10% discount on 1.4.2008 convertible on 31.3.2011. These are to be converted at 10% Premium. Discount Rate on non-Convertible Debentures is 13%.**

**Calculate Debt and Equity.**

**SOLUTION : 27**

**QUESTION 28:**

**A Ltd. Issued 9% Convertible Debentures at 10% discount for Rs 7,00,000 on 1.4.09. They are to be converted on 31.3.2012 at 5% premium. A Ltd Will pay cash bonus of Rs 50,000 on 31.3.2011. Debenture holders are required to pay Rs 20,000 for credit appraisal of Debenture on 31.03.2010. Similar Debenture without conversion rights carry rate of Interest of 18%. Calculate debt and equity.**

**SOLUTION : 28**

**QUESTION : 29**

**ASF Ltd. issued 10% Convertible Debentures for Rs 10,00,000 on 1.4.08. On 31.3.2011. Company will repay 40% debentures at 10% premium. On 31.3.2013 the company will convert remaining debentures into equity shares. Debenture-holders will have the option to receive cash instead of shares . Similar Debenture without conversion rights carry rate of Interest of 12%. Calculate debt and equity**

**SOLUTION : 29**

**QUESTION : 30**

**A Ltd. Issued on 1.4.2010, 12% debentures of Rs. 100 each for Rs. 10,00,000 at a discount of 6%. These are to be converted into equity shares. Date of conversion is 31.03.2013. Interest is charged yearly. Assume debenture without conversion right would be issued at 15%.**

**Calculate debt and equity .**

**SOLUTION : 30**

**QUESTION : 31**

**A ltd. Issued on 1.4.2008, 13% debentures of Rs. 15,00,000 at a discount of 10%. These are convertible into equity shares. Interest is paid yearly. At the end of year 3, the company has agreed to pay premium in cash @ 1%. Conversion date is 31.3.2013. Similar debentures, without conversion right can be issued at 18%. Calculate debt and equity. Prepare debt (financial liability) A/C and debt (equity) A/C.**

**SOLUTION : 31**

**QUESTION : 32**

**On 1.04.2010 X Ltd. Issued 9% Debentures Rs. 8,00,000 at 10% discount. Redemption Plan:-**

| | |
|---|---|
| **31.03.2012** | **50% Redemption at 10% Premium** |
| **31.03.2013** | **30% Redemption at 20% Premium** |
| **31.03.2014** | **20% Conversion at 10% Premium** |

**Calculate Financial Liability and Equity. Market rate is 13%**

**SOLUTION : 32**

## 26. CONVERTIBLE DEBT WITH ISSUER CALL (CALLABLE CONVERTIBLE BOND)

**WHAT IS CALLABLE BOND ?**

- Callable bond is one which gives the issuer a right to call back (buy) the bond from the bondholder before the maturity date at a specified price.
- This feature is in effect a call option written by the bondholder.
- The option premium (value of call) is payable by the issuer.

**Separating The Liability And Equity Components When The Instrument Has Embedded Derivatives**

- A compound instrument may also have embedded derivatives.
- For example, the instrument may contain a call option exercisable by the issuer.
- The value of any such embedded derivative features must be allocated to the liability component.

- The carrying amount of the liability component is established by measuring the fair value of a similar liability (with similar terms, credit status and embedded non-equity derivative features) but without an associated equity component.
- The carrying amount of the equity component is then determined by deducting the fair value of the liability component from the fair value of the compound instrument as a whole.

**Steps in accounting of Embedded derivative in callable bond**

**Step 1 –** Calculate the value of liability component as follows:

- Liability component (disregarding the call) – value of call payable by issuer
- *(This reflects the inclusion of the value of the additional embedded derivative feature (asset) in the liability component.)*

**Step 2 –** Calculate the value of Equity Component as follows:

- Equity component = Issue Proceeds – Value of Liability component as per step 1
- *[This represents the equity residual arrived at by subtracting from the fair value of the whole instrument the fair value of the liability component (which includes the value of the embedded derivative feature in the form of the purchased call feature).]*

**QUESTION : 33**

**Certain callable convertible debentures are issued at Rs 60. The value of similar debentures without call or equity conversion option is Rs 57. The value of call as determined using option pricing model is Rs 2. Determine the value of Liability and equity component.**

SOLUTION : 33

**Step 1 – value of liability component :**

**Liability component (disregarding the call) – value of call payable by issuer**

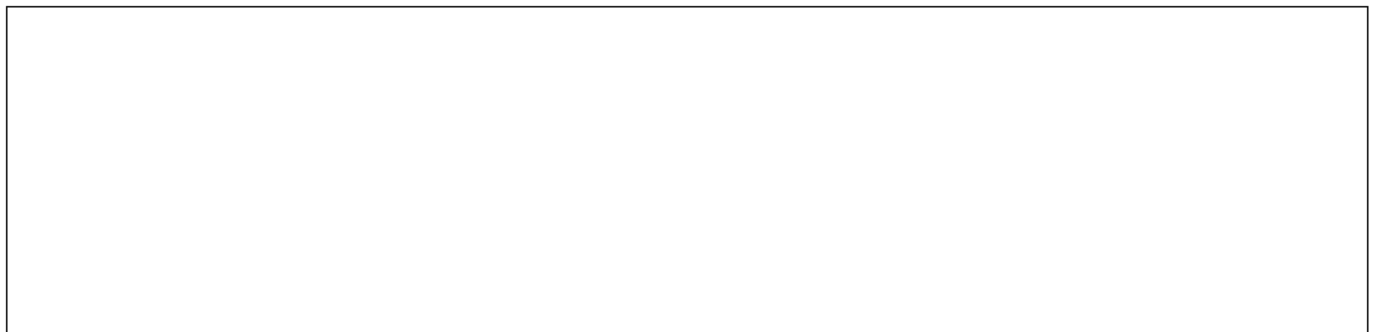
**=**

**Step 2 – value of Equity Component:**

**Equity component = Issue Proceeds – Value of Liability component as per step 1**

**=**

**Alternatively**



## 27. CONVERSION OF A COMPOUND INSTRUMENT

Upon conversion of a compound instrument, equity is issued and the liability component is derecognized.

Accounting Entry :

Liability A/C …………………….Dr

To Equity A/C

The original equity component recognized at inception remains in equity (although it may be reclassified from one line item of equity to another).

Accounting Entry :

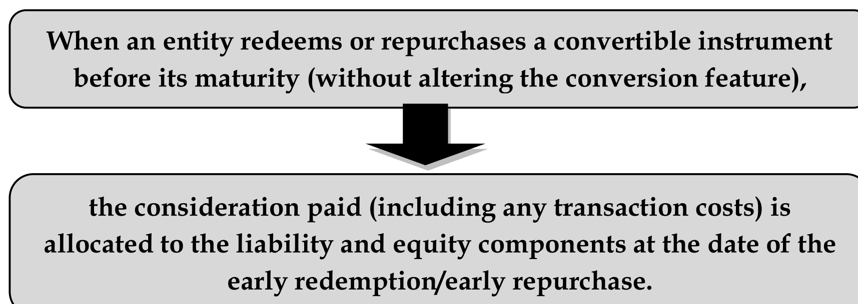
Equity A/C ……………………Dr

To Equity Share Capital A/C

To Securities Premium A/C

**Early redemption of a compound instrument**

- **When an entity redeems or repurchases a convertible instrument before its maturity (without altering the conversion feature),**




**Early redemption of a compound instrument**

| To the extent that the amount of the consideration allocated to the liability component | |
|---|---|
| Exceeds the carrying amount of the liability component at that time, a loss is recognized in profit or loss. | is smaller than its carrying amount, a gain is recognized in profit or loss. |

The amount of consideration allocated to equity is recognized in equity with no gain or loss being recognized (the equity component that is not eliminated may be reclassified to another line item within equity).

## 28. FOREIGN CURRENCY DENOMINATED CONVERTIBLE DEBT

**Foreign currency denominated convertible debt**

- An entity may issue an instrument denominated in a foreign currency (a currency other than the functional currency of the entity) that is convertible into a fixed number of ordinary shares of the entity.
- Such an instrument contains a written option to exchange a fixed number of equity instruments for a fixed amount of cash that is denominated in a foreign currency.
- A derivative contract over an entity's own equity is accounted for as equity only when it will be settled exclusively by the entity delivering (or receiving) a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset.
- An equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in entity's functional currency only.
- For example, in the case of a foreign currency denominated convertible bond, the conversion component fails the "fixed for fixed" test, as a fixed amount of foreign currency is not considered to represent a fixed amount of cash. Consequently, such bonds need to be classified as a liability in its entirety.

## 29. TREATMENT OF INTEREST, DIVIDENDS, GAINS AND LOSSES AND OTHER ITEMS ON LIABILITY/ EQUITY

- Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.

- Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.
- Transaction costs of an equity transaction are accounted for as a deduction from equity.

## 30. THE FOLLOWING ITEMS ARE TREATED AS INCOME OR EXPENSE IN PROFIT OR LOSS:

- Interest payments on a bond issued by an entity;
- Dividend payments on preference shares that are classified as financial liabilities;
- Gains and losses associated with redemption or refinancing an instrument classified as a financial liability;
- Gains and losses related to the carrying amount of an instrument that is a financial liability.
- Dividends that are non-discretionary represent a financial liability. Such dividends are recognized as income or expense in profit or loss.
- Dividends classified as an expense in profit or loss may be presented either with interest on other liabilities or as a separate item.

## 31. THE FOLLOWING ITEMS ARE ACCOUNTED FOR WITHIN EQUITY:

- Dividend payments on shares classified wholly as equity; and
- Incremental directly attributable costs incurred in successfully issuing or acquiring an entity's own equity instruments (including transaction costs, regulatory fees, amounts paid to regulatory, legal, accounting and other professional advisers, printing costs, stamp duties).
- The amount of transaction costs accounted for as a deduction from equity in the period is disclosed in line with the requirements of *IAS 1 "presentation of financial statements".*

## 32. TREASURY SHARES

- The shares which are bought back are called treasury shares.
- Treasury shares shall be deducted from equity.
- No gain/loss shall be recognized on treasury shares in Profit and Loss on purchase,sale, issue or cancellation of an entity's own equity instruments.
- Such treasury shares may be acquired and held by the entity or by the members of the consolidated group.
- Consideration paid or received shall be recognized directly in equity.

## 33. OFFSETTING FINANCIAL ASSETS AGAINST FINANCIAL LIABILITIES

- Set-off is allowed if and only if :
- There is a legally enforceable right to set them off.
- Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability.

**QUESTION : 34**

**Offsetting financial Assets against financial Liabilities**

**Entity A has a right to recover Rs.100 from Entity B against sales and an obligation to pay Rs.100 to Entity B against purchases. The amount is receivable and payable on demand. Can Entity A set-off the two amounts?**

**SOLUTION : 34**

## PROBLEMS FOR SELF-PRACTICE

**QUESTION : 35**

**Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Should this contract be classified as financial instrument?**

**SOLUTION : 35**

It is a cash settled transaction although valuation is linked to commodity price. So it is a financial instrument.

**QUESTION : 36**

**A Ltd issues a bond at principal amount of CU 1000 per bond. The terms of bond require annual payments in perpetuity at a stated interest rate of 8 per cent applied to the principal amount of CU 1000. Assuming 8 per cent to be the market rate of interest for the instrument when it was issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition. Evaluate the financial instrument in the hands of both the holder and the issuer.**

**SOLUTION : 36**

- For the Holder – right to receive cash in future – classifies to be a financial asset
- For the Issuer – contractual obligation to pay cash in future – classifies to be a financial liability.

**QUESTION 37 :**

**A Ltd. (the 'Company') makes purchase of steel for its consumption in normal course of business. The purchase terms provide for payment of goods at 30 days credit and interest payable @ 12% per annum for any delays beyond the credit period. Analyse the nature of this financial instrument.**

**SOLUTION 37 :**

A Ltd. has entered into a contractual arrangement for purchase of goods at a fixed consideration payable to the creditor. A contractual arrangement that provides for payment in fixed amount of cash to another entity meets the definition of financial liability.

**QUESTION 38 :**

**The amortisation schedule of the instrument is set out below:**

| Dates | Cash flows | Finance cost at effective interest rate | Liability | Equity |
|---|---|---|---|---|
| 1July 20X1 | 1,000,000 | - | 9,24,061 | 75,939 |
| 30 June 20X2 | (60,000) | 83,165 | 9,47,226 | 75,939 |
| 30 June 20X3 | (60,000) | 85,250 | 9,72,476 | 75,939 |
| 30 June 20X4 | (10,60,000) | 87,524 | - | 75,939 |

**Assume that D Ltd. has an early redemption option to prepay the instrument at ` 11 lakhs and on 30 June 20X3, it exercises that option. Calculate the value of the liability and equity components. Assume that Interest rate on 30 June 20x3 for one year maturity is 5%.**

**SOLUTION 38 :**

IAS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

The split will be made as below:

| Particulars | Amount (₹) |
|---|---|
| Present value of principal payable at 30 June 20X4 in one year's time (₹ 10 lakhs discounted at 5% for one year) | 9,52,381 |
| Present value of interest payable (₹ 60,000 discounted at 5% for one year) | 57,142 |
| Total liability component | 10,09,523 |
| Consideration paid | 11,00,000 |
| Residual – equity component | 90,477 |

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is debited to equity.

**QUESTION 39 :**

**K ltd. issued 500,000, 6% convertible debentures@ ` 10 each on 01 April 20X1. The debentures are due for redemption on 31 March 20X5 at a premium of 10%, convertible into equity shares to the extent of 50% and balance to be settled in cash to the debenture holders. The interest rate on equivalent debentures without conversion rights was 10%.**

**You are required to separate the debt and equity components at the time of issue and show the accounting entries in Company's books at initial recognition. The following present values of Re 1 at 6% and at 10% are provided:**

| Interest rate | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|
| 6% | 0.94 | 0.89 | 0.84 | 0.79 |
| 10% | 0.91 | 0.83 | 0.75 | 0.68 |

**SOLUTION 39 :**

Computation of debt component of convertible debentures on 01 April 20X1

| Particulars | Amount |
|---|---|
| Present value of principal amount repayable after 4 years | |
| (A) 5,000,000 * 50% * 1.10 * 0.68 (10% discount factor) | 1,870,000 |
| (B) Present value of interest [300,000 * 3.17] (4 years cumulative 10% discount factor) | 951,000 |
| Total present value of debt component (A) + (B) | 2,821,000 |
| Issue proceeds from convertible debentures | 5,000,000 |
| Value of equity component | 2,179,000 |

**Journal entry at initial recognition**

| Particulars | Dr. Amount (₹) | Cr. Amount (₹) |
|---|---|---|
| Bank A/c Dr. | 5,000,000 | |
| To 6% debenture A/c (liability component) | | 2,821,000 |
| To 6% debenture A/c (equity component) | | 2,179,000 |

(Being disbursement recorded at fair value)

**QUESTION 40 :**

**On 1 April 20X1, an 8% convertible loan with a nominal value of ` 6,00,000 was issued at par. It is redeemable on 31 March 20X5 also at par. Alternatively, it may be converted into equity shares on the basis of 100 new shares for each ` 200 worth of loan.**

**An equivalent loan without the conversion option would have carried interest at 10%. Interest of ` 48,000 has already been paid and included as a finance cost.**

**Present value rates are as follows:**

| Year End | @ 8% | @ 10% |
|---|---|---|
| 1 | 0.93 | 0.91 |
| 2 | 0.86 | 0.83 |
| 3 | 0.79 | 0.75 |
| 4 | 0.73 | 0.68 |

**How will the Company present the above loan notes in the financial statements for the year ended 31 March 20X2.**

**SOLUTION 40 :**

**Step 1** There is an 'option' to convert the loans into equity i.e. the loan note holders do not have to accept equity shares; they could demand repayment in the form of cash.

IAS 32 states that where there is an obligation to transfer economic benefits there should be a liability recognised. On the other hand, where there is not an obligation to transfer economic benefits, a financial instrument should be recognised as equity.

In the above illustration we have both – 'equity' and 'debt' features in the instrument. There is an obligation to pay cash – i.e. interest at 8% per annum and a redemption amount – this is 'financial liability' or 'debt component'. The 'equity' part of the transaction is the option to convert. So it is a compound financial instrument.

**Step 2** Debt element of the financial instrument so as to recognise the liability is the present value of interest and principal

The rate at which the same is to be discounted, is the rate of *equivalent* loan note *without* the conversion option would have carried interest at 10%, therefore this is the rate to be used for discounting

**Step 3** Calculation of the debt element of the loan note as follows:

8% Interest discounted at a rate of 10% Present Value (6,00,000 x 8)

| S. No | Year | Interest amount | PVF | Amount |
|---|---|---|---|---|
| Year 1 | 20X2 | 48,000 | 0.91 | 43,680 |
| Year 2 | 20X3 | 48,000 | 0.83 | 39,840 |
| Year 3 | 20X4 | 48,000 | 0.75 | 36,063 |
| | | | | 1,19,583 |
| Year 4 | 20X5 | 648,000 | 0.68 | 4,40,640 |
| **Amount to be recognised as a liability** | | | | 5,60,223 |

Initial proceeds (6,00,000)

**Amount to be recognised as equity** **39,777**

* In year 4, the loan note is redeemed therefore ₹ 6,00,000 + ₹ 48,000 = ₹ 6,48,000.

**Step 4** The next step is to recognise the interest component equivalent to the loan that would carry if there was no option to cover. Therefore, the interest should be recognised at 10%.

As on date ₹ 48,000 has been recognised in the statement of profit and loss i.e. 6,00,000 x 8% but we have discounted the present value of future interest payments and redemption amount using discount factors of 10%, so the finance charge in the statement of profit and loss must also be recognised at the same rate i.e. for the purpose of consistency.

The additional charge to be recognised in the income statement is calculated as:

Debt component of the financial instrument ₹ 5,60,000

| | |
|---|---:|
| Interest charge (5,60,000 x 10%) | ₹ 56,000 |
| Already charged to the income statement | (₹ 48,000) |
| Additional charge required | ₹ 8,000 |

**Journal Entries for recording additional finance cost for year ended 31 March 20X2**

| Particulars | Dr. Amount (₹) | Cr. Amount (₹) |
|---|---:|---:|
| Finance cost A/c Dr.<br>To Debt component A/c<br>(Being interest recorded for difference between amount recorded earlier and that to be recorded per IAS 32) | 8,000 | <br>8,000 |

**PROBLEM : 41**

**Entity A issues a 10 percent note with face value of $ 1000 for a period of three years. On maturity, the holder has an option either to receive a cash repayment of $1000 or 10,000 of the issuer's shares. The market interest rate for a note without a conversion feature would have been 12 percent at the date of issue. Entity has incurred transaction costs of $100 in issuing the convertible note.**

**There is a contractual obligation to pay cash for the annual interest payment and the principal amount at the end of three years that the issuer cannot avoid if the holder does not exercise the conversion option.**

**SOLUTION : 41**

The conversion option is classified as equity as it meets the fixed for fixed principle.

The split accounting is done as follows -

FV of the convertible note — FV of liability component = FV of equity component

| Year | Cash flow | Amount $ | Discount factor at 12 % | NPV of cash now $ |
|---|---|---:|---:|---:|
| 1 | Interest | 100 | 1/(1.12) | 89 |
| 2 | Interest | 100 | 1/(1.12)(1.12) | 80 |
| 3 | Interest and principal | 1 100 | (1.12)<br>1/(1.12)(1.12) | 783 |
| FV of liability component | | | | 952 |
| Equity component | | | 1000-952 | 48 |

**Transaction costs are to be** allocated to the liability and the equity components in the ratio of amounts allocated and accounted for as follows -

1) For Equity transaction, costs are deducted from equity.
2) For financial liabilities, not measured at fair value through profit or loss, transaction costs are deducted from the carrying amount of the financial liability.

| Allocated amount $ | Transaction cost $ | Carrying amount $ |
|---|---|---|
| Liability 952 | (100)*(952 / 1000) = 95 | 857 |
| Equity 48 | (100)*(48/ 1000) = 5 | 43 |

**PROBLEM : 42**

**Kappa is a listed entity whose year-end date is 30 September 2007. On 1 October 2006, Kappa issued a $6 million convertible loan note. The quoted rate of interest on the loan note was 2 percent per annum, payable on 30 September in arrears. The loan note was repayable at an amount of $7 million on 30 September 2009.**

**As an alternative to repayment, the lender may choose to receive 1 million shares in Kappa (having a nominal value of $1 each). The required rate of return for providers of this type of loan finance at 1 October 2006 was 10 percent per annum**

**SOLUTION : 42**

Under IAS 32, the convertible instrument needs to be split into liability and equity component.

The fair value of the liability is the present value of the cash outflow. The equity element is valued at the difference between the fair value of the instrument as a whole and the fair value of the liability. **$ '000**

| Fair value of the financial instrument as a whole | | 6000 |
|---|---|---|
| Initial carrying value of financial liability = PV of future cash outflows that would occur if the loan is repaid, discounted at 10% | {(120/ (1.10)) + [120/ (1.10) ^2] + [(7000+120)/ ( 1 . 10) ^3)]} | 5557 |
| Equity element = FV of financial instrument as a whole — FV of Liability | (6,000 - 5557) = | 443 |

The financial liability is not held for trading and so is measured using amortised cost.

$ '000

| Initial carrying value of financial liability | | 5557 |
|---|---|---|
| Finance cost | 10% * 5557 | 556 |
| Interest paid @ 2% on Face Value | 2% * 6000 | ( 120) |
| Closing Carrying Amount of Liability | | 5993 |

**PROBLEM : 43**

**On 1 October 2009 Epsilon issued 5 million loan notes that had a value of $1 per note. The issue costs were 3 cents per note. Each note holder will receive interest of 5 cents per note on 30 September of each year starting on 30 September 2010. The loan notes are repayable on 30 September 2019 at $1.20 per note. As an alternative to repayment, the loan note holders can elect to exchange their notes for shares in Epsilon. On 1 October 2009, the credit rating of Epsilon was such that it would have had to offer investors in non-convertible loan notes, a rate of return of 9 percent per annum on any investment. The impact of issue costs would increase the effective interest rate on such loan notes to 9.45 percent.**

**The following information regarding discount rates may be relevant:**

| Discount rate | Present value of $1 receivable | Cumulative present value of $1 at the end of year 10 receivable at the end of years 1—10 |
|---|---|---|
| 5% | 61 cents | $7.72 |
| 9% | 42 cents | $6.42 |

**SOLUTION : 43**

Under IAS 32, the convertible instrument needs to be split into liability and equity component. The fair value of the liability is the present value of the cash outflow. The equity element is valued at the difference between the fair value of the instrument as a whole and the fair value of the liability. $'000

| | | |
|---|---|---|
| Fair Value of instrument | | 5000 |
| Liability component | Present value of future cash outflows discounted at 9% = [(5,000 * 0.05) * $6.42) + [5,000 * 1.20 * $0.42)] | 4125 |
| Equity element | Fair Value of instrument — Fair value of liability = $(5000 - 4125) | 875 |
| Issue costs | (5,000 * $0.03)<br>These should be allocated to the liability and equity components in the ratio 4, 125:875 | 150 |
| Issue costs allocated to liability component | $(150 * 4125/5,000) | 124 |
| Issue costs allocated to the equity component | $(150 * 875/5,000) OR (150- 124) | 26 |
| The opening equity component | $ (875 - 26)<br>Equity component will be unchanged over life of instrument | 849 |
| The opening liability component | $ (4125-124)<br>Liability component will be measured at amortised cost using an effective interest rate of 9.45%. | 4001 |
| Finance cost for the year | $ (4,001 * 9.45%) | 378 |
| Closing liability | $ [(4001 + 378) - (5000 x 5%)] = $4379-250 | 4129 |

| Statement of financial position | $'000 |
|---|---|
| Non-current liability | 4 129 |
| Other components of equity | 849 |

| Statement of comprehensive income | $'000 |
|---|---|
| Finance cost | 378 |

**PROBLEM : 44**

**On 1 April 2010, Alpha issued 300 million loan notes of per note at par. The loan notes entitled the holders to an interest payment of 5 cents per note, payable annually in arrears. The loan notes are repayable at par on 31 March 2015. As an alternative to repayment, the holders can elect to convert the notes into equity shares in Alpha. On 1 April 2010 investors in non-convertible notes would expect an annual return of 8 percent.**

**You are given the following discount factors:**

| Discount rate | Present value of $1 receivable | |
|---|---|---|
| | At the end of year 5 | Cumulative at the end of year 1 - 5 |
| 5% | 78.4 cents | $4.33 |
| 8% | 68.1 cents | $3.99 |

**On 1 April 2010, the directors of Alpha recorded a loan liability of $300 million and in the year ended 31 March 2011, a finance cost of $15 million (300 million x 5 cents) in respect of these notes.**

**SOLUTION : 44**

Under IAS 32, the convertible instrument needs to be split into liability and equity component. The fair value of the liability is the present value of the cash outflow. The equity element is valued at the difference between the fair value of the instrument as a whole and the fair value of the liability. $'000

| | | |
|---|---|---|
| Fair value of the financial instrument as a whole | | 300000 |
| Liability element of compound financial instrument at 1 April 2010 | Present value of the future cash outflows discounted at 8%, (15000 * $3.99) +(300000 * $0.681 | 264150 |
| Equity component (Fair value of the financial instrument as a whole — Fair Value of Liability ) | $(300000-264150) | 35850 |
| Finance cost at 8% | $264,150 * 0.08 | 21132 |

**PROBLEM : 45**

**The long-term borrowings of Alpha include a loan at a carrying amount of $60 million which was taken out on 1 October 2012. The loan does not carry any interest but $75.6 million is repayable on 30 September 2015. This represents an effective annual rate of return of 8 percent for the investors. As an alternative to repayment, the investors can exchange their loan asset for equity shares in Alpha on 30 September 2015. The annual rate of return required by such investors on a non-convertible loan would have been 10 percent. Alpha has not charged any finance cost in respect of this loan for the year ended 30 September 2013.**

**The present value of $1 is payable/ receivable in three years time as follows:**

- **79.4 Cents when the discount rate is 8% per annum.**
- **75.1 cents when the discount rate is 10% per annum.**

**SOLUTION : 45**

Under IAS 32, the convertible instrument needs to be split into liability and equity component. The fair value of the liability is the present value of the cash outflow. The equity element is valued at the difference between the fair value of the instrument as a whole and the fair value of the liability, The equity component is presented as part of other components of equity in statement of financial position. The closing liability is presented as part of non current liabilities. $'000

| | | |
|---|---|---|
| Fair value of the financial instrument as a whole | | 60000 |
| Liability element of compound financial instrument at 1 October 2012 | Present value of the future cash outflow discounted at 10%. (75600 * 0.751) | 56776 |
| Equity component — (Fair value of the financial instrument as a whole — Fair Value of Liability ) | (60000 - 56776) | 3224 |
| Finance cost at 10% | (10% x 56776) | 5678 |
| Closing Carrying Amount of liability | (56776 + 5678) | 62454 |

**PROBLEM : 46**

**On 1 January 2009, Entity A issued a 10% convertible debenture with a face value of INR 1,000 maturing on 31 December 2018. The debenture is convertible into equity shares of Entity A at a conversion price of INR 25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11%**

**On 1 January 2014, the convertible debenture has a fair value of INR 1,700. Entity A makes a tender offer to the holder of the debenture to repurchase the debenture for INR 1,700, which the holder accepts. At the date of repurchase, Entity A could have Issued non-convertible debt with a five-year term bearing a coupon interest rate of How does Entity A account for the repurchase?**

**SOLUTION : 46**

The first step would be to see how the instrument is initially accounted for based on split accounting. In the financial statements of Entity A the carrying amount of the debenture is allocated on issue as follows: **INR**

| | |
|---|---|
| **Liability component** | |
| Present value of 20 half-yearly interest payments of INR 50, Discounted at 11% | 597 |
| Present value of INR 1,000 due in 10 years, discounted at 11%, Compounded half-yearly | 343 |
| | 940 |
| Equity component (Difference between INR 1,000 total proceeds and INR 940 allocated above) | 60 |
| **Total proceeds** | **1,000** |

The repurchase price is allocated as follows:

| **Liability component:** | **Carrying Value INR** | **Fair Value INR** | **Difference INR** |
|---|---|---|---|
| Present value of 10 remaining half- yearly interest Payments of INR 50, discounted at 11% and 8%, respectively | 377 (50 x Annuity factor | 405(50 x Annuity factor @4% | |
| Present value of INR 1,000 due In 5 years, discounted at 11% and 8%, compounded half yearly, respectively | 585 | 676 (1000 x 0.676) | |
| | 962 | 1,081 | (119) |
| Equity component * Balancing figure | 60 | 619* | (559) |
| Total | 1,022 | 1,700 | (678) |

Entity A recognises the repurchase of the debenture as follows'.

| | |
|---|---|
| Debit Liability component | INR 962 |
| Debit Debt settlement expense (P&L) | INR 119 |
| Credit Cash | INR 1,081 |
| To recognise the repurchase of the liability component | |
| Debit Equity component | INR 60 |
| Debit Reserves and Surplus | INR 559 |
| Credit Cash | INR 619 |
| To recognise the cash paid for the equity component | |

The debt settlement expense represents the difference between the carrying value of the debt component and its fair value.

**PROBLEM : 47**

**The amortisation schedule of the instrument is set out below:**

| Dates | Cash flows | Finance cost at effective interest rate | Liability | Equity |
|---|---|---|---|---|
| 1July 20X1 | 1,000,000 | - | 9,24,061 | 75,939 |
| 30 June 20X2 | (60,000) | 83,165 | 9,47,226 | 75,939 |
| 30 June 20X3 | (60,000) | 85,250 | 9,72,476 | 75,939 |
| 30 June 20X4 | (10,60,000) | 87,524 | - | 75,939 |

**Assume that D Ltd. has an early redemption option to prepay the instrument at ` 11 lakhs and on 30 June 20X3, it exercises that option. Calculate the value of the liability and equity components.**

**Assume that Interest rate on 30 June 20x3 for one year maturity is 5%.**

**SOLUTION : 47**

Ind AS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

The split will be made as below:

| Particulars | Amount (₹) |
|---|---|
| Present value of principal payable at 30 June 20X4 in one year's time (₹ 10 lakhs discounted at 5% for one year) | 9,52,381 |
| Present value of interest payable (₹ 60,000 discounted at 5% for one year) | 57,142 |
| Total liability component | 10,09,523 |
| Consideration paid | 11,00,000 |
| Residual – equity component | 90,477 |

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is debited to equity.

# IFRS 9 — FINANCIAL INSTRUMENT

## 1. INTRODUCTION

This standard contains guidance on the recognition, de-recognition, classification and measurement of financial instruments, including impairment and hedge accounting.

Recognition of impairment based on forecasted cash flow is envisaged in this standard.

## 2. FINANCIAL ASSETS AND FINANCIAL LIABILITIES - INITIAL RECOGNITION

**QUESTION 1 :**

**When should Financial assets and financial liabilities be initially recognized?**

**SOLUTION 1 :**

**EXAMPLES OF INITIAL RECOGNITION OF ARRANGEMENTS AS FINANCIAL ASSETS AND FINANCIAL LIABILITIES ARE:**

1. **Unconditional receivables and payables**
   - When the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
2. **Issued debt**
   - When the entity that issues it becomes a party to the contractual terms of the debt and, consequently, has a legal obligation to pay cash to the debt holder.
3. **Derivative**
   - Recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place

**ARRANGEMENTS THAT ARE NOT RECOGNIZED AS FINANCIAL ASSETS AND FINANCIAL LIABILITIES ARE:**

1. **PLANNED FUTURE TRANSACTIONS, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.**
2. **DERIVATIVE CONTRACTS to buy or sell non-financial items that are scoped out of IFRS 9 are not recognized as financial assets and financial liabilities because they are executory contracts.**
3. **ASSETS TO BE ACQUIRED AND LIABILITIES TO BE INCURRED AS A RESULT OF A FIRM COMMITMENT to purchase or sell goods or services are generally not recognized until at least one of the parties has performed under the agreement.**

## 3. FINANCIAL ASSETS AND LIABILITIES - INITIAL MEASUREMENT

- ▶ A Financial asset or a financial liability should be measured at initial recognition at its fair value plus or minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability. **(EXCEPTION – FVTPL)**
- ▶ Trade receivables are initially measured at their transaction price and not at fair value.

**QUESTION 2 : [Initial recognition of loan asset at concessional interest rate]**

**X Ltd. lends Rs.100 million for 5 years to one of its group company at 2% interest when the benchmark yield is 12%. What should be the fair value of the loan for initial recognition?**

**SOLUTION 2 :**

The fair value of a long-term loan or receivable that carries no interest can be estimated at the present value of all future cash receipts discounted using the prevailing market rate (s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset. The difference between the transaction price and fair value is accounted as loss/gain at initial recognition because this, the fair value is computed on the basis of observable market rate.

The difference of Rs. 36.05 million is expensed through profit and loss. This is fair value loss at initial recognition of financial asset.

**Accounting entry (Amount in Rs. million)**

| | | | |
|---|---|---|---|
| Loan Asset Account | Dr. | | |
| Fair Value Loss Account | Dr. | | |
| Bank Account | Cr. | | |

This type of fair value loss is popularly termed as Day 1 loss. Since the fair value is measured based on observable market rate, the gain or loss is recognised at initial recognition.

**QUESTION 3 :**

What if the fair value of a financial asset or a financial liability at initial recognition differs from the transaction price?

**SOLUTION 3 :**

## 4. TRANSACTION COSTS

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or a financial liability.

## 5. EXAMPLES OF TRANSACTION COSTS :

- Fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers,
- Levies by regulatory agencies and security exchanges, and
- Transfer taxes and duties.

However, debt premiums or discounts, financing costs, internal administrative costs are not transaction costs.

**The consequences of the treatment of transaction costs on initial measurement are:**

| | |
|---|---|
| **For debt instruments subsequently measured at amortized cost or FVTOCI** | Transaction costs are included in the calculation of effective interest rate (EIR) - in effect, they are amortized through profit or loss over the term of the instrument. |
| **For investments in equity instruments designated as at** | The transaction costs remain in equity and are not subsequently reclassified to profit or loss. An entity may choose to reclassify |

| FVTOCI | within equity the cumulative gain or loss (which includes transaction costs), for example, when the investment in equity instrument is derecognized. |
|---|---|
| **For financial instruments classified as at FVTPL** | Transaction costs are recognized in profit or loss immediately on initial recognition |

**QUESTION 4 : Transaction costs**

**An entity acquires a financial asset for Rs 100 plus a purchase commission of Rs 2 that is measured at Amortised Cost.**

**SOLUTION 4 :**

## 6. FINANCIAL ASSETS - CLASSIFICATION AND SUBSEQUENT MEASUREMENT

Under **IFRS 9**, financial assets are classified according to the measurement basis. Subsequent to initial recognition, the financial assets are measured at:

- **amortized cost,**
- **fair value through other comprehensive income (FVTOCI) or**
- **FVTPL.**

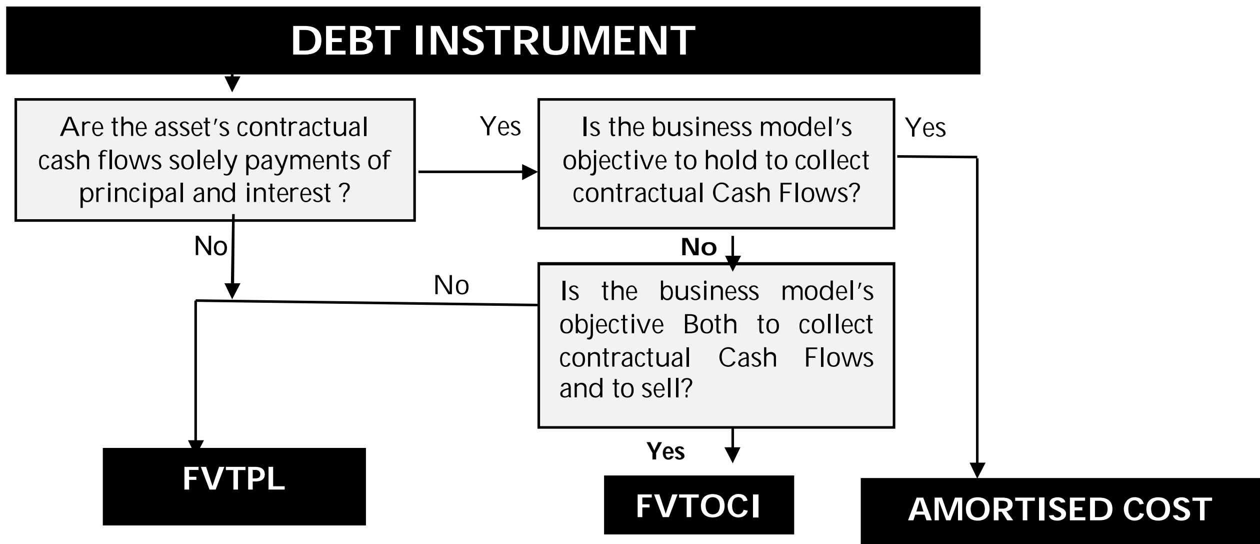
Investment in equity instruments are required to be measured at FVTPL, except that investment in equity instruments meeting certain criteria may be irrevocably designated as at FVTOCI on initial recognition.

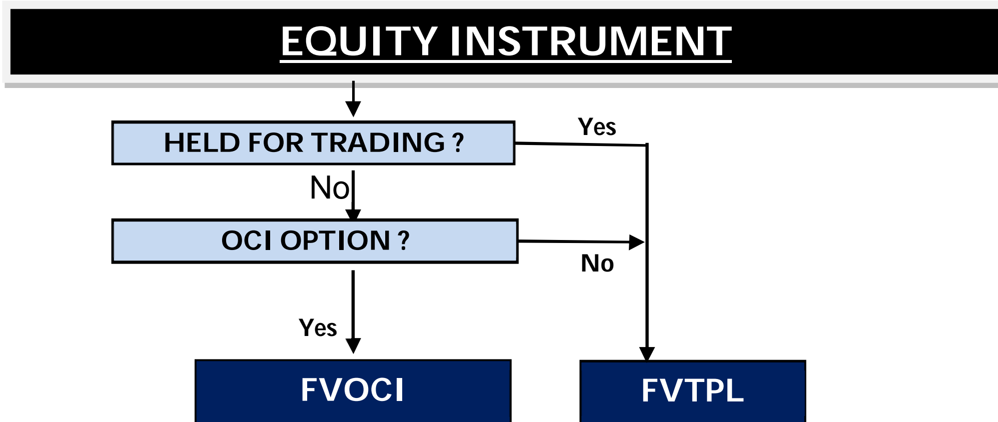
Except for financial assets that are designated at initial recognition as at FVTPL, the classification of a financial asset is based on:

- the entity's **business model** for managing the financial assets; and
- the **contractual cash flows** characteristics of the financial asset.

## 7. PRINCIPLES OF FINANCIAL ASSET CLASSIFICATION

**How to identify FVTPL, FVOCI and Amortised cost Instrument**






## 8. BUSINESS MODEL ASSESSMENT

Business model to hold assets to collect contractual cash flows

- Financial assets that are held within a business model whose objective is to hold assets in order to collect contractual cash flows over the life of the instrument.
- That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows (instead of managing the overall return on the portfolio by both holding and selling assets).

## 9. BUSINESS MODEL TO HOLD ASSETS BOTH TO COLLECT CONTRACTUAL CASH FLOWS AND TO SELL

There are various objectives that may be consistent with this type of business model.

For example, the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding.

To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.

Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and value of sales.

This is because selling financial assets is integral to achieving the business model's objective instead of being only incidental to it.

However, there is no threshold for the frequency or value of sales that must occur in this business model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

## 10. CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

For a financial asset that is a debt instrument to be measured at amortized cost or FVTOCI, its contractual terms must give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

For the purposes of applying this requirement, principal is the fair value of the financial asset at initial recognition, however that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

Interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.

The assessment as to whether contractual cash flows are solely payments of principal and interest is made in the currency in which the financial asset is denominated.

In practice only debt instruments held are capable of meeting the contractual cash flows characteristics test discussed above.

Derivative assets and investments in equity instruments will not meet the criteria.

**QUESTION 5:**

**Zero coupon bond**

- **Entity W acquires a zero coupon bond that was originally issued by Entity X. The terms of the bond require repayment of Rs 10 million by Entity X in 3 years and is not pre-payable. The terms of the bond do not include a contractual interest rate. Whether Entity W acquired the zero coupon bond at the date it was originally issued by Entity X or at a later date does not affect the assessment as to whether the asset can be classified at amortized cost or FVTOCI by Entity W.**

**SOLUTION 5 :**

## 11. FLOATING RATE LOANS

A financial asset that has a variable rate of interest that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time and other basic lending risks and costs, as well as a profit margin, will meet the contractual cash flow characteristics test.

**QUESTION 6 :**

**Entity S lends Rs 10 million to Entity T.**

**The terms of the loan require Entity T to repay Rs 10 million in 3 years and the loan is not pre payable. The interest rate on the loan is based on LIBOR plus 2 percent on Rs 10 million payable in arrears at the anniversary date of the lending.**

**The rate of LIBOR is determined in advance, i.e. at the start of each annual period. There are no other features in the contractual terms that result in any variability in the contractual cash flows.**

**Whether contractual cash flows characteristics test is met ?**

**SOLUTION 6 :**

**QUESTION 7:**

**<u>Adjustments to the coupon for changes in credit risk of the issuer</u>**

**Entity Q lends Rs 10 million to Entity P. The terms of the loan require repayment of Rs 10 million by Entity P in five years. The interest rate is payable yearly in arrears and is calculated as follows:**

**fixed rate of 6 percent (considered to be compensation for the time value of money); plus a credit margin that initially reflects the credit risk of the borrower at the date the loan is originated and is automatically adjusted on an annual basis during the loan term to reflect changes in the borrower's credit risk. Whether contractual cash flows characteristics test is met ?**

**SOLUTION 7 :**

## 12. PERPETUAL DEBT INSTRUMENTS

- The fact that an instrument is perpetual (i.e. it has no stated maturity date) does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding.
- Consideration will need to be given to the contractual interest rate, which will include whether it provides for consideration for **the**
  - **time value of money,**
  - **credit risk of the borrower,**
  - **liquidity risk, and**
  - **a profit margin for the lender.**
- Variability in the contractual cash flows due to factors other than this will generally result in the instrument failing the contractual cash flows characteristics test.

## 13. CRITERIA FOR MEASUREMENT AT FVTPL

- Any financial asset that **does not qualify for amortized cost measurement or measurement at FVTOCI** must be measured subsequent to initial recognition at FVTPL (except in the case of an investment in an equity instrument irrevocably designated as at FVTOCI).
- In addition, financial assets that are **held for trading or designated at initial recognition** as at FVTPL must be measured subsequent to initial recognition at FVTPL.

## 14. FINANCIAL ASSETS HELD FOR TRADING

**A financial asset is held for trading if:**

- it is acquired principally for **the purpose of selling it in the near term;**
- on **initial recognition it is part of a portfolio of identified financial instruments that are managed together** and for which there is evidence of a recent actual pattern of **short-term profit-taking**; or
- is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

## 15. DESIGNATION OF CERTAIN FINANCIAL ASSETS AS AT FVTPL

An entity may, at initial recognition, **irrevocably designate a financial asset** that meets the conditions for amortized cost measurement or measurement at FVTOCI as at FVTPL if that designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would have occurred if the financial asset had been measured at amortized cost or FVTOCI respectively.

**Investment in equity instruments are required to be measured at FVTPL**, except that investment in equity instruments meeting certain criteria may be **irrevocably designated as at FVTOCI on initial recognition.**

## 16. FVTPL

- Assets classified as at FVTPL are measured at **fair value.**
- **Gains and losses** that arise as a result of changes in fair value are **recognized in profit or loss**, except for those arising on hedging instruments that are designated in effective cash flow hedges or hedges of net investments in foreign operations.

- **Gains and losses** that arise **between the end of the last reporting period and the date an instrument is de-recognized** do not constitute a separate 'profit/loss on disposal'.
- Such gains and losses will have arisen prior to the disposal, while the item is still being measured at FVTPL, and should be recognized in profit or loss when they occur.

## 17. ACCOUNTING FOR FAIR VALUE THROUGH P&L (FVTPL) ASSETS

| | |
|---|---|
| Initial Recognition | On acquisition, FVTPL assets are recognised at Fair values. |
| Transaction cost | Transferred to P & L A/c. |
| On each reporting date | The instrument is **re-measured at fair value**. The difference is transferred to P & L A/C.<br>**On Increase in Value** :<br>Financial Asset A/C … Dr<br>To P & L A/C<br>**(Reverse the entry in case of decrease in value)** |
| On settlement date | The instrument is **re-measured at fair value.** The difference is transferred to **P & L A/C** |
| On sale | The difference between carrying amount and sale proceeds is **transferred to P & L A/C. Transaction cost** is transferred separately to **P & L A/C** |
| Dividend Income | Recognised in P & L Account when the right to receive the dividend is established |
| Examples | Non- Derivative -Shares, Debentures. Derivative – Future, Options. |

**QUESTION 8 :** - FVTPL

| Date | Particulars | Amount (Rs) |
|---|---|---|
| 07.02.18 | Purchased one share | 709 |
| 31.3.18 | Year-end date | 740 |
| 14.4.18 | Sale of share | 750 |

**SOLUTION 8 :**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| | | | |
| | | | |
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**QUESTION 8 : – FVTPL**

**On 1st April, 20X1 ASF Ltd bought 6% 1000 Bonds of ABC @ Rs 85 maturing on 31 March, 20X6. Bond to be valued at FVTPL. Market rate on 31 March 20X2 Rs 89.**

**Show the journal entries carrying value in SOFP and SOPL.**

**SOLUTION 9 :**

| Date | Particulars | | Debit | Credit |
|---|---|---|---|---|
| 1.4.20X1 | Investment A/C ((Bonds – FVTPL) A/C … | Dr | | |
| | To Bank A/C | | | |
| 31.3.20X2 | Bank A/c.. | Dr | | |
| | To Interest Income A/C (SOPL) | | | |
| 31.3.20X2 | Investment A/C ((Bonds – FVTPL) A/C … | Dr | | |
| | To P& L A/C | | | |
| | [unrealised gain = 1000 x (89-85) = 4000 transferred to SOPL] | | | |

**Statement of Comprehensive Income**

| A | **Other Income** | |
|---|---|---|
| | Interest Income | |
| | Unrealised Gain on Bonds-FVTPL | |

**Statement of Financial Position – Asset Side**

| A | **Current Assets** | |
|---|---|---|
| | Financial Assets | |
| | Investmens in Bonds-FVTPL (85000+4000) | |

**QUESTION 10 :** – FVTPL

On 1st April, 2020 ASF Ltd bought 1000 equity shares of B Ltd @ Rs 30, **stamp duty Rs 0.50 per share and commission on purchase @ Rs 0.30 per shares**. Equity shares are to be valued at FVTPL. Market rate on 31 March 2021 Rs 35.

Show the journal entries carrying value in SOFP and SOPL.

**SOLUTION 10 :**

**Statement of Comprehensive Income**

| Date | Particulars | | Debit | Credit |
|---|---|---|---|---|
| 1.4.2020 | Investment in Equity shares (FVTPL) A/C (1000 x 30) | Dr | 30,000 | |
| | To Bank A/C | | | 30,000 |
| 1.4.2020 | Transaction Cost A/C [1000 x (0.50+0.30)] | Dr | 800 | |
| | To Bank A/C | | | 800 |
| 31.3.2021 | Investment in Equity shares (FVTPL) A/C [1000 x (35-30)] | Dr | 5,000 | |
| | To P& L A/C | | | 5,000 |
| | [unrealised gain 4000 transferred to SOPL] | | | |
| 31.3.2021 | P& L A/C | Dr | 800 | |
| | To Transaction Cost A/C | | | 800 |
| | (Transaction Cost transferred to SOPL) | | | |

| A | **Other Income** | |
|---|---|---|
| | Fair Value Gain | 5000 |
| B | **Expenses –** Transaction Cost | 800 |

**Statement of Financial Position – Asset Side**

| A | **Current Assets** | |
|---|---|---|
| | Financial Assets | |
| | Investmens in Equity Shares of B Ltd (1000 x 35) | 35,000 |

## 18. AMORTISED COST CATEGORY

### CRITERIA FOR AMORTIZED COST MEASUREMENT

- **Two conditions need to be satisfied to measure a financial asset at amortized cost:**
- **Business model test** - The assets must be held in a business model whose objective is to collect the contractual cash flows (as opposed to an objective of realizing fair value through sale) **AND**
- **Contractual cash flows characteristics test.-** The contractual cash flows are solely payments of principal and interest on principal, where interest is the compensation for the time value of money and credit risk (the

## 19. ACCOUNTING FOR AMORTIZED COST

- The amortised cost category applies only to debt instrument financial assets that meet the specified criteria.
- Amortised cost measurement requires the application of the **effective interest method.**

**Accounting for AMORTISED COST CATEGORY**

| Initial Recognition | On acquisition, recognise at Fair values. |
|---|---|
| Transaction cost | Included in the cost. |
| Subsequent measurement | Measured every year at **amortised cost .** |
| Accounting | The accounting will be done through **effective interest rate method.** |
| Effective interest rate | Effective interest rate is<br>- The rate that exactly discounts<br>- Estimated future cash payments (or receipts) through the expected life of the Financial Instrument (FI) to the net carrying amount of FI.<br>It is the Internal Rate of Return (IRR). |
| On maturity | On maturity the amortised amount will be equal to the maturity proceeds. |
| Change in Fair Value | **Gains and losses resulting from fluctuations in fair value are not recognised** for financial assets classified in the amortised cost measurement category. |

**QUESTION 11 :**

**WHAT is Amortized cost**

**SOLUTION 11 :**

Amortised cost of a financial instrument is defined as the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

**QUESTION 12:**

**A Ltd issued 6 % debentures of Rs 10 lacs at 10 % discount redeemable after 3 years at par. Prepare debenture account assuming Amortized cost category.**

**SOLUTION 12 :**

**QUESTION 13:** Amortized cost –

- On January 1, 20X5, Entity A purchases a bond in the market for Rs 53,993. The bond has a principal amount of Rs 50,000 that will be repaid on December 31, 20X9. The bond has a stated rate of 10% payable annually, and the quoted market interest rate for the bond is 8%.
- Required
- Indicate whether the bond was acquired at a premium or a discount.
- Prepare an amortization schedule that shows the amortized cost of the bond at the end of each year between 20X5 and 20X9 and reported interest income in each period. Journalise.

**SOLUTION 13 : :AMORTISATION SCHEDULE**

| Year | Amortised cost at the beginning | Interest received @ 10% | Interest income recognised @ 8% | Amortisation of Debt Premium | Amortised cost at the end |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 = 3-4 | 6 = 2 - 5 |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

## JOURNAL ENTRIES

**QUESTION 14 :** AMORTIZED COST

- On January 1, 20X5, Entity A purchases a bond in the market for Rs 93,400. The bond has a principal amount of Rs 100,000 that will be repaid on December 31, 20X9. The bond has a stated rate of 6% payable annually, and the quoted market interest rate for the bond is 7.64%.

**REQUIRED**

- Indicate whether the bond was acquired at a premium or a discount.
- Prepare an amortization schedule that shows the amortized cost of the bond at the end of each year between 20X5 and 20X9 and reported interest income in each period. Journalise.

**SOLUTION 14:** :Amortisation Schedule

| Year | Amortised cost at the beginning | Interest received @ 6% | Interest income recognised @ 7.64% | Amortisation of Debt Discount | Amortised cost at the end |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 = 3-4 | 6 = 2 - 5 |
| | | | | | |
| | | | | | |
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## JOURNAL ENTRIES

## 20. TREATMENT OF STAFF ADVANCES

- Staff advances are given at a concessional rate of interest. Staff advances will be dealt with as follows:
- **Step 1 –** identify cashflow arising out of contract.
- **Step 2 –** discount such cashflows at effective interest rate which will be management's estimate.
- **Step 3 -** value of staff advance to be shown as asset = Present Value of Cashflows calculated above.
- **Step 4** – Calculate Staff cost

Staff cost = Amount lent to staff – Value of staff advance as per step 3

- **Step 5 – Treatment of staff cost**
  - Staff cost will be written off over vesting period as per the contract, or
  - Immediately, if no vesting period.

**QUESTION 15 :- Amortized cost**

**C Ltd granted Rs. 10,00,000 loan to its employees on January 1, 2009 at a concessional rate of 4% p.a. Loan is to paid in five equal instalments along with interest. Market rate of interest for such loan is 10% p.a.**

- **Record the entries for the year ended 31.12.09 for the loan transaction, and also calculate the value of loan initially to be recognised and amortised cost for all the subsequent years.**
- **The Present value factors based on discount factor of 10% can be taken as 0.9090, 0.8263, 0.7512, 0.6829 and 0.6208.**
- **Prepare staff loan account.**

**Step 1 : Calculation of initial recognition amount of loan to employees**

| Year | Principal | Interest @ 4% | Total cashflow | PV factor | PV |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 = 2+3 | 5 | 6=4 x 5 |
| | | | | | |
| | | | | | |
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| | | | | | |

**Step 2 : Calculation of amortised cost of loan to employees**

| Year | Amortised cost (opening balance) | Interest to be recognised@ 10% | Repayment including interest | Amortised cost (closing balance) |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5=2+3-4 |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |

**SOLUTION 15 :**

| | | | |
|---|---|---|---|
| **1** | Staff Loan A/C...........................Dr<br>To Bank A/C | | |
| **2** | Staff Cost A/C ..........................Dr<br>To Staff Loan A/C (10,00,000 – 8,54,763) | | |
| **3** | Staff Loan A/C...........................Dr<br>To Interest on Staff Loan A/C | | |
| **4** | Bank A/C ..................................Dr<br>To Staff Loan A/C | | |
| **5** | Interest on Staff Loan A/C......Dr<br>To Profit and Loss A/C | | |
| **6** | Profit and Loss A/C..................Dr<br>To Staff Cost A/C | | |

**QUESTION 16 :**

**FEE Ltd., borrows a sum of Rs 20 crore from COFEE Ltd., repayable as a single bullet payment at the end of 5 years. The interest thereon @ 5% p.a. is payable at yearly rests. Since the market is 8% FEE Ltd paid an origination fee of Rs 2.40 crores to COFEE Ltd., to compensate COFEE Ltd., for the lower rate of interest. Apart from the above, there are no other transactions between the two parties. You are required to show the value at which COFEE Ltd., would recognize the loan and the annual interest thereon. Prepare Loan to FEE Ltd A/C.**

**SOLUTION 16 :**

**QUESTION 17 :**

**B Ltd gave advance to C Ltd FOR Rs 10,00,000 on 1.4.18. at interest rate of 10%. B Ltd received Rs 15,000 as processing charges. B Ltd gave at 31.3.19 loyalty bonus Rs 5,000 and as per contract B Ltd is to receive Rs 10,000 on 31.3.2021 for re-verification of credit fee. Loan is to be repaid by C Ltd on 31.3.2022.**

**SOLUTION 17 :**

## 21. FVTOCI

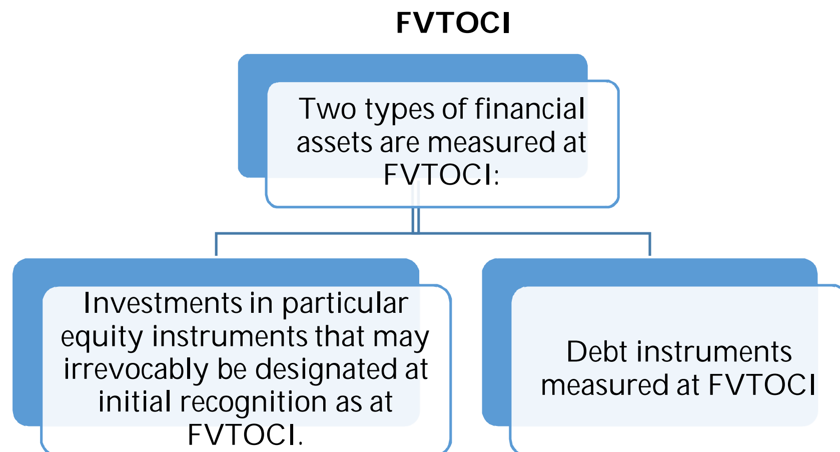
### CRITERIA FOR MEASUREMENT AT FVTOCI

- A financial asset should be measured at FVTOCI if **both of the following conditions are met:**
- The asset is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale (the business model test); and
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the contractual cash flows characteristics test).

## DESIGNATION OF EQUITY INSTRUMENTS AS AT FVTOCI

- At initial recognition, an entity may make an **irrevocable election** to present in other comprehensive income subsequent changes in fair value of an investment in equity instrument that is not held for trading nor contingent consideration recognized by an acquirer in a business combination to which **IFRS 3** Business Combinations applies.
- This election is made on an instrument-by-instrument (i.e. share-by-share) basis.

**FVTOCI**




## 22. EQUITY INSTRUMENTS MEASURED AT FVTOCI

**Investments in particular equity instruments that may irrevocably be designated at initial recognition as at FVTOCI.**

- If this election is made, only dividend income on the investment is recognized in profit or loss, with all other gains and losses (including those relating to foreign exchange) recognized in OCI.
- Those gains and losses remain permanently in equity and are not subsequently transferred to profit or loss even on De-recognition.
- However, the entity may transfer the cumulative gain or loss within equity.

**Scheme of Journal Entries to be passed:**

| Date | Particulars | | Debit | Credit |
|---|---|---|---|---|
| 1 | **On Initial Recognition** | | | |
| | Financial Asset A/C | Dr | | |
| | To Bank A/c | | | |
| 2 | **Increase in Fair Value** | | | |
| | Financial Asset A/C | Dr | | |
| | To OCI | | | |
| 3 | **Decrease in Fair Value** | | | |
| | OCI A/C | Dr | | |
| | To Financial Asset A/C | | | |
| 4 | **On Sale/Realisation** | | | |
| | Bank A/c | Dr | | |
| | Profit and loss A/C (Loss) | Dr | | |
| | To Financial Asset A/C | | | |
| | To Profit and loss A/C (profit) | | | |
| 5 | **On transfer of OCI to Other Component of Equity** | | | |
| | OCI A/C | Dr | | |
| | To Other Equity A/C | | | |

**QUESTION 18 :**

**X Ltd. invested in equity shares as on 2.9.2014. The trans-action price of the shares was Rs.100 million and there was a transaction cost of Rs. 0.05 million. It made irrevocable election to classify the investment as at fair value through other comprehensive income. At the year end, the fair value of the investment is Rs. 102 million. If the investments were sold at the year end, it would have incurred a transaction cost of Rs. 0.06 million. Should the fair value at the yearend be Rs.102 million minus transaction cost of 0.06 million? How should the fair value change be accounted for?**

**SOLUTION 18 :**

At subsequent measurement fair value of the financial asset is not computed net of costs to sell. The fair value is Rs. 102 million. Entity shall recognise change in fair value (Year end fair value Rs. 102 million minus initial fair value Rs.100.05 million i.e. Rs.1.95 million) in the Statement of Other Comprehensive Income and accumulate in a separate component of equity (may be termed as fair value reserve).

Fair value at initial measurement is transaction price plus directly attributable transaction costs.

**QUESTION 19 :** – **FVTOCI**

**On 1st April, 2020 ASF Ltd bought 1000 equity shares of B Ltd @ Rs 30, stamp duty Rs 0.50 per share and commission on purchase @ Rs 0.30 per shares. Equity shares are to be valued at FVTOCI.**
**Market rate on 31 March 2021 Rs 35.**

**Show the journal entries carrying value in SOFP and SOPL.**

| Date | Particulars | | Debit | Credit |
|---|---|---|---|---|
| 1.4.2020 | Investment in Equity shares (FVTOCI) A/C | Dr | | |
| | To Bank A/C (1000 x 30) + [1000 x (0.50+0.30)] | | | |
| 31.3.2021 | Investment in Equity shares (FVTOCI) A/C | Dr | | |
| | To Fair Value Reserve A/C (OCI) [1000 x 35 -30800] | | | |
| | [unrealised gain transferred to OCI] | | | |

**Statement of Comprehensive Income**

| A | **Other Comprehensive Income** | Rs |
|---|---|---|
| | Fair Value Gain on Investment in shares | |

**Statement of Financial Position – Asset Side**

| A | **Non - Current Assets** | |
|---|---|---|
| | Financial Assets | |
| | Investmens in Equity Shares of B Ltd (1000 x 35) | |

## 23. DEBT INSTRUMENTS MEASURED AT FVTOCI:

- For these, **changes in fair value should be recognized in OCI** except for:
  - ✓ **interest** calculated using the effective interest rate;
  - ✓ **foreign exchange gains and losses**; and
  - ✓ **impairment gains and losses,**

  until the financial asset is de-recognized or reclassified.
- When the financial asset is derecognized, the cumulative gain or loss previously recognized in OCI is reclassified from equity to profit or loss as a reclassification adjustment under IAS 1 *Presentation of Financial Statements.*

- If a debt instrument asset is measured at FVTOCI, the amounts that are recognized in profit or loss are the same as the amounts that would have been recognized in profit or loss if the financial asset had been measured at amortized cost.

**Scheme of Journal Entries to be passed:**

| Date | Particulars | | Debit | Credit |
|---|---|---|---|---|
| 1 | **On Initial Recognition** | | | |
| | Financial Asset A/C | Dr | | |
| | To Bank A/c | | | |
| 2 | **Year-end Interest Income to be recognised using EIR** | | | |
| | Financial Asset A/C | Dr | | |
| | To Interest Income | | | |
| **3** | **Interest Received** | | | |
| | Bank A/C | Dr | | |
| | To Financial Asset A/C | | | |
| **4** | **Increase in Fair Value** | | | |
| | Financial Asset A/C | Dr | | |
| | To OCI | | | |
| **5** | **Decrease in Fair Value** | | | |
| | OCI A/C | Dr | | |
| | To Financial Asset A/C | | | |
| **6** | **On Sale/Realisation** | | | |
| | Bank A/c | Dr | | |
| | Profit and loss A/C (Loss) | Dr | | |
| | To Financial Asset A/C | | | |
| | To Profit and loss A/C (profit) | | | |
| **7** | **On transfer of OCI to profit and loss** | | | |
| | OCI A/C | Dr | | |
| | To Profit and loss A/C | | | |

**QUESTION 20 : Bonds – FVTOCI**

**On 1 April, 2021 bought 6% 1000 Bonds of ABC @ Rs 85 maturing on 31 March, 2026.**

**Market rate on 31 March, 2022 Rs 89. The financial asset is held to achieve an objective by both collecting contractual cash flows and selling financial assets. Show the journal entries. Effective rate of Interest is 9.95%.**

## SOLUTION 20 :

| Year | Opening balance | Effective Interest earned @ 9.95% | Interest Received | Closing Balance |
|---|---|---|---|---|
| 1 | | | | |
| 2 | | | | |
| 3 | | | | |
| 4 | | | | |
| 5 | | | | |
| | | | | |

**Journal Entries:**

## 24. MEASUREMENT OF UNQUOTED EQUITY INSTRUMENTS

- **IFRS 9** requires all investments in equity instruments and contracts on those instruments to be measured at fair value. However, **IFRS 9** also requires that in some limited circumstances, cost may be an appropriate estimate of fair value.
- That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.
- Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

## 25. SUMMARY OF PROVISIONS FOR FINANCIAL ASSET

| Financial Asset | IFRS 9 Classification | Subsequent Measurement | Value Changes |
|---|---|---|---|
| **Debt Instrument** | Amortised Cost | Amortised Cost | Interest, impairment loss, foreign exchange gain or loss – recognised in profit or loss.<br>On de-recognition, any gain or loss is recognized in profit or loss |
| | FVTOCI | Fair Value | Interest, impairment loss, foreign exchange gain or loss – recognised in profit or loss.<br>Other gain or loss in OCI.<br>On de-recognition, cumulative gain or loss in OCI is re-classified to profit or loss. |
| | FVTPL | Fair Value | Change in fair value recognized in profit or loss |
| **Equity Investment** | FVTOCI | Fair Value | Dividend is recognized in profit or loss.<br>Change in fair value is recognized in OCI.<br>No re-classification of gain or loss to profit or loss and directly transferred to equity.<br>Also, no impairment is recognized in profit or loss. |
| | FVTPL | Fair Value | Change in fair value recognized in profit or loss |

## 26. DERECOGNITION

- The term "derecognition" refers to when an entity should remove an asset or liability from its SOFP.
- It is reverse of recognition.
- Applicable to:
  - Securitisation transaction;
  - Debts/receivables factoring;

## 27. DERECOGNITION OF A FINANCIAL ASSET :

**PRIMARY CONDITIONS :**

An entity should derecognise a financial asset when, and only when:

1. The **contractual rights** to the cash flows from the **financial asset expire**; or
2. It transfers the financial asset and the transfer qualifies for derecognition in accordance with the standard.

**OTHER CONDITIONS ;**

- **Qualify for derecognition if the entity:**
  - ✓ Has transferred substantially all the risks and rewards of ownership; or
  - ✓ Has **not retained control** of the asset, in the case if entity has neither transferred nor retained substantially all the risks and rewards of ownership.
- **Do not qualify for derecognitionif the entity:**
  - ✓ Has retained substantially all the risks and rewards of ownership, Or
  - ✓ Has retained control of the asset, in the case if entity has neither transferred nor retained substantially all the risks and rewards of ownership (also known as continuing involvement approach).
  - ✓

**Journal Entry for Continued Involvement :**

Financial Asset for continued involvement .. DR

To Financial Liability for continued involvement

## 28. ACCOUNTING FOR DERECOGNITION – FULL DERECOGNITION

- Financial asset (FA) is fully derecognisd.
- On **derecognition** of a financial asset, the **difference** between the carrying amount and consideration received is recognise in the **statement of profit and loss**.
- Scheme of Journal Entry:

| Date | Particulars | | Debit | Credit |
|---|---|---|---|---|
| | Bank A/C | Dr | | |
| | Profit and loss A/C (loss) | Dr | | |
| | To Financial asset | | | |
| | To Profit and loss A/C (profit) | | | |

## 29. DERECOGNITION - PARTIAL TRANSFER

- Step 1 – Identify different parts (or strips) of FA.
- Step 2 : Find the fair value of different parts (or strips).
- Step 3 : Divide the carrying amount of the asset in the ratio of Fair Value.
- Step 4 : Pass journal entries for the disposal.

Scheme of Journal Entries:

| Date | Particulars | | Debit | Credit |
|---|---|---|---|---|
| 1 | **Identify strips** | | | |
| | Strips A/C (step 3 above) | Dr | | |
| | To Financial Assets A/C | | | |
| 2 | **De-recognition entry on sale or transfer of strips** | | | |
| | Bank A/C | Dr | | |
| | Profit and loss A/C (loss) | Dr | | |
| | To Transferred Strips A/C | | | |
| | To Profit and loss A/C (profit) | | | |
| **Note : Balance strips will continue in SOFP as per accounting of Financial Assets.** | | | | |

**QUESTION 21 :** Partial Transfer

**A has given a loan of Rs 10,000 to Mr. B. He transferred a part of that asset at a fair value of Rs9,460 and he retained the remaining part whose fair value is Rs 3,740. Pass the journal entries.**

**QUESTION 22 :** Securitisation

**B Ltd has given 10% Loan to X Ltd for Rs 10,00,000. B Ltd has securitized it for 9 % rate of interest with ARCIL. Term of loan is 5 years. Journalise**

**QUESTION 23 :** Securitisation

**B Ltd has given 10% Loan to X Ltd for Rs 10,00,000 . B Ltd has securitized it for 12 % rate of interest with ARCIL. Term of loan is 3 years. B Ltd has only securitised only interest strip. Journalise.**

**QUESTION 24 :**

**A Ltd. has Loan of Rs 10,00,000 on interest Rate of 10% p.a. It Securitized 40% of principal and 7% Interest strip on remaining principal (with interest there on). Period of Loan is 3 Years. Discount rate used by ARCIL is 15%. Pass journal Entry.**

**QUESTION 25 :**

**ASF Ltd. has lent a sum of Rs10 lakhs @ 18% per annum for 10 years. The loan had a Fair Value of Rs 12,23,960 at the effective interest rate of 13%. ASF Ltd. transferred its right to receive the Principal amount of the loan on its maturity with interest, after retaining rights over 10% of principal and 4% interest that carries Fair Value of Rs 29,000 and Rs 1,84,620 respectively. The consideration for the transaction was Rs 9,90,000.**

**The interest component retained included a 2% fee towards collection of principal and interest that has a Fair Value of Rs 65,160.**

**You are required to show the Journal Entries to record derecognition of the Loan**

## 30. EXAMPLES OF TRANSACTIONS WHERE AN ENTITY HAS TRANSFERRED SUBSTANTIALLY ALL RISKS AND REWARDS OF OWNERSHIP

1. A sale of a financial asset where the seller (transferor) does not retain any rights or obligations (e.g., an option or guarantee) associated with the sold asset
2. A sale of a financial asset where the transferor retains a call option to repurchase the transferred asset, at the transferor's option, but that option is deep-out-of-the-money (i.e., it is not probable that the option will be exercised)
3. A sale of a financial asset where the transferor writes a put option that obligates it to repurchase the transferred asset, at the transferee's option, but that option is deep-out-of-the money

## 31. EXAMPLES OF TRANSACTIONS WHERE AN ENTITY RETAINS SUBSTANTIALLY ALL RISKS AND REWARDS OF OWNERSHIP :

- A sale of a financial asset where the transferor retains a call option to repurchase the transferred asset, at the transferor's option, where the option is deep-in-the-money (i.e., it is highly probable that the option will be exercised)
- A sale of a financial asset where the transferor issues (writes) a put option that obligates it to repurchase the transferred asset, at the transferee's option, where the option is deep-in-the money

**QUESTION 26 :**

**During the reporting period, Entity A has sold various financial assets.**

**Required. Help Entity A by evaluating the extent to which de-recognition is appropriate in each of the following cases.**

| S.N | QUESTION | ANSWER |
|---|---|---|
| A | Entity A sells a financial asset for Rs 10,000. There are no strings attached to the sale, and no other rights or obligations are retained by Entity A. | Entity A should derecognize the transferred financial asset, because it has transferred all risks and rewards of ownership. |
| B | Entity A sells an investment in shares for Rs 10,000 but retains a call option to repurchase the shares at any time at a price equal to their current fair value on the repurchase date. | Entity A should derecognize the transferred financial asset, because it has transferred substantially all risks and rewards of ownership. While Entity A has retained a call option (i.e., a right that often precludes derecognition), the |

| | | exercise price of this call option is the current fair value of the asset on the repurchase date. Therefore, the value of call option should be close to zero.<br>Accordingly, Entity A has not retained any significant risks and rewards of ownership. |
|---|---|---|

**QUESTION 27 :**

**ASF Ltd. has lent a sum of Rs 50000 @ 18% per annum for 10 years. ASF Ltd. transferred its right to receive the Principal amount of the loan on its maturity with and the right to receive 14% interest per year. Of the balance 4 % interest, 2% is due to the transferor i.e ASF Ltd as service fee for collection of principal and interest. The expected cost of collection is RS 400. ASF Ltd has retained the right to receive the remaining 2 % interest per year. Show the Journal Entries to record derecognition of the Loan assumimg expected yield rate 13% p.a..**

**QUESTION 28 :**

- **10% Loan Amount**
- **Time = 3 years.**
- **A Ltd securitized 40% principal strip along with interest right of 7 % on total principal. Discount rate is 14%. Journalise. Prepare Loan Account, Sold Strip Account and Unsold Strip Account**

## 32. RECLASSIFICATION OF FINANCIAL ASSETS

- An entity is required to reclassify financial assets when it changes its business model for managing financial assets.
- **Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line.**

**Example of change in an entity's business model**

ASF Ltd has a portfolio of commercial loans that it holds to sell in short term. ASF Ltd acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash-flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash-flows.

## 33. WHEN IS RECLASSIFICATION OF FINANCIAL ASSETS NOT PERMITTED ?

- No change in the business model for managing financial assets.
- Investments in equity instruments that are designated as at FVTOCI at initial recognition cannot be reclassified, since, the election to designate as at FVTOCI is irrevocable.
- It is not appropriate for financial assets that are designated as at FVTPL to be reclassified after initial recognition.

## 34. CHANGE IN TERMS OF AN INSTRUMENT.

### IS IT RECLASSIFICATION OR DERECOGNITION ?

- If the terms of an instrument change sufficiently to warrant de-recognition, this would not be a reclassification; instead, the old asset is derecognized and the new one is recognized.

**Example : Reclassification Versus Recognition And De-recognition**

- Entity X invests in a convertible bond issued by Entity Y. Upon conversion, Entity X will receive a predetermined number of Entity Y's non-derivative equity instruments in exchange for giving up its right to receive the principal on the bond.
- On conversion, the convertible bond is derecognized and ceases to be measured at FVTPL.
- The equity instruments recognized may be classified as at FVTPL or designated as at FVTOCI at their initial recognition.
- The conversion does not give rise to a reclassification because the original instrument is derecognized.

## 35. RECLASSIFICATION OF FINANCIAL ASSETS - ACCOUNTING PRINCIPLES

- If an entity reclassifies financial assets, it is required to apply the reclassification prospectively from the reclassification date.
- Previously recognized gains, losses (including impairment gains or losses) or interest are not restated.
- Till the date of re-classification, apply old method of classification. For example –
  - apply effective interest rate method in case of amortised cost category upto the date of re-classification,
  - change in fair value in case of FVTPL/FVTOCI instrument upto the date of re-classification,
- Shift the book value of old classification to new classification. After re-classification, financial asset should be at fair value if the new classification is FVTPL/FVTOCI. The fair value is determined at re-classification date.

**CASE I**

**AMORTISED COST TO FVTPL**

- **Its fair value is measured at the reclassification date.**
- **Any gain or loss arising from a difference between the precious amortized cost of the financial asset and fair value is recognized in profit or loss**

**QUESTION 29 :**

**Bonds carried at amortised cost for Rs. 1,25,000 reclassified as FVTPL**

**Fair Value on reclassification Rs. 90,000. Journalise.**

**CASE II**

**AMORTISED COST TO FVTOCI**

- **Its fair value is measured at the reclassification date.**
- **Any gain or loss arising from a difference between the precious amortized cost of the financial asset and fair value is recognized in other comprehensive income**

**QUESTION 30 :**

**Bonds carried at amortised cost for Rs. 1,25,000 reclassified as FVTOCI**

- **Fair Value on reclassification Rs. 90,000. Journalise.**

**CASE III**

**FVTPL TO AMORTISED COST**

- **Its fair value at the reclassification date become its new gross carrying amount.**
- **The effective interest rate is calculated based on the new gross carrying amount.**

**QUESTION 31 :**

**Bonds for Rs. 1,25,000 at FVTPL reclassified from FVTPL to Amortised cost**

- **Fair Value on reclassification date Rs. 90,000, Journalise.**

**CASE IV**

**FVTPL TO FVTOCI**

- **The financial asset continues to be measured at fair value.**

**QUESTION 32 :**

**Bonds for Rs. 1,25,000 at FVTPL reclassified from FVTPL to FVTOCI**

- **Fair Value on reclassification date Rs. 90,000. Journalise.**

**CASE V**

**FVTOCI TO AMORTISED COST**

- **The financial asset is reclassified at its fair value at the reclassification date.**

**QUESTION 33 :**

**Bonds (FVTOCI) for Rs. 1,25,000 reclassified as Amortized Cost**

**• Fair Value on reclassification Rs. 90,000, Journalise.**

**CASE VI**

**FVTOCI TO FVTPL**

- **The financial asset continues to be measured at fair value.**

**QUESTION 34 :**

**Bonds (FVTOCI) for Rs. 1,25,000 reclassified as FVTPL**

**• Fair Value on reclassification Rs. 90,000. Journalise.**

## 36. REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS:

- This requires the **delivery of the asset** and settlement of the asset and settlement of the due within stipulated time frame established by regulations and conventions.
- A contract that requires or **permits net settlement** of the change in the value of the contract is **not a regular way contract.**
- Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- The choice is to be opted for all investment in an accounting period.
- A regular way purchase or sale of financial assets should be recognised and derecognized either on **trade date or on settlement date**.
  - The **trade date** is the date that an entity **commits itself to purchase** or sell an asset.
  - The **settlement date** that is the date on which an **asset is delivered.**

## 37. TRADE DATE ACCOUNTING:

- The financial asset purchased or sold should be accounted for on the **trade date**.

## 38. SETTLEMENT DATE ACCOUNTING:

- The financial asset purchased or sold should be accounted for on the **settlement date**. Investment should be recorded at fair value on settlement date.

## 39. CHANGES IN THE FAIR VALUES BETWEEN TRADE DATE AND SETTLEMENT DATE

- The fair value of a financial asset may change during the period between the trade date and settlement date.
- **In settlement date accounting**, such changes in the fair values of financial assets classified as **FVTOCI',** are recognised in appropriate equity account.
- In case of **'financial assets at fair value through profit or loss'**, these changes in fair values are recognised in the **statement of profit and loss.**
- The changes in fair values of **financial assets carried at amortised cost** are **not recognised.**

## 40. SCHEME OF JOURNAL ENTRIES – Trade Date Accounting

| | Amortised cost | FVTOCI | FVTPL |
|---|---|---|---|
| | | | |
| | | | |
| | | | |

## 41. SCHEME OF JOURNAL ENTRIES – Settlement Date Accounting

| | Amortised cost | FVTOCI | FVTPL |
|---|---|---|---|
| | | | |
| | | | |
| | | | |

**QUESTION 35 : Trade date accounting and Settlement date accounting**

**On March 30, 2024, fair value per ordinary DEBENTURE of A Ltd. was Rs.45. On this date, B Ltd. committed to buy 10,000 of these DEBENTURES at fair value. B Ltd. paid the price and accepted delivery of these DEBENTURES on April 3, 2024. B Ltd. closed its annual accounts on March 31, 2024. Fair value of A Ltd. DEBENTURES was Rs.45.40 on March 31, 2024 and Rs.45.30 on April 3, 2024.**

**Show journal entries in the books of B Ltd. in respect of above in the following three cases:**

**B Ltd. classifies its investments in A Ltd. as 'Amortised cost category'**

**B Ltd. classifies its investments in A Ltd. as 'financial asset at fair value through OCI'**

**B Ltd. classifies its investments in A Ltd. as 'financial asset at fair value through profit or loss'**

**SOLUTION 35 :**

**Investments in A Ltd. is classified as 'Amortised cost category'**

**Trade Date Accounting**

| | | | |
|---|---|---|---|
| March 30, 2024 | Investments (10,000 x 45)<br>To Payable | | |
| April 3, 2024 | Payable<br>To Bank | | |

**Settlement Date Accounting**

| | | | |
|---|---|---|---|
| April 3, 2024 | Investments (10,000 x 45)<br>To Bank | | |

**Investments in A Ltd. is classified as 'financial asset at fair value through OCI**

**Trade Date Accounting**

| | | | |
|---|---|---|---|
| March 30, 2024 | Investments (10,000 x 45)………………. Dr<br>To Payable | | |
| March 31, 2024 | Investments [10000 x(45.40 – 45)]…….Dr<br>To Fair value Reserve A/c | | |
| April 3, 2024 | Payables…………………………… Dr<br>To Bank | | |
| April 3, 2024 | Fair Value Reserve A/C……… Dr<br>To Investments [10000 x(45.40 – 45.30)] | | |

**Investments in A Ltd. is classified as 'financial asset at fair value through OCI**

**Settlement Date Accounting**

| | | | |
|---|---|---|---|
| March 30, 2024 | No Entry | | |
| March 31, 2024 | Fair Value Change A/C ………………….Dr<br>To Fair Value Reserve (OCI) | | |
| April 3, 2024 | Investments A/C<br>Fair Value Reserve A/C<br>To Bank<br>To Fair Value Change A/C | | |

**Investments in A Ltd. is classified as 'FVTPL**

**Trade Date Accounting**

| | | | |
|---|---|---|---|
| March 30, 2024 | Investments (10000 x 45)<br>To Payable | | |
| March 31, 2024 | Investments [10,000 x (45.40- 45 )]<br>To Profit & Loss A/c | | |
| April 3, 2024 | Payables<br>To Bank | | |
| April 3, 2024 | Profit & Loss A/c<br>[10,000 x (45.40 – 45.30)]<br>To Investments | | |

**Investments in A Ltd. is classified as 'FVTPL**
**Settlement Date Accounting**

| March 30, 2024 | No Entry | | |
|---|---|---|---|
| March 31, 2024 | Fair Value Change A/C………….. Dr<br>[10000 x(45.40 – 45)]<br>To Profit & Loss A/c | | |
| April 3, 2024 | Investments [10000 x 45.30 ]<br>P&L A/c [10,000 x (45.40 – 45.30)]<br>To Bank (10,000 x 45)<br>To Fair Value Change A/C | | |

## 42. FINANCIAL LIABILITIES CLASSIFICATION AND SUBSEQUENT MEASUREMENT

### FINANCIAL LIABILITIES CLASSIFICATION AND SUBSEQUENT MEASUREMENT

- All Financial liabilities are required to be classified and subsequently measured at AMORTIZED COST, except for:
  - Financial liabilities at FVTPL;
  - Financial liabilities that arise when a transfer of a Financial asset does not qualify for de-recognition or when the continuing involvement approach applies;
  - Financial guarantee contracts not designated as at FVTPL that are not accounted for under **IFRS 117** *Insurance Contracts;* and
  - commitments to provide a loan at a below-market interest rate.
  - Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements.

**QUESTION 36 :**

**On January 1, 2015, Entity A issued a 10 % Debenture in the market for Rs 53,993. The Debenture has a principal amount of Rs 50,000 that will be repaid on December 31, 2019. The quoted market interest rate (IRR) is 8%. Prepare Debenture Account. Assume 'Amortised cost category'.**

**QUESTION 37 :**

**On January 1, 2015, Entity A issued a 6 % Debenture in the market for Rs 93,400. The Debenture has a principal amount of Rs 100,000 that will be repaid on December 31, 2019. The quoted market interest rate (IRR) is 7.64%. Prepare Debenture Account. Assume 'Amortised cost category'.**

**QUESTION 38 :**

**B Ltd gave advance to C Ltd FOR Rs 10,00,000 on 1.4.18. at interest rate of 10%. B Ltd received Rs 15,000 as processing charges.**

**B Ltd gave at 31.3.19 loyalty bonus Rs 5,000 and as per contract B Ltd is to receive Rs 10,000 on 31.3.2021 for re-verification of credit fee. Loan is to be repaid by C Ltd on 31.3.2022. Prepare Loan Account in the books of C Ltd. Assume 'Amortised cost category'.**

## 43. FINANCIAL LIABILITIES AT FVTPL

**Two sub-categories:**

1. Financial liabilities classified as **held for trading**; and
2. Financial liabilities **designated by the entity as FVTPL**. This is an option available in limited circumstances. The designation is irrevocable so that, once it has been made, the liability cannot subsequently be reclassified into another category during its life.

## 44. FINANCIAL LIABILITIES CLASSIFIED AS HELD FOR TRADING

**A Financial liability is held for trading if it falls into one of the following categories:**

- Financial liabilities incurred principally for the purpose of repurchasing them in the near term;
- Financial liabilities that on initial recognition form part of a portfolio of identified Financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; and
- derivative liabilities, unless the derivative is a Financial guarantee contract or it forms part of a designated and effective hedging relationship.

## 45. EXAMPLES OF LIABILITIES THAT WOULD BE CLASSIFIED AS HELD FOR TRADING AND THUS INCLUDED IN HELD FOR TRADING CATEGORY:

- An **interest rate swap** that is not accounted for as a hedging instrument;
- A **derivative liability** incurred upon writing a foreign exchange option that is not accounted for as a hedging instrument;
- An **obligation to deliver financial assets borrowed by a short-seller** (i.e. An entity that sells financial assets it has borrowed and does not yet own); and
- A **quoted debt instrument that the issuer plans to buy back in the near term** depending on movements in the debt instrument's fair value, i.e. A financial liability that is incurred with the intention to repurchase it in the near term.

## 46. DESIGNATION OF FINANCIAL LIABILITIES AS AT FVTPL

- A Financial liability may upon initial recognition be designated as at FVTPL only in one of the following circumstances:
- it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases;
- The election to designate a Financial liability as at FVTPL has to be made at initial recognition of the Financial liability and cannot subsequently be revoked.

**QUESTION 39 : Fair value option: issued fixed rate debt**

**Entity A issues fixed rate debt. In order to economically hedge the fair value risk associated with interest payments on the fixed rate debt, Entity A concurrently enters into an interest rate swap with a bank (receive fixed, pay floating), which has the same terms and payment dates as the debt.**

**The interest rate swap is a derivative that must be measured at FVTPL.**

**SOLUTION 39:**

By designating the fixed rate debt as at FVTPL on initial recognition, the entity will achieve a substantial offset in profit or loss against the fair value movements on the held for trading derivative.

Because the instruments share a common risk (interest rate risk), Entity A will seek to demonstrate that applying the fair value option results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring the derivative at FVTPL and measuring the debt at amortized cost.

## 47. CLASSIFICATION OF FINANCIAL LIABILITIES ASSUMED IN A BUSINESS COMBINATION

- When financial liabilities are assumed in a business combination, those liabilities should be classified in the consolidated financial statements of the acquirer into one of the permitted categories mentioned above.

- It is entirely possible that the classification of a financial liability for these purposes may differ from its classification in the financial statements of the acquiree.
- For example, the acquirer in its consolidated financial statements may choose to designate a financial liability as at FVTPL at initial recognition even though the acquiree may have classified it otherwise when it first recognized the liability.

## 48. SUBSEQUENT MEASUREMENT

- Amortized cost of Financial liabilities is determined using the effective interest method.
- **In case of Financial liabilities measured at FVTPL,** fair value gains and losses are recognized in profit or loss except that in the case of Financial liabilities (other than loan commitments or Financial guarantee contracts) that are designated at FVTPL, the gains or losses are required to be presented as follows:
  - ✓ **the amount of the change in the fair value of the Financial liability that is attributable to changes in the credit risk** of that liability should be **presented in OCI**; and
  - ✓ **the remainder of the change in the fair value of the liability should be presented in profit or loss** unless the treatment of the effects of changes in the liability's credit risk described above would create or enlarge an accounting mismatch in profit or loss (in which case all gains or losses are recognized in profit or loss).

## 49. LOAN COMMITMENTS AND FINANCIAL GUARANTEE CONTRACTS

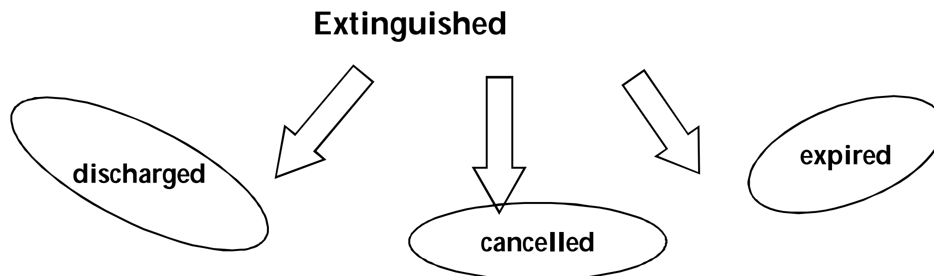
- All gains and losses on loan commitments and financial guarantee contracts that are designated as at FVTPL are recognized in profit or loss.

## 50. RECLASSIFICATION OF FINANCIAL LIABILITIES

- An entity shall not reclassify any financial liability.

## 51. DERECOGNITION OF FINANCIAL LIABILITIES

A financial liability should be removed from the SOFP when, and only when, it is




**The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished and the consideration paid, should be recognised in the statement of profit and loss.**

## 52. SUMMARY OF PROVISIONS FOR FINANCIAL LIABILITY

| Financial Liability | Classification | Subsequent measurement | Value changes |
|---|---|---|---|
| Financial Liability at FVTPL (including derivatives) | FVTPL | Fair value | Changes in fair value that is attributable to changes in **credit risk** is recognised in **OCI.**<br>Remaining amount of changes in fair value is recognised in profit and loss.<br>**On de-recognition, amount recognised in OCI is not re-classified to profit and loss. It is transferred with in equity.** |

| Other Liabilities | Amortised cost | Amortised cost | Interest, revenue, credit impairment, foreign exchange gain or loss recognised in profit and loss.<br>On Derecognition, any gain or loss recognised in profit and loss. |
|---|---|---|---|

## 53. DERIVATIVES & EMBEDDED - DERIVATIVES

**Definition of Derivative**

- A derivative is a financial instrument or other contract which has all the following features:
  - Value changes in response to an underlying
  - Requires no initial net investment or smaller initial net investment than would be required for instruments with similar responses to changes in market factors
  - Settled at a future date

**Examples of derivatives include, forwards, commodity futures, currency futures, index futures, call and put options on commodity, currency and indices, interest rate swaps and currency swap**

Derivatives financial assets and derivative financial liabilities are:

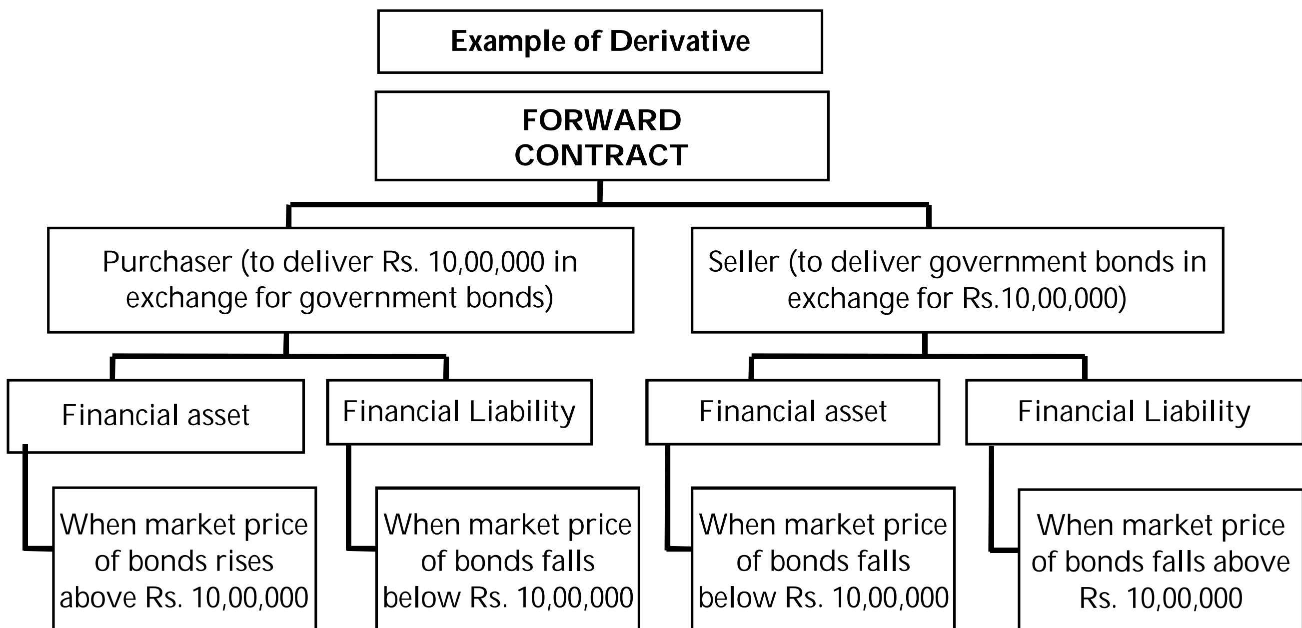
- Always deemed held for trading

  **UNLESS**

- They are designated and are effective hedging instruments

## 54. ACCOUNTING OF DERIVATIVES

- A derivative – can be a Financial Asset or a Financial Liability.
- Initial and subsequent measurement of a derivative instrument is at Fair Value (FV)
- Changes in Fair Value through Profit and Loss
  - Unless the derivative qualifies as hedge instrument and for Hedge Accounting




## 55. ACCOUNTING TREATMENT OF FUTURE CONTRACTS

- **Futures contract is a derivative instrument under which the Buyer and Seller of a future have obligation to buy and sell (respectively) a given quantity of the underlying asset at a given price at a given future date.**

- **Examples :**
  - **Index Futures (e.g. Nifty Index Future),**
  - **Equity Share Futures (e.g. Reliance Industries Future),**
  - **Commodity Futures (e.g. Gold/Silver Future),**

## 56. FEATURES OF FUTURE CONTRACTS

- Exchange Traded – Futures contract is normally traded on an Exchange.
- Standardized – It has standardized contract terms (i.e. Standard Qty and Qty of underlying assets, Standard time of Settlement)
- More Liquid – It offers more liquidity since it is traded on an exchange.
- No Counter party risk – It does not suffer from counterparty risk (i.e. the possibility of default by any one of the parties to the contract)
- Settlement – It is settled by payment of difference at maturity date.
- Margin Requirement – Both Buyer and Seller of a future contract are required to pay the margin.
- Unlimited Profits/Losses – For both Buyer and Seller of a future contract, Profits & Losses are unlimited

## 57. ACCOUNTING TREATMENT OF FUTURE CONTRACT

**ON ENTERING INTO FUTURE CONTRACT**

| 1. For payment of Initial Margin to buy/sell Future Contract |
|---|
| **Initial Margin – Nifty Index Future (NIF) A/c** |
| **To Bank A/c** |
| **(Being the Initial Margin paid to buy/sell Future)** |

**INITIAL RECOGNITION OF A FUTURE CONTRACT:**

- It should be measured **at Fair Value** on the Date of Acquisition.
- Generally fair Value is NIL since the Future Contract is acquired at prevailing market terms.

| Future Contract A/C | Dr. | [With NIL Amount] |
|---|---|---|
| To Bank A/C | | |
| (Being Future Contract entered) | | |

**For Payment of Mark to Market Margin**

| <u>**In case of Future contract to purchase**</u><br>▪ If Closing Rate for the first Trading day is less than Contract Rate or Closing Rate for the subsequent Trading day is less than Closing Rate for the previous Trading day.<br><u>**In case of Future Contract to sell**</u><br>If Closing Rate for the first Trading Day is more than Contract Rate or Closing Rate for the subsequent Trading Day is more than Closing Rate for the previous Trading day |
|---|
| **M to M Margin – NIF A/c** |
| **To Bank A/c** |

**Subsequent Measurement of a Future Contract**

Change in the Fair Value is recognized in the Statement of Profit & Loss.

| Journal Entry | | |
|---|---|---|
| Profit & Loss A/C | Dr. | [With Loss on Revaluation] |
| To Future Contract A/C | | |
| (Being the Loss on Revaluation of Future Contract) | | |

**Note:** Reverse Entry in case of Profit on Revaluation

**Squaring up before Closing of Expiry Date**

| Journal Entry | | |
|---|---|---|
| Bank A/C | Dr. | [With Difference received] |
| *Future Contract A/C | Dr. | [With carrying Amount of Derecognized Future Contract] |
| ** Profit & Loss A/c | Dr. | [Loss on Squaring up] |
| To *Future Contract A/C | | [With carrying Amount of Derecognized Future Contract] |
| To ** Profit & Loss A/c | | [Profit on Squaring up] |
| (Being the Difference received on Squaring up) | | |
| **For Refund of Initial Margin on Squaring up/ Settlement of Future Contract** | | |
| Bank A/c | | |
| To Initial Margin-NIF A/c | | |
| [With Margin Received] | | |

**QUESTION 40 :**

- **Mr. A enters into future contract on 28.3.18. Initial margin is Rs 30,000.**
- **Initial margin on subsequent days were as follows**
- **29.3.18 – Rs 35000**
- **30.3.18 – Rs 25000**
- **31.3.18 - Rs 27000**
- **Pass journal entries.**

**QUESTION 41 :**

- **Mr. A enters into future contract (long) for 100 shares @ 300 each. He paid Rs 5000 initial margin. Date of contact is 27.7.2018. settlement date is 29.9.18**
- **Price of share on subsequent days were as follows**
- **27.7.18 – Rs 315**
- **12.8.18 – Rs 350**
- **16.8.18 - Rs 340**
- **31.8.18 – Rs 290**
- **29.9.18 – Rs 310**
- **Pass journal entries.**

**QUESTION : 42**

**Entity XYZ, whose functional currency is the Indian Rupees, sells products in France denominated in Euro. XYZ enters into a contract with an investment bank to convert Euro to Indian Rupees at a fixed exchange rate. The contract requires XYZ to remit Euro based on its sales volume in France in exchange for Indian Rupees at a fixed exchange rate of 55.00. Is that contract a derivative?**

**SOLUTION 42:**

**QUESTION : 43**

On February 1, 2009, Future Ltd. entered into a contract with Son Ltd. to receive the fair value of 1000 Future Ltd.'s own equity shares outstanding as on 31-01-2010 in exchange for payment of Rs.1,04,000 in cash i.e., Rs.104 per share. The contract will be settled in net cash on 31.01.2010.

The fair value of this forward contract on the different dates were:

Fair value of forward on 01.02.2009 Nil

Fair value of forward on 31.12.2009 Rs.6,300

Fair value of forward on 31.01.2010 Rs.2,000

Presuming that Future Ltd. closes its books on 31st December each year, pass entries:

1. If net settled is in cash.
2. If net is settled by Son Ltd. by delivering shares of Future Ltd.

**QUESTION :44**

The market received rumour about ABC corporation's tie-up with a MNC. This has induced the market price to move up. If the rumour is false, the ABC corporation stock price will probably fall dramatically. To protect from this an investor has bought the call and put options.

He purchased one 3 months call with a striking price of Rs. 42 for Rs. 2 premium, and paid Re. 1 per share premium for a 3 months put with a striking price of Rs. 40.

Determine the Investor's position if the tie up offer bids the price of ABC Corporation's stock up to Rs. 43 in 3 months. Determine the Investor's ending position, if the tie up programme fails and the price of the stocks falls to Rs. 36 in 3 months.

**QUESTION : 45**

A buys following equity options from Mr. B.

| Date of purchase | Type of option | Expiry date | Premium per unit | Lot size | Strike price |
|---|---|---|---|---|---|
| 29.3.17 | Call | 31.5.17 | 15 | 200 | 880 |
| 29.3.17 | put | 31.5.17 | 20 | 200 | 885 |

A and B follow 31st march as year ending date. On 31st march:

(1) For call options May 2017 Strike price Rs 880, closing rate of premium Rs 6 per unit.

(2) For Put options May 2017 Strike price Rs 885, closing rate of premium Rs 28 per unit.

On 31.5.17, the closing price is 882. Pass journal entries in the books of both parties.

**QUESTION : 46**

**A buys following equity options from Mr. B.**

| Date of purchase | Type of option | Expiry date | Premium per unit | Lot size | Strike price |
|---|---|---|---|---|---|
| 29.3.17 | CALL | 31.5.17 | 15 | 200 | 880 |
| 29.3.17 | PUT | 31.5.17 | 20 | 200 | 885 |

**Suppose A and B follow 31st December as year ending date. On 31.5.17, the closing price is 882. Pass journal Entries.**

**QUESTION : 47**

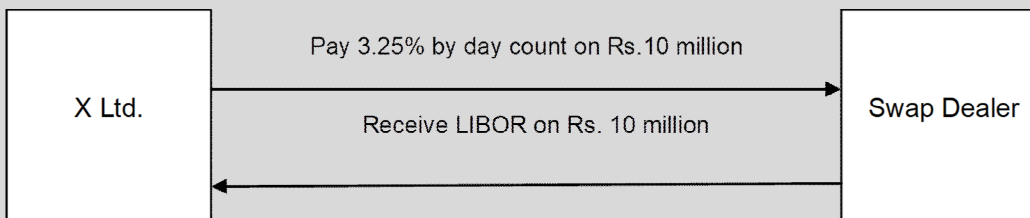
**Mr. A buys a call option of ABC Ltd on 30th July 2018 with a strike price of Rs 250. Expiry date is 30.8.18. Premium = Rs 20 per unit. Lot size = 100. Show the accounting in the books of Mr. A if share price on expiry date is Rs 260 and option is (a) settled in cash (b) settled by delivery of asset.**

**QUESTION : 48**

**X Ltd. enters into a contract to purchase 10 tons of Copper at a price of Rs. 50,000 per ton after 6 months. Is it a derivative?**

**QUESTION : 49**

**X Ltd. has entered a 5 year Pay Fixed Receive Variable swap contract with a swap dealer for a notional amount of Rs.10 million. The swap rate is 6.5% p.a. But the contract requires that X would pay gross at fixed rate every Jan 1 and July 1 and receive gross at floating rate.**




**Does this swap contract satisfy the definition of derivatives?**

**Analysis:**

Yes. (i) value of the instrument changes in response to an underlying (identification of the underlying and response to value change are important steps in determining whether contract is a derivative contract), (ii) no initial investment or smaller initial investment if similar value changes to be achieved through the underlying and (iii) settlement at a future date. The interest rate swap contract (IRS) shall be evaluated. It satisfies all the conditions that its value changes in response to the change in the interest rate, there is no initial investment and it is settled in future date(s).

**QUESTION : 50 [Aggregation of non-derivatives to treat as a derivative]**

**ABC Ltd. issued 5 year 8% Debentures of Rs.100 million to XYZ Ltd. In turn XYZ Ltd. issued 3-month LIBOR based debentures of Rs.100 million for a maturity of 5 years. Should these offsetting loans be treated as derivatives?**

**SOLUTION : 50**

Non-derivative contracts are aggregated based on the following criteria:

(i) They are contracted at the same time and in contemplation of one another;

(ii) They have same counterparty;

(iii) They relate to same type of risk - in this case interest rate risk;

(iv) There is no economic need or substantive business purpose for structuring these transactions.

The above-mentioned criteria are fulfilled in this case. These offsetting loans becomes pay fixed receive floating interest rate swap for ABC Ltd. and pay floating receive fixed interest rate swap for XYZ Ltd. Together they constitute a derivative contract. These contracts should be combined and accounted for as a derivative at fair value through profit or loss.

**QUESTION : 51 [purchase volume based foreign currency contract]**

**ABC purchases goods in US$. It enters into a contract with a US Bank to convert its US$ purchases for the year 2015-16 into Indian Rupee at fixed exchange rate of US$ 1 = Rs. 64.10. Is this contract a derivative?**

**SOLUTION 51 :**

It is a derivative contract having two underlying variables, purchase volume and exchange rate. It has no initial investment and to be settled at a future date.

**QUESTION : 52 [Prepaid forward]**

**X Ltd. enters into a contract to buy 1000 equity shares of A Ltd. from one of its existing shareholders Mr. S @ Z 100 per share. Delivery is agreed after 3 months. Current market price of such shares is Rs. 125. Mr. X pays the forward price upfront. 3 month forward price is Rs. 105. Is this contract a derivative?**

**SOLUTION 52 :**

Yes. Value of the forward changes in response to the change in price of the underlying Moreover, X Ltd. made an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. To make outright purchase, X Ltd. would have invested @ Rs. 125 and to buy exchange-traded forward it would have paid Rs. 105.

## 58. IMPAIRMENT OF FINANCIAL ASSETS

**Recognition of expected credit losses**

1. An entity shall recognise a loss allowance for expected credit losses on
   a. a financial asset that is measured in accordance with this Standard,
   b. a lease receivable,
   c. a contract asset or a loan commitment and
   d. a financial guarantee contract to which the impairment requirements apply.
2. An entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition.
3. If, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses

**How to calculate expected credit losses**

▶ The present value of difference between :
   a. The contractual cashflow that are due to the entity; and
   b. Cashflow the entity expects to receive

**QUESTION 53 :**

**As on 31.3.2015, Rs 20 Lakhs of debtors is overdue. The debtors have negotiated to pay dues after 1 year only 75 % of the overdue amount. Discount rate is 12%.**

**Calculate expected credit Loss. Pass journal entry.**

## 59. EMBEDDED DERIVATIVES

**What are embedded derivatives?**

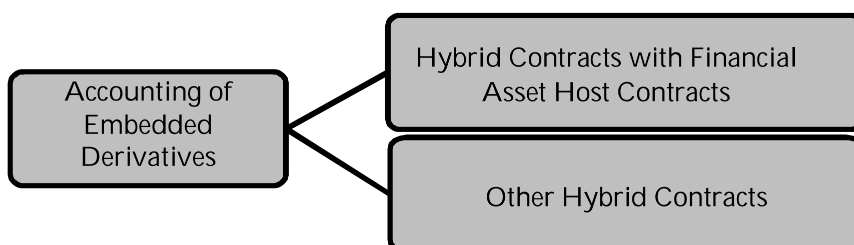
- In simple words, it is a derivative instrument embedded (surrounded or fenced by) in another contract, which is known as host contract.

**Hybrid instrument =The combination of a "Host contract" and an "Embedded derivative"**

Entities should not be able to avoid recognition and measurement merely by embedding a derivatives in a non-derivatives financial instrument or other contract.

### EMBEDDED DERIVATIVES

- Consider Debentures
  - This is a primary financial instrument
- An option contract to buy or sell shares
  - Derivative
- If combined : Primary + a derivative = we get an embedded derivative
  - A convertible debt instrument is an embedded derivative.




**Hybrid Contracts with Financial Asset Hosts**

- If a hybrid contract contains a host that is an asset within the scope of this Standard, an entity shall apply the requirements of this standard to the entire hybrid contract.

**Other Hybrid Contracts**

- If a hybrid contract contains a host that is not an asset, an embedded derivative shall be separated from the host and accounted for as a derivative if, and only if:
- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

**QUESTION 54 :**

**Entity A is seeking to identify embedded derivatives that are required to be separated under IFRS 9. It is considering whether these contracts contain embedded derivatives:**

**(a) An investment in a bond whose interest payments are linked to the price of gold. The bond is classified as at fair value through profit or loss (FVTPL).**

**(b) An investment in a bond whose interest payments are linked to the price of silver. The bond is classified as FVTOCI.**

**(c) An investment in a convertible debt instrument that is classified as FVTOCI.**

**(d) A lease contract that has a rent adjustment clause based on inflation**

***Required:*** **Identify any embedded derivatives in these cases and, in each case, determine whether any identified embedded derivative requires separate accounting.**

## 60. HEDGE ACCOUNTING

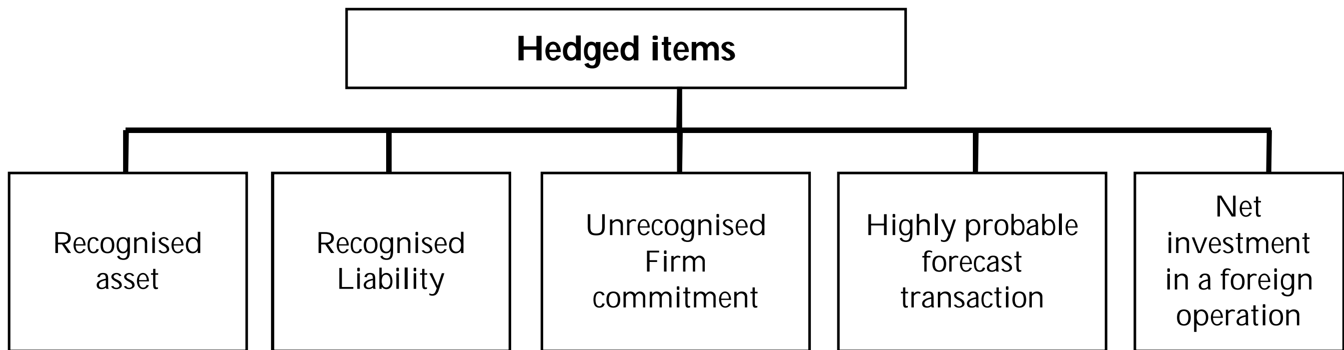
- Hedging refers to actions designed to reduce future uncertainty of cash flow or value of assets, liabilities etc.
- A forward exchange contract to buy foreign currency for future payments in foreign currency is an example of hedge.
- The hedge accounting refers to recognition of changes in values of hedged item and financial instrument used for hedging in the same period.

## 61. EXAMPLE ON HEDGING

- ABC Ltd an Indian company enters into a contract to acquire new machinery from Alabama, an American Company. The cost of the machinery is $ 50,000 and payable in 1 years' time. ABC Ltd's functional currency is INR and the current exchange rate is $ 1: INR 50.
- ABC Ltd. faces the exchange risk associated with this contract. To eliminate this risk, ABC Ltd enters into a forward contract to acquire $ 50,000 in 1 years' time at the current exchange rate.
- In 1 years' time when ABC Ltd. has to pay $50,000 to Alabama, pay Rs. 25,00,000 for the machinery irrespective of whether the exchange rate has moved up or down.
- This is known as 'Hedging'.

## 62. A HEDGED ITEM VS. INSTRUMENT

- **Hedged item** – A hedged item is an
  - asset,
  - liability, or
  - tranasction
- that exposes an entity to risk of changes in fair value or future cash flows and is designated as being hedged.




## 63. A HEDGED ITEM VS. INSTRUMENT

▶ **Hedging instrument** – A hedging instrument is a financial instrument, mostly a derivative, designated for hedging a specific item of asset, liability etc.

**Derivatives not regarded as hedge instruments are treated as held for trading instruments.**

## 64. HEDGE ACCOUNTING OBJECTIVE – GET THE TIMING RIGHT

- **Matching principle** – Gain or loss on the hedging instrument is recognised in profit and loss **in the same period** when the item that is being hedged affects profit and loss.
- In the case of **perfect hedge**, the gains and losses on the hedging instrument and the hedged item perfectly off-set in profit and loss **in the same period.**

## 65. ASSESSING HEDGE EFFECTIVENESS

- **Hedge effectiveness**: It is the degree to which changes in the fair value or cash flows of the hedged item that are offset by changes in the fair value or cash flows of the hedging instrument.
- There would be changes in fair values
- These changes occur both in the hedged item and in the hedging instrument
- Where the changes value of hedged item offset (or closely offset) the changes in hedging instrument, then the hedge is deemed as highly effective

## 66. DIFFERENT TYPES OF HEDGES

**(a) FAIR VALUE HEDGE**

This is a hedge of the **exposure to changes in fair value** of a recognised asset or liability or an unrecognised firm commitment that could affect profit or loss. **(Example – ASF Ltd has fixed the value of its inventory by entering into a future contract)**

**(b) CASH FLOW HEDGE:**

This is a hedge of the **exposure to variability in cash flows** that is attributable to a recognised asset or liability, e.g. future interest payments on variable rate debt, or a highly probable forecast transaction that could affect profit or loss. **(Example – ASF Ltd has a highly probable sale of commodity in future fixes the selling price of the goods by entering into a future contract.)**

**(c) HEDGE OF A NET INVESTMENT IN A FOREIGN OPERATION:**

Foreign operation is a foreign subsidiary, foreign associates and foreign joint venture. These are hedges, **designed to protect against translation losses** that may arise on translation of foreign currency financial statement into reporting currency.

## 67. CONDITIONS TO BE MET TO QUALIFY FOR HEDGE ACCOUNTING

**For exercising the option (hedge accounting) certain pre-conditions are to be met -**

▶ **Formal designation and documentation (hedged item – hedging instrument, nature of risk being hedged etc, risk management objectives and strategy).**

- **The hedge is expected to be <u>highly effective – Change in fair value or cashflow of hedging instrument offsets changes in fair value or cashflow of hedged item.</u>**
- Hedge is assumed on an **<u>on-going basis for its effectiveness.</u>**

## 68. ACCOUNTING FOR FAIR VALUE HEDGES

Variability of changes in fair value of a recognised asset or liability or a firm commitment is protected.

**Example –** Interest rate risk associated with a portfolio of financial assets (or liabilities)

- Fixed rate liabilities like loans
- Fixed rate assets like investments in bonds
- Investment in equity securities

**Accounting**

(a) The Hedging instrument is measured at fair value & fair value changes are recognised in Profit & loss A/c

(b) If the hedging instrument **hedges the Equity Instrument**, which is designated as FVTOCI, **the fair value** changes are **recognised in OCI.**

(c) If the hedge item is otherwise carried at Amortised cost, its carrying amount is adjusted by the hedging gain or loss. This adjustment is recognised in P & L A/c to offset the effect of the Gain / Loss in the hedging Instrument. The effective Interest will also be adjusted.

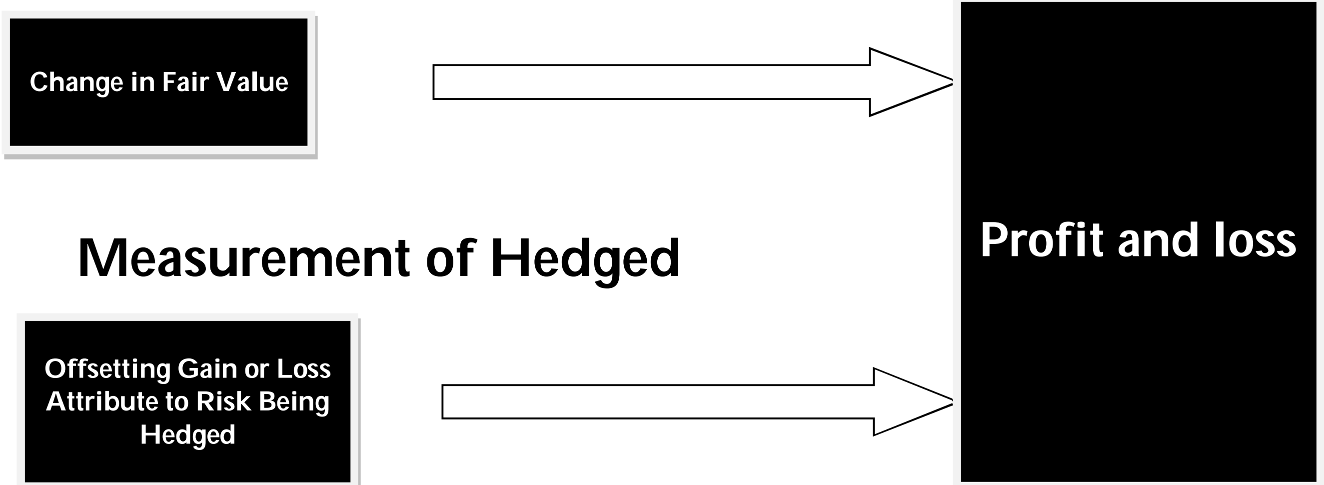
(d) If the hedged item is a debt instrument measured as at FVTOCI there is no change in the valuation of the hedged item. However, hedging Gain or loss on the hedged item are recognised in P & L A/c instead at OCI.

(e) If the hedged item is an equity instrument measured as at FVTOCI the fair value gain / loss of equity instrument continues to be recognised in OCI. The Gain / Loss on Hedging Instrument is recognised in OCI to achieve off-setting.

(f) When on unrecognised firm commitment is designated as hedged item subsequent cumulative change in the FV of firm commitment is recognized as an asset or liability with corresponding Gain / Loss recognised in P & L A/c. Change FV of hedging instrument is also recognised in P & L A/c.

Subsequently when the entity executes the firm commitment to acquire an asset or a liability the initial carrying amount of the asset or the liability is adjusted to include the cumulative change in the fair value of firm commitment that was recognised in the SOFP.

**ACCOUNTING FOR FAIR VALUE HEDGE**



**Impact of Fair Value Hedge Accounting**

| Gain or Loss Recognition | | | |
|---|---|---|---|
| | **Period 1** | **Period 2** | **Total** |
| Hedged item | (10) | (10) | (10) |
| Hedged Derivatives | 10 | | 10 |
| Earnings | 0 | ⇦0 | 0 |

## 69. INTEREST RATE SWAP

- It can be defined as a financial contract between two parties to exchange one series of cash flows (fixed interest) for another series of cashflows (variable or floating rate) on an agreed amount called notional principal for an agreed period of time.

**QUESTION 55 :** Fair Value Hedge Accounting

**Entity A has originated a 5% fixed rate loan asset that is measured at amortized cost ($100,000). Because Entity A is considering whether to securitize the loan asset (i.e., to sell it in a securitization transaction), it wants to eliminate the risk of changes in the fair value of the loan asset. Thus, on January 1, 20X6, Entity A enters into a pay-fixed, receive-floating interest rate swap to convert the fixed interest receipts into floating interest receipts and thereby offset the exposure to changes in fair value. Entity A designates the swap as a hedging instrument in a fair value hedge of the loan asset. Market interest rates increase. At the end of the year, Entity A receives $5,000 in interest income on the loan and $200 in net interest payments on the swap. The change in the fair value of the interest rate swap is an increase of $1,300. At the same time, the fair value of the loan asset decreases by $1,300.**

***Required***

- ✓ **Prepare the appropriate journal entries at the end of the year.**
- ✓ **Assume that all conditions for hedge accounting are met.**

**SOLUTION 55 :**

| | | | |
|---|---|---|---|
| 1 | Dr Cash<br>Cr Interest income<br>*(To record interest income on the loan)* | | |
| 2 | Dr Cash<br>Cr Interest income<br>*(To record the net interest settlement of the swap)* | | |
| 3 | Dr Derivative<br>Cr Hedging gain<br>*(To record the increase in the fair value of the swap)* | | |
| 4 | Dr Hedging loss<br>Cr Loan asset<br>*(To record the decrease in the fair value of the loan asset attributable to the hedged risk)* | | |

**QUESTION 56 : Fair Value Hedge Accounting**

**A Ltd has given a 10 % fixed loan to S Ltd. A Ltd measures this loan at an amortised cost of Rs 250,000. A Ltd plans to hive-off the receivable at a later stage and as a measure to safeguard against fall in value of its dues enters into pay-fixed, receive floating interest rate swap to convert the fixed interest receipts into floating interest receipts. A Ltd designates the swap as a hedging instrument in a fair value hedge of the loan asset.**

**Over the following months, market interest rates increase and A Ltd earns interest income of Rs. 25,000 on the loan and Rs. 1,000 as net interest payment on the swap. The fair value of loan asset decrease by Rs 5,000 while that of interest rate swap increases by Rs. 5,000. All conditions required for hedge accounting are satisfied. Pass journal entries in the books of A Ltd.**

**SOLUTION 56 :**

| | | | |
|---|---|---|---|
| 1 | Dr Cash<br>Cr Interest income<br>*(To record interest income on the loan)* | | |
| 2 | Dr Cash<br>Cr Interest income<br>*(To record the net interest settlement of the swap)* | | |
| 3 | Dr Derivative<br>Cr Hedging gain<br>*(To record the increase in the fair value of the swap)* | | |
| 4 | Dr Hedging loss<br>Cr Loan asset<br>*(To record the decrease in the fair value of the loan asset attributable to the hedged risk)* | | |

**QUESTION 57 : Fair Value Hedge Accounting**

**On April 1, 2007. A Ltd. borrowed Rs.10 lakh at annual fixed interest rate of 7% payable half-yearly. The life of the loan is 4 years with no pre-payment permitted. The company expected the interest rate to fall and on the same day, it entered into an interest rate swap arrangement, whereby the company would pay 6 months LIBOR and would receive annual fixed interest of 7% every half-year. The swap effectively converted the company's fixed rate obligation to floating rate obligation.**

**The following value of swap and debt are available**

| | Value of swap (Rs. in lakhs) | Value of debt (Rs. in lakhs) |
|---|---|---|
| Sept 30, 2007 | +0.2 | 10.2 |
| March 31, 2008 | - 0.1 | 9.9 |

**SOLUTION 57 :**

| | | | |
|---|---|---|---|
| 1 | Interest A/C ..........................Dr<br>To Bank A/C<br>*(To record interest Payment on loan for first half year)* | | |
| 2 | Loss on Valuation of Debt A/c… ..Dr<br>To Loan A/C<br>*(To record increase in value of debt recognised)* | | |
| 3 | Swap Hedge A/C…………………..Dr<br>To Gain on Swap Hedge A/C<br>*(To record the increase in the fair value of the swap)* | | |
| 4 | Bank A/C……………………………….Dr<br>To Interest A/C<br>*(Being Swap settlement received for first half year)* | | |
| 5 | Interest A/C ..........................Dr<br>To Bank A/C<br>(To record interest Payment on the loan for 2nd half year) | | |
| 6 | Loan A/C… ..Dr<br>To Gain on Valuation of Debt A/c<br>(To record decrease in value of debt recognised) | | |
| 7 | Loss on Swap Hedge A/C……… Dr<br>To Swap Hedge A/C<br>(To record the decrease in the fair value of the swap) | | |
| 8 | Interest A/C…………………………Dr<br>To Bank A/C<br>(Being Swap settlement paid for 2nd half year) | | |

**QUESTION 58 :**

**ASF Ltd has Rupee as its functional currency it has choosen to treat all hedges of foreign currency risk associated with firm commitment as fair value hedges. In Jan. 2017 it contracts with the US supplier to purchase a Machinery. The machine will be delivered in July 2017 and the contracted price is Dollar 1000. ASF Ltd contracts with a bank to purchase USD 1000 in July at a forward rate of Rs 60/ dollar. If the fair value of the forward contract at the end of 31.03.2017 (year end) is Rs 3000 positive to ASF, on delivery Rs 5000 positive to ASF. Spot exchange rate in July is Rs 65/USD**

**Pass Journal entries.**

**QUESTION 59 :**

**ASF Ltd maintains an inventory of Cocoa that it uses in production of chocolate. ASF wants to hedge the risk of the price changes in cocoa inventory on 01.07.2005. It enters into a forward derivative instrument that is indexed to cocoa.**

**The Fair Value of the cocoa inventory has decreased by Rs 50,000 & the fair value of the derivative has increased by Rs 50,000.**

**Pass Journal Entry to recognize Fair Value hedge.**

**QUESTION 60 :**

**On 01.01.2010 ASF Ltd issued Rs 200 million, 5 year 9% Fixed Rate Debt. Interest on debt is payable annually. ASF interest rate risk policy requires that all debts are at variable rates this can be achieved either through issuing variable rate debt or by issuing fixed rated debt & swapping it into variable. To maintain compliance with this variable it entered into interest rate swap to convert the debt from fixed to variable & designate the swap as FV hedge. The swap is a 5 years pay MIBOR receive 6.5% fixed rate swap.**

**ASF satisfies the hedge accounting criteria.**

**The FV of the swap & the carrying amount of the debt as adjusted for changes in FV attributable to the hedges risk are as follow.**

| | | (Rs. In million) | |
|---|---|---|---|
| 1.1.2010 | 30.06.2010 | 31.12.2010 | |
| Issue debt | 200 | 205 | 201 |
| Swap | _ | 5 | 1 |

**Pass Journal Entries to reflect the FV hedge.**
**Ignore Interest Entries.**

**QUESTION 61 :**

**During year 1 an investor purchases a fixed rate debt security for Rs. 10 million based on IFRS 9 principal. It is classified as FVTOCI. At the end of year 1 the FV of the asset is Rs 11 million to protect this value the investor enters into a hedge by acquiring a derivative with NIL F.V. By the end of year 2 the derivative has FV of Rs. 0.5 million & the debt security has a corresponding decline in FV Pass Journal Entry for the FV hedge.**

## 70. CASH FLOW HEDGE

Variability of cash flows that is attributable to a particular risk associated with a FA or FL or a highly probable transaction – is protected.

Example – interest rate payment on variable rate debt-

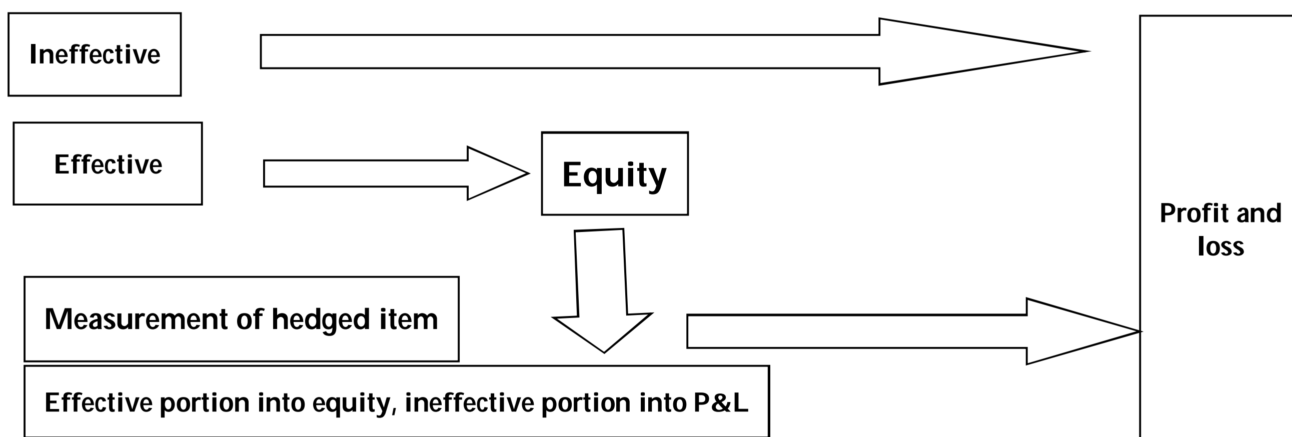
- Variable rate liabilities like loans
- Variable rate assets like investments in bonds

**Accounting for cash flow hedges**

If a cash flow hedge meets the conditions for application of hedge accounting:

1. Change in FV of hedging instrument are initially recognised in OCI & taken to a separate component of equity. The ineffective portion of the change in the FV of the hedging instrument (If any) is recognized in 'P & L A/c'.
2. **The Amount recognized in OCI should be <u>lower of:</u>**
   I. Cumulative gain / Loss on hedging instrument from the inception of the hedge, and
   II. The cumulative change in FV (PV) of the expected future cash flow on the hedged item the inception of the hedge.
3. If the cumulative change in the hedging instrument exceeds the changes in hedged item, ineffectiveness is recognized in 'P & L A/c'. If the cumulative change in hedging instrument is less than change in hedged item, no ineffectiveness will be recognised.

4. For Cash flow hedges of a forecast transaction which subsequently results in the recognition of a 'non-financial item' (eg : fixed Asset / Inventory), or where a hedged forecast transaction for a non-financial Asset / liability become a firm commitment for which FV hedge accounting is applied, the carrying Amount of that item must be adjusted for the accumulated Gain / Loss recognized directly in Equity.
5. For other cash flow hedge, the accumulated gain / loss recorded in Equity should be reclassified to P & L A/c. In the same period during which the hedged expected future cash flow affect P & L A/c. For eg: when a forecast sale occurs.
6. Where there is a cumulative loss on the hedging instrument (OCI A/c – Dr. balance) & it is no longer expected that loss will be recovered, it must be immediately recognized in P & L A/c.
7. **If a hedged forecast transaction subsequently results into recognition of Financial Asset / Financial Liability, than 'OCI' is transferred to 'P & L A/c'.**
8. **Hedges that no longer meet the criteria for hedge accounting -** In this case, the cumulative gain or loss on the hedging instrument that has been recognised in OCI from the period the hedge was effective shall remain separately in equity until the forecast transaction occurs.




**P & L or Equity or both?**

Cash flow hedge accounting:

Step 1: Compare

(a) cumulative gain/loss on hedging instrument (say 140) with

(b) cumulative change in the PV of cash flows from hedged item (say 110), and pick up the lower amount.

Step 2: Take 110 to equity and 30 to P & L (ineffective)

**Impact of Cash Flow Hedge Accounting**

| | **Gain or Loss Recognition** | | |
|---|---|---|---|
| | **Period 1** | **Period 2** | **Total** |
| Hedged item | | 10 | 10 |
| Hedged Derivative | (10) | (10) | (10) |
| Earnings | 0 | 0 | 0 |

**QUESTION 62 :** Cash Flow Hedge Accounting

Entity A is a producer of widgets. To hedge the risk of declines in the price of 100 widgets that it expects to sell on December 31, 20X8, Entity A on January 1, 20X7, enters into a net-settled forward contract on 100 widgets for delivery on December 31, 20X8. During 20X7, the change in the fair value of the forward contract is a decrease of $8,000. During 20X8, the change in the fair value of the forward contract is an increase of $2,000. On December 31, 20X8, Entity A settles the forward contract by paying $6,000. At the same time, it sells 100 widgets to customers for $93,000.

***Required***

Prepare the appropriate journal entries on January 1, 20X7, December 31, 20X7, and December 31, 20X8. Assume that all conditions for hedge accounting are met and that the hedging relationship is fully effective (100%).

**QUESTION 63 :**

On 4th January 2012, P Ltd has forecasted sale of 1 million kg of chemical on 15th Dec, 2012 to L Ltd in UK on 4th Jan. 2012 P Ltd designates the cash flow of a forecast sale as a hedged item & enters into forward exchange contract to sale 4 million pound based on the forecast receipt (1 million x £ 4 / kg)

The forward contract locks the value of the £ to be received at a rate of Rs 80 / £. At the inception the FV of the derivative is zero.

On 30th June, 2012. the FV of forward contract is Rs. (-) 100,000. On 15th Dec. 2012 the transaction occurred as expected. The FV of forward contract is Rs (-) 150,000 as rupee continued to weaken against £.

Pass Journal Entries.

**QUESTION 64 :**

On 30th Sept. 2017, entity A hedges the anticipated sale of 24 tons of pulp on 1st March, 2018 by entering into a forward contract the contract requires net settlement in cash determined as a difference between the future spot price of pulp on a specified commodity exchange & Rs 1000.

Entity a expect to sale a pulp in a different market. It determines that a forward contract is an effective hedge.

On 31st Dec. 2017 the spot price of pulp has increased both in local market & in the exchange. The increase in local market exceeds the increase in exchange. As a result a PV of expected cash flow from the sale on the local market is Rs 1100 the FV of forward contract is (-) Rs 80.

Pass Journal Entry :

**QUESTION 65 :**

ASF Ltd planned to purchase goods amounting to $ 10,000 in 9 months' time.

| Date | Cl. Exchange rate | Forward Rate | Terms of Forward |
|---|---|---|---|
| 01.01.2015 | 62.20 | 62.40 | 9 months |
| 31.03.2015 | 62.40 | 62.55 | 6 months |
| 30.06.2015 | 63.67 | 63.75 | 3 months |
| 30.09.2015 | 64.10 | - | - |

Appropriate risk free rate is 8%. The best estimate for the projected exchange rate on 30.09.2015 is forward rate of the appropriate term.

Pass Journal Entries.

**QUESTION 66 :**

**ASF Ltd uses INR as its functional currency. ASF wants to limit the effect of currency fluctuation in its Financial Statements, by hedging highly probable forecasted USD denominated sales for the month of July, 2019. ASF expects to sale $ 1,35,00,000 during the month of July, 2019. On 01.01.2019. ASF enters into 6 months forward contract to sale $ 1,35,00,000 @ Rs 47.50 / $**

| Date | Spot Rate | Forward Rate for June, 2019 |
|---|---|---|
| 01.01.2019 | 47.80 | 47.50 |
| 31.03.2019 | 48.10 | 47.90 |
| 30.06.2019 | 48.50 | - |

- **Appropriate risk free rate is 6%, Assume hedge is fully effective & there is no ineffective portion.**

Pass Journal entry.

**QUESTION 67 :** CASH FLOW HEDGE & FV HEDGE :

**ASF Ltd uses INR as its functional currency. It wants to limit the effect of currency fluctuation in its. financial statements, by hedging highly probable forecasted USD denominated sales and resulting receivable. ASF expects to sale USD 135,00,000 on 30.06.2019 which will be realised on 31.10.2019**

**To hedge the foreign currency risk it enters in forward contract on 01.01.2019 to sale USD 135,00,000 @ forward Rate of Rs 47.50 / $**

| Date | Spot Rate | Forward Rate for 31.10.2019 |
|---|---|---|
| 01.01.2019 | 47.80 | 47.50 |
| 31.03.2019 | 48.10 | 47.90 |
| 30.06.2019 | 48.50 | 48.80 |
| 30.09.2019 | 48 | 48.20 |
| 31.10.2019 | 48.30 | - |

**Risk free rate is 6% per assume. The hedge is fully effective. ASF designates the forwards contract as a hedging instrument in a Cash Flow hedge of highly probable forecast sale for USD 135,00,000 on 30.06.2019 and thereafter as a FV hedge of the resulting receivable of USD 135,00,000.**

Pass Journal entry.

## 71. ACCOUNTING FOR HEDGES OF A NET INVESTMENT

- Hedges of a net investment in a foreign operation including a hedge of a monetary item, should be accounted for similarly to cash flow hedges:

| **Effective portion into equity, ineffective portion into P&L** |
|---|

- The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in the equity account should be recognised in the statement of profit and loss on disposal of the foreign operation.

# IFRS 7 — FINANCIAL INSTRUMENT DISCLOSURES

## 1. INTRODUCTION

Financial instruments should be grouped according to its class, for which an entity should consider at a minimum, whether instruments are measured at amortized cost or fair value and whether these are within or outside the scope of this standard.

Such classification should render better understanding of the significance, impact, nature and extent of risks associated with the financial instruments to the users of financial statements easier.

## 2. DEFINITIONS

- **Credit risk**

  The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

- **Currency risk**

  The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

- **Interest rate risk**

  The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

- **Liquidity risk**

  The risk that an entity will encounter difficulty in meeting obligation associated with the financial liabilities.

- **Market risk**

  The risk that fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risks: currency risk, interest rate risk and other price risk.

- **Past due**

  A financial asset past due when a counterparty has failed to make a payment when contractually due.

- **Sensitivity analysis**

  An analysis showing how profit or loss and equity would have been affected by changes in relevant risk variable (interest rate, foreign currency exchange rates and other prices) that were reasonably possible at reporting date.

## 3. STATEMENT OF FINANCIAL POSITION RELATED DISCLOSURES

**The categories of Financial Assets classified into**

- Financial assets at fair value through Profit or Loss (FVTPL) showing separately those
  - Designated as FVTPL and
  - mandatorily classified as FVTPL,
- Financial assets measured at amortized cost
- Financial liabilities measured at amortized cost

- Financial assets at fair value through Other Comprehensive Income (FVTOCI) - showing separately
  - those classified as FVTOCI and
  - equity instruments designated on initial recognition as FVTOCI,
- **Financial assets at fair value through Profit or Loss (FVTPL) showing separately those :**
  - **designated as FVTPL**
  - **Those held for trading**

**Where an entity has designated a financial asset or liability as at fair value through Profit or Loss, which otherwise would have been measured at amortized cost or FVTOCI it shall disclose:**

- maximum exposure to credit risk,
- the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
- amount of changes, **during the period and cumulatively**, in the fair value of the **financial assets** attributable to changes in
  - credit risk and
  - he amount of change in fair value of any related credit derivatives

**Where an entity has designated a financial liability as at fair value through Profit or Loss**

- It shall disclose the amount of change during the period and cumulatively, in the fair value of such liability that is attributable to changes in the credit risk of that liability.
- The difference between the carrying amount of financial liability and the contractual liability of the entity.

**Where an entity has designated investments in equity instruments to be measured at FVTOCI,**

- It shall disclose investments that have been designated,
- Reasons for using this presentation alternative,
- Fair value of each such investment at the end of the reporting period,
- Dividends recognized during the period,
  - Showing separately those related to investments derecognized during the period and
  - from investments held at the end of reporting period
  - Any transfer of the cumulative gain or loss within equity.

**Where a financial asset has been reclassified**

- The date of reclassification,
- Detailed explanation of change in business model and description of effect on the financial statements and
- The amount reclassified into and out of each category, in the year of reclassification.

**For financial assets reclassified out of FVTOCI,** it shall disclose

- fair value of the financial assets at the end of the reporting period and
- fair value gain or loss that would have been recognized if the reclassification had not been done.

**For financial assets reclassified out of FVTPL,**

- For each reporting period after reclassification, for financial assets reclassified out of FVTPL, effective interest rate determined on date of reclassification and the interest revenue recognized.

**An entity shall also make disclosures of the following:**

- Carrying amount of financial assets in respect of which lien or other encumbrances have been created, and the terms and conditions of such a pledge or lien.
- A reconciliation of the changes in the allowance account for credit losses for each class of assets (where impairment loss is accounted for separately rather than adjusting the carrying amount directly)
- Existence of special features in a financial instrument, such as a compound instrument with multiple embedded derivatives whose values are interdependent.
- Defaults and breaches in loans payables are also to be disclosed.

## 4. STATEMENT OF COMPREHENSIVE INCOME RELATED DISCLOSURES

1. **Net Gains or Net Losses on**
   - Financial assets at fair value through profit or loss (FVTPL) and financial liabilities at fair value through P&L - showing separately those
   - designated as FVTPL and
   - mandatorily classified as FVTPL
     - Financial assets measured at amortized cost
     - Financial liabilities measured at amortized cost
     - Investments in equity instruments designated as FVTOCI
     - Financial assets at fair value through Other Comprehensive Income (FVTOCI)
2. Total interest income and expense relating to financial assets that are measured at amortized cost or FVTOCI and financial liabilities not measured at FVTPL
3. Fee income **and** expenses arising from financial assets or liabilities
4. Analysis of gain or loss recognized in the statement of profit or loss arising from de-recognition of financial assets measured at amortized cost.

## 5. OTHER DISCLOSURES

**Accounting Policies**

- **Disclose significant accounting policies relating to Financial Instruments comprising measurement basis.**

**In the area of hedge accounting,**

- An entity shall disclose description of each type of hedge, instruments designated as hedging instruments, nature of risks being hedged.
- **In case of cash flow hedges**, timing of expected cash flows and timing when these are likely to affect profit or loss,
- **In case of fair value hedges**, gains or losses in respect of hedging instruments and in hedged items.
- Fair value of each class of financial assets and liabilities in a manner that it permits a comparison with carrying amounts; methods and valuation techniques adopted in estimating fair values shall also be disclosed.

**Nature and extent of risks arising from financial instruments**

- An entity shall disclose, information that enables users of financial statements to evaluate nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.
- These fall broadly under two groups, namely qualitative disclosures and quantitative disclosures.

### Qualitative disclosures

**Disclose**

a. **Entity's exposures to risk and how they arise.**
b. **Entity's objectives, policies and processes for managing the risk and the method used to measure the risks.**
c. **Any change in (a ) or (b) from previous period.**

### Quantitative disclosures

- The various methods used for managing risk should be disclosed as part of the accounting policy.
- The quantitative information disclosed should be based on the information provided internally to key management personnel.

## 6. DISCLOSURE RELATING TO CREDIT RISK

- maximum exposure to credit risk at the reporting date without taking account any collateral held or other credit enhancements,
- description of collateral held or other credit enhancements,
- credit quality of financial assets that are not impaired and not past due,
- Carrying amount of financial assets whose terms have been renegotiated which otherwise have been impaired or past due.

## 7. DISCLOSURES RELATING TO FINANCIAL ASSETS THAT ARE PAST DUE OR IMPAIRED

- For financial assets that are past due or impaired,
- an analysis of age of financial assets that are past due and not impaired on enhancements are obtained,
- nature and carrying guarantees amount of such financial or non-financial assets and
- Whether they are readily convertible to cash, as also the policy for disposing it should be disclosed.

## 8. DISCLOSURES RELATING TO LIQUIDITY RISK

<u>Disclosure relating to liquidity risk includes</u>

- Maturity analysis of non-derivative financial liabilities that shows the remaining contractual maturities
- Maturity analysis of derivative financial liabilities showing remaining contractual maturities
- description on management of liquidity risk should be disclosed.

## 9. DISCLOSURES RELATING TO MARKET RISK

- Disclosure relating to market risk includes sensitivity analysis of financial instruments for various types of market risk to which the entity is exposed.
- Impact on the profit or loss and equity if there is a change in the relevant risk variable that is expected to be reasonable on the reporting date should also be disclosed.
- The relevant risk variables are interest rates, foreign exchange rate risks and other price risks.
- The methods and assumptions that were used in preparation of sensitivity analysis, changes from previous period and the reasons for such changes should also be disclosed.

**EXAMPLE :**

**Interest Rate**

- At 31 December 20X2, if interest rates at that date had been 10 basis point lower with all other variables held constant, post-tax profit for the year would have been Rs 1.7 million (20Xl – Rs. 2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings. If interest rates had been 10 basis point higher, with all other variables held constant, post-tax profit would have been Rs 1.5 million (20X1 – Rs 2.1 million) lower, arising mainly as a result higher interest expense on variable borrowings. Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowing that has occurred as the entity's debt has matured.

**Foreign currency exchange rate risk**

- At 31 December 20X2, if the Rs had weakened 10 per cent against the US dollar With all other variables held constant, post-tax profit for the year would have been Rs 2.8 million (20X1 – Rs 6.4 million) lower, and other comprehensive income would have been Rs 1.2 million (20X1 – Rs 1.1 million (higher. Conversely if the Rs had Strengthened 10 per cent against the US other with all other variables held constant, post-tax profit would have been Rs 2.8 million (20X1 – Rs 6.4 million) higher, and other comprehensive income would have been Rs 1.2 million (20X1 – Rs 1.1 million) lower.

## 10. MAJOR CHANGE IN IND AS 107 VIS-À-VIS IFRS 7 NOT RESULTING IN CARVE OUT

1. **Disclosure of description of Gains and Losses presented in the Separate Income Statement:**
   - IFRS 7 requires disclosure of description of gains and losses presented in the separate income statement, where separate income statement is presented.
   - This requirement is not provided in In AS 107 consequential to the removal of option regarding two statement approach in Ind AS 1 as compared to IAS 1.
   - Ind AS 1 requires that the components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.
2. **Different terminologies have been used in Ind AS e.g., the term 'balance sheet' is used instead of 'Statement of financial position' and 'Statement of profit and loss' is used instead of 'Statement of comprehensive income.'**
3. **Transitional provisions given in IFRS 7 have not been given in Ind AS 107 since all transitional provisions have been included in Ind AS 101.**

# IFRS 13 — FAIR VALUE MEASUREMENT

## 1. INTRODUCTION

IFRS 13 seeks to increase consistency and comparability in fair value measurements and related disclosures through a 'fair value hierarchy'. The hierarchy categorizes the inputs used in valuation techniques into three levels. The hierarchy gives the highest priority to (unadjusted) quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

## 2. DEFINITIONS

**Active Market :** A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

**Cost approach:** A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

**Entry price:** The price paid to acquire an asset or received to assume a liability in an exchange transaction.

**Exit price:** The price that would be received to sell an asset or paid to transfer a liability.

**Expected cash flow:** The probability-weighted average (i.e. mean of the distribution) of possible future cash flows.

**Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Highest and best use:** The use of a **non-financial asset** by market participants that would maximize the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used.

**Income approach:** Valuation techniques that convert future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

**Inputs:** The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following:

(a) The risk inherent in a particular valuation technique used to measure fair value (such as a pricing model); and

(b) the risk inherent in the inputs to the valuation technique .Inputs may be observable or unobservable.

**Level 1 inputs:** Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

**Level 2 inputs:** Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

**Level 3 inputs:** Unobservable inputs for the asset or liability.

**Market approach:** A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

**Market corroborated inputs:** Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

**Market participants**: Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

(a) They are **independent of each other**, i.e. they are not related parties as defined in IAS 24, although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into at market terms.

(b) They are **knowledgeable, having a reasonable understanding about the asset or liability** and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.

(c) They are **able to enter into a transaction** for the asset or liability.

(d) They **are willing to enter into a transaction** for the asset or liability, i.e. they are motivated but not forced or otherwise compelled to do so.

**Most advantageous market:** The market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

**Non-performance risk:** The risk that an entity will not fulfil an obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk.

**Observable inputs:** Inputs that are developed using market data, such as publicly available information about actual events or transactions and that reflect the assumptions that market participants would use when pricing the asset or liability.

**Orderly transaction:** A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and-customary for transactions involving such assets or liabilities; it is not a forced transaction (e.g.- a forced liquidation or distress sale).

**Principal market:** The market with the greatest volume and level of activity for the asset or liability.

**Risk premium:** Compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability. Also referred to as a 'risk adjustment'.

**Transaction costs:** The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:

(a) They result directly from and are essential to that transaction.

(b) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in IFRS 5).

**Transport costs:** The costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.

**Unit of account:** The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.

**Unobservable inputs:** Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

## 3. SINGLE FRAMEWORK FOR MEASURING FAIR VALUE

**IFRS 13** Fair Value Measurement applies to **IFRSs** that require or permit fair value measurements or disclosures and provides a single framework for measuring fair value and requires disclosures about fair value measurement.

The Standard defines fair value on the basis of an 'exit price' notion and uses a 'fair value hierarchy', which results in a market-based, rather than entity-specific, measurement.

## 4. SCOPE (NON- APPLICABILITY OF THIS STANDARD)

This standard does not apply to the following items prescribed in other standards, though they are measured at fair value:

1. Share based payment transactions
2. Leasing transactions

3. Measurements similar to fair value but not fair value, viz., net realizable value under IAS 2 Inventories and value in use under IAS 36 Impairment of Assets
4. Disclosure of plan assets measured at fair value in accordance with IAS 19 Employee Benefits
5. Disclosures by Retirement benefit plan investments measured at fair value in accordance with IAS 26 Accounting and Reporting by Retirement Benefit Plans
6. Disclosures for assets measure at fair value less costs to sell in accordance with IAS 36

Hence, in other **IFRSs**, wherever fair value is applied, this standard should be used for both measurement and disclosure.

## 5. OVERALL FAIR VALUE MEASUREMENT APPROACH

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all of the following:

- the particular asset or liability that is the subject of the measurement (consistently with its unit of account)
- for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use)
- the principal (or most advantageous) market for the asset or liability
- the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within whichthe inputs are categorized

## 6. MEASUREMENT

Fair value is the PRICE that would be received to sell AN ASSET or paid to transfer a LIABILITY in an orderly TRANSACTION between MARKET PARTICIPANTS at the measurement date

**The asset or liability:** An entity should take into account the characteristics of the asset or liability being measured that amarket participant would take into account when pricing the asset or liability at measurement date (e.g. the condition and location of the asset and any restrictions on the sale and use of the asset)

**The transaction:** Fair value measurement assumes an orderly transaction between market participants at the measurement date under current market conditions. Fair value measurement assumes a transaction taking place in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability

**Market participants:** The market participants need not be entity specific. The market participants should be identified based on factors such as the asset or liability, the principal market and the expected market participants for the entity

**The Price:** The price is the exit price regardless of whether that price is directly observable or estimated using another valuationtechnique. The price should not be adjusted for transaction costs. If location is characteristic of the asset, then price should be adjusted for the transport costs incurred to transport the asset from its current location to the market.

**EXAMPLE : Market A and Market B are at different prices. Omega enters into transaction in both markets and can access the price in those markets for the assets at measurement date.**

| | Market A | Market B |
|---|---|---|
| **Price** | **26** | **25** |
| **Transaction Costs** | **3** | **1** |
| **Transportation cost** | **2** | **2** |
| **Fair value** | **24**<br>**(26-2)** | **23**<br>**(25-2)** |

## 7. APPLICATION TO NON-FINANCIAL ASSET

A fair value measurement of a non-financial asset takes into account **its highest and best use.**

The highest and best use of a non-financial asset takes into account, the use of the asset that is

1. physically possible, **(e.g., the location or size of the property)**
2. legally permissible **(e.g. Zoning regulation)** and
3. financially feasible **(e.g. Required return on investment).**

When measuring the fair value of a non-financial asset used in combination of with other assets or in combination with other assets and liabilities, the effect of valuation might be:

- the same whether used on stand-alone basis or as a group
- incorporated through adjustment to the stand-alone value of the asset
- incorporated through the assumptions relating to market participants
- incorporated into the valuation technique used to measure fair value of the asset

## 8. APPLICATION TO LIABILITIES AND AN ENTITY'S OWN EQUITY INSTRUMENTS

A fair value measurement of a **financial or non-financial liability** or an **entity's own equity instruments** assumes it is transferred to a market participant at the measurement date, **without settlement, extinguishment, or cancellation at the measurement date.**

The fair value of a liability reflects

- non-performance risk (the risk the entity will not fulfill an obligation), including
- an entity's own credit risk and assuming the same non-performance risk before and after the transfer of the liability

**PROBLEM 1 :**

**Z Ltd has a non-financial liability on account of advance from customers of Rs. 100 lakhs. While measuring fair value of this liability, Z Ltd shall consider the effect of the failure of timely delivery of the goods and services. Suppose there exists a legal or constructive obligation of paying a compensation for the delay. How should the Z Ltd apply non-performance risk for the purpose of fair value measurement? Assume that compensation of delayed delivery 1 lakh and probability of which is 50%.**

**SOLUTION : 1**

Z Ltd shall take into account probability of default and find out weighted average additional payment to be made for failure to maintain the delivery schedule.

The fair value of liability is Rs. 100.50 lakhs (Rs.100 lakhs + 50% of Rs.1 lakh).

An optional exception applies for certain financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk, provided conditions are met (additional disclosure is required).

## 9. FAIR VALUE AT INITIAL RECOGNITION

The most relevant indicator of fair value at the time of initial recognition is the transaction price itself. **However, such transaction price should be an exit price rather than an entry price.**

| EXAMPLE |
|---|
| **When an asset is acquired or a liability is assumed, the transaction price is the price paid to acquire an asset or received to assume the liability (entry price), whereas, fair value is the price that would be received to sell the asset or paid to transfer the liability (exit price).** |

## 10. WHEN WILL TRANSACTION PRICE NOT BE EQUAL TO FAIR VALUE ?

Transaction price may not be equal to fair value.

**For example,**
- **Related party transactions,**
- **Seller under financial difficulty,**
- **Transactions entered in different markets.**

**PROBLEM 2 :**

X Ltd. granted loans to Y Ltd. for 5 years at 8.5% which is treasury bond yield of equivalent maturity. But the incremental borrowing rate of Y Ltd. is 12%. In this case loan is granted to Y Ltd. at below market rate of interest. The loan amount is Rs. 100 million. This transaction price of the loan Rs. 100 million. IFRS 9 requires that a financial asset or financial liability is measured at fair value at the initial recognition. Should the transaction price be treated as fair value? If not, find out the fair value. What is the accounting treatment of the difference between the transaction price and fair value at initial recognition?

**SOLUTION : 2**

Fair value of the loan shall be measured applying income approach (present value technique). See Paragraphs 18.6 & 18.7. Fair value of the loan is the present value of future cash flows arising out of interest payment and repayment of principal discounted at market rate of interest.

$$\text{Fair Value} = \frac{8}{(1+12\%)^1} + \frac{8}{(1+12\%)^2} + \frac{8}{(1+12\%)^3} + \frac{8}{(1+12\%)^4} + \frac{8}{(1+12\%)^5} = \text{Rs.85.58 million}$$

The difference Rs. 14.42 million is recognised in the profit or loss as fair value loss.

## 11. VALUATION TECHNIQUES

An entity uses valuation techniques appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants and the measurement date under current market conditions.

**Three widely used valuation techniques are:**

## 12. MARKET APPROACH

Uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities **(e.g. a business)**

| EXAMPLE |
|---|
| **In case of unlisted equity having positive EPS market multiples (like price earnings ratio) are used to determine the price.**<br>**Price earnings ratio is the observable input.**<br>**The selection of the appropriate multiple within the range requires judgment, considering qualitative and quantitative factors specific to the measurement.** |

## 13. COST APPROACH-

It reflects the amount that would be required currently to replace the service capacity of an asset **(current replacement cost)**

## 14. INCOME APPROACH

It converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts.

**For example**, present value techniques, option pricing models, multiple-period excess earnings method.

| EXAMPLE |
|---|
| **● Value of equity is determined applying earning models or dividend models.** |
| **● Value of the bond is determined by present value of interest and principal repayment.** |

In some cases, a single valuation technique will be appropriate, whereas in others multiple valuation techniques will be appropriate.

## 15. FAIR VALUE HIERARCHY

IFRS 13 looks to increase consistency and comparability in fair value measurements and related disclosures through a 'fair value hierarchy'.

The hierarchy categorizes the inputs used in valuation techniques into three levels.

The hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

If the inputs used to measure fair value are categorised into different levels of the fair value hierarchy, the fair value measurement is categorised in its entirety in the level of the lowest level input that insignificant to the entire measurement (based on the application of judgement)

| TABLE : FAIR VALUE HIERARCHY | | |
|---|---|---|
| **Level 1** | **Level 2** | **Level 3** |
| Quoted price (unadjusted) in active market<br>Quoted price in an active market provides the most reliable evidence of fair value. This is used without adjustment except those stated in Paragraph 79, IFRS 13 | Inputs other than quoted prices included in Level 1 that are observable for the asset or liability<br>If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the as-set or liability. | Unobservable inputs for the asset or liability Unobservable inputs shall be used to measure fair value to the extent that relevant observable in-puts are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. |
| Level 1 Inputs are available for many financial assets and financial liabilities and commodities.<br>These assets and liabilities may be traded in multiple exchanges.<br>Level 1 Inputs are collected from the principal market or most advantageous market. It also assessed whether the entity has access to that market. | Examples are –<br>a. quoted prices for similar assets or liabilities in active markets.<br>b. quoted prices for identical or similar assets or liabilities in markets that are not active.<br>c. inputs other than quoted prices that are observable for the asset or liability, for example | The objective of fair value measurement remains the same, i.e. an exist price at the measurement date from the perspective of a market participant.<br>An entity shall develop unobservable inputs using the best information available in the circumstances which might include entity's own data.<br>For the purpose of developing |

| | | |
|---|---|---|
| | i. interest rates and yield curves observable at commonly quoted intervals;<br>ii. implied volatilities; and<br>iii. credit spreads.<br>d.market-corroborated inputs. | unobservable in-puts, although an entity may begin with its own input, it shall adjust those data from the perspective of market participants. This adjustment is required for entity-specific factor included in the entity's own date which is not available to other market participants |
| No adjustment to Level 1 inputs are allowed except which are set out in Para-graph 79, IFRS 13 | *Adjustment to Level 2 in-puts is carried. | Risk adjustment may be necessary in the fair value measurement when there is significant measurement uncertainty. |

## 16. LEVEL 1 INPUTS

Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.

A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available, with limited exceptions.

If an entity holds a position in a single asset or liability and the asset or liability is traded in an active market, the fair value of the asset or liability is measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity, even if the market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

## 17. LEVEL 2 INPUTS

Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

**Level 2 inputs include:**

- quoted prices for similar assets or liabilities in active markets
- quoted prices for identical or similar assets or liabilities in markets that are not active
- inputs other than quoted prices that are observable for the asset or liability, for example
  - interest rates and yield curves observable at commonly quoted intervals
  - implied volatilities
  - credit spreads
- inputs that are derived principally from or corroborated by observable market data by correlation or other means('market-corroborated inputs').

**PROBLEM 3 :**

**Asset A is a contractual right to receive Rs 1000 after one year. Asset B is a contractual right to receive Rs 1250 in two years and has a market price of Rs 1080. How should the discount rate adjustment technique be applied to Asset A. There is no comparable asset which matures in one year. The zero coupon yield curve on government securities two years rate is 40bp higher than one year rate.**

**SOLUTION : 3**

**PROBLEM 4 :**

**Assets A is a contractual right to receive Rs 1000 after one year. Asset B is a contractual right to received Rs 1200 in one year and has a market price of Rs 1120. How should the discount rate adjustment technique be applied to Asset A?**

SOLUTION 4 :

**PROBLEM 5 :**

**Sun Ltd acquired 5% equity shares of Moon Ltd., an unlisted company for Rs. 100 lakhs. It was assessing the fair value at subsequent measurement (at the end of the reporting period). It observed a recent transaction of the company shares in which Star Ltd acquired 20% of equity shares of Moon Ltd for Rs. 600 lakhs - this is based on EV / EBITDA of 8. As on the reporting date EBITDA is Rs. 400 lakhs. Assume that there is no debt capital of the company. At the time of initial recognition, Sun Ltd assessed that non-controlling discount is 10%.**

**How should Sun Ltd measure the fair value as on the reporting date?**

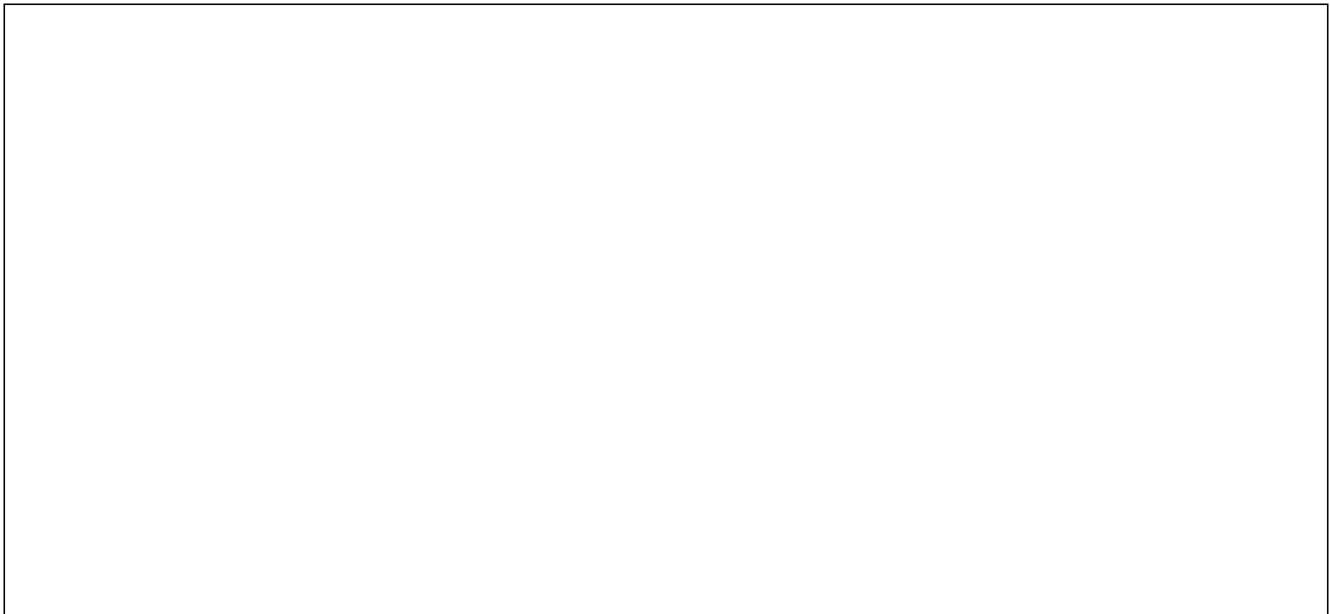
SOLUTION 5 :

**PROBLEM 6 :**

**X Ltd. acquired 5% equity shares of Y Ltd, as unlisted company for Rs. 100 lakhs. It was assessing the fair value at subsequent measurement (at the end of the reporting period). It observed a recent transaction of a listed company (L Ltd) shares in which Z Ltd. acquired 60% of equity shares of L Ltd @ Rs 500 as against pre-announcement price of Rs 430. This results in an EV/EBITDA multiple of company peers of Y Ltd of 8. As on the reporting date EBITDA of Y Ltd is Rs 4 crore. Assuming that there is long-term loan of Y Ltd is Rs 5 crores.**

**How should X Ltd measure the fair value as on the reporting date?**

SOLUTION 6 :



## 18. LEVEL 3 INPUTS

Level 3 inputs are **unobservable inputs** for the asset or liability.

Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

An entity develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data, taking into account all information about market participant assumptions that is reasonably available.

**EXAMPLE :**

**For cash generating unit, financial forecast which include cashflows developed using entity's own data.**

**PROBLEM 7 :**

Silicon Ltd. is a manufacturer of home lighting solutions. Silicon is reviewing the fair valuation of certain assets and liabilities in light of the introduction of IFRS 13. It carries an asset that is traded in different markets and is uncertain as to which valuation to use. The asset has to be valued at fair value. Silicon Ltd. currently only buys and sells the asset in the Market C. The data relating to the asset are set out below.

| Year to 31 December 2014 | Market A | Market B | Market C |
|---|---|---|---|
| Annual Volume of market – units | 45,000 | 18,000 | 15,000 |
| Price | $100 | $96 | $106 |
| Transport Costs | ($6) | ($6) | ($8) |
| Transaction Costs | ($2) | ($4) | ($4) |

**Required : Discuss how Silicon Ltd should value the above asset applying IFRS 13.**

**SOLUTION 7 :**

**PROBLEM 8 :**

**An asset is sold in two different active markets at different prices. Win Ltd enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. In Market A, the price that would be received is Rs 260, transaction costs in that market are 30 and the costs to transport the asset to that market are Rs 20. Thus the net amount that would be received is Rs 210. In Market B, the price that would be received is Rs 250, transaction costs in that market are Rs 10 and the costs to transport the asset to that market are Rs 20. Thus the net amount that would be received in Market B is Rs 220.**

**What should be the fair value of the asset if Market A is the principal market? What should be fair value if none of the markets is principle market?**

**ANSWER :** If Market A is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs i.e., Rs. 240.

If none of the market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximizes the amount that would be received to sell the asset, after taking into account transaction costs and transport costs:

Market A Rs 210 & Market B Rs 220

Thus fair value is determined on the basis of the price in the Market B i.e., price minus transport costs i.e., Rs 230.

## 19. DISCLOSURES

Disclosures are based on whether the fair value measurements are recurring or non-recurring in nature. Recurring fair value measurements are those instances where other IFRSs permits or requires the asset or liability to be measured at fair value as at reporting period. Non-recurring fair value measurements are instances where IFRSs requires fair value measurements only in particular circumstances.

**The following disclosures shall be made:**

- Fair value measurement at the end of the reporting period for recurring and non-recurring fair value measurements
- In case of non-recurring fair value measurements, the reasons for fair value measurement at the reporting period
- The level of fair value hierarchy within which the fair value measurements are categorized in their entirety
- The amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred
- Description of the valuation techniques and the inputs used in the fair value measurement for recurring and non-recurring fair value measurements categorized within Level 2 and Level3. If there is any change in valuation technique, the entity should disclose change and reasons for making the change
- For fair value measurements within Level 3, quantitative information about significant unobservable inputs used in the fair value measurements, a reconciliation from opening balances to the closing balances disclosing
  - o Total gains or losses for the period recognised in profit or loss
  - o Total gains or losses for the period recognised in othercomprehensive income
  - o Purchases, sales, issues and settlements
  - o Amount of any transfers into and out of Level 3
  - o Amount of unrealized gains or losses included in profit and loss
  - o Description of valuation process used by the entity
- If the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differsfrom its highest and best use.

## 20. MAJOR CHANGE IN IND AS 113 VIS-A-VIS IFRS 13 NOT RESULTING IN CARVE OUT

**Paragraph 7(b) of IFRS 13:**Paragraph 7(b) of IFRS 13 refers to IAS 26 'Accounting and Reporting by Retirement Benefit Plans, which is not relevant for the companies. Hence the paragraph is deleted in Ind AS 113.

## PROBLEMS FOR SELF-PRACTICE

**PROBLEM 9 :**

**An asset is sold in 2 different active markets (a market in which transaction for the asset or liability takes place with sufficient frequency and volume to provide pricing information on an ongoing basis) at different prices.**

**An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date.**

**In Market A:**

**The price that would be received is 26, transaction costs in that market are 3 and the costs to transport the asset to that market are 2 (i.e., the net amount that would be received is 21).**

**In Market B:**

**The price that would be received is 25, transaction costs in that market are 1 and the costs to transport the asset to that market are 2 (i.e., the net amount that would be received in Market B is 22).**

**SOLUTION 9 :**

If Market A is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (24).

If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximizes the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e., the net amount that would be received in the respective markets).

Because the entity would maximize the net amount that would be received for the asset in Market B (22), the fair value of the asset would be measured using the price in that market (25), less transport costs (2), resulting in a fair value measurement of 23.

**PROBLEM 10 :**

**Company J acquires land in a business combination. The land is currently developed for industrial use as a factory site. Although the land's current use is presumed to be its highest and best use unless market or other factors suggest a different use, Company J considers the fact that nearby sites have recently been developed for residential use as high-rise apartment buildings.**

**On the basis of that development and recent zoning and other changes to facilitate that development, Company J determines that the land currently used as a factory site could be developed as a residential site (e.g., for high-rise apartment buildings) and that market participants would take into account the potential to develop the site for residential use when pricing the land.**

**SOLUTION 10 :**

The highest and best use of the land is determined by comparing the following:

- The value of the land as currently developed for industrial use (i.e., an assumption that the land would be used in combination with other assets, such as the factory, or with other assets and liabilities); and
- The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs necessary to convert the land to a vacant site. The value under this use would take into account risks and uncertainties about whether the entity would be able to convert the asset to the alternative use (i.e., an assumption that the land would be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of these values. In situations involving real estate appraisal, the determination of highest and best use might take into account factors relating to the factory operations (e.g., the factory's operating cash flows) and its assets and liabilities (e.g., the factory's working capital

# IFRS 3 — BUSINESS COMBINATION

## 1. INTRODUCTION

The necessity of a standard on Business Combination assumes importance considering the fact that companies are increasingly stretching their business in foreign countries for best-fit business combinations. Business combinations are most common form of business transaction through which companies grow in size rather than organic activities

## 2. SCOPE UNDER IFRS 3

IFRS 3 applies to a transaction or other event that meets the definition of a business combination. This Standard **does not apply to:**

(a) the formation of a joint venture.

(b) the acquisition of an asset or a group of assets that does not constitute a business i.e. it is an asset acquisition

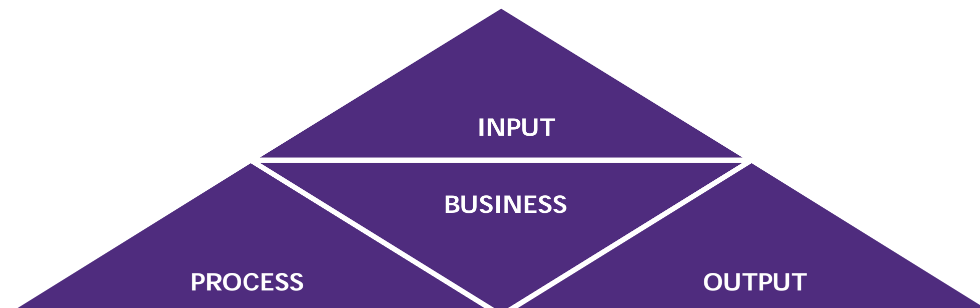
## 3. WHAT IS BUSINESS ?

The term 'business' is defined as an

- integrated set of activities and assets
- that is capable of being conducted and managed
- for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

## 4. ELEMENTS OF BUSINESS

The three elements of a business are defined as follows:




**(a)** **Input**: Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it.

**EXAMPLE : 1**

(b) **Process**: Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs.

**EXAMPLE : 2**

These processes typically are documented, but an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. **(Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)**

**(c)** **Output**: The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

**QUESTION : 1**

**IT department is a cost centre to K&K Co, a legal firm. IT Outsourced Ltd, specialises in the provision of IT services to legal firms. K&K Co sells its IT department to IT Outsourced Ltd, consisting of plant and equipment, working capital and staff. Is IT dept of K & K Co. a business?**

**SOLUTION : 1**

## 5. WHAT IS BUSINESS COMBINATION

A business combination is a transaction in which the **acquirer obtains control of another business (the acquiree)**.

- Under IFRS 3, Business combination occurs when an entity obtains **control** of a **business** by acquiring net assets or acquiring its significant equity interest. As such, two elements are required for a transaction to be a business combination under IFRS 3:
  - the acquirer obtains control of an acquiree ("control" as defined in IFRS 10); and
  - the acquiree is a business
- An acquirer might obtain control of an acquiree in a variety of ways, for example:
  - by transferring cash, cash equivalents or other assets (including net assets that constitute a business);
  - by incurring liabilities;
  - by issuing equity interests;
  - by providing more than one type of consideration; or
  - without transferring consideration, including by contract alone.
- A business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:
  - one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;
  - one combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners;
  - all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity; or a group of former owners of one of the combining entities obtains control of the combined entity.

**QUESTION : 2**

**Company X is a liquor manufacturer and has traded for a number of years. The company produces a wide variety of liquor and employs a workforce of machine operators, testers, and other operational, marketing and administrative staff. It owns and operates a factory, warehouse and machinery and holds raw material inventory and finished products.**

**On 1st January 20X1, Company Y pays USD 80 million to acquire 100% of the ordinary voting shares of Company X. No other type of shares has been issued by Company X. On the same day, the four main executive directors of Company Y take on the same roles in Company X. Are the activities of X Ltd. qualified to be a business?**

**SOLUTION : 2**

The application of the definition is less clear in situations as illustrated in the following examples:

**QUESTION : 3 Investment in a development stage entity**

**Company D is a development stage entity that has not started revenue-generating operations. The workforce consists mainly of research engineers who are developing a new technology that has a pending patent application. Negotiations to license this technology to a number of customers are at an advanced stage. Company D requires additional funding to complete development work and commence planned commercial production.**

**The value of the identifiable net assets in Company D is INR 750 million. Company A pays INR 600 million in exchange for 60% of the equity of Company D (a controlling interest). Are the activities of D Ltd. qualified to be a business?**

**SOLUTION : 3**

**QUESTION : 4 Acquisition of an entity holding investment properties**

**Company A acquires 100% of the equity and voting rights of Company Q, which owns three investment properties. The properties are multi-tenant residential condominiums subject to short-term rental agreements that oblige Company Q to provide substantial maintenance and security services, which are outsourced with specialist providers. Company Q has five employees who deal directly with the tenants and with the outsourced contractors to resolve any non-routine security or maintenance requirements. These employees are involved in a variety of lease management tasks (e.g identification and selection of tenants; lease negotiation and rent reviews) and marketing activities to maximise the quality of tenants and the rental income. Are the activities of Q Ltd. qualified to be a business?**

**SOLUTION : 4**

**QUESTION : 5** Seller retains some activities and assets

**Company S is a manufacturer of a wide range of products. The company's payroll and accounting system is managed as a separate cost centre, supporting all the operating segments and the head office functions.**

**Company A agrees to acquire the trade, assets, liabilities and workforce of the operating segments of Company S but does not acquire the payroll and accounting cost centre or any head office functions. Company A is a competitor of Company S. Can Company A account for the acquisition as a business combination?**

**SOLUTION : 5**

**QUESTION : 6** Acquisition of a shell company

**Company A is a property development company with a number of subsidiary companies, each of which holds a single development. After completion of the development, Company A sells its equity investment because the applicable tax rate is lower than that applicable to the sale of the underlying property.**

**Company A is planning to start the development of a large new retail complex. Rather than incorporating a new company, Company A acquires the entire share capital of a 'shell' company. Does this shell company qualify to be a business? Will IFRS 3 be applicable?**

**SOLUTION : 6**

**QUESTION : 7**

**Company A is a pharmaceutical company. Since inception, the Company had been conducting in-house research and development activities through its skilled workforce and recently obtained an intellectual property right (IPR) in the form of patents over certain drugs. The Company's has a production plant that has recently obtained regulatory approvals. However, the Company has not earned any revenue so far and does not have any customer contracts for sale of goods. Company B acquires Company A.**

**Required:** Does Company A constitute a business in accordance with IFRS 3?

**SOLUTION : 7**

The definition of business requires existence of inputs and processes. In this case, the skilled workforce, manufacturing plant and IPR, along with strategic and operational processes constitutes the inputs and processes in line with the requirements of IFRS 3.

When the said inputs and processes are applied as an integrated set, the Company A will be capable of producing outputs; the fact that the Company A currently does not have revenue is not relevant to the analysis of the definition of business under IFRS 3. Basis this and presuming that Company A would have been able to obtain access to customers that will purchase the outputs, the present case can be said to constitute a business as per IFRS 3.

**QUESTION : 8**

**Modifying the above illustration, if Company A had revenue contracts and a sales force, such that Company B acquires all the inputs and processes other than the sales force, then whether the definition of the business is met in accordance with IFRS 3?**

**SOLUTION : 8**

Though the sales force has not been taken over, however, if the missing inputs (i.e., sales force) can be easily replicated or obtained by the market participant to generate output, it may be concluded that Company A has acquired business. Further, if Company B is also into similar line of business, then the existing sales force of Company B may also be relevant to mitigate the missing input. As such, the definition of business is met in accordance with IFRS 3.

**QUESTION : 9 [Buying controlling stake in a running business]**

**X Ltd. is a garment manufacturer and has been in operation for last 10 years. The company produces a wide range of garments and employs workforce of designers, machine operators, quality checkers, and other operational, marketing and administrative staff. It owns and operates a factory, warehouse and machinery and holds raw material inventory and to finished products.**

**On 1 April 2015, A Ltd. paid 30 cr. to acquire 100% of the ordinary voting shares of X Ltd. No other type of shares has been issued by X Ltd.**

**SOLUTION : 9**

## 6. THE ACQUISITION METHOD

The following key steps are involved in the acquisition accounting for business combinations:

Step 1 : Identifying the acquirer.

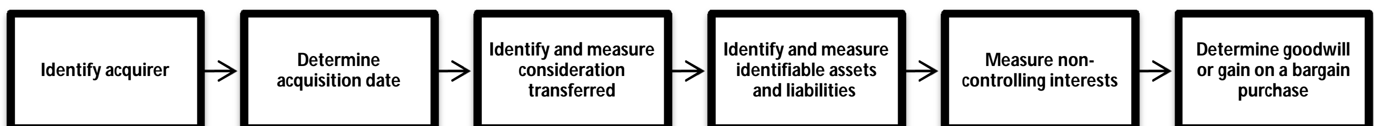
Step 2 : Determining the acquisition date.

Step 3: Identify and measure consideration transferred

Step 4 : Recognising and measuring the identifiable assets acquired, the liabilities assumed

Step 5 : Recognising and measuring non-controlling interest in the acquiree; and

Step 6 : Recognising and measuring goodwill or a gain from a bargain purchase




## 7. IDENTIFYING ACQUIRING ENTERPRISE

### 9.1 The Acquiring Enterprise

All business combination within the scope of IFRS 3 are accounted under the acquisition method (also known as purchase method). In order to apply the purchase method, the parties involved has to identify the **acquirer i.e the entity that obtains the control of another entity.** The another entity on whom the control is established is termed as acquire. This is because the acquiree's assets and liabilities is what is accounted as per the recognition and measurement principles of the standard.

The acquiring enterprise is the enterprise which obtains control and the determination of control is as per the guidance given in IFRS 10. It may so happen that guidance in IFRS 10 does not clearly indicate which of the combining entity is the acquirer. In such a case, IFRS 3 provides additional guidance on identifying the acquirer.

As per IFRS 10 'Consolidated Financial Statements', an investor controls an investee if and only if the investor has all the following:

a) power over the investee;

b) exposure, or rights, to variable returns from its involvement with the investee; and

c) the ability to use its power over the investee to affect the amount of the investor's returns.

The above definition is very wide and control assessment does not depend only on voting rights instead it depends on the following as well:

- ✓ Potential voting rights;
- ✓ Rights of non-controlling shareholders; and
- ✓ Other contractual right of the investor if those are substantive in nature.

Control assessment has been discussed in detail in the chapter of Consolidated Financial Statements. One example on potential voting rights and its implication on assessment of control is provided below for the students to understand the concept of control.

**In order to ascertain control it is very important not to look at only the voting rights and evaluate other factors like board control, potential voting rights etc.**

| INDICATOR OF CONTROL | | |
|---|---|---|
| More than 50% rights Voting | Power to appoint remove board of directors and | Investor have excersiable potential rights voting currently |

**QUESTION : 10 Potential voting rights**

**Company P Ltd., a manufacturer of textile products, acquires 40,000 of the equity shares of Company X (a manufacturer of complementary products) out of 1,00,000 shares in issue. As part of the same agreement, Company P purchases an option to acquire an additional 25,000 shares. The option is exercisable at any time in the next 12 months. The exercise price includes a small premium to the market price at the transaction date.**

**After the above transaction, the shareholdings of Company P's two other original shareholders are 35,000 and 25,000. Each of these shareholders also has currently exercisable options to acquire 2,000 additional shares.**

**SOLUTION : 10**

In assessing whether it has obtained control over Company X, Company P should consider not only the 40,000 shares it owns but also its option to acquire another 20,000 shares (a so-called potential voting right). In this assessment, the specific terms and conditions of the option agreement and other factors are considered:

- the options are currently exercisable and there are no other required conditions before such options can be exercised
- if exercised, these options would increase Company P's ownership to a controlling interest of over 50% before considering other shareholders' potential voting rights (65,000 shares out of a total of 1,25,000 shares)
- although other shareholders also have potential voting rights, if all options are exercised Company P will still own a majority (65,000 shares out of 1,29,000 shares)
- the premium included in the exercise price makes the options out-of-the-money. However, the fact that the premium is small and the options could confer majority ownership indicates that the potential voting rights have economic substance.

By considering all the above factors, Company P concludes that with the acquisition of the 40,000 shares together with the potential voting rights, it has obtained control of Company X.

## 8. ACQUISITIONS THROUGH PAYMENT OF CASH OR INCURRING OF LIABILITY

In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

## 9. ACQUISITIONS THROUGH ISSUE OF EQUITY INSTRUMENT

In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree.

**Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:**

a) **The relative voting rights in the combined entity after the business combination:** The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

b) **The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest**—The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

c) **The composition of the governing body of the combined entity**—The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

d) **The composition of the senior management of the combined entity**—The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

e) **The terms of the exchange of equity interests**—The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

f) **The acquirer is usually the combining entity whose relative size (measured in, for example, assets, revenues or profit) is significantly greater than that of the other combining entity or entities.** In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.

**QUESTION : 11**

**Company A and Company B operate in power industry and both entities are operating entities. Company A has much larger scale of operations than Company B. Company B merges with Company A such that the shareholders of Company B would receive 1 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 20% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 80% of the capital in Company A. Who is the acquirer?**

**SOLUTION : 11**

In this transaction, Company A is the acquirer for the purposes of accounting for business combination as per IFRS 3. This is because, by merging the entire shareholding of Company B, Company A has acquired control over Company B. Further, the shareholders of erstwhile Company B do not obtain control over Company A on account of shares received as part of purchase consideration, as they hold only 20% of the paid-up capital of Company A.

**QUESTION : 12 New parent pays cash to effect a business combination**

**Company A decided to spin-off two of its existing businesses (currently housed in two separate entities, Company B and Company C). To facilitate the spin-off, Company A incorporates a new entity (Company D) with nominal equity and appoints independent directors to the board of Company D. Company D signs an agreement to purchase Companies B and C in cash, conditional on obtaining sufficient funding. To fund these acquisitions, Company D issues a prospectus offering to issue shares for cash.**

**At the conclusion of the transaction, Company D is owned 99% by the new investors with Company A retaining only a 1% non-controlling interest. Who is the acquirer?**

**SOLUTION : 12**

In this situation, a set of new investors paid cash to obtain control of Company D in an arm's length transaction. Company D is then used to effect the acquisition of 100% ownership of

Companies B and C by paying cash. Company A relinquishes its control of Companies B and C to the new owners of Company D.

Although Company D is a newly formed entity, Company D is identified as the acquirer not only because it paid cash but also because the new owners of Company D have obtained control of Companies B and C from Company A.

Identification of the acquiring enterprise is very critical and the accounting may change significantly if the accounting acquirer is different than legal acquirer.

## 10. ACQUISITION INVOLVING REVERSE ACQUISITION

A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance above. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.

For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public entity is the **legal acquirer** because it issued its equity interests, and the private entity is the **legal acquire** because its equity interests were acquired. However, application of the guidance given in above paragraph results in identifying:

a) the public entity as the **acquire** for accounting purposes (the accounting acquiree); and

b) the private entity as the **acquirer** for accounting purposes (the accounting acquirer).

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles of IFRS 3, including the requirement to recognise goodwill, will apply.

**QUESTION : 13**

**Company A and Company B operate in power industry and both entities are operating entities. Company A has much smaller scale of operations than Company B. Company B merges Company A such that the shareholders of Company B would receive 10 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 70% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 30% of capital of Company A. Post-acquisition, the management of Company B would manage the operations of the combined entity. Who is the acquirer?**

**SOLUTION : 13**

In this transaction, Company B is the acquirer for the purposes of accounting for business combination as per IFRS 3. This is because, after merger, the shareholders of erstwhile Company B would have a controlling interest and management of the combined entity. As such, in substance, Company B has acquired control over Company A.

It is important to note that the Company B would be considered as an acquirer for accounting purposes only (i.e., accounting acquirer). For legal purposes as well as for reporting purposes, it is the Company A that would be considered as an acquirer (i.e., legal acquirer).

Appropriate identification of an acquirer is relevant, as the net assets of the accounting acquiree (rather than that of the accounting acquirer) are recognised at fair value.

## 11. DETERMINING THE ACQUISITION DATE

**ACQUISITION DATE** - The date on which the acquirer obtains control of the acquire, is called the Acquisition Date.

**CLOSING DATE** - The date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquire is referred to as closing date.

The acquisition date need not necessarily be the closing date. It is possible that the acquirer might obtain control on a date that is either earlier or later than the closing date.

The acquisition date needs to be determined correctly.· The significance is that recognition and measurement of assets and liabilities revolve around the acquisition date.

**QUESTION : 14**

**Company A acquired 80% equity interest in Company B for cash consideration. The relevant dates are as under:**

| | |
|---|---|
| **Date of shareholder agreement** | **June 1, 20X1** |
| **Appointed date as per shareholder agreement** | **April 1, 20X1** |
| **Date of obtaining control over the board representation** | **July 1, 20X1** |
| **Date of payment of consideration** | **July 15, 20X1** |
| **Date of transfer of shares to Company A** | **August 1, 20X1** |

**What is the acquisition date?**

**SOLUTION : 14**

**QUESTION : 15**

**Can an acquiring entity account for a business combination based on a signed non-binding letter of intent where the exchange of consideration and other conditions are expected to be completed with 2 months?**

**SOLUTION : 15**

**QUESTION : 16**

**On April 1 Company X agrees to acquire the share of Company B in an all equity deal. As per the binding agreement Company X will get the effective control on 1 April however the consideration will be paid only when the shareholders' approval is received. The shareholders meeting is scheduled to happen on 30 April. If the shareholder approval is not received for issue of new shares, then the consideration will be settled in cash. What is the acquisition date?**

**SOLUTION : 16**

**QUESTION : 17**

**A enters into an agreement with the shareholders of B on 1 April 2011 to acquire a controlling interest in B.The agreement provides that the effective date of transfer is 1 April 2011 and is subject to approval by the shareholders of A at a meeting scheduled for 1 July 2011. What is the acquisition date?**

**SOLUTION : 17**

## 12. STEP ACQUISITIONS

In the case an entity acquires an entity step by step through series of purchase then **the acquisition date will be the date on which the acquirer obtains control.**

Till the time the control is obtained the Investment will be accounted as per the requirements of other IFRS 9, if the investments are covered under that standard or as per IAS 28, if the investments are in Associates.

**EXAMPLE : 3**

**On 31 December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 per cent interest in Entity B, which gives it control of Entity B. This transaction is referred as a business combination achieved in stages, sometimes also referred to as a step acquisition.**

In a business combination achieved in stages, the acquirer shall re-measure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or OCI, as appropriate.

In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in OCI. Any amount, which was previously recognised in OCI, should be recognised on the same basis as would have been the case if the acquirer had directly disposed of the previously held equity interest. This implies the following:

(a) If (before the acquisition of controlling stake) the acquirer was holding the equity investment as a passive investor, i.e., less than 20% stake, and it had accounted for the investment as at FVTOCI under IFRS 9, it will recognize any further gain/loss arising on fair value re-measurement at the acquisition date in OCI. Also, any amount related to investment previously recognized in OCI will continue to be recognized in OCI and cannot be recycled to profit or loss. This is the same treatment that would apply if the entity disposes of its equity investment classified as at

(b) If (before the acquisition of controlling stake) the acquirer was holding the equity investment as a passive investor, i.e., less than 20% stake, and it had accounted for the investment as at FVTPL under IFRS 9, it will recognize any further gain/loss arising on fair value re-measurement at the acquisition date in profit or loss.

(c) If (before the acquisition of controlling stake) the acquirer was holding the equity investment as an associate/joint venture and therefore applied the equity method to the investment, it will recognize any gain/loss arising on fair value re-measurement at the acquisition date in profit or loss. Also, any amount related to investment previously recognized in OCI will be reclassified to profit or loss if such reclassification was required on disposal of the investment.

## 13. DETERMINATION OF THE PURCHASE CONSIDERATION

The consideration transferred in a business combination shall be measured **at fair value**, which shall be calculated as the total of **the acquisition-date fair values of the assets (including cash) transferred by the acquirer**, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer.

**Examples of potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, *contingent consideration*, ordinary or preference equity instruments, options, warrants and member interests of *mutual entities*.**

## 14. EXCEPTION TO THE FAIR VALUE IN DETERMINATION OF PURCHASE CONSIDERATION

**Share Based payments** - However, any portion of the **acquirer's share-based payment awards exchanged for awards held by the acquiree's employees** that is included in consideration transferred in the business combination shall be measured in accordance with the requirements of **IFRS 2, Share Based payments.**

The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, non-monetary assets or a business of the acquirer). If so, the acquirer shall re-measure the transferred assets or liabilities to their fair values as of the acquisition date and recognise the resulting gains or losses, if any, in profit or loss.

This means that if the acquirer has transferred a land as a part of the business combination arrangement to the owners of the acquiree then the fair value of the land will be considered in determining the fair value of the consideration. Consequently, the land will be de-recognised in the financial statements of the acquirer and the difference between the carrying amount of the land and the fair value considered for purchase consideration will be recorded in profit and loss.

**Transferred assets or liabilities remain within the combined entity** - However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognise a gain or loss in profit or loss on assets or liabilities it controls both before and after the business combination.

**Fair value of the assets transferred or liability incurred should be measured on the acquisition date to determine the fair value. Any direct cost of acquisition should be recorded directly in profit and loss account and should not be included in purchase consideration.**

## 15. BUSINESS COMBINATION ACHIEVED WITHOUT THE TRANSFER OF CONSIDERATION

An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include:

(a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

(b) Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.

(c) The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously.

In a business combination achieved by contract alone, the acquirer shall attribute to the owners of the acquiree the amount of the acquiree's net assets recognised in accordance with this IFRS.

In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer's post-combination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the non-controlling interest.

## 16. DIRECT COST OF ACQUISITION

**The direct cost of acquisition is <u>not included</u> in determination of the purchase consideration.**

Cost which include like **finder's fees, due diligence cost accounting, legal fees, investment banker fees, even bonuses paid to employees** for doing a successful acquisition will **not be included in the cost of acquisition.**

## 17. CONTINGENT CONSIDERATION

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement.

**The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.**

The acquirer shall classify an obligation to pay contingent consideration **as a liability or as equity** on the basis of the definitions of an equity instrument and a financial liability in accordance with the requirement of IAS 32 Financial Instruments: Presentation, or other applicable IFRSs.

The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

**EXAMPLE : 4**

**Company A acquires Company B in April 20X1 for cash. The acquisition agreement states that an additional Rs 20 million of cash will be paid to B's former shareholders if B succeeds in achieving certain specified performance targets. A determines the fair value of the contingent consideration liability to be 15 million at the acquisition date. At a later date, the probability of meeting the said performance target becomes lower.**

As certain consideration is based on achieving certain performance parameters in future, the consideration is contingent on achieving those parameters. As such, the transaction involves contingent consideration. Further, since the consideration is to be settled for a variable amount in cash, such consideration would be in the nature of financial liability rather than equity.

As at the acquisition date, the acquirer should consider the acquisition date fair value of contingent consideration as part of business combination. Accordingly, such recognition would increase goodwill (or reduce gain on bargain purchase, as the case may be).

In the above example, if the chance of meeting the performance criteria becomes less probable, then in such a case, the contingent consideration in the nature of financial liability should be re-measured and the impact for the change in the fair value should be recognised in statement of profit and loss.

## 18. PURCHASE PRICE ALLOCATION

### RECOGNITION OF ASSETS AND LIABILITIES OF THE ACQUIRED ENTITY

As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.

The most important principle in a purchase price allocation exercise is to recognize and measure all the assets and liabilities acquired on the acquisition date.

**Recognition**

Following conditions have to be considered while recognising the assets and liabilities of the acquiree:

- To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities.

  **EXAMPLE : 5**

  **Costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date.**

  **Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post combination financial statements in accordance with other IFRS.**

- Only those assets and liabilities which have been assumed as a part of the business combination deal should only be recorded and not any other assets which are not related to the acquisition to which other applicable IFRS should be applied.

- When the acquirer applies the recognition principle under business combination it may record certain assets and liabilities which the acquiree had not recorded earlier in their financial statements.

**EXAMPLE : 6**

- **The acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.**

**There are CERTAIN EXCEPTIONS to specific assets and liabilities which have been discussed below.**

- The assets and liabilities has to be classified as per the **requirement of applicable IFRS** which will depend on the contractual terms, economic conditions, etc.
- In some situations, IFRS provide for different accounting depending on how an entity classifies or designates a particular asset or liability.

**EXAMPLE : 7**

**Classification of particular financial assets and liabilities as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income in accordance with IFRS 9, "Financial Instruments".**

The only **EXCEPTION TO THE ABOVE PRINCIPLE** is that for **lease contract and insurance contracts** classification will be based on the basis of the conditions existing at inception and not on acquisition date.

**EXAMPLE : 8**

**Company B has entered into certain lease arrangements which were appropriately classified as finance leases, based on facts and circumstances as at inception. Company B was acquired by Company A and consequently all the identifiable net assets including the lease arrangements were taken over by Company A.**

**Based on facts and circumstances as at the *acquisition* date, Company A determines that the lease arrangement meets the criteria for operating lease. In this example, Company A would be required to retain the original lease classification of the lease arrangements and thereby recognise the lease arrangements as finance leases. As such, Company A would not be able to consider the lease arrangements as taken on operating lease basis.**

## 19. MEASUREMENT PRINCIPLE

The assets and liabilities recognized based on the aforesaid recognition principles has to be measured based on the following principles:

- The acquirer shall measure the identifiable **assets acquired and the liabilities assumed** at their acquisition-date **fair values.**
- For each business combination, the acquirer shall measure at the acquisition date components **of non-controlling interest** in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:
  - fair value; or
  - The present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets
- All other components of non-controlling interests shall be measured at their acquisition date fair values, unless another measurement basis is required by IFRS.

## 20. EXCEPTION TO THE RECOGNITION OR MEASUREMENT PRINCIPLE

The exception principles laid out in this standard for recognition or measurement of certain assets and liabilities are only limited to acquisition date accounting and may be different than the requirements of other IFRS.

The application of the above principles may result in two scenarios:

- An asset or liability which otherwise would not have been recorded gets recorded.
- The assets and liabilities are measured at a value other than the acquisition date fair values.

| ITEMS | GUIDANCE UNDER IFRS 3 |
|---|---|
| **Contingent liability** | IAS 37, Provisions, Contingent Liabilities and Contingent Assets, defines a contingent liability as:<br>(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or<br>(b) a present obligation that arises from past events but is not recognised because:<br>i. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or<br>ii. the amount of the obligation cannot be measured with sufficient reliability.<br>The requirements in IAS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. **Therefore, contrary to IAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation if its fair value can be measured reliably.** |

**EXAMPLE : 9**

A suit for damages worth Rs 10 million was filed on Company B for alleged breach of certain contract provisions. Company B had disclosed the same as a contingent liability in its financial statements, as it considered that it is a present obligation for which it was not probable that the amount would be payable. Company A acquire Company B and determines the fair value of the contingent liability to be Rs 2 million.

Company A would recognise Rs 2 million in its financial statements as part of acquisition accounting, even if it is not probable that payment will be required to settle the obligation as the **fair value can be measured reliably.**.

| | |
|---|---|
| **Income taxes** | As per the requirement of IAS 12 no deferred tax consequence should be recorded on initial recognition of deferred tax **except** assets and liabilities acquired during business combination. Accordingly, the acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in **accordance with IAS 12, Income Taxes.**<br>The acquirer shall account for the **potential tax effects of temporary differences** and carry forwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition **in accordance with IAS 12.** |
| **Employee benefits** | The acquirer records the fair value of the obligations for any post retirement obligation **as per the principles of IAS 19** which is an exception of the general fair value rule. |
| **Indemnification assets** | The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. |

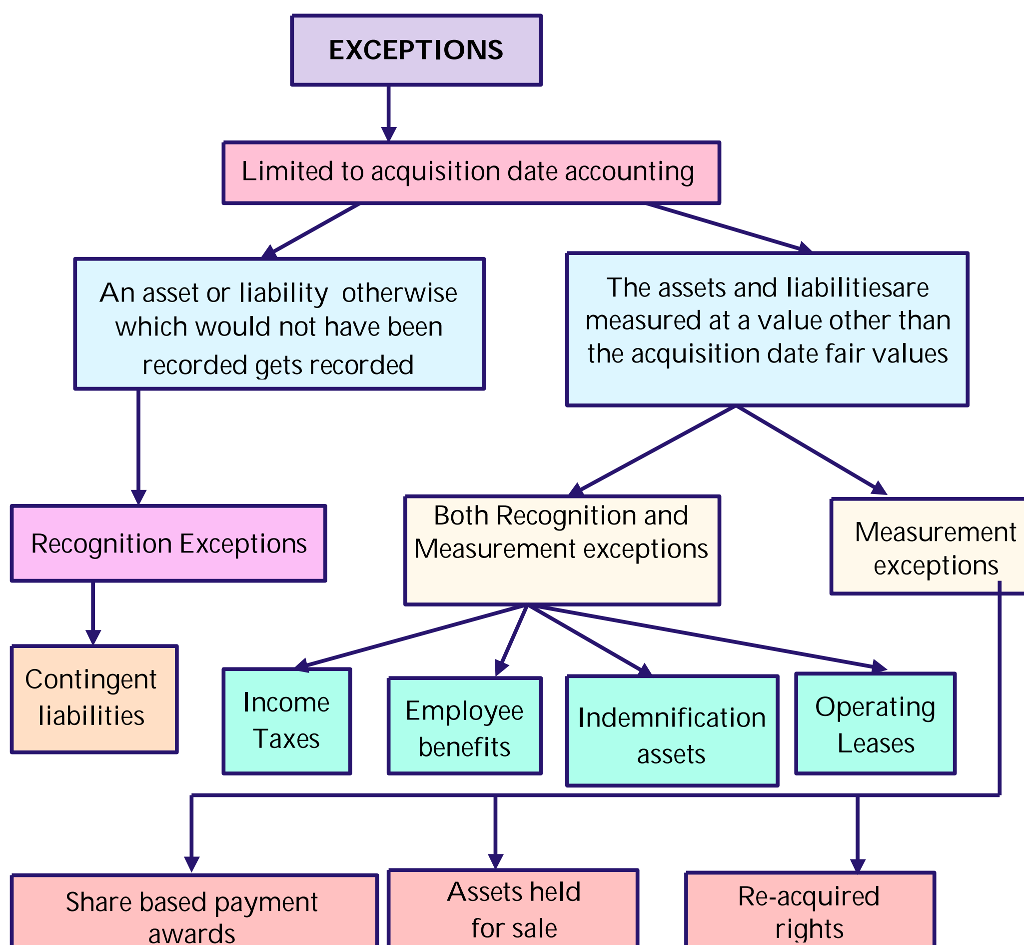
| | |
|---|---|
| | For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount.<br>As a result, the acquirer obtains an indemnification asset. The acquirer shall recognise an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. |

**EXAMPLE : 10**

**Company A acquires Company B in a business combination on April 1, 20X1. B is being sued by one of its customers for breach of contract. The sellers of B provide an indemnification to A for the reimbursement of any losses greater than Rs 100. There are no collectability issues around this indemnification. At the acquisition date, Company A determined that there is a present obligation and therefore the fair value of the contingent liability of Rs 250 is recognised by A in the acquisition accounting. In the acquisition accounting A also recognises an indemnification asset of Rs 150 (Rs 250 - Rs 100).**

| | |
|---|---|
| **Reacquired rights** | These are the rights which the acquirer before acquisition may have granted to the acquiree to use certain assets which belongs to the acquirer. It does not matter whether the asset was recorded in the financial statement of the acquirer or not.<br>For example, license to use the brand name, Franchisee rights etc.<br>If an acquirer acquires an acquiree which had certain rights granted to it by the acquirer then the business combination results in settlement of the right and accordingly any settlement gain or loss should be considered as a **separate transaction from business combination and will be recorded in the financial statement of the acquirer.**<br>**The acquirer shall measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract without considering the effect of potential renewals.** |
| **Intangible assets** | The acquirer shall record separately from Goodwill, the identifiable intangible acquired in a business combination.<br>An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion. |
| **Share based payment transactions** | The acquirer shall measure a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer **in accordance with the method in IFRS 2**, Share-based Payment, at the acquisition date. |
| **Assets held for sale** | The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date **in accordance with IFRS 5**, Non-current Assets Held for Sale and Discontinued Operations, at fair value less costs to sell in accordance with that IFRS. |
| **Operating lease** | **Acquiree is a lessee**<br>The acquirer shall recognise no assets or liabilities related to an operating lease in which the acquiree is the lessee except:<br>• If the terms of the operating lease are favourable to the acquirer then it should record an intangible asset and if it is unfavourable then it should record a liability.<br>• An identifiable intangible asset may be associated with an operating lease, |

| | |
|---|---|
| | which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, for example, as a customer relationship. In that situation, the acquirer shall recognise the associated identifiable intangible asset(s) in accordance guidance provided for intangible asset. |
| | **Acquiree is a lessor**<br>If the aquiree is a lessor then no adjustment is recorded for the asset which is recorded in the financial statements of the acquiree, however, the lease rentals are considered for determining the fair value of the asset. |
| **Assembled workforce** | The acquirer subsumes into Goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date.<br>An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. **Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.** |
| **Unearned revenue** | Unearned revenue arises because of the application of the revenue recognition criteria applied by the acquiree. It should be evaluated whether there is any obligation on the acquisition date to be fulfilled and accordingly an asset or liability against it should be recorded. |



**Intangible Assets**

An intangible asset should be recorded separately from Goodwill if either the separability criteria is met or it arises out of contractual legal criterion.

**Contractual Legal criterion**

An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.

**For example:**

a. An acquiree leases a manufacturing facility under an operating lease that has terms that are favourable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favourable compared with the terms of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even though the acquirer cannot sell or otherwise transfer the lease contract.

b. An acquiree owns and operates a nuclear power plant. The licence to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognise the fair value of the operating licence and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

c. An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related licence agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related licence agreement separately from one another would not be practical.

**Separability criteria**

The separability criterion means that an acquired intangible asset is **capable** of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability.

An intangible asset that the acquirer would be able to sell, license or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license or otherwise exchange it.

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.

**EXAMPLE : 11**

Customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion.

However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

**Following are the possible sources of information and broad indicator to be used to identify any possible intangible separately from goodwill:**

**A. Internal sources:**

- **Financial statements of the acquiree-**
  - significant R&D cost may be indicator that there may be possible technology related intangible
  - Significant sales promotion or marketing cost- this is a strong indicator of marketing related intangible like distributor network, Marketing collaterals etc

- Customer acquisition cost- lot of company spend money to acquire new customers like online e-commerce companies provide incentive to register a customer as a first time user or download their app. That may be a strong indicator of existence of customer list as an intangible

- **Share purchase agreement-**This can also be a strong indicator of existence of any technical know-how, trademarks or patent which are included in the agreement can provide a indicator of an existence of an intangible
- **Purpose of acquisition**- The reason for acquisition may also indicate the possible intangible to be recorded. For e.g. Coca Cola acquired Thumps Up with an intention to close the brand which will result in increase in its market share. Accordingly, this will also be a possible intangible asset.

**QUESTION : 18**

**Company A, FMCG company acquires an online e-commerce company E, with the intention to start doing retailing. The e-commerce company has over the period have 10 million registered users. However, the e-commerce company E does not have any intention to sale the customer list. Should this customer list be recorded as an intangible in a business combination?**

**SOLUTION : 18**

After initial recognition, an acquirer accounts for intangible assets acquired in a business combination in accordance with the provisions of IAS 38, Intangible Assets. However, as described in IAS 38, the accounting for some acquired intangible assets after initial recognition is prescribed by other IFRS.

### REACQUIRED RIGHTS

As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets.

**Examples** of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement.

A reacquired right is an identifiable intangible asset that the acquirer recognises separately from goodwill.

If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss.

**QUESTION : 19**

**Vadapav Limited is a successful company has number of own stores across India and also offers franchisee to other companies. Efficient Ltd is one of the franchisee of Vadapav Ltd and is and operates number of store in south India. Vadapav Ltd. decided to acquire Efficient Ltd due to its huge distribution network and accordingly purchased the outstanding shares on 1 April 20X2. On the acquisition date, Vadapav determines that the license agreement reflects current market terms.**

**SOLUTION : 19**

## 21. GOODWILL – RECOGNITION AND MEASUREMENT

The acquirer shall recognise Goodwill as of the acquisition date measured as the **excess of (a) over (b) below:**

a) the aggregate of:

   i. the purchase consideration transferred at acquisition-date fair value;

   ii. the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS ; and

   iii. in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred.

To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree in place of the acquisition-date fair value of the consideration transferred.

## 22. BARGAIN PURCHASE

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the net assets value acquired in a business combination exceeds the purchase consideration.

**The acquirer shall recognise the resulting gain in statement of profit or loss.**

The gain shall be attributed to the acquirer and there will **no allocation to the non-controlling shareholders.**

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.

The IFRS standard itself acknowledges that it is very rare that a bargain purchase in a business combination will arise and accordingly **the standard re-emphasise the above point by requiring the entities to reassess and identify the clear reason why it is a bargain purchase business combination**. For e.g. acquisition of business in a bankruptcy sale, or sale of business due to a regulatory requirement.

**EXAMPLE : 12**

**Entity X is one of the largest liquor manufacturing company in the world and it acquires another Entity Y which has significant presence in India and UK. However, the competition commission in UK has issued orders to sell one division of the UK assets of Entity Y in order to comply with the local competition regulation in UK within a specified timeline. Entity Z another boutique liquor manufacturer realises the opportunity and purchase the assets of Entity Y from Entity X.**

**In the given case above it is more likely than not that there could be an element of bargain purchase as the Entity X was under compulsion to sell the assets within a specified timeline.**

**As mentioned above before recognising a gain on a bargain purchase, the acquirer shall determine whether there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase. If such evidence exists, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review.**

The acquirer shall then review the procedures used to measure the amounts this IFRS requires to be recognised at the acquisition date for all of the following:

- the identifiable assets acquired and liabilities assumed;

- the non-controlling interest in the acquiree, if any;
- for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and
- the consideration transferred.

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

**MEASUREMENT PERIOD**

IFRS 3 provides a measurement period window wherein if all the required information is not available on the acquisition date then the entity will be requiring to do the purchase price allocation on a provision basis. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this IFRS:

- the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;
- the consideration transferred for the acquiree (or the other amount used in measuring goodwill);
- in a business combination achieved in stages, the equity interest in the acquire previously held by the acquirer; and
- the resulting goodwill or gain on a bargain purchase.

Any change i.e. increase and decrease in the net assets acquired due to new information available during the measurement period which existed on the acquisition date will be adjusted against goodwill.

However, after the measurement period ends, any change in the value of assets and liabilities due to an information which existed on the valuation date will be accounted as an error as per IAS 8, Accounting policies, Changes in Accounting Estimates and Errors.

**QUESTION : 20**

**Entity X acquired 100% shareholding of Entity Y on 1 April 20X1 and had complete the preliminary purchase price allocation and accordingly recorded net assets of INR 100 million against the purchase consideration of 150 million. Entity Y had significant carry forward losses on which deferred tax asset was not recorded due to lack of convincing evidence on the acquisition date. However, on 31 March 20X2, Entity Y won a significant contract which is expected to generate enough taxable income to recoup the losses. Accordingly, the deferred tax asset was recorded on the carry forward losses on 31 March 20X2. Whether the aforesaid losses can be adjusted with the Goodwill recorded based on the preliminary purchase price allocation?**

**SOLUTION : 20**

## 23. DETERMINING WHAT IS PART OF THE BUSINESS COMBINATION TRANSACTION

The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination.

In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, i.e. amounts that are not part of the exchange for the acquiree. The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. **Separate transactions shall be accounted for in accordance with the relevant IFRS.**

**A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction.**

The following are **examples of separate transactions** that are **not to be included** in applying the acquisition method:

- a transaction that in effect settles pre-existing relationships between the acquirer and acquiree;
- a transaction that remunerates employees or former owners of the acquiree for future services; and
- a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, in determining whether the transaction is separate from Business combination:

I. **The reasons for the transaction**- Understanding the reasons why the parties to the combination (the acquirer and the acquiree and their owners, directors and managers and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed.

   For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

II. **Who initiated the transaction**—Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree.

   For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination.

   On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.

III. **The timing of the transaction**—The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree.

For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

**QUESTION : 21**

**Progressive Ltd is being sued by Regressive Ltd for an infringement of its Patent. At 31 March 20X2, Progressive Ltd recognised a INR 10 million liability related to this litigation. On 30 July 20X2, Progressive Ltd acquired the entire equity of Regressive Ltd for INR 500 million.**

**On that date, the estimated fair value of the expected settlement of the litigation is INR 20 million.**

**SOLUTION : 21**

## CONTINGENT PAYMENTS TO EMPLOYEE SHAREHOLDERS

**Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements.**

Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a) **Continuing employment**—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement.

   The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document.

   A contingent consideration arrangement in which the **payments are automatically forfeited if employment terminates is remuneration for post-combination services.**

   Arrangements in which the contingent payments are **not affected by employment termination** may indicate that the **contingent payments are additional consideration** rather than remuneration.

b) **Duration of continuing employment**—If the period of required employment **coincides with or is longer than the contingent payment period,** that fact may indicate that the contingent payments are, in substance, **remuneration.**

c) **Level of remuneration**—Situations in which employee remuneration other than the contingent payments is at a reasonable level in comparison with that of other key employees in the combined entity may indicate that the **contingent payments are additional consideration rather than remuneration.**

d) **Incremental payments to employees**—If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, **that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration.**

e) **Number of shares owned—**The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement.

For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit sharing arrangement intended to provide remuneration for post-combination services.

Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration.

The pre-acquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, should also be considered.

f) **Linkage to the valuation**—If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration.

Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide remuneration.

g) **Formula for determining consideration—**Theformula used to determine the contingent payment may be helpful in assessing the substance of the arrangement.

For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree.

In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit sharing arrangement to remunerate employees for services rendered.

h) **Other agreements and issues—**The terms of other arrangements with selling shareholders (such as agreements not to compete, executory contracts, consulting contracts and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree.

For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognise separately in its post-combination financial statements.

In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

**SUMMARY**

| Lead to conclusion as remuneration | Indicators | Lead to conclusion as contingent consideration |
|---|---|---|
| Payment forfeited on termination of employment | Continnuing employment | Payment not affected by termination of employment |
| Coincides with or exceeds payment period | Duration of required employment | Shorter than payment period |
| Not reasonable compared to other employees | Level of other elements of remunerations | Reasonable compared to other employees |
| Other non-employee selling shareholders receive lower additional payments (on a per share basis) | Incremental payments to other non-employee selling shareholders | Other non-employee selling share holders receive similar additional payments (on a per share basis) |
| Selling share holders remaining as empioyees owned substantially all shares | Number of Shares owned when all selling shareholders receive the same level of additional consideration (per share) | Selling shareholders remaining as employees owned only a small portion of shares |
| Formula for additional payment consistent with other profit-sharing arrangemerts rather than valuation approach | Linkage of payments to valuation of business | Initial consideration at low-end range of business valuation, and formula for additional payment linked to the valuation approach |
| Formula is based on performance, such as percentage of earnings | Formula for additional payments | Formula is based on a valuation, such as multiple of earnings |

**QUESTION : 22**

**KKV Ltd acquires a 100% interest in VIVA Ltd, a company owned by a single shareholder who is also the KMP in the Company, for a cash payment of USD 20 million and a contingent payment of USD 2 million. The terms of the agreement provide for payment 2 years after the acquisition if the following conditions are met:**

- **the EBIDTA margins of the Company after 2 years after the acquisition is 21%.**
- **the former shareholder continues to be employed with VIVA Ltd for at least 2 years after the acquisition. No part of the contingent payment will be paid if the former shareholder does not complete the 2 year employment period.**

**SOLUTION : 22**

## 24. ACQUIRER SHARE BASED PAYMENT AWARDS EXCHANGED FOR AWARDS HELD BY THE ACQUIREE'S EMPLOYEES

- An acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree.
- The above share based payment awards will include vested and unvested shares.

- Exchanges of share options or other share-based payment awards in conjunction with a business combination are accounted for as modifications of share-based payment awards in accordance with IFRS 2, Share based Payment.
- If the acquirer replaces the acquiree awards, either all or a portion of the market-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. Market based measure means that awards will be re-measured on the acquisition date as per the requirements of IFRS 2.
- In situations in which acquiree awards would expire as a consequence of a business combination and if the acquirer replaces those awards when it is not obliged to do so, all of the market-based measure of the replacement awards shall be recognised as remuneration cost in the post-combination financial statements in accordance with IFRS 2. That is to say, none of the market-based measure of those awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obliged to replace the acquiree awards if the acquiree or its employees have the ability to enforce replacement.

  For example, for the purposes of applying this guidance, the acquirer is obliged to replace the acquiree's awards if replacement is required by:

  (a) the terms of the acquisition agreement;

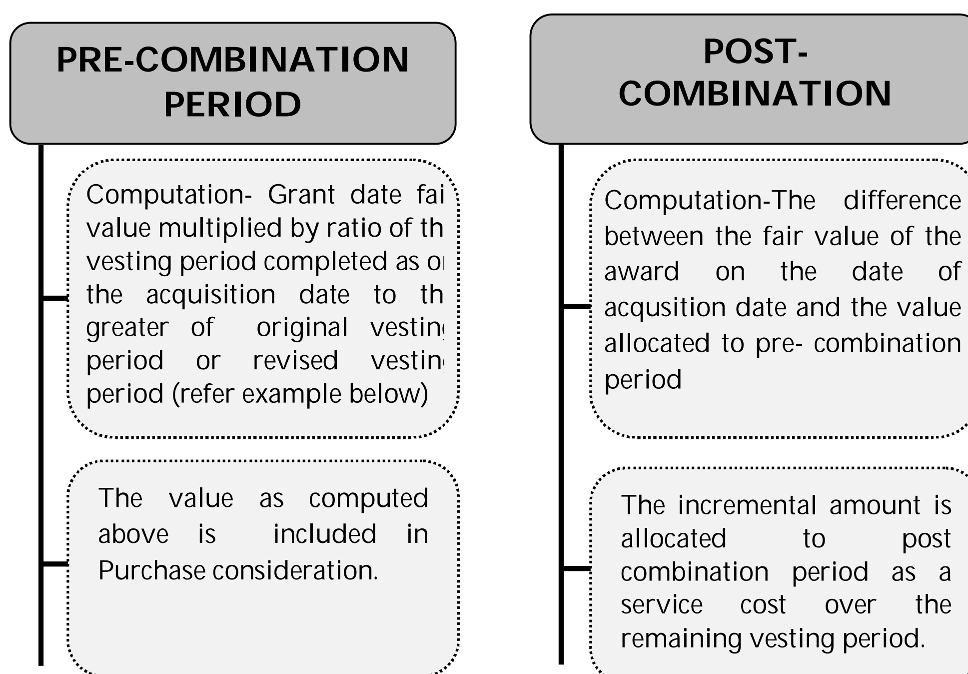
  (b) the terms of the acquiree's awards; or

  (c) applicable laws or regulations.
- To determine the portion of a replacement award that is part of the consideration transferred for the acquiree and the portion that is remuneration for post-combination service, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with IFRS 102. The portion of the market-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to pre-combination service.
- The portion of the replacement award attributable to pre-combination service is the market based measure of the acquiree award multiplied by the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the acquiree award. The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in IFRS 2.
- The portion of a non-vested replacement award attributable to post-combination service, and therefore recognised as remuneration cost in the post-combination financial statements, equals the total market-based measure of the replacement award less the amount attributed to pre-combination service. Therefore, the acquirer attributes any excess of the market-based measure of the replacement award over the market-based measure of the acquiree award to post-combination service and recognises that excess as remuneration cost in the post-combination financial statements.
- The acquirer shall attribute a portion of a replacement award to post-combination service if it requires post combination service, regardless of whether employees had rendered all of the service required for their acquiree awards to vest before the acquisition date.
- The portion of a non-vested replacement award attributable to pre-combination service, as well as the portion attributable to post-combination service, shall reflect the best available estimate of the number of replacement awards expected to vest.

  **For example, if the market-based measure of the portion of a replacement award attributed to pre-combination service is Rs. 100 and the acquirer expects that only 95 per cent of the award will vest, the amount included in consideration transferred in the business combination is Rs. 95**.

- Changes in the estimated number of replacement awards expected to vest are reflected in remuneration cost for the periods in which the changes or forfeitures occur not as adjustments to the consideration transferred in the business combination.
- Similarly, the effects of other events, such as modifications or the ultimate outcome of awards with performance conditions, that occur after the acquisition date are accounted for in accordance with IFRS 2 in determining remuneration cost for the period in which an event occurs.
- The same requirements for determining the portions of a replacement award attributable to pre-combination and post-combination service apply regardless of whether a replacement award is classified as a liability or as an equity instrument in accordance with the provisions of IFRS 2. All changes in the market-based measure of awards classified as liabilities after the acquisition date and the related income tax effects are recognised in the acquirer's post-combination financial statements in the period(s) in which the changes occur.
- The income tax effects of replacement awards of share-based payments shall be recognised in accordance with the provisions of IAS 12, Income Taxes.

The above guidance on Share based payment as per the IFRS 3 can be summarized as follows:




**QUESTION : 23**

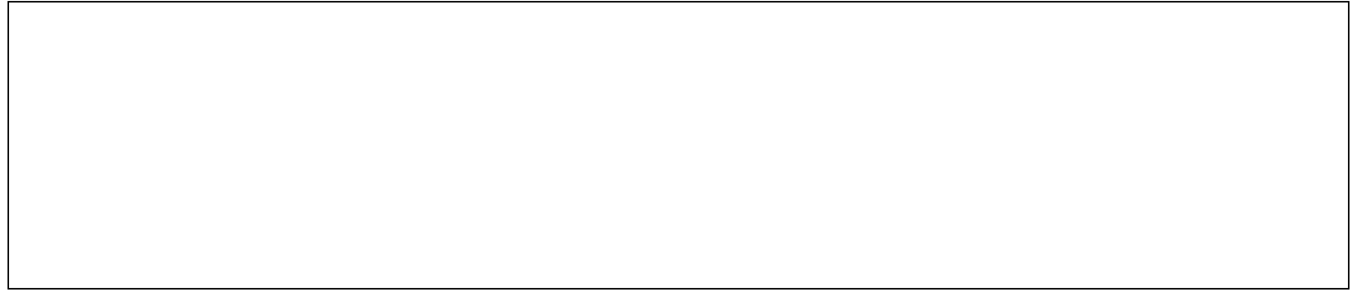
**Green Ltd acquired Pollution Ltd. as a part of the arrangement Green Ltd had to replace the Pollution Ltd.'s existing equity-settled award. The original awards specify a vesting period of five years. At the acquisition date, Pollution Ltd employees have already rendered two years of service.**

**As required, Green Ltd replaced the original awards with its own share-based payment awards (replacement award). Under the replacement awards, the vesting period is reduced to 2 year (from the acquisition date).**

**The value (market-based measure) of the awards at the acquisition date are as follows:**

- **original awards: INR 500**
- **replacement awards: INR 600. As of the acquisition date, all awards are expected to vest.**

**SOLUTION : 23**



**NON-REPLACEMENT AWARDS**

The acquiree may have outstanding share-based payment transactions that the acquirer does not exchange for its share-based payment transactions.

If vested, those acquiree share-based payment transactions are part of the non-controlling interest in the acquiree and are measured at their market-based measure.

If unvested, they are measured at their market-based measure as if the acquisition date were the grant date.

The market-based measure of unvested share-based payment transactions is allocated to the non-controlling interest on the basis of the ratio of the portion of the vesting period completed to the greater of the total vesting period and the original vesting period of the share-based payment transaction. The balance is allocated to post-combination service.

The above means that the acquiree's existing award will be settled in its own shares and the consequential shareholders will become the Non-controlling shareholders. The above principles can be summarized as follows:

**Vested shares -**

- the value credited to Share based payment reserve is classified as NCI.

**Unvested -**

- Pre-combination period is considered as a part of NCI
- Post-combination period- is recorded as employee cost and the credit forms part of the NCI in the balance sheet.

**QUESTION : 24**

**P a real estate company acquires Q another construction company which has an existing equity settled share based payment scheme. The awards vest after 5 years of employee service. At the acquisition date, Company Q's employees have rendered 2 years of service. None of the awards are vested at the acquisition date. P did not replace the existing share-based payment scheme but reduced the remaining vesting period from 3 years to 2 year. Company P determines that the market-based measure of the award at the acquisition date is INR 500 (based on measurement principles and conditions at the acquisition date as per IFRS 102).**

**SOLUTION : 24**

**NON-CONTROLLING INTEREST IN AN ACQUIREE**

When a subsidiary is not wholly owned, (i.e. owned 100% by the parent), a part of the net assets belong to the minority shareholders. This is called non-controlling interest (NCI).

▪ Measure NCI either at:

▪ (a) either at fair value

▪ (b) or at an amount that represents the proportionate share of non-controlling interests, in the net-assets of acquiree.

**Option 1: Measuring non-controlling interest at fair value**

= Number of the equity shares not held by the acquirer x market price prevailing on the date of acquisition.

**Option 2: Measuring non-controlling interest by calculating the share of the fair value of net assets acquired**

= Proportionate NCI holding X acquisition date FV of net assets

Where, FV of net assets = FV of all identified assets – FV of all identified liabilities

OR

**Share capital + all reserves on acquisition date + FV adjustment on acquisition**

**QUESTION : 25**

**On 1 April 2019 Wish Co buys 80% shares for Rs 20,000 of Dish Co. Details of Dish Co at 31 March 2019 are: Ordinary shares Rs 20,000**

**Retained earnings Rs 2,000**

**The fair value of the non-controlling interest is Rs 5,000.Account for the acquisition for Wish Co. applying both the methods of non-controlling interest.**

**QUESTION : 26**

**Mariplex acquires 75% of shares of Barnlet for $140 million. The identifiable assets are measured at $250 in million and the liabilities assumed are measured at $50 million. The valuer appointed by Mariplexdetermines the fair value of the 25% non-controlling interest in Barnlet as $42 million. Calculate goodwill / both methods.**

## 25. SUBSEQUENT MEASUREMENT AND ACCOUNTING

In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination **in accordance with other applicable IFRS** for those items, depending on their nature.

However, this IFRS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:

a) reacquired rights;

b) contingent liabilities recognised as of the acquisition date;

c) indemnification assets; and

d) Contingent consideration.

### REACQUIRED RIGHTS

A reacquired right recognised as an intangible asset shall be amortised over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

### CONTINGENT LIABILITIES

After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:

(a) the amount that would be recognised in accordance with IAS 37; and

(b) the amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 18, Revenue from Contracts with Customers.

**INDEMNIFICATION ASSETS**

At the end of each subsequent reporting period, the acquirer shall measure an indemnification asset that was recognised at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset. The acquirer shall derecognise the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it.

**CONTINGENT CONSIDERATION**

Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date.

Such changes are measurement period adjustments to the extent is on account of **conditions which existed as of the acquisition date will be adjusted against goodwill.**

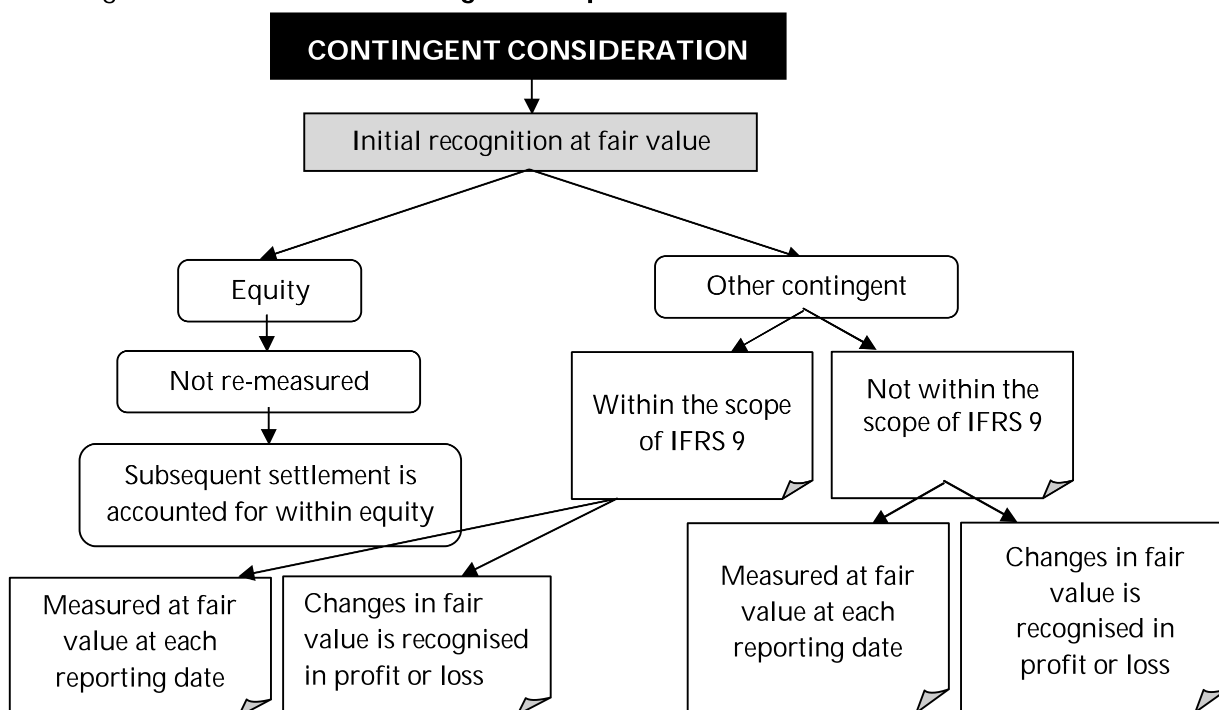
However, **changes resulting from events after the acquisition date**, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

(a) Contingent consideration **classified as equity** shall **not be re-measured** and its subsequent settlement shall be accounted for within equity.

(b) **Other contingent consideration** that:

i. is within the scope of **IFRS 9** shall be measured at **fair value at each reporting date** and changes in fair value shall be recognised in **profit or loss in accordance with IFRS 9.**

ii. is**not within the scope of IFRS 9** shall be measured **at fair value at each reporting date** and changes in fair value shall be **recognised in profit or loss**.




## 24. DISCLOSURES

The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

a) during the current reporting period; or

b) after the end of the reporting period but before the financial statements are approved for issue.

IFRS 3 requires detailed disclosures on Business Combination. The acquirer shall disclose the following information for each business combination that occurs during the reporting period:

a. the name and a description of the acquiree.

b. the acquisition date.

c. the percentage of voting equity interests acquired.

d. the primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree.

e. a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.

f. the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:

  I. cash;

  II. other tangible or intangible assets, including a business or subsidiary of the acquirer;

  III. liabilities incurred, for example, a liability for contingent consideration; and

  IV. equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of measuring the fair value of those instruments or interests.

g. for contingent consideration arrangements and indemnification assets:

  i. the amount recognised as of the acquisition date;

  ii. a description of the arrangement and the basis for determining the amount of the payment; and

  iii. an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

h. for acquired receivables:

  i. the fair value of the receivables;

  ii. the gross contractual amounts receivable; and

  iii. the best estimate at the acquisition date of the contractual cash flows not expected to be collected. The disclosures shall be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables.

  iv. the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.

i. for each contingent liability recognised, the information required in IAS 37, Provisions, Contingent Liabilities and Contingent Assets. If a contingent liability is not recognised because its fair value cannot be measured reliably, the acquirer shall disclose:

  i. the information required by IAS 37; and

  ii. the reasons why the liability cannot be measured reliably.

j. the total amount of goodwill that is expected to be deductible for tax purposes.

k. for transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination:

  i. a description of each transaction;

  ii. how the acquirer accounted for each transaction;

  iii. the amounts recognised for each transaction and the line item in the financial statements in which each amount is recognised; and

  iv. if the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement amount.

l. the disclosure of separately recognised transactions required by (l) shall include the amount of acquisition-related costs and, separately, the amount of those costs recognised as an expense and the

line item or items in the statement of profit and loss in which those expenses are recognised. The amount of any issue costs not recognised as an expense and how they were recognised shall also be disclosed.

m. in a bargain purchase-
    i. the amount of any gain recognised in statement of profit and loss;
    ii. a description of the reasons why the transaction resulted in a gain in case of (i) above.

n. for each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date:
    i. the amount of the non-controlling interest in the acquiree recognised at the acquisition date and the measurement basis for that amount; and
    ii. for each non-controlling interest in an acquiree measured at fair value, the valuation technique(s) and significant inputs used to measure that value.

o. in a business combination achieved in stages:
    i. the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and
    ii. the amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination and the line item in the statement of profit and loss in which that gain or loss is recognised.

p. Following additional information:
    i. the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of profit and loss for the reporting period; and
    ii. the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. This IFRS uses the term 'impracticable' with the same meaning as in IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are approved for issue, the acquirer shall disclose the information required as above unless the initial accounting for the business combination is incomplete at the time the financial statements are approved for issue. In that situation, the acquirer shall describe which disclosures could not be made and the reasons why they cannot be made.

To meet the objective of the IFRS 3 disclosure requirement, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

a) if the initial accounting for a business combination is incomplete for particular assets, liabilities, non-controlling interests or items of consideration and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally
    i. the reasons why the initial accounting for the business combination is incomplete;
    ii. the assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete; and
    iii. the nature and amount of any measurement period adjustments recognised during the reporting period.

b) for each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires:

i. any changes in the recognised amounts, including any differences arising upon settlement;
ii. any changes in the range of outcomes (undiscounted) and the reasons for those changes; and
iii. the valuation techniques and key model inputs used to measure contingent consideration.

c) for contingent liabilities recognised in a business combination, the acquirer shall disclose the information required by IAS 37 for each class of provision.

d) a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period showing separately:
i. the gross amount and accumulated impairment losses at the beginning of the reporting period.
ii. additional goodwill recognised during the reporting period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with IFRS 5, Non-current Assets Held for Sale and Discontinued Operations. iii. adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period
iv. goodwill included in a disposal group classified as held for sale in accordance with IFRS 5 and goodwill derecognised during the reporting period without having previously been included in a disposal group classified as held for sale
v. impairment losses recognised during the reporting period in accordance with IAS 36. (IAS 36 requires disclosure of information about the recoverable amount and impairment of goodwill in addition to this requirement.)
vi. net exchange rate differences arising during the reporting period in accordance with IAS 21, The Effects of Changes in Foreign Exchange Rates.
vii. any other changes in the carrying amount during the reporting period.
viii. the gross amount and accumulated impairment losses at the end of the reporting period.

e) the amount and an explanation of any gain or loss recognised in the current reporting period that both:
i. relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and
ii. is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements.

The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.

## QUESTION : 27

On 9 April 20X2, Shyam Ltd. a listed company started to negotiate with Ram Ltd, which is an unlisted company about the possibility of merger. On 10 May 20X2, the board of directors of Shyam authorized their management to pursue the merger with Ram Ltd. On 15 May 20X2, management of Shyam Ltd offered management of Ram Ltd 12,000 shares of Shyam Ltd against their total share outstanding. On 31 May 20X2, the board of directors of Ram Ltd accepted the offer subject to shareholder vote. On 2 June 20X2 both the companies jointly made a press release about the proposed merger.

On 10 June 20X2, the shareholders of Ram Ltd approved the terms of the merger. On 15 June, the shares were allotted to the shareholders of Ram Ltd.

The market price of the shares of Shyam Ltd was as follows:

| Date | Price |
|---|---|
| 9 April | 70 |
| 10 May | 75 |

| 15 May | 60 |
|---|---|
| 31 May | 70 |
| 2 June | 80 |
| 10 June | 85 |
| 15 June | 90 |

What is the acquisition date and what is purchase consideration in the above scenario?

## QUESTION 28:

Black Co acquired 100% shares in White Co on 31 December 2015. BS of Black and White On that date were

| | | Black Co | | White Co |
|---|---|---|---|---|
| Non-current assets | | | | 35,000 |
| Tangible assets | | 60,000 | | |
| Investments: Shares of White Co (100% shares in white) | | 30,000 | | |
| Loan stock of White Co | | 5,000 | | |
| Current assets | | | | |
| Inventories | 10,000 | | 8,000 | |
| Receivables | 8,000 | | 9,000 | |
| Cash at bank | 4,000 | 22 ,000 | - | 17,000 |
| Total assets | | 117,000 | | 52,000 |
| | | | | |
| EQUITY AND LIABILITIES | | | | |
| Equity | | | | |
| Ordinary shares | 73,000 | | 16,000 | |
| Retained earnings | 30,000 | 103,000 | 12,500 | 28,500 |
| Non-current liabilities | | | | |
| Loan stock | - | | | 10,000 |
| Current liabilities | | | | |
| Bank overdraft | - | | 3,000 | |
| Payables | 14,000 | 14,000 | 10,500 | 13,500 |
| Total liabilities | | 117,000 | | 52,000 |

Prepare CBS

## QUESTION : 29

X Ltd. acquired the business of Y Ltd. comprising of all assets and liabilities excepting cash. Assets of the acquiree comprise of Tangible Fixed Assets Rs 100 million,

Intangibles Assets 10 million Inventories 30 million, Trade receivables 30 million, Trade payables 30 million and Loans 40 million. Trade receivables include amount due from X Ltd. 10 million. X Ltd. pays 130 million as purchase consideration.

Fair value of assets and liabilities : Tangible fixed assets 130 million, Intangible Assets 12 million, Inventories 25 million and Trade receivables excluding amount due from X Ltd. 18 million, Trade payables 30 million and Loan 40 million.

Tax base for tangible asset and intangible asset are 80 million and intangible asset 5 million respectively. Assume that for taxation purpose the tax base of the acquiree will apply. Tax benefit will be available on

write down of inventories and trade receivables of the acquiree when actually expensed. Deferred tax assets or liabilities are measured applying effective tax rate of 25%.

X Ltd. agrees to pay the Managing Director of Y Ltd. a salary of 10 million p.a. during the post-acquisition period for a term of 1 year to oversee smooth merger of the business of Y Ltd. along with the businesses of X Ltd. It is proposed to include this obligation as part of business combination.

Show accounting entries for business combination.

## QUESTION 30 :

A Ltd. acquired B Ltd. on payment of 50 cr. cash and transferring a retail business, the fair value of which is 30 cr.

Assets acquired and liabilities assumed in the acquisition is 72 cr. Find out Goodwill.

## QUESTION 31 :

A Ltd. purchased 60% shares of B. Ltd. paying Rs 1050 million. No. of issued capital of B Ltd. is 1 million.

Fair value of identifiable assets of B Ltd. is Rs 1280 million and that of liabilities is Rs 100 million.

As on the date of acquisition, market price per share of B Ltd. Is Rs1550. Find out goodwill.

## QUESTION 32 :

On 1 April 2015, A Ltd. acquires 80 percent of the equity interests of B Ltd., a private company, in exchange for cash of 150 million. Because the former owners of B Ltd. needed to dispose of their investments in the company by a specified date, they did not have sufficient time to market B Ltd. to multiple potential buyers. The management of A Ltd. initially measures that the separately recognisable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirements of Ind AS 103. The identifiable assets are measured at Rs 240 million and the liabilities assumed are measured at 40 million. A Ltd. engages an independent consultant, who determines that the fair value of the 20 per cent non-controlling interest in B Ltd. is Rs 45 million.

The amount of B. Ltd.'s identifiable net assets of Rs 200 million exceeds the fair value of the consideration transferred plus the fair value of the noncontrolling interest in B Ltd. by Rs 5 million. Therefore, A Ltd. reviews the procedures it is used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest in B Ltd. and the consideration transferred. After that review, A Ltd. decides that the procedures and resulting measures were appropriate.

Deferred tax liability arising out of assets acquired Rs 3 million Show necessary accounting entry.

## QUESTION 33 :

X Ltd. acquired Y Ltd. by transfer of its retail division (fair value of which is Rs 360 million) and 10,00,000 equity shares to the previous owners of Y Ltd. Market price of equity share of X Ltd. (par value Rs 10 each) as on the date of acquisition was Rs 350 per share. It was decided to pay the purchase consideration to the liquidator of Y Ltd.

Assets and liabilities of retail segment of X Ltd. (Amount in Rs Million)

| | Carrying Amount | Acquisition date Fair value |
|---|---|---|
| Equipment | 120 | 130 |
| Inventories | 120 | 150 |
| Receivables | 110 | 110 |
| Trade payables | 30 | 30 |

As on the acquisition date assets and liabilities of Y Ltd. were as follows:

**(Amount in Rs million)**

| | Carrying amount | Acquisition date fair value |
|---|---|---|
| Land and Building | 30 | 50 |
| Plant and machinery | 500 | 600 |
| Equipment | 20 | 10 |
| Inventories | 100 | 80 |
| Receivables | 100 | 80 |
| Cash and Cash Equivalents | 10 | 10 |
| Total Assets | 760 | 830 |
| Loans | 100 | 100 |
| Trade Payables | 30 | 30 |
| Total Liabilities | 130 | 130 |
| Net Assets | 630 | 700 |

Find out purchase consideration and goodwill on business combination. Show accounting entry of acquirer for business combination.

## QUESTION : 34

A Ltd. has issued equity share capital of 100 million. On 1.4.2015, H Ltd. acquired 60 million shares of A Ltd. from its shareholders by issuing 2 million shares @ 800 each. Market price per share of A Ltd. is Rs 27.50 per share.

Fair value of identifiable assets and liabilities of A Ltd. are Rs 3000 million and Rs 500 million respectively.

Based on the above information, H Ltd. wishes to recognise a goodwill of 100 million. Advise the company in the light of the requirement of Ind AS 103.

## QUESTION : 35

kappa is an entity that regularly purchases subsidiaries. Kappa prepares financial statements to 30 September each year.

On 30 June 2005 the entity acquired all the 100 million equity shares of Lambda by issuing one share in Kappa for every two shares acquired in Lambda. On 30 June 2005 the market value of a Kappa share was Rs.5.40 and the market value of Lambda share Rs.2.70.

The directors of Lambda prepared a balance sheet as at 30 June 2005 and the net assets of Lambda that were included were measured at Rs.180 million (their fair values at that date). The directors of Kappa noted that the following assets of Lambda had not been included in the draft balance sheet prepared by the directors:

i. Internally developed brands having an identifiable fair value of Rs. 10 million at 30 June 2005.

ii. The value of future services of existing employees that was estimated to have a value of Rs.15 million at 30 June 2005.

**Required:**

Calculate the goodwill arising on initial consolidation of Lambda at 30 June 2005 and explain (without performing any calculations) how its carrying amount at 30 September 2005 would be measured.

## QUESTION : 36

Company A and Company B are in power business. Company A holds 25% of equity shares of Company B. On November 1, Company A obtains control of Company B when it acquires a further 65% of Company B's shares, thereby resulting in a total holding of 90%. The acquisition had the following features:

- **Consideration:** Company A transfers cash of ` 59,00,000 and issues 1,00,000 shares on November 1. The market price of Company A's shares on the date of issue is ` 10 per share. The equity shares issued as per this transaction will comprise 5% of the post-acquisition equity capital of Company A.

- **Contingent consideration:** Company A agrees to pay additional consideration of ` 7,00,000 if the cumulative profits of Company B exceed ` 70,00,000 over the next two years. At the acquisition date, it is not considered probable that the extra consideration will be paid. The fair value of the contingent consideration is determined to be ` 3,00,000 at the acquisition date.
- **Transaction costs:** Company A pays acquisition-related costs of ` 1,00,000.
- **Non-controlling interests (NCI):** The fair value of the NCI is determined to be ` 7,50,000 at the acquisition date based on market prices. Company A elects to measure non-controlling interest at fair value for this transaction.
- **Previously held non-controlling equity interest:** Company A has owned 25% of the shares in Company B for several years. At November 1, the investment is included in Company A's consolidated statement of financial position at ` 6,00,000, accounted for using the equity method; the fair value is ` 20,00,000.

  The fair value of Company B's net identifiable assets at November 1 is ` 60,00,000, determined in accordance with Ind AS 103.

  **Required**

  Determine the accounting under acquisition method for the business combination by Company A.

## QUESTION : 37

On September 30, 20X1 Entity A issues 2.5 shares in exchange for each ordinary share ofEntity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, EntityA issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

The fair value of each ordinary share of Entity B at September 30, 20X1 is 40. The quotedmarket price of Entity A's ordinary shares at that date is 16.

The fair values of Entity A's identifiable assets and liabilities at September 30, 20X1 are thesame as their carrying amounts, except that the fair value of Entity A's non- current assetsat September 30, 20X1 is 1,500.

The statements of financial position of Entity A and Entity B immediately before the businesscombination are:

| | Entity A (legal parent, accounting acquiree) | Entity B (legal subsidiary, accounting acquirer) |
|---|---|---|
| Current assets | 500 | 700 |
| Non-current assets | 1,300 | 3,000 |
| Total assets | 1,800 | 3,700 |
| Current liabilities | 300 | 600 |
| Non-current liabilities | 400 | 1,100 |
| Total liabilities | 700 | 1,700 |
| Shareholders' equity | | |
| Retained earnings | 800 | 1,400 |
| Issued equity | | |
| 100 ordinary shares | 300 | |
| 60 ordinary shares | 600 | |
| Total shareholders' equity | 1,100 | 2,000 |
| Total liabilities and shareholders' equity | 1,800 | 3,700 |

## QUESTION: 38

Company A acquired 90% equity interest in Company B on April 1, 2010 for a considerationof Rs 85 crores in a distress sale. Company B did not have any instrument recognised inequity. The Company appointed a

registered valuer with whose assistance, the Companyvalued the fair value of NCI and the fair value identifiable net assets at Rs 15 crores andRs 100 crores respectively.

**Required**

Find the value at which NCI has to be shown in the financial statements

## QUESTION : 39

Company A acquires 70 percent of Company S on January 1, 20X1 for consideration transferred of Rs 5 million. Company A intends to recognise the NCI at proportionate share of fair value of identifiable net assets. With the assistance of a suitably qualified valuation professional, A measures the identifiable net assets of B at Rs 10 million. A performs a review and determines that the business combination did not include any transactions that should be accounted for separately from the business combination.

**Required**

State whether the procedures followed by A and the resulting measurements are appropriate or not. Also calculate the bargain purchase gain in the process.

## QUESTION 40 : (Business Combination in stages)

Prince Ltd. holds 30% shares in Crown Ltd. which was acquired on 15/7/2014. In separate financial statements, the investment in associate is carried at cost Rs200 million. In the consolidated financial statements as at 31st March 2017, the investment is recognized applying equity method accounting at Rs 300 million (inclusive of goodwill Rs 15 million). Accretion to cost was partly recognise as share of profit in the profit and loss amounting to Rs 80 million and balance Rs 20 million in other comprehensive income.

On 1st April 2017, Prince Ltd. acquired another 30% stake of Crown Ltd. for Rs 350 million. As on date of acquisition, fair value of identifiable assets and liabilities of Crown Ltd. were determined as Rs 1200 million and Rs 200 million respectively. Deferred tax liability has been reassessed based on acquisition date fair value of assets and liabilities at Rs 40 million. Market price of previously held 30% interest is Rs 330 million. How should Price Ltd. recognise the acquisition of controlling stake in Crown Ltd.?

## QUESTION : 41

A Ltd., an acquiree of a business combination, replaces share based awards even though it is not obliged to do so as the acquiree's share based award would expire as a consequence of a business combination. The market based measure of this replacement award is Rs. 2 million. Should it be recognisecl as a liability assumed in a business combination ?

## QUESTION : 42

On 1 October 2014 Hawaii purchased 8 million of Texas's 12 million equity shares. The acquisition was financed as follows:

A cash payment of $2.00 per share; $1.20 per share being payable on 1 October 2014 and $0.80 being payable on 30 September 2015. Any discounting calculations should be performed using a cost of capital of 8% per annum.

A share exchange of 1 equity share in Hawaii for every 2 shares acquired in Texas. The market value of a Texas share was $3.90 on 1 October 2014. The market values of a Hawaii share were $4 on 1 October 2014 and $4.20 on 31 March 2015.

A further share issue by Hawaii on 30 September 2015 of 1 share for every 8 shares acquired in Texas provided the profits after tax of Texas exceeded a given figure. Estimates indicate that this share issue is likely to be made. The fair value of this contingent consideration on 1 October 2014 was $4 million; this has increased to $4.2 million at 31 March 2015.

Hawaii incurred acquisition costs of $600,000. $350,000 of these costs were external due diligence costs, $100,000 were Hawaii's best estimate of management time spent in negotiating the acquisition, and $150,000 were costs incurred in connection with the issue of Hawaii's shares,

The directors of Hawaii carried out a fair value exercise on 1 October 2014 and the following matters emerged:

The net assets of Texas that were recognised in Texas' s own financial statements were $30 million based on their carrying amounts in the individual financial statements of Texas.

On 1 October 2014 the carrying amount of Texas's freehold property was $15 million. The property had been purchased on 1 October 2004 for $17.5 million and the buildings element of the property (allocated cost $10 million) was being depreciated over its estimated useful economic life of 40 years. On 1 October 2014 the market value of the property was $22 million, of which $12 million related to the buildings element. The original estimate of the useful economic life of the buildings is still considered valid,

On 1 October 2014 Texas was engaged in contracts with three different customers under which it supplied each customer for a five-year-period from 1 October 2014. The directors of Hawaii believe that this creates an intangible asset with a fair value of $7.5 million. In addition the directors of Hawaii believe that the fair value of the assembled workforce of Texas creates an intangible asset with a fair value of $15 million. The average remaining working life of the employees of Texas at 1 October 2014 is 15 years. Neither of these intangible assets has been recognised in the individual financial statements of Texas.

At 1 October 2014 Texas was engaged in a legal dispute with a customer. The directors of Texas consider that the case can be successfully defended and have made no provision for legal costs in its financial statements. The directors of Hawaii estimated that the fair value of the claim at 1 October 2014 was $600,000. Events since 1 October 2014 have reduced this estimate to $500,000 by 31 March 2015 (these events do not affect the fair value of the claim at 1 October 2014).

Due to the acquisition of Texas the directors of Hawaii intend to reorganise the group, starting in June 2016. The estimated cost of this reorganisation is $20 million.

In the year ended 31 March 2015 Texas reported a post-tax profit of $6 million (accruing evenly over the period) and paid a dividend of $1.5 million on 31 December 2014 out of post-acquisition profits. The retained earnings of Hawaii at 31 March 2015 were $18 million. This figure includes the dividend received from Texas but does not include any other adjustments to its own earnings that are required as a result of the acquisition of Texas, The acquisition costs of $600,000 referred to above have been charged to retained earnings by Hawaii. Hawaii has no subsidiaries other than Texas and no associates or joint venture entities.

The non-controlling interest in Texas was valued at $17.5 million on acquisition by Hawaii.

**REQUIRED :**

Compute the goodwill on acquisition of Texas as initially measured at 1 October 2014.

## QUESTION : 43

X holds 46% of 100 million equity shares issued by Y Ltd. This is recognised as investment in associate in the separate financial statements at cost of Rs. 4600 million. In the consolidated financial statements, the investment is accounted for applying equity method accounting at Rs. 6300 million. The difference of 2300 million has been recognised in the consolidate profit and loss as share of profit from the associate.

Fair value of identifiable assets and liabilities of Y Ltd. as on 1.4.2015 :

Assets (other than cash and cash equivalents) Rs. 14000 Million, Cash and cash equivalents Rs.1800 million, Liabilities Rs. 2000 million.

As on 1 April 2015, Y Ltd. repurchases 10 million equity shares @ Rs. 160 per share (i.e. for Rs. 1600 million)

This repurchase gives controlling interest to X Ltd.

How should the company recognise the impact of gaining controlling interest in Y Ltd. ?

## QUESTION : 44

ABC has entered into share purchase agreement whereby it acquired 100% interest and control over entity DEF. The consideration payable for the acquisition is INR 1,000 million in cash.

Prior to the acquisition, ABC had received a loan from DEF which carries interest at a fixed rate. The loan liability is appearing in ABC's balance sheet at INR 100 million. Since the grant of loan, market interest rates have gone- up. Consequently, the fair value of the loan liability is assessed to be INR 90 million. ABC has determined that the fair value of the net identifiable assets and liabilities of DEF at the date of acquisition is INR 920 million. This includes INR 90 million in respect of the fixed rate loan to ABC.

Out of total consideration of INR 1,000 million paid for DEF acquisition, INR 90 million, in substance, pertain to repayment of DEF loan. Thus, the true consideration transferred for purposes of determining goodwill is INR 910 million (INR 1,000 million - INR 90 million). The loan agreement is favourable by INR 10 million (INR 100 million carrying amount - INR 90 million fair value). Pass journal Entry in the books of ABC.

## QUESTION : 45

A Ltd., the acquirer, assumed a liability to pay damages related to an accident in one of the plant of the B Ltd., the acquiree. Part of the liabilities are covered by an insurance policy,

A Ltd. recognises a liability of Rs. 20 lakhs and insurance claims of Rs. 10 lakhs. It was assessed that settlement of the claims will require another 6 months.

The claims were settled at Rs. 24 lakhs and insurance company paid Rs. 11 lakhs.

A Ltd. recognised goodwill provisionally at Rs. 5 lakhs.

How should A Ltd. account for these changes during the measurement period ?

## QUESTION : 46

A Ltd., the acquirer, assumed a liability to pay damages related to an accident in one of the plant of the B Ltd., the acquiree. Part of the liabilities are covered by an insurance policy.

A .Ltd. recognises a liability of Rs. 20 lakhs and insurance claims of Rs. 10 lakhs. It was assessed that settlement of the claims will require another 6 months. The claims were settled at Rs. 15 lakhs and insurance company paid Rs. 9 lakhs.

A Ltd. recognised goodwill provisionally at Rs. 2 lakhs.

How should A Ltd. account for these changes during the measurement period.

## QUESTION : 47

AX Ltd. and BX Ltd. amalgamated on and from 1st January 20X2. A new Company ABX Ltd. was formed to take over the businesses of the existing companies.

**Summarized Balance Sheet as on 31-12-20X2** INR in '000

| Assets | Note No. | AX Ltd | BX Ltd |
|---|---|---|---|
| **Non-current assets** | | | |
| Property, Plant and Equipment | | 8,500 | 7,500 |
| Financial assets | | | |
| Investments | | 1,050 | 550 |
| **Current assets** | | | |
| Inventory | | 1,250 | 2,750 |
| Trade receivable | | 1,800 | 4,000 |
| Cash and Cash equivalent | | 450 | 400 |

| | | | |
|---|---|---|---|
| | | 13,050 | 15,200 |
| **EQUITY AND LIABILITIES** | | | |
| **Equity** | | | |
| Equity share capital (of face value of INR 10 each) | | 6,000 | 7,000 |
| Other equity | | 3,050 | 2,700 |
| **Liabilities** | | | |
| **Non-current liabilities** | | | |
| Financial liabilities | | | |
| Borrowings | | 3,000 | 4,000 |
| **Current liabilities** | | | |
| Trade payable | | 1,000 | 1,500 |
| | | **13,050** | **15,200** |

ABX Ltd. issued requisite number of shares to discharge the claims of the equity shareholders of the transferor companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd:

Assuming BX ltd is a larger entity and their management will take the control of the entity.

The fair value of net assets of AX and BX limited are as follows :

| Assets | AX Ltd ('000) | BX Ltd ('000) |
|---|---|---|
| Fixed assets | 9,500 | 1,000 |
| Inventory | 1300 | 2900 |
| Fair value of the business | 11,000 | 14,000 |

## QUESTION : 48

The balance sheet of Professional Ltd and Dynamic Ltd as of 31 March 20X2 is given below:

| Assets | Professional Ltd | Professional Ltd |
|---|---|---|
| **Non-Current Assets:** | | |
| Property plant and equipment | 300 | 500 |
| Investments | 400 | 100 |
| **Current assets:** | | |
| Inventories | 250 | 150 |
| Financial assets | 400 | 230 |
| Trade receivable | 450 | 300 |
| Cash and cash balances | 250 | 100 |
| **Total** | **2.000** | **1,380** |
| | | |
| **Equity and Liabilities** | | |
| **Equity** | | |
| Share capital- Equity shares of ` 100 each | 500 | 400 |
| Reserve and surplus | 730 | 180 |
| OCI | 80 | 45 |
| **Non-Current liabilities:** | | |
| Long term borrowings | 250 | 200 |
| Long term provisions | 50 | 70 |
| Deferred tax | 40 | 35 |
| **Current Liabilities:** | | |

| Short term borrowings | 100 | 150 |
|---|---|---|
| Trade payable | 250 | 300 |
| **Total** | **2,000** | **1,380** |

Other information

(a) Professional acquired 70% of Dynamic Ltd on 1 April 20X2 for by issuing its own share in the ratio of 1 share of Professional Ltd for every 2 shares of Dynamic Ltd. The fair value of the shares of Professional Ltd was 40.

(b) The fair value exercise resulted in the following:( all nos in Lakh)

(a) PPE fair value on 1 April 20X2 was 350.

(b) Professional Ltd also agreed to pay an additional payment that is higher of 35 lakh and 25% of any excess of Dynamic Ltd in the first year after acquisition over its profits in the preceding 12 months. This additional amount will be due after 2 years. Dynamic Ltd has earned 10 lakh profit in the preceding year and expects to earn another 20 Lakh.

(c) In addition to above, Professional Ltd also had agreed to pay one of the founder shareholder a payment of 20 lakh provided he stays with the Company for two year after the acquisition.

(d) Dynamic Ltd had certain equity settled share based payment award (original award) which got replaced by the new awards issued by Professional Ltd. As per the original term the vesting period was 4 years and as of the acquisition date the employees of Dynamic Ltd have already served 2 years of service. As per the replaced awards the vesting period has been reduced to one year (one year from the acquisition date). The fair value of the award on the acquisition date was as follows:

i. Original award- INR 5

ii. Replacement award- INR 8.

(e) Dynamic Ltd had a lawsuit pending with a customer who had made a claim of 50. Management reliably estimated the fair value of the liability to be 5.

(f) The applicable tax rate for both entities is 30%.

You are required to prepare opening consolidated balance sheet of Professional Ltd as on 1 April 20X2.

## QUESTION : 49

Acquirer A Ltd. issues a replacement award under a business combination transaction market based measurement of which under IFRS 2 is Rs.10 million. The original award of acquiree has a market based measure of Rs. 9 million. Under the replacement awards the employees are not required to provide any further service after the acquisition date, and vesting period has been completed under the acquiree's award. Should the additional obligation be treated as liability assumed in business combination?

## QUESTION : 50

Acquirer A Ltd. issues a replacement award under a business combination transaction, the market based measurement of which under IFRS 2 is Rs. 10 million. The employees are required to render 2 years service after business combination to be entitled to the awards. The original award of acquiree has a market based measure of Rs. 9 million on the date of acquisition, and a vesting period of 5 years which all the employees have completed. Should the additional obligation be treated as liability assumed in a business combination ? If not allocate the obligation into pre-combination obligation and post-combination remuneration.

## QUESTION : 51

Acquirer A Ltd. issues a replacement award under a business combination transaction, the market based measurement of which under IFRS 2 is Rs. 10 million. The employees are not required to render any service after business combination. The original award of acquiree has a market based measure of Rs. 9 million on the

date of acquisition, and a vesting period of 5 years of which the employees have completed 2 years only. Should the additional obligation be treated as liability assumed in a business combination ?

## QUESTION : 52

Parent acquires 80% of Subsidiary for Rs 60,000. The subsidiary's net assets at date of acquisition were Rs 62,500. In the year following acquisition, but within 12 months of the acquisition date, it was identified that the value of land was Rs 2,500 greater than that recognised on acquisition.

## QUESTION : 53

X Ltd. acquired the business of Y Ltd. for Rs. 40 crores. The purchase consideration includes payment for settlement of a law suit against X Ltd. Rs. 30 lakhs. In the books of X Ltd. there is provision for the law suit amounting to Rs. 40 lakhs. But Y Ltd. did not recognise any asset as it would have lead to recognition of a contingent asset. X Ltd. also recognised deferred tax asset of Rs. 12 lakhs. Fair value of identified assets acquired is Rs. 45 cr, and fair value of liabilities assumed is Rs. 10 cr. Deferred tax liability worked out based on tax base of acquiree and the fair value is Rs. 1 cr. How should the company recognise the business combination transaction existing relationship ? Assume that the tax authority will not allow any tax benefit on this settlement since the payment occurred during negotiation of the business combination.

## QUESTION : 54

ASF Ltd acquired 60 % shares of Y Ltd on 1.4.18. it agreed to pay Rs 10,00,000 in cash, 30,000 equity shares of ASF Ltd whose fair value is Rs 85 per share. ASF Ltd also agreed to pay deferred consideration of Rs 30,00,000 after 3 years. In case Y Ltd earned beyond certain limit, additional consideration will be paid at the end of first year for Rs 5,00,000. Fair value of contingent consideration = Rs 1,00,000. Rate of discount = 10%. ASF Ltd follows cost method of IAS 27. Journalise entries for 3 years assuming contingent consideration was paid. Fair value of shares of Y Ltd was 150, 140 and 190 on 31.3.19, 31.3.20 and 31.3.21 respectively.

## QUESTION : 55

On 1.4.2018 ASF Ltd agreed to purchase 30,000 shares of A Ltd from P Ltd. Total number of shares of A Ltd are 50,000. ASF Ltd agreed to pay:

1. Cash - Rs 50,000
2. Rs 10 Lacs after 3 years
3. Land whose fair value is Rs 6 Lacs.
4. ASF Ltd will issue own shares 10,000 whose fair value is Rs 22 (Face value is Rs 10).
5. Discount factor = 10%
6. If profit of A Ltd exceeded Rs 1 Crore, then, ASF Ltd will pay Rs 8 Lacs after 2 years. Fair value of contingent consideration is Rs 2,00,000. Fair value on 31.3.19 was Rs 3 lacs and Rs 8 Lacs on 31.3.2020. Amount paid is Rs 8 Lacs.

   Journalise acquisition entry on 1.4.18 and prepare

   1. Investment in A Ltd A/c
   2. Contingent Consideration A/c
   3. Deferred Consideration A/c

# IAS 27 SEPARATE FINANCIAL STATEMENTS

## 1. INTRODUCTION

An entity is normally required to prepare consolidated financial statements of the group whenever an entity has subsidiaries, associates or joint ventures. Financial Reporting for such cases would be done based on concerned standards (IAS 28, IFRS 10, 11 and 12).

However, when an entity chooses to prepare separate financial statements or when local regulations require separate financial statements, the requirements of this standard should be applied.

## 2. CONSOLIDATED FINANCIAL STATEMENTS

**Consolidated Financial Statements** are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

## 3. SEPARATE FINANCIAL STATEMENTS

**Separate financial statements** are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 **Financial Instruments** **or using the equity method as described in IAS 28 Investments in Associates and Joint Ventures.**.

Separate Financial Statements are those presented in addition to consolidated financial statements.

Financial Statements in which Equity method is applied for accounting for investment in associates or joint ventures, such financial statements are not separate financial statements.

**If an entity does not have any subsidiary, associate or joint venture, the financial statements prepared by the entity are not referred to as separate financial statements.**

Separate financial statements can be prepared only when an entity has a subsidiary or an associate or joint venture.

**<u>An entity that is exempted in accordance with IFRS 10 from consolidation or IAS 28 from applying the equity method may present separate financial statements as its only financial statements</u>**.

**An investment entity that is required, throughout the current period and all comparative periods presented, to apply the exception to consolidation for all of its subsidiaries in accordance with IFRS 10 presents separate financial statements as its only financial statements.**

## 4. ACCOUNTING IN SEPARATE FINANCIAL STATEMENTS

Accounting for investments in subsidiaries, associates or joint ventures in the separate financial statements should either be at

- Cost, or
- In accordance with IFRS 9 (Fair Value), or
- **<u>Equity method as described in IAS 28</u>**

The entity shall apply the same accounting for each category of investments. **For Example – If an entity has two associates, it can not account investment in one associate at cost and other with IFRS 9.**

If an entity accounts for an investment in associate or joint venture at in accordance with IFRS 9 (Fair Value) as per the option given in IAS 28, accounting in separate financial statements should also be as per fair value.

## 5. JOURNAL ENTRY ON ACQUISITION OF INVESTMENT, IN SFS

Journal entry on acquisition of investment, in SFS, would be:

Investment A/C………………Dr

To Cash and Bank a/c

To Vendor A/c

(Being Investment Purchased)

IFRS 9 requires investments to be accounted at fair value (always). Change in fair value can be recognized either through profit and loss or OCI.

**PROBLEM : 1**

**A Ltd purchased 10,000 equity shares of B Ltd at Rs 15. Total shares of B Ltd are 50,000.**

**Date of purchase : 01.04. 2018.**

**On 31.3.19, fair value of shares is Rs 21.**

**On 31.3.20, fair value of shares is Rs 17.**

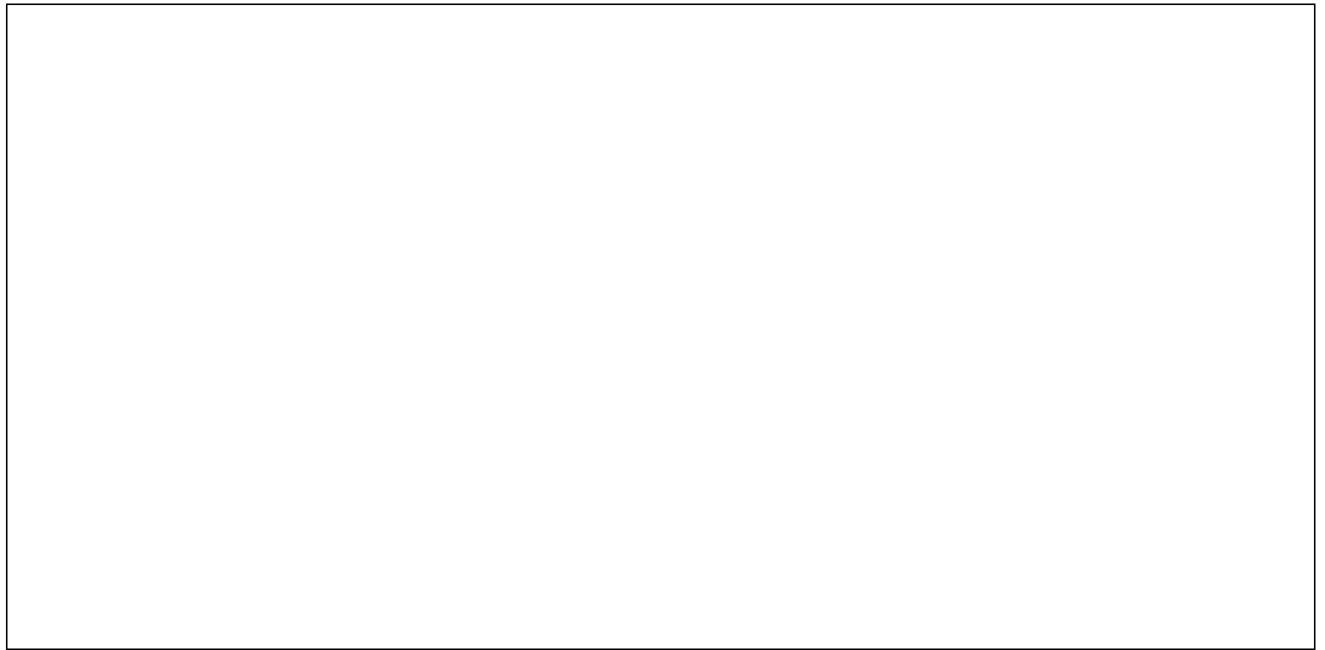
**Journalise assuming –**

**a. Cost model**

**b. FVTPL**

**c. FVTOCI**

**SOLUTION : 1**



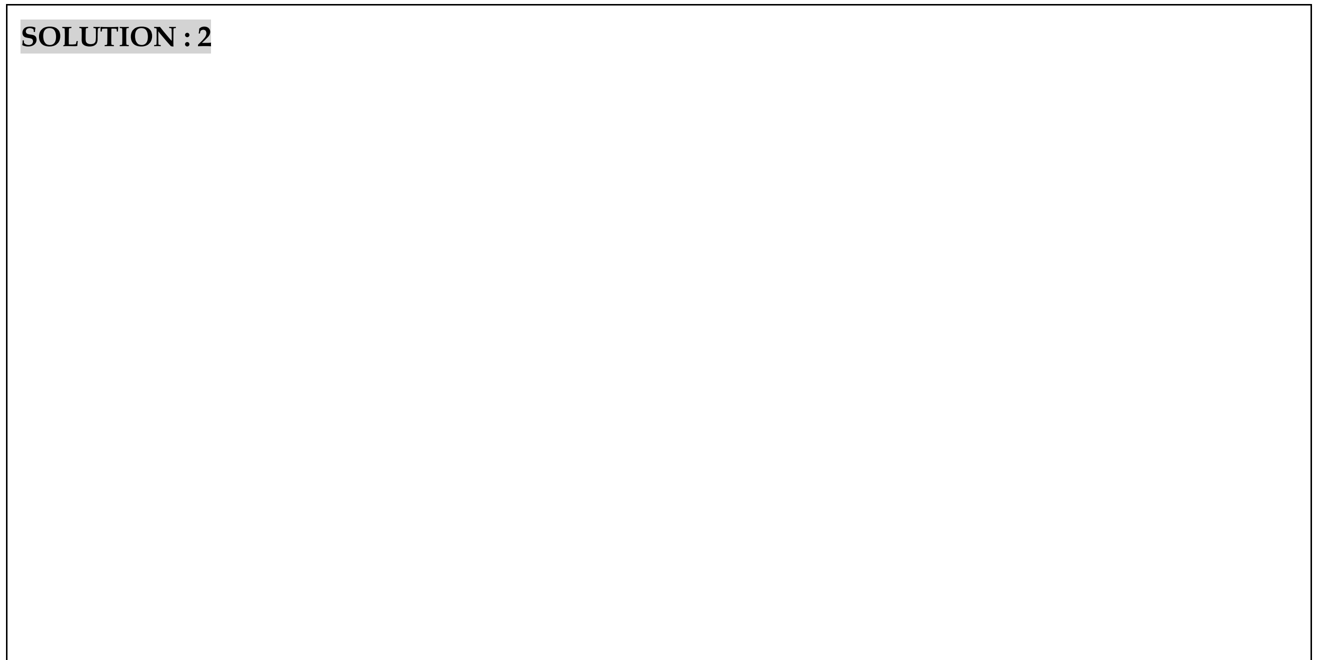
## 6. DIVIDEND INCOME

Dividend income from subsidiary, associate or joint venture should be accounted in profit or loss when the right to receive dividend is established. **The dividend is recognised in profit or loss unless the entity elects to use the equity method, in which case the dividend is recognised as a reduction from the carrying amount of the investment.**

**PROBLEM : 2**

**ASF Ltd purchased shares of B Ltd for Rs 30 on 01.06.2020. ASF Ltd received dividend from B Ltd for year ended 31.3.2020 @ Rs 4 per share. Fair Value of investment on 30.06.2020 is Rs 29. Year ending date of ASF Ltd is Rs 30.06.2020. Pass Journal entry in the books of ASF Ltd.**

**SOLUTION : 2**



## 7. CLASSIFICATION AS HELD FOR SALE

When the investments that are accounted at cost are subsequently classified as held for sale **or for distribution (or included in a disposal group that is classified as held for sale or for distribution)**, accounting should be in accordance with IFRS 5. However, investments accounted at fair value will continue to be accounted under IFRS 9 until disposal.

## 8. WHEN A PARENT CEASES TO BE AN INVESTMENT ENTITY, OR BECOMES AN INVESTMENT ENTITY

| When an entity becomes an Investment Entity | When an entity ceases to be an Investment Entity |
|---|---|
| Account as per FVTPL as per IFRS 9.<br>Note 1 – Any difference between carrying amount and fair value – Taken to profit and loss.<br>Note 2 – Any cumulative balance in OCI will be recycled to Profit and Loss (It seems to be an exception to IFRS 9, as recucling is not allowed) | Option1 – Cost - The fair value at the date of change of status will be deemed cost.<br>Option 2 – Continue to account for an investment in a subsidiary in accordance with IFRS 9. |

## 9. REORGANISATION

When reorganisation results in creation of new parent, the new parent accounts for the investment at cost if following conditions are satisfied;

- the new parent obtains control over the original parent by issuing equity instruments in exchange for existing equity instruments,
- the assets and liabilities of the new group and the original group is same immediately before and after the reorganization
- the owners of the original parent before and after the reorganization have the same absolute and relative interests in the net assets of the new group

the new parent should measure the investment in original parent at its share of equity items as per separate financial statements of original parent before such reorganization.

**PROBLEM : 3**

**Google Ltd, a parent company re-organizes its group structure. It creates a new company Alphabet Ltd, which issues equity shares in exchange of Google Ltd. Carrying amount of components of Equity of Google Ltd as per its SFS is as follows:**

| | |
|---|---|
| | |
| | |
| | |
| | |
| | |

**At what amount Alphabet Ltd recognize investment in Google Ltd?**

**SOLUTION : 3**

## 10. EXEMPTION FROM CFS

In accordance with IFRS 10, certain entities are exempted from preparation of consolidated financial statements. When such entities prepare separate financial statements, any investments in subsidiaries, associates and joint ventures should be accounted as prescribed in this standard.

## 11. DISCLOSURE REQUIREMENTS WHEN EXEMPTION FROM CFS IS AVAILED

**In the notes to accounts**

- The fact that the financial statements are separate financial statements
- Exemption from consolidation has been used

- Name and principal place of business of entity which produces consolidated financial statement for public use
- Address where such consolidated financial statements are obtainable
- List of significant investment in subsidiaries, joint ventures and associates with name of those investees, principal place of business and its proportion of ownership interest held
- Description of method used to account those investments

## 12. DISCLOSURE REQUIREMENTS WHEN WHEN AN INVESTMENT ENTITY IS A PARENT

When an investment entity that is a parent prepares separate financial statements as its only financial statements, it shall disclose that fact. The investment entity shall also present the disclosures relating to investment entities required by IFRS 12 Disclosure of Interests in Other Entities.

## 13. DISCLOSURE REQUIREMENTS

**An entity shall apply all applicable IFRSs when providing disclosures in its separate financial statements.**

When a parent or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, the parent or investor shall identify the financial statements prepared in accordance with IFRS 10, IFRS 11 or IAS 28 to which they relate. The parent or investor shall also disclose in its separate financial statements:

- The fact that the financial statements are separate financial statements
- Reasons why separate financial statements are prepared if not required by law
- List of significant investment in subsidiaries, joint ventures and associates with
- name of those investees,
- principal place of business and its proportion of ownership interest held
- Description of method used to account those investments

## 11. MAJOR CHANGES IN IND AS 27 VIS-À-VIS IAS 27 NOT RESULTING IN CARVE OUTS

1. ***Separate Financial Statements:*** IAS 27 requires to disclose the reason for preparing separate financial statements if not required by law. In India, since the Companies Act mandates preparation of separate financial statements, such requirement has been removed in Ind AS 27.
2. ***Option to use Equity Method:*** IAS 27 allows the entities to use the equity method to account for investment in subsidiaries, joint ventures and associates in their Separate Financial Statements (SFS). This option is not given in Ind AS 27, as the equity method is not a measurement basis like cost and fair value but is a manner of consolidation and therefore would lead to inconsistent accounting conceptually.

## PROBLEMS FOR SELF-PRACTICE

**PROBLEM : 4**

**A company AB Ltd. holds investments in subsidiaries and associates. In its separate financial statements, AB Ltd. wants to elect to account its investments in subsidiaries at cost and the investments in associates as financial assets at fair value through profit or loss (FVTPL) in accordance with with IFRS 9 Financial Instruments.**

**Whether AB Limited can carry investments in subsidiaries at cost and investments in associates in accordance with IFRS 9 in its separate financial statements?**

**SOLUTION : 4**

It may be noted that although the 'category' is used in number of Standards, it is not defined in any of the IFRS. It seems that subsidiaries, associates and joint ventures would qualify as separate categories.

Thus, the same accounting policies are applied for each category of investments - i.e. each of subsidiaries, associates and joint ventures.

However, paragraph 10 of IAS 27 should not be read to mean that, in all circumstances, all investments in associates are one 'category' of investment and all investments in joint ventures or an associate are one category' of investment.

These categories can be further divided into sub-categories provided the sub-category can be defined clearly and objectively and results in information that is relevant and reliable.

For example, an investment entity parent can have investment entity subsidiary (at fair value through profit or loss) and non-investment entity subsidiary (whose main purpose is to provide services that relate to the investment entity's investment activities) as separate categories in its separate financial statements.

In the present case, investment in subsidiaries and associates are considered to be different categories of investments.

Furture IAS 27 requires to account for the investment in subsidiaries, joint ventures and associates either at cost, or in accordance with IFRS 9 for each category of Investment.

Thus, AB Limited can carry its investments in subsidiaries at cost and its investments in associates as financial assets in accordance with IFRS 9 in its separate financial statements.

**PROBLEM : 5**

**X Ltd. carries investment in subsidiary at cost in its separate financial statement. It become an investment entity within the meaning of IFRS 10 as on 1.10.2017. Cost of investment in subsidiary Rs 10 crores.**

**Fair value of investment as on 1.10.2017 : Rs 20 crores.**

**The entity has transferred the gain to Fair Value Reserve as per requirement of IFRS 9.**

**How does the entity account for investment in subsidiary as per IAS 27 on the date it becomes an investment entity?**

**SOLUTION : 5**

X Ltd. shall account for investment in subsidiary at FVTPL i.e. at Rs. 30 cr.

T'he difference Rs 20 cr. is recognised as gain or loss in the Statement of Profit or Loss.

**PROBLEM : 6**

X Ltd. carries investment in subsidiary at fair value through other comprehensive income in its separate financial statements. It becomes an investment entity within the meaning of IFRS 10 as on 1.10.2017.

Cost of investments in subsidiary Rs 10 **crores.**

Fair value of investments as on 1.10.2017: Rs 30 **crores.**

What change in measurement is required as per IAS 27.

**SOLUTION : 6**

The entity shall credit the accumulated fair value gain of Rs 20 cr. to profit and loss. It may be mentioned that accumulated fair value profit can ordinarily be transferred to general reserve when the financial asset is at 'FVTOCI'.

# IFRS 11 JOINT ARRANGEMENTS

## 1. INTRODUCTION

IFRS 11 prescribes accounting for all joint arrangements and establishing principles to determine the type of arrangement.

## 2. JOINTARRANGEMENT

**A joint arrangement**: is an arrangement of which two or more parties have joint control.

Note – "Control" in "joint control" refers to the definition of "control" in IFRS 10.

## 3. JOINT CONTROL

**Joint control** is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activitiesrequire the **unanimous consent of the parties sharing control.**

Before assessing whether an entity has joint control over an arrangement, an entity first assesses whether the parties, or a group of the parties, control the arrangement (in accordance with the definition of control in IFRS 10.

After concluding that all the parties, or a group of the parties, control the arrangement collectively, an entity shall assess whether it has joint control of the arrangement. **Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that collectively control the arrangement.**

## 4. CHARACTERISTICS OF JOINT ARRANGEMENT

A joint arrangement has the following characteristics:

1. **Existence of a contract :**the parties are bound by a **contractual arrangement**, and
2. **Joint control**: the contractual arrangement gives two or more parties joint control of the arrangement.

A joint arrangement is either a joint operation or a joint venture.

## 5. COMMON TERMS INCLUDED IN CONTRACTUAL ARRANGEMENTS:

- **The purpose, activity and duration of the joint arrangement.**

  The agreement might explain, for example, why the parties created the joint arrangement and how long they intend to operate it. It would establish who the parties creating the joint arrangement are, which parties exercise joint control and which parties do not.

- How the members of the board of directors, or equivalent governing body of the joint arrangement, are appointed.
- The agreement could establish how the parties nominate members onto the board, what their responsibilities are and how the board of directors can be removed. It would also establish the voting rights of each board member.
- **The decision-making process -** This establishes the existence of joint control via decision-making processes. It could include details on what activities would qualify as relevant activities'. These activities require unanimous consent by the parties exercising joint control.
- **The capital or other contributions** required of the parties.
- How the parties share assets, liabilities, revenues and expenses or profits or losses arising from the joint arrangement - This is a key factor in determining whether the arrangement is classified as a joint operation or a joint venture.
- The delegation of the entity's day-to-day operation to one of the parties to the joint arrangement.
- Transfer of interests to new parties or among existing parties.
- Arbitration procedures, which become particularly important when the parties cannot reach unanimous agreement.

## 6. HOW DO WE ASSESS "JOINT CONTROL" ?

- IFRS 10 defines 'control' and shall be used to determine whether all the parties, or a group of the parties, are exposed, or have rights, to variable returns from their involvement with the arrangement and have the ability to affect those returns through their power over the arrangement.
- When all the parties, or a group of the parties, **considered collectively**, are able to direct the activities that significantly affect the returns of the arrangement (i.e. the relevant activities), the parties control the arrangement collectively

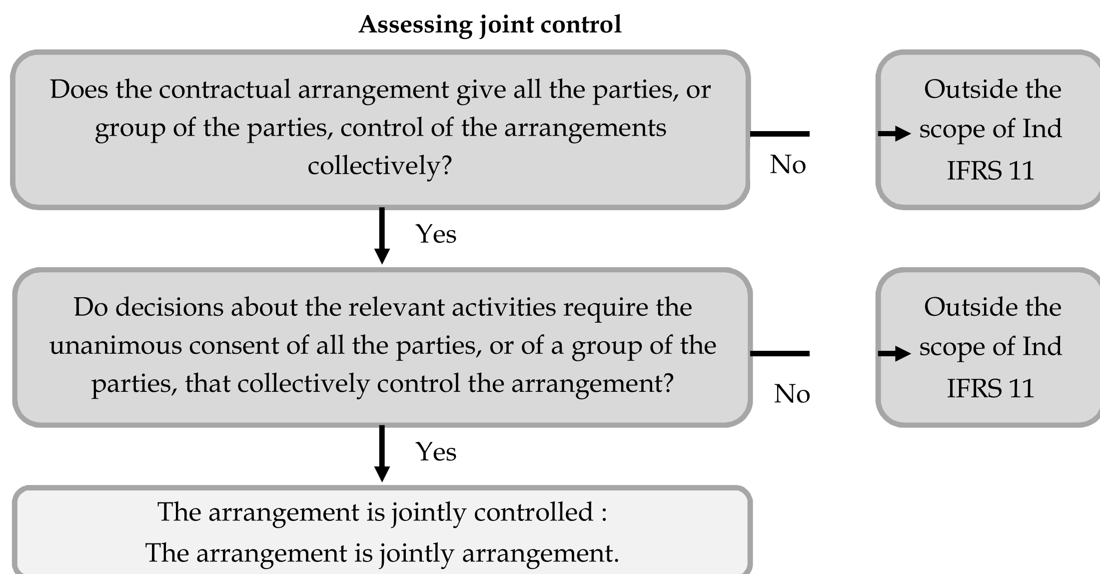
- In assessing whether an entity has joint control of an arrangement, an entity shall assess first whether all the parties, or a group of the parties, control the arrangement.

- **IFRS10 defines control and shall be used to determine whether all the parties, or a group of the parties, are exposed, or have rights, to variable returns from their involvement with the arrangement and have the ability to affect those returns through their power over the arrangement.**

- when all the **parties, or a group of the parties, considered collectively, are able to direct the activities that significantly affect the returns of the arrangement** (i.e. the relevant activities), the parties control the arrangement collectively.
- Assessing whether the arrangement is jointly controlled by all of its parties or by a group of the parties, or controlled by one of its parties alone, can require judgment.

**Flowchart to understand - "How do we assess Joint Control"**

**Assessing joint control**




**CASE I:**

- **Sometimes the decision-making process that is agreed upon by the parties in their contractual arrangement implicitly leads to joint control:**

**PROBLEM 1 :** **[Implicit joint control]**

**Two parties, A Ltd. and B Ltd., establish an arrangement in which each has 50 per cent of the voting rights and the contractual arrangement between them specifies that at least 51 per cent of the voting rights are required to make decisions about the relevant activities. There is no specific mention about unanimous decision making for relevant activities. Does joint control exist in this case?**

**SOLUTION : 1**

**PROBLEM 2 :**

**X Ltd. and Y Ltd. form a new joint arrangement (JA Ltd.). Articles of association of JA Ltd. include a clause that states all shareholders must unanimously agree on the relevant activities of the entity. No other agreement is entered into by the shareholders to manage the activities of JA Ltd. Should the arrangement satisfy contractual arrangement test of IFRS 11 to define the arrangement as joint arrangement?**

**SOLUTION 2 :**

**CASE II:**

- **In other circumstances, the contractual arrangement requires a MINIMUM PROPORTION OF THE VOTING RIGHTS to make decisions about the relevant activities:**
- **When that minimum required proportion of the voting rights can be achieved by more than one combination of the parties agreeing together, that arrangement is not a joint arrangement unless the contractual arrangement specifies which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement.**

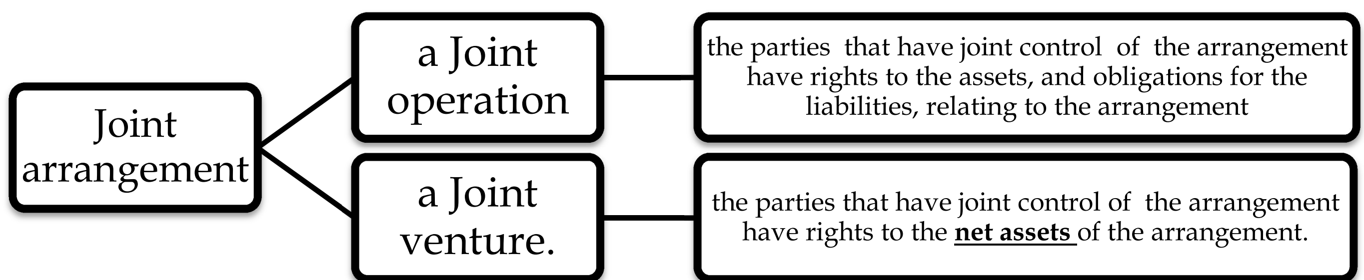
**PROBLEM : 3**

**An arrangement has three parties: Om has 50% of the voting rights in the arrangement and Jay and Jagdish each have 25%. The contractual arrangement between Om, Jay and Jagdish specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement. Discuss the different combinations of joint control that can affect the decision making of the relevant activities of the arrangement?**

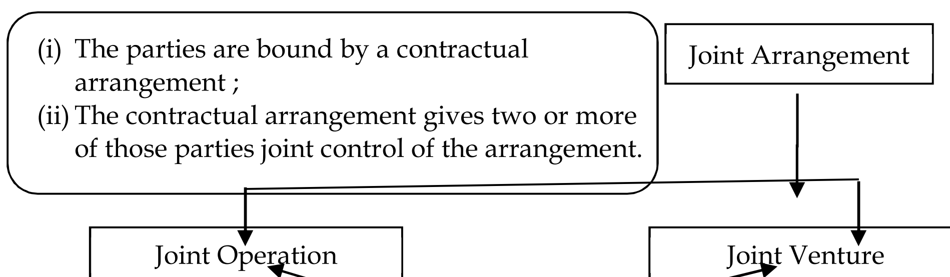
**SOLUTION : 3**

Om can block any decision, it does not control the arrangement because it needs the agreement of either Jay or Jagdish. Om, Jay and Jagdish collectively control the arrangement. However, there is more than one combination of parties that can agree to reach 75% of the voting rights (ie either Om and Jay or Om and Jagdish). In such a situation, to be a joint arrangement the contractual arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to decisions about the relevant activities of the arrangement.

## 7. CLASSIFICATION OF JOINT ARRANGEMENT




**CLASSIFICATION OF JOINT ARRANGEMENT**




**Basis of Classification:**

1. the structure of the joint arrangement
2. when the joint arrangement is structured through a separate vehicle—
   - the legal form of the separate vehicle
   - the terms of the contractual arrangement
   - when relevant, other facts and circumstances

## 8. JOINT OPERATION:

A joint arrangement that is not structured through a separate vehicle is a joint operation.

A Joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

In such cases, the contractual arrangement establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement, and the parties' rights to the corresponding revenues and obligations for the corresponding expenses .

**Joint operator:** A party to a joint operation that has joint control of that joint operation.

**EXAMPLE : 3**

**Gas pipeline connects two points between Mumbai and Pune by distance of about of 150 K.m. Gas pipeline is owned jointly along with equipment by two companies X Ltd. and Y Ltd.**

**The joint operation states that the maintenance of the oil pipeline will also be shared on an equal basis by two parties.**

**Each party will recognize his share in pipeline in SOFP and include his share of expense in the statement of P & L.**

## 9. JOINT VENTURE

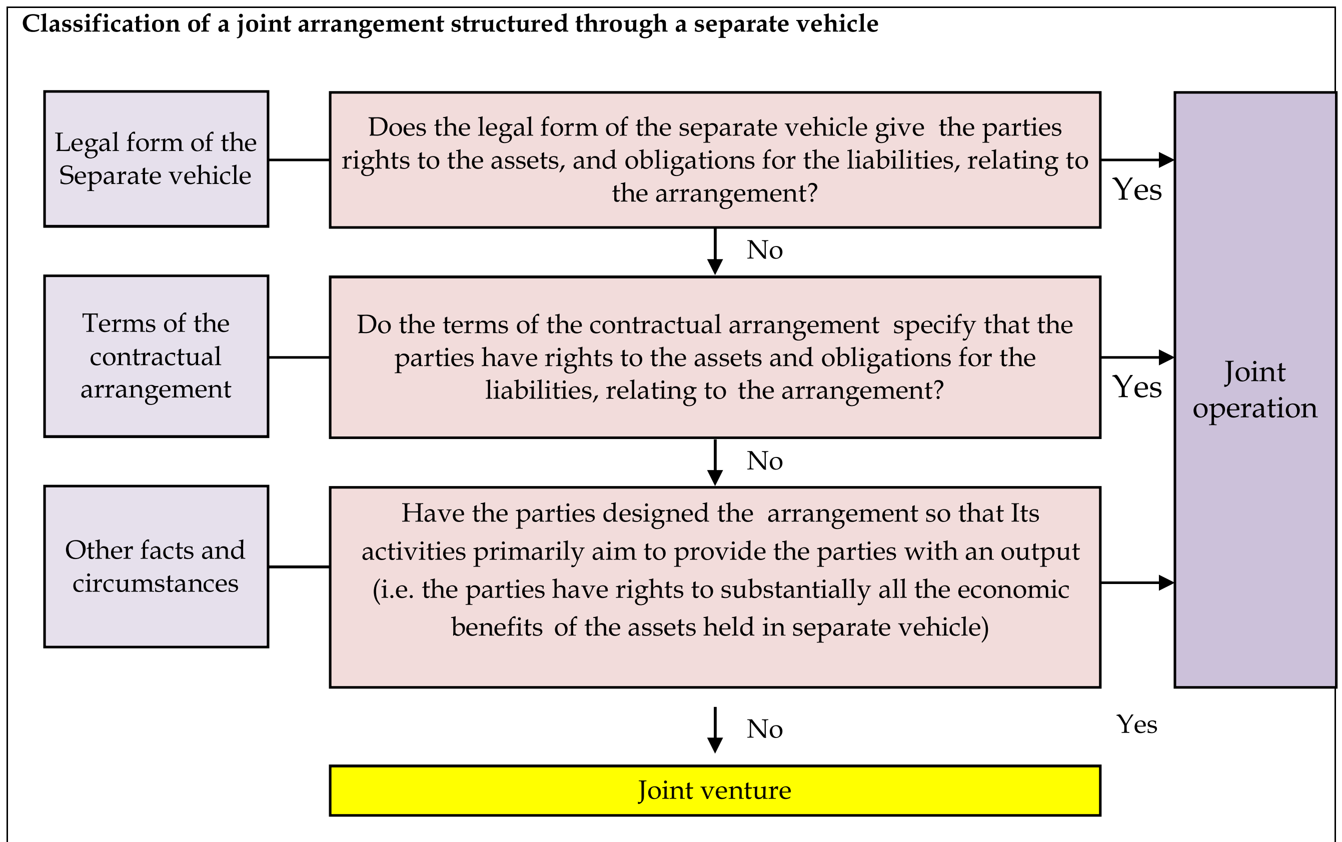
**Joint venture:** A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle **can be either a joint venture or a joint operation.**

**Venturer:** A party to a joint venture that has joint control of that joint venture.

The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement. An entity determines the type of joint arrangement in which it is involved by considering the structure and form of the arrangement, the terms agreed by the parties in the contractual arrangement and other facts and circumstances.

**Classification of a joint arrangement structured through a separate vehicle**




**PROBLEM : 4**

**ASF Ltd has a joint arrangement with two other companies to share control of XYZ Ltd.The arrangement states that all three companies have an equal say in running of XYZ Ltd. Will this arrangement be treated as Joint venture?**

**SOLUTION : 4**

**This arrangement will be treated as Joint venture. ASFLtd will apply Equity method of accounting as per IAS 28.**

## 10. PARTY TO A JOINT ARRANGEMENT:

An entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

## 11. SEPARATE VEHICLE:

A separately identifiable financial structure, including separate legal entities or entities recognized by statute, regardless of whether those entities have a legal personality.

## 12. ACCOUNTING FOR JOINT OPERATIONS

A joint operator recognises in relation to its interest in a joint operation:

- its assets, including its share of any assets held jointly;
- its liabilities, including its share of any liabilities incurred jointly;
- its revenue from the sale of its share of the output of the joint operation;
- its share of the revenue from the sale of the output by the joint operation; and
- its expenses, including its share of any expenses incurred jointly.

A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant IFRSs.

A party that participates in, but does not have joint control of, a joint operation shall also account for its interest in the arrangement in accordance with the above if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation.

**PROBLEM : 5**

**ASF Ltd and Reliance Ltd agree to manufacture goods in India and sell in UK. All manufacturing and selling activities require unanimous consent during 2019-20.**

| S.No | Paticulars | Rs lacs |
|---|---|---|
| A | Sale of goods to UK | 10 |
| B | Expenses | 9 |
| C | Machines were acquired for manufacturing of goods | 6 |
| D | Loan taken for such machinery | 1 |
| E | Ratio of sharing between ASF and Reliance Ltd | 60:40 |

1. **Whether the business of manufacturing and selling is joint arrangement ?**
2. **Prepare Extracts of SFS of ASF Ltd**

## 13. ACCOUNTING FOR JOINT VENTURES

A Joint venturer recognizes its interest as investment in accordance with **IAS 28 using equity method.**

## 14. SEPARATE FINANCIAL STATEMENTS

In Separate financial statements, joint operations will be accounted as per this standard, whereas Joint ventures will be accounted in accordance with IAS 27.

In its separate financial statements, a party that participates in, but does not have joint control of, a joint arrangement shall account for its interest in:

(a) a joint operation in accordance with this IFRS;

(b) a joint venture in accordance with IFRS 9, unless the entity has significant influence over the joint venture, in which case it shall apply IAS 27.

**PROBLEM : 6**

**ASF Ltd and Reliance Ltd formed ASF Reliance Ltd. ASF Ltd holds 60% share and Reliance holds 40%. All relevant activities are directed in accordance with contract. It requires unanimous consent. Financial Statement of ASF Reliance Ltd is :**

| P and L | Rs Lacs |
|---|---|
| Sales | 10 |
| Expenses | 9 |
| Profit | 1 |

| SOFP | Rs Lacs |
|---|---|
| NCA - PPE | 6 |
| Share Capital | 4 |
| Other Equity | 2 |

**Share capital is contributed by A and B. Prepare extracts of SFS and CFS of ASF Ltd.**

## SUMMARY

| | | |
|---|---|---|
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**Important Note :**

IFRS 11 applies only to the accounting by Joint operators, and not to the accounting by the separate vehicle that is the Joint operation.

Thus, the Financial Statements of the separate vehicle would be prepared in accordance with applicable standards.

## 15. MAJOR CHANGE IN IND AS 11 VIS-A-VIS IFRS 11 NOT RESULTING IN CARVE OUT

**Appendix C 'Business Combinations under Common Control' :** Paragraph B33D refers to the accounting specified in Appendix C 'Business Combinations under Common Control' of Ind AS 103 for the acquisition of an interest in a joint operation when the parties sharing joint control, including the entity acquiring the interest in the joint operation, are under the common control of the same ultimate controlling party or parties both before and after the acquisition, and that control is not transitory. IFRS 11 scopes out the same as IFRS 3, Business Combinations, does not deal with business combinations under common control.

# PROBLEM FOR SELF PRACTICE

**PROBLEM : 7**

**There is an arrangement in which Ram Ltd and Shyam Ltd each have 35% of the voting rights in the arrangement with the remaining 30% being widely dispersed. Decisions about the relevant activities require approval by a majority of the voting rights. Do Ram & Shyam have joint control over the arrangement?**

**SOLUTION : 7**

Ram and Shyam have joint control of the arrangement only if the contractual arrangement specifies that decisions about the relevant activities of the arrangement require both Ram and Shyam agreeing.

**PROBLEM : 8**

**Hari and Ram enter into a contractual arrangement to buy a two storied music store, which they will lease to other parties. Hari will be responsible for leasing first floor and Ram will be responsible for leasing second floor. They can make all decisions related to their respective floors and keep all of the income with respect to their floors. Ground floor will be jointly managed — all decisions and with respect to ground floor must be unanimously agreed between Hari and Ram. Discuss the applicability of IFRS 11.**

**SOLUTION : 8**

There are three arrangements:

1. First floor that Hari controls and hence will not be accounted under IFRS 11.
2. Second floor that Ram controls and thus will not be accounted under IFRS 11.
3. Ground floors that Hari and Ram jointly control is a joint arrangement (within the scope of IFRS 11).

**PROBLEM : 9**

**Company AB and Company CD enter into an agreement for the production and sale of garments. In the industry, there are three activities that will significantly make impact on the returns of the arrangement:**

1. **Production of the garments — Company AB makes all the decisions for this activity**
2. **Sales and Marketing activities — Company CD is makes all the decisions for these activities**
3. **Both the companies must approve all financial related matters**

**Discuss whether company AB and CD have joint control over the arrangement?**

**SOLUTION : 9**

In first two matters, unanimous consent is not required as long as parties are working within the approved budgets and financial constraints. Thus, the parties have liberty to perform their respective responsibilities.

Here, the parties have to examine which of the three activities most significantly affect the returns of the arrangement. If any of the first two activities determine the profits of the arrangement significantly, there is no joint control over the arrangement.

However, there may be the case where the financial policies majorly impact the execution of other two activities and hence determine the profit of the arrangement. Since unanimous consent is required for financial policies, management may conclude that there is joint control.

**PROBLEM : 10**

**Shareholders C and D form a new joint arrangement (entity CD). Entity CD's article of association including a clause stating that all shareholders must unanimously agree on the entity's relevant activities. The shareholders have not entered into any other agreement to manage the activities of entity CD. Determine whether clause in CD's articles of association is sufficient to meet the definition of joint arrangement?**

**SOLUTION : 10**

Entity CD meets the definition of a joint arrangement even though there is no separate joint venture agreement. The clause in entity CD's articles of association is sufficient for meeting the definition of a joint arrangement, provided entity CD's articles of association are legally binding.

**PROBLEM : 11**

**ECL Limited has a wholly owned subsidiary, entity B, that holds a portfolio of buildings. ECL Limited wishes to reduce its exposure to this market. It sells 50% of its investment in entity B to Investment Bank. ECL Limited and Investment Bank enter into a contractual agreement, whereby decisions regarding entity B's relevant activities are made jointly. ECL Limited continues to act as asset manager of entity B for a specified fee, and decisions are made in line with the entity B's pre- approved budgets and business plan. Is entity B jointly controlled?**

**SOLUTION : 11**

Entity B is jointly controlled, as ECL Limited and investment bank are required to agree unanimously on relevant activities, and ECL Limited must manage the entity's operations in line with these decisions.

**PROBLEM : 12**

**Three separate aerospace companies form an alliance to jointly manufacture an aircraft. They carry responsibility for different areas of expertise such as :**

- **Manufacturing engines**
- **Manufacturing fuselage and wings; and**
- **Aerodynamics**

**They carry out different parts of the manufacturing process, each using its own resources and expertise in order to manufacture, market and distribute the aircraft jointly. The three entities share the revenues from the sale of aircraft and jointly incur expenses. The revenues and common costs are shared, as agreed in the consortium contract.**

**Parties also incur their own separate costs such as labour costs, manufacturing costs, supplies, inventory of unused parts and work in progress. Each party recognizes its separately incurred costs in full. Would the arrangement be classified as joint operation?**

**SOLUTION : 12**

This arrangement is classified as a joint operation because:

- The arrangement is not structured through a separate vehicle;
- Each party has obligations for the costs it incurs separately; and
- The contractual agreement outlines that each party is entitled to a share of revenue and associated costs from the sale of aircrafts based on the pre-determined agreement.

**PROBLEM : 13**

**Two parties structure a joint arrangement in an incorporated entity. Each party has a 50 per cent ownership interest in the incorporated entity. The incorporation enables the separation of the entity from its owners and as a consequence the assets and liabilities held in the entity are the assets and liabilities of the incorporated entity.**

**I. Identify the type of arrangement?**

**II. If the parties modify the features of corporation though a contractual arrangement such that each has an interest in assets and each is liable for liabilities what type of joint arrangement would that be?**

**SOLUTION : 13**

(i) On assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle indicates that the parties have rights to the net assets of the arrangement. In this case it would be classified as joint venture.

(ii) If the parties modify the features of the corporation through their contractual arrangement so that each has an interest in the assets of the incorporated entity and each is liable for the liabilities of the incorporated entity in a specified proportion. Such contractual modifications to the features of a corporation can cause an arrangement to be a joint operation.

**PROBLEM : 14**

**Two parties, W and F form a limited company to build and use a pipeline to transport gas. Each party has a 50% interest in the company. Under their contractual terms, entities W and F must each use 50% of the pipeline capacity; unused capacity is charged at the same price as used capacity. Entities W and F can sell their share of the capacity to a third party without consent from the both investors. The Price entities W and F pay for the gas transport is determined in a way that ensures all costs incurred by the company can be recovered. The Joint arrangement is structured through a separate vehicle. Each party has a 50% interest in the company. However, the contractual terms require a specific level of usage by each party and, because of the pricing structure, and the entities have an obligation for the company's liabilities. What type of joint arrangement the company might be?**

**SOLUTION : 14**

This entity might be a joint operation despite its legal form.

**PROBLEM : 15**

**Two parties structure a joint arrangement in an incorporated entity (entity D) in which each party has a 50 per cent ownership interest. The purpose of the arrangement is to manufacture materials required by the parties for their own, individual manufacturing processes. The arrangement ensures that the parties operate the facility that produces the materials to the quantity and quality specifications of the parties. The legal form of entity D (an incorporated entity) through which the activities are conducted initially indicates that the assets and liabilities held in entity D are the assets and liabilities of entity D. The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of entity D.**

**I. What type of joint arrangement would entity D be?**

**II. Would your classification change if the parties instead of using the share of output themselves sold to third parties?**

**III. If the parties changed the terms of contractual arrangement such that entity D would be able to sell the output to third parties, would your answer be the same as in part (i) above?**

**SOLUTION : 15**

I. The legal form of entity D and the terms of the contractual arrangement indicate that the arrangement is a joint venture.

However, the parties also consider the following aspects of the arrangement:

- The parties agreed to purchase all the output produced by entity D in a ratio of 50:50. Entity D cannot sell any of the output to third parties, unless this is approved by the two parties to the arrangement. Because the purpose of the arrangement is to provide the parties with output they require, such sales to third parties are expected to be uncommon and not material.
- The price of the output sold to the parties is set by both parties at a level that is designed to cover the costs of production and administrative expenses incurred by entity D. On the basis of this operating model, the arrangement is intended to operate at a breakeven level.

  From the fact pattern above, the following facts and circumstances are relevant:
- The obligation of the parties to purchase all the output produced by entity D reflects the exclusive dependence of entity D upon the parties for the generation of cash flows and, thus, the parties have an obligation to fund the settlement of the liabilities of entity D.
- The fact that the parties have rights to all the output produced by entity D means that the parties are consuming, and therefore have rights to, all the economic benefits of the assets of entity D.

These facts and circumstances indicate that the arrangement is a joint operation.

ii. The conclusion about the classification of the joint arrangement in these circumstances would not change if, instead of the parties using their share of the output themselves in subsequent manufacturing process, the parties sold their share of the output to third parties.

iii. If the parties changed the terms of the contractual arrangement so that the arrangement was able to sell output to third parties, this would result in entity D assuming demand, inventory and credit risks. In that scenario, such a change in the facts and circumstances would require reassessment of the classification of the joint arrangement.

**PROBLEM 16:**

**P and Q form a joint arrangement PQ using a separate vehicle. P and Q each own 50% of the Capital in PQ. However, the contractual terms of the joint arrangement state that P has the rights to all of Machinery and the obligation to pay Bank Loan in Q. P and Q have rights to all other assets in PQ, and obligations for all other liabilities in PQ in proportion to their capital share (i.e., 50%).**

**PQ's SOFP is as follows:**

| **SOFP** | | | |
|---|---|---|---|
| **Laibilities** | **Rs** | **Assets** | **RS** |
| Capital | 1,50,000 | Machinery | 2,50,000 |
| Bank Loan | 75,000 | Cash | 50,000 |
| Other Loan | 75,000 | | |
| | **3,00,000** | | **3,00,000** |

**What would you record in P's financial statements to account for its rights and obligations in PQ?**

**SOLUTION : 16**

Under IFRS 11, we would record the following in its financial statements, to account for its rights to the assets in PQ and its obligations for the liabilities in PQ.

| | |
|---|---:|
| Machinery | 250,000 |
| Cash | 25,000 |
| Capital | 75,000 |
| Bank Loan | 75,000 |
| Other Loan | 32,500 |

**PROBLEM : 17**

**Entity C and entity D operates in a telecommunication industry and entered into a joint arrangement in order to combine their 4G access networks. The purpose of this arrangement is to reduce operating cost for both parties, make capital infrastructure savings and obtain economies of scale from jointly managing and maintaining a consolidated network.**

**All significant decisions about strategic investing and financing activities are decided by a simple majority of the voting rights. Entity C and entity D each have one vote in the decision making process.**

**Discuss whether it is a joint arrangement or not.**

**SOLUTION : 17**

All decisions about the relevant activities require consent of both parties, so the arrangement is a joint arrangement. The contractual arrangement does not explicitly require unanimous consent, but the fact that all decisions must be made by majority leads to implicit joint control.

**PROBLEM : 18**

**NFG Limited is owned by numerous shareholders with the following holdings:**

- **Shareholders N owns 51%**
- **Shareholders F owns 30%**
- **The rest of the shares are widely held by other investors, altogether 19%.**

**NFG Limited's articles of association require a 75% majority to approve decisions about any of the entity's relevant activities. They also outline that each shareholder is entitled to vote in proportion to its respective ownership interest. Is NFG ltd jointly controlled?**

**SOLUTION : 18**

NFG Limited is jointly controlled by shareholders N and F. based on their ownership interest (collectively 81%), they must act together to make decisions regarding NFG Limited's relevant activities. Shareholder N does not control NFG Limited, as it cannot unilaterally make decisions because a 75% majority is required.

**PROBLEM : 19**

**Two entities, E and F, set up an entity and sign a joint operating agreement. The board contains three directors appointed by and representing each entity. The board is the entity's main decision-making body. Decisions are made by simple majority. Each party has a 50% interest in the net profit generated. Discuss whether the entity is jointly controlled by E & F.**

**SOLUTION : 19**

Entities E and F are likely to have joint control, because each party has a 50% interest in net profit and both have a right to appoint three directors. This is because the three directors representing a single shareholder would generally be presumed to vote in accordance with the wishes of that shareholder. So the consent of both entity E and entity F would be required for decision making, and this would represent joint control.

However, if the directors are not obliged to represent one shareholder, decisions will be made by simple majority. It is possible that (say) one director of shareholder E agrees with three directors of shareholder F and takes a decision that is against the interest of shareholder E. Although this is expected to be unlikely in practice, such a situation would not represent joint control.

All relevant facts have to be considered before reaching such a conclusion.

**PROBLEM : 20**

**Entities P and Q set up a joint venture company, entity PQ by signing a joint operating agreement. Both investors delegate one director to entity PQ's board of directors. Both directors have to agree unanimously on the decisions on the annual budget. The joint operating agreement also sets up an operating committee and specifies power delegated by the board of directors to the committee.**

**The operating committee has the main operational decision-making responsibility. Decisions are made by simple majority in this committee. Only entity P can appoint members to the operating committee.**

**Discuss if Entity PQ is a joint arrangement or not.**

**SOLUTION : 20**

Entity PQ is not a joint arrangement; entity P has control over entity PQ. Decisions about relevant activities are not made at the board of directors level but at the operating committee level. Entity P has control over the operating committee because it can appoint its members. The fact that the directors have veto rights over the annual budget is important, but the operating committee in this example has the power to control entity PQ's relevant activities.