PwC Reporting*InBrief*

Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 12

In brief

The Ind AS Implementation Committee of Institute of Chartered Accountants of India (ICAI) constituted the Ind AS Transition Facilitation Group (ITFG) to address issues faced by preparers, users and other stakeholders on applicability and implementation of Ind AS. ITFG issues clarifications in the form of periodic bulletins.

This *InBrief* provides an overview of the clarifications issued by the ITFG in its Bulletin 12.

Let's talk

1. Immovable property such as land or building which meet the definition of property, plant and equipment (PP&E) as per Ind AS 16, *Property, Plant and Equipment* shall be subsequently measured at cost or revaluation model. If an item of PP&E is revalued, the entire class of PP&E to which that asset belongs needs to be revalued. Immovable properties which meet the definition of investment property as per Ind AS 40, *Investment Property* shall be subsequently measured at cost only.

2. Where a first time adopter of Ind AS has elected to apply fair value as the deemed cost of an item of PP&E, then government grant related to that asset needs to be recognised on the date of transition by setting up the grant as deferred income. The resulting adjustment will be made in retained earnings or, if appropriate, another category of equity at the date of transition to Ind AS.

3. Para D7AA of Ind AS 101, *First-time adoption of Ind AS* permits an entity to continue with previous Indian GAAP carrying values as the deemed cost for all of the items of PP&E. Any intra-group profits or losses forming part of the deemed cost needs to be eliminated while preparing consolidated financial statements of the parent entity.

4. Previous GAAP carrying value used as the deemed cost under Ind AS 101 can only be adjusted for those adjustments which are consequential and arise as a result of applying the transition requirements of Ind AS 101.

5. Where a loan borrowed from one bank has been prepaid by availing a new loan from another bank, the prepayment would result in extinguishment of the old loan. The prepayment premium paid shall be recognised in profit or loss as part of the gain or loss on extinguishment of the loan. Loan processing fees paid on the origination of the new loan will be included in the computation of the effective interest rate (EIR) of the new loan.

6. The branch office of a foreign company established in India is not incorporated under the Indian Company Law. It is only an establishment of a foreign company in India. The Branch office is just an extension of the foreign company in India. Accordingly, the branch office of a foreign company is not required to comply with Ind AS.

7. Where a first-time adopter has applied the exception under para B10 of Ind AS 101, then it shall not recognise the benefit of government loan at below-market rate of interest as a government grant with respect to government loans existing on the date of transition. Previous Indian GAAP carrying amount of the government loan on the date of transition shall be the carrying amount under Ind AS. The exception available under para B10 of Ind AS 101 also applies to sales tax deferral schemes.

8. Entities should evaluate the terms and conditions of the comfort letter to assess whether it can be considered as a financial guarantee as per Ind AS 109, *Financial Instruments*. A comfort letter shall be accounted as a financial guarantee contract if it creates a contractual obligation to make specified payments to the holder of the guarantee in case of default by the specified debtor.

9. Financial guarantee issued shall be initially recognised at fair value. Where the financial guarantee has been issued on arms-length terms, fair value is likely to be equal to the commission received. Financial guarantee should subsequently be measured at the higher of the amount of loss allowance as per Ind AS 109 and the amount initially recognised less cumulative amount of income recognised in accordance with Ind AS 18, *Revenue*.

10. Where a first-time adopter has availed the business combination exemption under Appendix C of Ind AS 101, the deemed cost of the financial assets and liabilities (acquired as part of the past business combination) for Ind AS shall be their carrying amounts in accordance with the previous Indian GAAP immediately following the business combination.

11. Where the date from which the amalgamation is proposed to be effected in the books of the accounts of the amalgamated company is different from the acquisition date as per Ind AS 103, *Business Combinations,* the auditor shall state this fact in the certificate as required to be issued under Section 232 (3) of the Companies Act, 2013. If National Company Law Tribunal (NCLT) approves the scheme of amalgamation with a different appointed date as compared to the acquisition date as per Ind AS 103, the appointed date approved by the NCLT will be the acquisition date.

In detail

1. Subsequent measurement of immovable property

Subsequent measurement of immovable property such as land and/or building depends on whether such immovable property meets the definition of PP&E as per Ind AS 16 or investment property as per Ind AS 40. PP&E 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. On the other hand, investment property is a property (land or a building or part of a building or both) held to earn rentals or for capital appreciation or both rather than for use in the production or supply of goods or services or for administrative purposes or sale in the ordinary course of business.

An entity can adopt either the cost or revaluation model for subsequent measurement of PP&E. The policy choice is by class of assets, not individual assets within a class. An entity may therefore have one or more classes of assets on a cost basis and other classes of assets on the revaluation basis.

Where the immovable property meets the definition of investment property as per Ind AS 40, it shall be subsequently measured at cost only.

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> A class of assets is a grouping of assets of a similar nature and use in an entity's operations. An entity can adopt meaningful classes that are appropriate to the type of business and assets held by an entity. Examples of classes of assets given in Ind AS 16 include:
>
> a. Land;
> b. Land and building;
> c. Machinery;
> d. Ships;
> e. Aircraft;
> f. Motor vehicles;
> g. Furniture and fittings;
> h. Office equipment; and
> i. Bearer plants.
>
> The definition of PP&E does not permit classes of assets to be determined solely on a geographical basis, but is otherwise reasonably flexible. In the consolidated financial statements, the items of PP&E in the same class across different entities in the group need to be accounted for on a consistent basis.
>
> Ind AS 101 requires a first time adopter of Ind AS to use the same accounting policies in its opening balance sheet and throughout all periods presented in its first Ind AS financial statements. Accordingly, whichever accounting policy is adopted by a first time adopter for subsequent measurement of its PP&E, the same needs to be applied consistently throughout all periods presented in the first Ind AS financial statements.

2. Recognition of government grants related to PP&E on date of transition

Ind AS 101 does not provide any exemption/exception with respect to government grant related to asset (other than government loans at below market interest rate). Accordingly, government grant related to PP&E shall be recognised as at the transition date by setting up the grant as deferred income. If an entity had deducted the government grant from the carrying value of the PP&E under the previous GAAP and elects to measure such PP&E at its fair value as deemed cost on the date of transition, then any consequential adjustment related to recognition of government grant shall be recognised in retained earnings or if appropriate, another category of equity. No adjustment with respect to recognition of government grant shall be made to the fair value of PP&E. This is because fair value is determined as per Ind AS 113, *Fair Value Measurement* which is the exit price that would be received to sell an asset in an orderly transaction. Fair value is a market based measurement, not an entity-specific measurement and accordingly, the fair value of an asset is independent of the government grant received.

3. Previous GAAP deemed cost of PP&E

The ITFG issued two clarifications related to use of previous GAAP carrying values of PP&E as the deemed cost on the date of transition.

i. Elimination of intra-group profits or losses: If an entity chooses to use the previous GAAP carrying values of the PP&E as the deemed cost on the date of transition, then any intra-group profits or losses[1] included in the previous GAAP carrying values should be eliminated in the consolidated financial statements.

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Consider an example:
Company P is holding 49% voting rights in Company A and the remaining shareholders of Company A are widely dispersed. Company A was considered an associate of Company P under previous Indian GAAP. Under Ind AS, considering the principles of de-facto control, it has been concluded that Company A is a subsidiary of Company P. Prior to the transition date, Company P sold freehold land to Company A for 100 crore INR with profit of 10 crore INR.

At what value should the land be recognised in the opening Ind AS consolidated balance sheet of Company P, if P has elected to use previous GAAP carrying value of PP&E as the deemed cost.

Response:
Para D7AA of Ind AS 101 states that a first-time adopter to Ind AS may elect to continue with previous GAAP carrying values of all of its PP&E as the deemed cost on the transition date. In the consolidated financial statements, previous GAAP amounts of subsidiary shall be that amount used in preparing and presenting consolidated financial statements. *Where a subsidiary was not consolidated under previous GAAP, the amount required to be reported by the subsidiary as per previous GAAP in its individual financial statement shall be previous GAAP amount*. No further adjustment to the deemed cost shall be made for transition adjustments that might arise from application of other Ind Ass.

Since Company A was not consolidated by Company P under the previous Indian GAAP, basis application of the above requirements of para D7AA of Ind AS 101, previous GAAP carrying values would be determined to be 100 crore INR based on the individual financial statements of Company A, which in the given facts also includes 10 crore INR of intra-group profit. Para B86 of Ind AS 110, *Consolidated Financial Statements* requires intra-group profits or losses recognised in assets such as inventory and fixed assets should be eliminated in full. Accordingly, considering clarification of ITFG, Company P shall recognise freehold land in the consolidated financial statements at 90 crore INR (after elimination of intra-group profits of 10 crore INR).

ii. Where Ind AS 101 requires retrospective application of Ind AS in respect of an asset and/or liability with corresponding impact on another item of asset and/or liability for which previous GAAP deemed cost exemption has been applied, then in such cases, the previous GAAP carrying amounts shall be adjusted since those adjustment are only consequential and arises because of application of the transition requirements of Ind AS 101. No further adjustment should be made due to application of other Ind AS.

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Through this clarification, ITFG has reiterated that previous GAAP deemed cost of PP&E shall be adjusted for only those adjustments which are consequential and arise on account of application of transition requirements of Ind AS 101. Examples of such adjustments would include:

(i) recognition of government grant related to PP&E as deferred income, which was deducted from the carrying value of PP&E under the previous Indian GAAP
(ii) unamortised amount of processing fees related to borrowings which was capitalised under the previous Indian GAAP as part of PP&E, which however under Ind AS is required to be adjusted from carrying value of the loan to arrive at its amortised cost under Ind AS 109.

4. Accounting for extinguishment of liability

Where an entity has prepaid the original bank loan by taking a new loan from another bank, the original loan shall be derecognised and accounted for as an extinguishment. The difference between carrying amount of the loan extinguished and the consideration paid (including liabilities assumed) shall be recognised in profit or loss as gain or loss on extinguishment. Any costs or fees incurred on extinguishment such as prepayment premium paid shall be recognised in profit or loss as part of the gain or loss on extinguishment. Loan processing fees which solely relates to the origination of

[1] *Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements.*

the new loan shall be considered as transaction cost and will be included in the calculation of effective interest rate of the new loan as per Ind AS 109.

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Consider an example:
ABC Ltd had obtained a loan from Bank A in April 2016 amounting to 100 crore INR repayable after 5 years. ABC Ltd incurred processing fees of 5 crore INR on such loan from Bank A. In April 2017, ABC Ltd. obtains a fresh loan from Bank B and prepaid the earlier loan obtained from Bank A. The processing fees on the new loan is 2 crore INR. The prepayment premium is 1% of the loan amount. The carrying value of the loan from Bank A on the date of prepayment is 96 INR crore (net of unamortised loan processing fees).

How should the transaction be accounted for in the books of ABC Ltd.?

Response:
Since ABC Ltd has prepaid the loan from Bank A by taking a new loan, the original loan shall be derecognised and accounted for as an extinguishment. Difference between consideration paid of 100 crore INR and the carrying value of the loan prepaid of 96 crore INR shall be recognised in profit or loss as loss on extinguishment of loan (i.e. 4 crore INR). Prepayment premium of 1% of the loan amount (i.e. 1 crore INR) shall also be recognised in profit or loss as part of the loss on extinguishment of loan.

The loan processing fees of 2 crore INR incurred on the origination of the new loan from Bank B represents the transaction costs arising on origination of such new loan, and accordingly shall form part of the effective interest rate of the new loan from Bank B.

5. Applicability of Ind AS

The branch office of a foreign company established in India is not incorporated under the Indian Company Law. It is just an extension of the foreign company in India. Accordingly, the branch office of a foreign company is not required to comply with Ind AS.

6. Government loan with a below market rate of interest

Government loan with a below market rate of interest is required to be measured at fair value on initial recognition. The difference between proceeds received and initial carrying value of the loan is recognised as government grant under Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance.*

Ind AS 101 para B10 provides an exception to first-time adopters to apply the requirements of Ind AS 20 prospectively to government loans existing at the date of transition to Ind AS. Accordingly, in such situations entities need not recognise the corresponding benefit of any below market rate of interest as a government grant.

Consequently, if a first-time adopter did not, under the previous Indian GAAP, recognise and measure a government loan in accordance with Ind AS 20, it uses such loan's previous Indian GAAP carrying amount at the date of transition to Ind AS to be the loan's carrying amount in the opening Ind AS balance sheet. The entity applies Ind AS 109 to the measurement of such loans after the date of transition to Ind AS.

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Consider an example:
Entity A received a government loan of 100 crore INR from the state government in 2014. The loan is repayable at the end of 4 years and carries no interest. Under the previous Indian GAAP, the loan was carried at 100 crore INR and no benefit of below market rate of interest was separately recognised as government grant. How should entity A account for such loan at the date of transition to Ind AS?

Response:
If entity A applies the exception of para B10 of Ind AS 101, it shall measure the loan at the date of transition to Ind AS at its previous Indian GAAP carrying amount (i.e. 100 crore INR). The carrying value at the date of transition is the starting point to compute effective interest rate on the loan. Since the loan is repayable at par, the effective interest rate of the loan is 0%.

ITFG also clarified that the exception mentioned in para B10 of Ind AS 101 shall also be applicable to sales tax deferral schemes. Under such schemes, the amount of sales tax collected is retained and is required to be repaid after specified years. This makes such an arrangement similar to an interest free loan from the government. Accordingly, the above exception shall apply to amounts collected and remaining payable at the date of transition.

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In respect of sales tax collected and repayable after the date of transition, the entity would apply provisions of Ind AS 20, and separately record benefit of any below market rate of interest as a government grant.

7. Comfort letter

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. A comfort letter shall be accounted as a financial guarantee contract if it creates a contractual obligation to make specified payments to the holder of guarantee in case of default by the specified debtor. As such the contract may not necessarily be called as financial guarantee contract and it may take any name or legal form, however the treatment will be same as that of a financial guarantee contract. If a contract legally meets these requirements, then it would be accounted for as the financial guarantee contract as per Ind AS 109.

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Consider an example – Parent provides a comfort letter to a subsidiary
A subsidiary of a group takes out a loan with a bank. The parent provides a comfort letter to the subsidiary such that if the subsidiary fails to repay the loan to the bank when due, the parent will pay on its behalf. Is the comfort letter a financial guarantee contract?

Response:
No. The comfort letter simply constitutes an undertaking given by the parent to its subsidiary that, in the event the subsidiary fails to repay the loan to the bank when due, the parent will step in and discharge the subsidiary's debt. This is not a financial guarantee contract as the parent has not provided any guarantee to the bank (nor would the bank be able to enforce payment under what is effectively a private arrangement between the parent and its subsidiary) to repay the loan if the subsidiary defaults.

8. Accounting of financial guarantee contract

A financial guarantee contract issued is initially recognised at fair value. In case of a financial guarantee contract on arm's length basis, fair value of the contract is likely to equal the commission received. Subsequently, financial guarantee shall be measured at the higher of the amount of the expected credit loss determined in accordance with Ind AS 109 and the amount initially recognised less cumulative amount of income recognised in accordance with Ind AS 18.

9. Deemed cost of financial assets and liabilities acquired as part of business combination

Ind AS 101 does not contain transitional relief for financial instruments and requires the application of Ind AS 109 retrospectively. Where an entity elects to apply the business combination exemption of Ind AS 101 to not restate past business combination, carrying amount in accordance with the previous Indian GAAP immediately following the business combination is the deemed cost of the financial assets and liabilities acquired in a past business combination. Fair value or amortised cost for the financial instruments acquired in a past business combination shall be determined from the date of business combination and not from the date of origination of such financial instrument.

If the acquired financial instruments are classified as fair value through profit or loss/fair value through other comprehensive income, then such instruments should be measured at fair value at the date of transition to Ind AS. If these instruments are classified as amortised cost, then the entity determines the carrying amount on the transition date by taking the carrying amount of the loan at the date of business combination under the previous Indian GAAP and then applying the effective interest rate after considering the amount and timing of expected settlement of such financial instrument.

10. Acquisition date for business combination and impact on auditors certificate

For a business combination other than under common control, the date of acquisition is the date from which the acquirer obtains control of the acquiree. For business combination under common control, entities are required to restate the financial information in the financial statements in respect of the prior periods as if the business combination had occurred from the beginning of the preceding period in the financial statements. In case where the auditor is of the view that as per the proposed accounting treatment, the date from which amalgamation is effected in the books of accounts of the amalgamated company is different from the acquisition date as per Ind AS 103, *Business Combinations*, the auditor shall state the same in the certificate as required to be issued under Section 232 (3) of the Companies Act, 2013. If the National Company Law Tribunal (NCLT) approves the scheme of amalgamation with a different appointed date as compared to the acquisition date as per Ind AS 103, the appointed date approved by the NCLT will be the acquisition date. In such situations, the company should provide appropriate disclosures and the auditor should consider the requirements of relevant auditing standards.

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In accordance with para 9 of Ind AS 103, acquisition date is defined as '*the date on which the acquirer obtains control of the acquiree, which is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date*'.

The date on which control passes is a matter of fact and is to be determined after considering all pertinent facts and circumstances, including any substantive regulatory or shareholder approvals.

The International Accounting Standards Board (IASB) also acknowledged in its basis for conclusion of IFRS 3 Business Combinations, that for convenience an entity might wish to designate an acquisition date of the end (or the beginning) of a month, date on which it closes its books, rather than the actual acquisition date during the month. Unless events between the 'convenience' date and the actual acquisition date result in material changes in the amounts recognised, that entity's practice would comply with the requirements of IFRS 3.

Accordingly, preparers to consider the above guidance of the ITFG and Ind AS 103 while drafting the accounting treatment in the schemes involving business combination to be filed with NCLT for approval.

The takeaway

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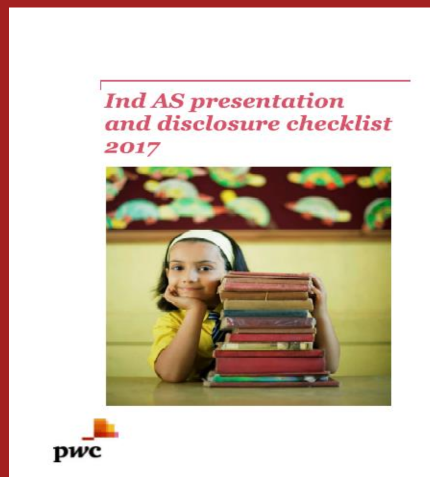
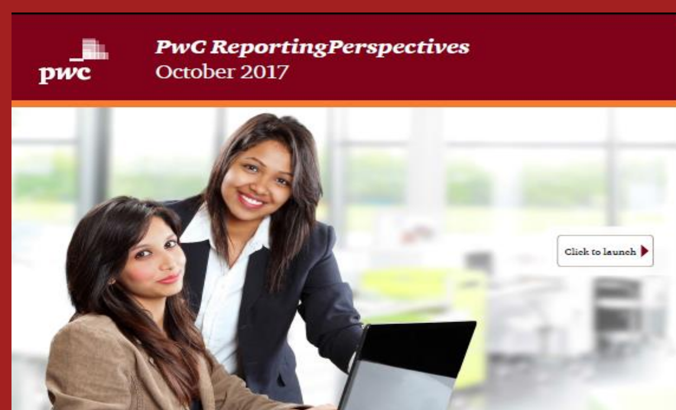
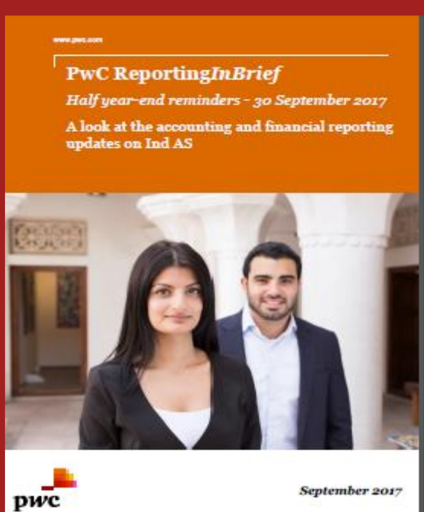
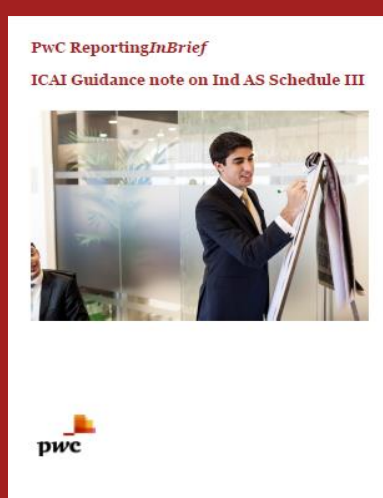
Clarifications by ITFG is useful for the companies and other stakeholders as they navigate their journey through Ind AS. The current bulletin provides clarity on some of the key issues commonly faced by the stakeholders such as acquisition date for business combinations, previous GAAP deemed cost of PP&E, accounting of below-market rate of interest loan from government, accounting of comfort letter and financial guarantee. This will promote consistency in interpretation and implementation of Ind AS. Entities should however exercise judgement and carefully evaluate the ITFG clarifications whilst applying them to their specific facts and circumstances.

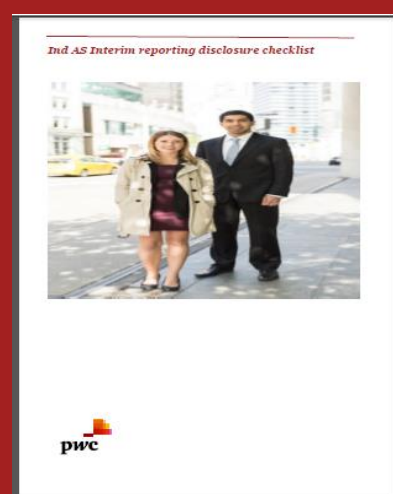
Previous publications











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