PwC Reporting*InBrief*

Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 14

In brief

The Ind AS Implementation Committee of the 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 14 and our insights on these clarifications and related interpretative issues.

Let's talk

- Loan processing fees is considered as an integral part of the effective interest rate (EIR) of a borrowing. Where such borrowing is in connection with the construction or acquisition of a qualifying asset, processing fees to the extent amortised as per the EIR method, shall be capitalised as part of the cost of the asset till the period of capitalisation permitted under Ind AS 23, *Borrowing Costs*.
- Accounting for site restoration cost in case of a leasehold land depends on whether the lease is a finance or an operating lease.
    (i) If the lease is determined to be a finance lease, present value of the estimated restoration costs shall be capitalised on initial recognition along with the property, plant and equipment (PP&E) and a corresponding liability shall be recognised. PP&E along with the capitalised restoration costs shall be depreciated over the estimated useful life. .
    (ii) If the lease is determined to be an operating lease, present value of the estimated restoration costs to remove the leasehold structure or improvement shall be capitalised with the leasehold structure or improvement and depreciated over the lease term or the estimated useful life of the structure or improvement, whichever is lower.
- Where advances received from customers for supply of goods or services constitute a significant financing component, entity shall adjust the consideration (including advance payments) for the effects of time value of money.
- Preference shares which are redeemable or convertible at issuer's option with discretionary dividend shall be classified as equity provided the conversion option is substantive. This is because the issuer has the ability to avoid making cash payment or settling the instrument through issue of variable number of its own shares.
- Court or National Company Law Tribunal (NCLT) order approving a scheme of amalgamation involving entities under common control with retrospective effect, subsequent to the balance sheet, is an adjusting subsequent event.
- Financial instruments which are held as stock-in-trade shall be recognised and measured in accordance with Ind AS 109, *Financial Instruments* and presented in accordance with Ind AS 32, *Financial Instruments: Presentation*. Disclosures in accordance with Ind AS 107, *Financial Instruments: Disclosures* shall also be provided in respect of such financial instruments.
- Where an entity upon transition elects to apply fair value as the deemed cost of the PP&E or Ind AS 16, *Property, Plant and Equipment* retrospectively and subsequently measures the PP&E based on the revaluation model as per Ind AS 16, then any revaluation surplus recognised in accordance with previous Indian GAAP shall be transferred to retained earnings or another category of equity. Revaluation gain or loss as determined as per Ind AS 16 shall be recognised on the date of transition to Ind AS in equity as revaluation reserve. Any subsequent changes in revaluation after the date of transition to Ind AS shall be recognised in other comprehensive income.

In detail

1. **Accounting of processing fees incurred on borrowings specific to a qualifying asset**

As per Ind AS 23, borrowing costs include interest expense calculated using the EIR method as described in Ind AS 109. As per Ind AS 109, in applying EIR method, an entity identifies fees that are an integral part of the EIR of a financial instrument such as loan origination fees. Such fees are treated as an adjustment to the EIR, unless the financial instrument is measured at fair value through profit or loss. Accordingly, where a borrowing is measured at amortised cost, processing fees incurred to avail the borrowing shall form part of the EIR. Where such borrowing is in connection with a qualifying asset, processing fees to the extent amortised as per the EIR method, shall be capitalised as part of the cost of the asset till the period of capitalisation permitted under Ind AS 23.

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As per Ind AS 109, origination fees paid on issuing financial liabilities measured at amortised cost is integral part of the EIR and are treated as an adjustment to the EIR. Loan origination fees might consist of:
i. Fees that are charged to the borrower as 'pre-paid' interest or to reduce the loan's nominal interest rate (explicit yield adjustments).
ii. Fees to compensate the lender for origination activities, such as: evaluating the borrower's financial condition; evaluating and recording guarantees, collateral and other security arrangements; negotiating the instrument's terms; preparing and processing documents; and closing the transaction.
iii. Other fees that relate directly to the loan origination process (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly).

Let's understand the accounting treatment of loan processing fees by way of an example:

Company A obtains a loan of 10 million INR for construction of a factory on 1 April 2016 from a bank with interest rate of 8% per annum. Company A incurs loan processing fees of 0.7 million INR. The loan is measured at amortised cost and is repayable on 31 March 2019. The factory is ready for its intended use on 31 December 2017. Assuming that the conditions specified by Ind AS 23 for capitalisation of borrowing costs are met, how should the loan processing fees be accounted?

Response:
The processing fees charged by the bank is an integral part of obtaining the loan and shall be treated as an adjustment to the EIR of the loan. The EIR is the rate which discounts all of the cash outflows (that is, annual interest payments of 0.8 million INR for three years and the principal repayment of 10 million INR at the end of tenure of the loan) to the loan's present value of 9.3 million INR (10 million INR less loan processing fees of 0.7 million INR). In this case, the EIR computed by a discounted cash flow calculation is approximately 10.86% per annum, and so Company A recognises borrowing costs at 10.86% per annum applying the EIR method. Since the loan is in connection with a qualifying asset, such borrowing costs shall be capitalised with the cost of the factory till it is ready for its intended use i.e. 31 December 2017. Borrowing costs after 31 December 2017 shall be charged to profit or loss.

2. Accounting of site restoration cost in case of a leasehold land

Accounting of site restoration cost in case of leasehold land depends on whether lease is a finance lease or operating lease as per Ind AS 17, *Leases*.

(i) Lease is determined to be a finance lease: Ind AS 16 states that cost of an item of PP&E includes initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. Accordingly, site restoration cost that is expected to be incurred at the end of the lease term shall be capitalised along with the PP&E with a corresponding obligation recognised as a provision as per Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*. The amount to be recognised as provision for site restoration cost under Ind AS 37 is the best estimate of the expenditure required to settle the obligation discounted to the present value when the effect of time value of money is material. The PP&E including the site restoration costs shall be depreciated over the estimated useful life while the discounted provision is progressively unwound, with the unwinding charge shown as a finance cost. Capitalisation of such finance cost is not permitted under Ind AS 23.

(ii) Lease is determined to be an operating lease: Where an entity constructs an asset or a structure on leasehold land and it is required to be removed or dismantled at the end of the lease term, it shall recognise a provision for the removal obligation since it has a present obligation to remove the improvements at the end of the lease term. In such case, the entity shall capitalise the leasehold building or improvements along with the associated removal obligation and depreciate it over the lower of its estimated useful life or the lease term.

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Let's understand the accounting of site restoration costs by way of an example:

Entity A obtains a land under an operating lease for a term of 30 years. It constructs a factory building on the land for 1,000 million INR having a useful life of 30 years. Entity A subsequently measures its PP&E at cost. As per lease agreement, Entity A is expected to restore the land to its original condition at the end of the tenure. It has estimated, using existing technology, that the cost of site restoration will be 200 million INR at the end of useful life. For the purpose of this example, it has been assumed that the obligation arises on day 1 and will be paid out at the end of 30th year. It has also been assumed that the risk-free rate is 4.5% and it does not change throughout the tenure. How should the site restoration liability be accounted by entity A?

Response:
The present value of the site restoration obligation is 53.40 million INR, using a discount rate of 4.5%. The cost of the building on such leasehold land should be recorded at 1,053.40 million INR, which includes cost of construction of the factory building and initial estimate of cost of site restoration. The cost of 1,053.40 million INR should then be depreciated over the period of 30 years, resulting in an annual depreciation charge of 35.11 million INR (of which 1.78 million INR per annum relates to capitalised site restoration obligation) using the straight line method.

The site restoration obligation increases over the years due to the unwinding of discount. The unwinding of the discount is presented as finance cost in the statement of profit and loss.

Initial estimate of the restoration cost is re-estimated at every period end. For example, management may consider developments in technology to revise its initial estimate of the restoration obligation.

Although there is no specific guidance in Ind AS 37, Appendix A to Ind AS 16 requires changes in the estimated cost of decommissioning or changes in the discount rate to be added to or deducted from the cost of the asset and to be depreciated prospectively over its remaining useful life. This method is consistent with the accounting for other changes in estimates dealt in Ind AS 16.

Any amount deducted from the cost of the asset must not exceed the asset's carrying amount. Any excess should be recognised immediately in the statement of profit and loss. Management will also need to consider whether any increase in the asset's carrying amount is recoverable, in which case the asset needs to be tested for impairment.

3. Discounting of advance payment received from a customer for goods or services

Ind AS 18, *Revenue* requires entities to measure revenue at the fair value of consideration received or receivable. In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. When the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest-free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

Drawing parallel with the above guidance, ITFG has clarified that when an entity receives advance payment from a customer for providing goods or services, then it should evaluate whether the payment terms provide it with a significant benefit of financing. In making such evaluation, judgement should be exercised and consideration should be given to factors such as whether, the arrangement has been entered in the normal course of business, the advance payment is as per the typical payment terms within the industry and having a primary purpose other than financing, it is a security for future supply of limited goods or services or other relevant factors depending on the facts and circumstances of each case. Where it is concluded that arrangement does constitute a significant financing component, the consideration (including advance payment) received from the customer should be adjusted for time value of money.

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Basis above ITFG guidance, it appears that if there is a significant time lag between when the good or services are to be provided and when the advance consideration is received, entities need to evaluate whether advance includes a significant financing element. If there is a significant financing element, it is necessary to adjust the consideration for time value of money so as to arrive at the fair value of the consideration. As clarified by ITFG, all relevant facts and circumstances should be considered to evaluate whether the arrangement constitutes a significant financing component. There may be instances where there is a time lag between the payment dates and provision of goods or services, however it may not contain a financing element, for example where the upfront payment is to secure supply of the product or when the timing of delivery of goods or services is at the discretion of the customer.

Let's understand the accounting where the advance consideration constitutes a significant financing component:

Entity A is manufacturer of machinery. It provides customers with the following payment alternatives:
(i) Customer can pay the invoice price of 2 million INR when the machinery is delivered in 2 years' time; or
(ii) Customer can pay 1 million INR upfront as deposit and make a final payment of 0.75 million INR when the machinery is delivered

If the customer chooses to pay up-front deposit, how should entity A measure the revenue under Ind AS 18 and the deposit liability?

Response:

The upfront deposit is not only a payment for the machinery but also provides financing to entity A. Entity A shall record deposit liability of 1 million INR and record interest expense thereon over the 2 year period at the interest rate implicit in the arrangement (i.e. 12% per annum.). Revenue of 2 million INR shall be recognised in year 2 when the machinery is delivered. Accounting to be followed in each year is provided below:

Year 1
Entity A shall recognise interest expense of 0.12 million INR on the deposit of 1 million INR (1 million INR x 12%). The carrying value of the deposit at end of year 1 shall be 1.12 million INR.

Year 2
Entity A shall recognise interest expense of 0.13 million INR on the carrying value of the deposit of 1.12 million INR (1.12 million INR x 12%). The carrying value of the deposit at end of year 2 shall be 1.25 million INR. On delivery of the machinery, Entity A shall recognise revenue of 2 million INR (which shall consists of carrying value of the deposit of 1.25 million INR and final payment from the customer of 0.75 million INR).

The above view expressed by ITFG is aligned with IFRS 15, *Revenue from Contracts with Customers* which requires effect of significant financing component to be considered in both situations i.e. where payments from the customer are in advance or in arrears of performance. In contrast, IAS 18/Ind AS 18, *Revenue* does not specifically address situations where the consideration is received in advance. Accordingly, the ITFG has provided the above interpretative guidance.

Interestingly, the International Financial Reporting Interpretations Committee (IFRIC) discussed the concept of accruing interest on advance payments from customers while drafting IFRIC 18, *Transfers of assets from customers* and noted that paragraph 11 of IAS 18 requires taking time value of money into account only when payment are deferred.

4. Classification of preference shares redeemable or convertible at the option of the issuer with discretionary dividend

As per paragraph 16 of Ind AS 32, a financial instrument shall be classified as equity instrument only if both of the conditions below are met:

(a) The instrument includes no contractual obligation:
- (i) to deliver cash or another financial asset to another entity; or
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

(b) If the instrument will or might be settled in the issuer's own equity instruments, it is:
- (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
- (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Accordingly, preference shares issued by the subsidiary to its parent which at the option of the subsidiary are either redeemable in cash or convertible into fixed number of equity shares of the subsidiary and carry discretionary dividend shall be classified as equity instrument in the books of the subsidiary, provided the conversion option is substantive. In such case, the subsidiary has an unconditional ability to avoid making a cash payment or settling the preference shares by issuing variable number of its own equity shares.

The parent shall classify the preference shares as an investment in subsidiary in its separate financial statements and shall measure the same at cost or fair value, as per the accounting policy selected by the parent as per Ind AS 27, *Separate Financial Statements*. In the consolidated financial statements of the parent, the transaction shall be eliminated.

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The above ITFG clarification assumes that the conversion option is substantive. Where the conversion option is not considered substantive, guidance in Ind AS 32, paragraph 20(b) shall apply.

Ind AS 32 paragraph 20(b) states that a financial instrument is a financial liability if it provides that, on settlement, the entity will deliver either cash or another financial asset or its own shares whose value is determined to exceed substantially the value of cash or other financial asset. Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will have little choice but to redeem the obligation in cash; the holder has been guaranteed, in substance, receipt of an amount that is at least equal to the cash settlement option. The instrument is a financial liability.

5. Accounting of financial instruments held as stock-in-trade

Ind AS 2, *Inventories* applies to all inventories except financial instruments. A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Ind AS 109 applies to all types of financial instruments with certain exceptions as envisaged in paragraph 2 of Ind AS 109. Accordingly, the principles of recognising and measuring financial instruments are governed by Ind AS 109, its presentation is governed by Ind AS 32 and the disclosures are prescribed in Ind AS 107, even if these instruments are held as stock-in-trade by a company.

PwC Insights:
Paragraph BA.7 of Ind AS 109 states that trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin. Equity instruments that are held for trading are required to be classified as fair value through profit or loss as per Ind AS 109.

6. Accounting of scheme of amalgamation involving entities under common control approved after balance sheet date with a retrospective effect

Where the court or NCLT order approves a scheme of amalgamation involving entities under common control with retrospective effect subsequent to the balance sheet date but before the approval of financial statements by the board of directors, the effective date for accounting is prior to the balance sheet date, because the court or NLCT's approval is an event that provide additional evidence to assist the estimation of amounts of assets and liabilities that existed at the balance sheet date. As such, an adjusting event has occurred which requires adjustment to the assets and liabilities of the transferor company which are being transferred. For example, company A is entering into a scheme of amalgamation with its subsidiary for merger of the subsidiary with itself. Company A obtains approval of the NCLT in April 2018, which is after the year end of 31 March 2018 but before the approval of the financial statements for the year ended 31 March 2018 by the board of directors. The appointed date as per the scheme of amalgamation is 1 April 2017. The approval of the scheme by the NCLT subsequent to year end shall be considered as an adjusting event and the effect of the business combination shall be incorporated in the separate financial statements of Company A for the year ending 31 March 2018.

PwC Insights:
Ind AS 103, *Business Combinations* defines acquisition date 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 approval such as NCLT approval.

Ind AS 10, *Events after the Reporting Period* paragraph 22(a) considers a major business combination after reporting period as a non-adjusting event. Paragraph 14 of Appendix C to Ind AS 103 which deals with business combination of entities under common control also states that when a business combination is effected after the balance sheet but before the approval of the financial statements for issue by either party to the business combination, disclosure is made in accordance with Ind AS 10, but the business combination is not incorporated in the financial statements.

Considering the above response of the ITFG, it appears that a common control merger transaction which is effected through a NCLT/Court approved scheme after the balance sheet but with a retrospective appointed date would get accounted from an earlier date as compared to let's say a business slump sale transaction involving entities under common control. Where a business slump sale transaction is approved by the Board of Directors before the balance sheet date, however the closing of transaction including any other substantive approvals and payment of consideration takes place after the balance sheet but before issuance of the financial statements, then basis the acquisition date guidance and paragraph 14 of Appendix C to Ind AS 103, such business acquisition would be considered a non-adjusting subsequent event and accounted after the balance sheet date.

Accordingly, economically similar transactions may get accounted in different periods, due to differences in the legal form or structure of those underlying transactions.

7. Accounting treatment of revaluation surplus recognised under the previous Indian GAAP on PP&E on the date of transition to Ind AS when an entity chooses to apply revaluation model for subsequent measurement under Ind AS 16

Where an entity upon transition elects to apply fair value as the deemed cost of the PP&E or Ind AS 16 retrospectively and subsequently measures the PP&E based on the revaluation model, the revaluation surplus recognised under the previous Indian GAAP on PP&E shall be transferred to retained earnings or if appropriate, another category of equity. Revaluation surplus as determined as per Ind AS 16 shall be recognised on the date of transition to Ind AS in equity as revaluation reserve. Any subsequent changes in revaluation after the date of transition to Ind AS shall be recognised in other comprehensive income. Further, if a company chooses to apply the revaluation model for subsequent measurement then it shall comply with the same policy for all periods (including transition date) presented in the first Ind AS financial statements.

The takeaway

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 accounting of loan processing fees, land restoration costs, discounting of advances received from customer for goods or services, classification of optionally convertible preference shares and accounting of amalgamation approved by NCLT after balance sheet date but before the date of approval of the financial statements. 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.

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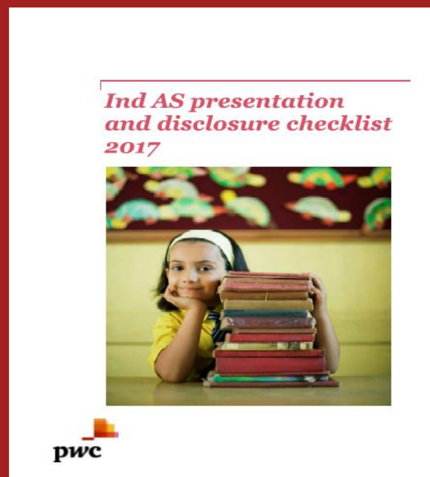

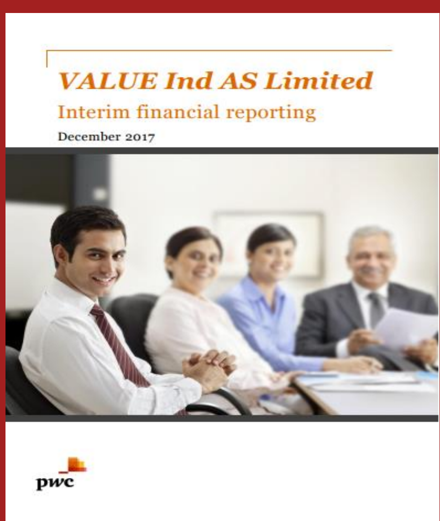

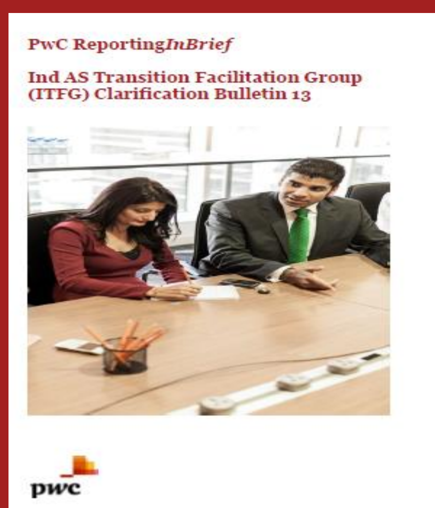

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