PwC Reporting*InBrief*

Ind AS Transition Facilitation Group (ITFG) Clarification Bulletin 16

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 16 and our insights on these clarifications, including related interpretative issues.

Let's talk

1. When a subsidiary provides a financial guarantee to a bank in respect of a loan availed by its parent without charging any guarantee fee or commission, the economic substance of the arrangement is that the subsidiary has effectively made a distribution to parent. In the separate financial statements, the subsidiary should initially recognise the financial guarantee obligation at fair value with a corresponding debit to equity. The financial guarantee should be subsequently measured at the higher of the expected credit loss determined in accordance with Ind AS 109, *Financial Instruments* and the amount initially recognised (i.e. fair value) less any cumulative amount of income recognised in accordance with Ind AS 18, *Revenue*/Ind AS 115, *Revenue from Contracts with Customers*. The parent shall in its separate financial statements, credit the fair value of the guarantee to profit or loss (unless the distribution clearly represents a recovery of part of the cost of the investment measured at fair value through other comprehensive income) with a corresponding debit to the carrying amount of the loan. Such adjustment to the loan would have the effect of the fair value of guarantee being included in determination of effective interest rate on the loan.
2. Where a parent has provided a financial guarantee to a bank in respect of a loan availed by its subsidiary without charging any guarantee fee or commission and the subsidiary repays the loan before its tenure, the unamortised guarantee obligation outstanding in the books of the parent should be recognised in profit or loss.
3. Interest and penalty payable under Section 234A/B/C of the Income-tax Act; 1961 is not based on the taxable profit of an entity (but are based on the current tax liability of an entity). Accordingly, these payments are not in the nature of income taxes within the meaning of IAS 12, *Income Taxes* or Ind AS 12, *Income Taxes* and should not be clubbed with current tax for presentation purposes. Other interest and penalties under the Income-tax Act; 1961 are also generally not expected to qualify as income taxes. As per the Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013 (the 'Guidance Note') issued by ICAI, interest and penalties which are compensatory in nature shall be presented as 'interest expense' and other penalties as 'other expenses'.
4. Where there is an assignment of a loan from bank to asset reconstruction company (ARC), the borrower should assess whether there is a legal release of its primary liability to the bank. If it is so concluded, then the existing loan is extinguished. In such case, the original loan from bank is derecognised and a new loan from ARC is recognised at fair value. The difference between the fair value of the new loan recognised and the carrying amount of original loan derecognised is recognised in profit or loss. If the change in lender does not result in legal release of the borrower from its primary liability to the bank, the borrower needs to consider whether there is substantial modification of the terms of the original liability. A substantial modification of the terms is accounted as an extinguishment of the financial liability. The terms are considered to be substantially different if the present value of the cash flows under the new terms discounted using the original effective interest rate is different from the carrying amount of the original liability by 10% or more. Where the difference is below the threshold of 10%, a qualitative test may be required to be carried out to determine whether modifications of the terms that are not captured by the quantitative analysis are substantial.
5. Investment made by an entity in units of money-market mutual funds (MMFs) would generally not meet the definition of 'cash equivalent' as per Ind AS 7, *Statement of Cash Flows* since value of MMFs keeps changing due to changes in interest rates. Accordingly, the amount of cash that will be received from redemption or sale of units may not be known at the time of the initial investment and the value of such units may be subject to a more than insignificant risk of change during the investment period.
6. Demerger of business from parent to its subsidiary after the transition date to Ind AS shall be accounted by the subsidiary (acquirer) as common control business combination as per Appendix C of Ind AS 103, *Business Combinations* i.e. as per pooling of interest method. Where the accounting treatment of demerger is approved by the court/tribunal in the scheme of demerger, the accounting approved by the court/tribunal needs to be followed. If the accounting treatment approved by the court/NCLT is not in accordance with Ind AS, the financial statements of acquirer (i.e. the subsidiary in this case) should include appropriate disclosures with respect to such deviation.
7. Classification of lease of land as finance or operating lease depends on the indicators for classification of lease provided in Ind AS 17, *Leases*. Where a lessee pays a nominal amount for lease of land and a large lump sum amount for use of common infrastructure facilities of a textile park, the lump sum amount paid includes an element towards lease of land. An entity (lessee) needs to assess whether the common infrastructure facilities are essential to utilise the right in relation to lease of land such as access roads. If it is concluded in the affirmative, then the right to use both land and common infrastructure facilities is accounted as a single set of right, unless the terms of the agreement such as tenure, renewal option in respect of land and common infrastructure facilities are different. Further, if it is concluded that textile park is providing services in the form of common infrastructure facilities, the upfront payment needs to be split between the minimum lease payments (MLPs) towards lease of land and prepayment for future services. The amount allocated to MLPs towards lease of land has to be considered for the purpose of determining the classification of lease of land as operating or finance lease as per Ind AS 17.

In detail

1. **Accounting of financial guarantee issued by subsidiary to a bank in respect of a loan availed by its parent**
   Where a subsidiary provides a financial guarantee to a bank in respect of a loan availed by its parent without charging any guarantee fee or commission, the economic substance of the arrangement is that the subsidiary has effectively made a distribution to parent. The accounting of such financial guarantee shall be as follows:
   (a) Separate financial statements of subsidiary: The financial guarantee obligation (unearned financial guarantee commission) should be initially recognised at fair value with corresponding debit to equity. The financial guarantee is subsequently measured at the higher of the amount determined in accordance with the expected credit loss model as per Ind AS 109 and amount initially recognised (fair value) less, where appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 18/Ind AS 115. The fact that subsidiary is in losses and has not paid any dividend to the parent does not impact the accounting treatment in the separate financial statements of subsidiary.
   (b) Separate financial statements of parent: Although, Ind AS 109 does not specifically address the accounting for financial guarantee by the beneficiary (parent), the economic substance of the transaction represents a distribution by the subsidiary to the parent, the parent should also account for the financial guarantee. The parent should credit fair value of the guarantee to profit or loss (unless the distribution clearly represents a recovery of part of the cost of the investment measured at fair value through other comprehensive income) with a corresponding debit adjustment to the carrying amount of the loan obtained from bank. Such adjustment to the loan would have the effect of the fair value of guarantee being included in determination of effective interest rate on the loan.

> PwC Insights:
> ITFG in its bulletin 13 dealt with the accounting of financial guarantee provided by a company's director in respect of a loan availed by the company without any charge. ITFG clarified that since the Company (beneficiary) does not pay any fees to the director, it is not required to account for such financial guarantee. Fair value of the loan is expected to be the loan proceeds considering the unit of account as the guaranteed loan.
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> The ITFG in its current bulletin stated that above view was given considering that financial guarantee was given by the director. ITFG clarified that the principle of attribution acquires significance in a parent-subsidiary relationship in which case the beneficiary should recognise the financial guarantee in its financial statements.
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> Ind AS 109/IFRS 9, *Financial Instruments* does not specifically address the accounting for financial guarantees by the benificiary, and neither there is any requirement in Ind AS 24/IAS 24, *Related Party Disclosures* to fair value non-arm's length related party transactions. Therefore, globally under IFRS, there is an accounting policy choice. In a parent subsidiary relationship, the beneficiary (subsidiary) could either:
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> - fair value the loan from the bank by reference to a normal market rate of interest that it would pay on a similar but un-guaranteed loan, and take the benefit of the interest differential to equity as a capital contribution from the parent; or
> - view the unit of account as being the guaranteed loan, in which case the fair value would be expected to be the face value of the proceeds that the subsidiary receives.

2. **Accounting of financial guarantee issued by the parent without any charge in respect of a bank loan availed by its subsidiary, which is prepaid by the subsidiary before its tenure**
   Where a parent provides a financial guarantee without any charge in respect of a bank loan availed by the subsidiary, the parent being the issuer of the financial guarantee is required to recognise the financial guarantee at fair value with a debit adjustment to investment in subsidiary. The attribution to investment upon providing financial guarantee is in substance the consideration that the parent would have otherwise collected for providing similar guarantee to unrelated third party. In case of prepayment of loan by an unrelated third party, the parent would have generally not refunded the consideration and would have recognised the entire unrecognised commission in profit or loss. ITFG also clarified that similar accounting should be followed where subsidiary prepays the loan guaranteed by the parent i.e. the parent should recognise the outstanding guarantee obligation on the date of prepayment of the loan by the subsidiary in its profit or loss.

3. **Presentation of interest and penalties related to income taxes**
   As per Ind AS 12, current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. An entity's obligation for current tax arises because it earns taxable profit during a period. An entity's obligation for interest or penalties, on the other hand, arises because of its failure to comply with one or more of the requirements of the income tax law (e.g. failure to deposit income tax). The obligations for current tax and those for interest or penalties arise due to reasons that are fundamentally different in nature. The Guidance Note requires that interest or penalties should not be clubbed with current tax. The Guidance Note states that interest and penalties which are compensatory in nature should be classified as interest expense under 'finance costs' and other penalties should be classified as 'other expenses'.

As per the recent International Financial Reporting Interpretations Committee (IFRIC) agenda decision, entities do not have an accounting policy choice between applying IAS 12, *Income Taxes* and applying IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* to interest and penalties. If an entity considers a particular amount payable or receivable for interest and penalties to be an income tax, then the entity applies IAS 12 to that amount. If an entity does not apply IAS 12 to a particular amount payable or receivable for interest and penalties, it applies IAS 37 to that amount. IFRIC noted that there might be situations where an amount payable or receivable for interest or penalties may be in the nature of income-taxes and thus will be within the scope of IAS 12. In considering whether an amount of interest or penalty is in the scope of IAS 12, an entity considers whether the interest or penalty is a tax and whether that tax is based on taxable profits. Since IFRS is applicable across a large number of jurisdictions, an entity should consider whether tax laws in the jurisdiction and other facts and circumstances indicate that this amount is based on a taxable profit i.e. a 'net' amount. For example, in India, interest and penalty payable under section 234/A/B/C of the Income-tax Act, 1961 will not qualify as income-taxes within the meaning of IAS 12 or Ind AS 12. Other interest and penalty under the Income-tax Act, 1961 is also generally not expected to qualify as income tax.

4. Accounting in the books of the borrower as a result of assignment of loan to ARC

When there is an assignment of loan from a bank to ARC, the borrower is required to assess whether the assignment results in a legal release of its primary liability to the bank. If it is concluded in the affirmative, then the existing loan is extinguished. In such case, the original loan from bank is derecognised and a new loan from ARC is recognised at fair value. The difference between the fair value of the new loan recognised and the carrying value of original loan derecognised is recognised in profit or loss. Where it is assessed that the change in lender does not result in legal release of the borrower from its primary liability to the bank, the borrower needs to consider whether there is substantial modification of the terms of the original liability. The terms are substantially different if the present value of the cash flows under the new terms is at least 10% different from the present value of the remaining cash flows of the original liability, using the original effective interest rate.

Where present value of the new cash flows under the new terms is different from the present value of the remaining cash flows of the original liability by less than 10%, a qualitative analysis may be required to be carried out by the borrower to determine whether the modification of the terms that are not captured by the quantitative analysis are substantial. There may be situations where the modification of financial liability is so fundamental that derecognition is appropriate whether or not the 10% test is met.

If as part of the terms of assignment, a part of the loan is settled by way of issue of own equity shares, then such partial settlement is accounted in accordance with Ind AS 109 - Appendix D (Extinguishing Financial Liabilities with Equity Instruments) i.e. the difference between the fair value of the equity shares issued and the part of the loan settled is recognised in profit or loss.

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Paragraph B3.3.6 of Ind AS 109 requires an entity to determine whether the present value of the new cash flows under the new terms is at least 10% different from the present value of the remaining cash flows of the original liability, using the original effective interest rate. If the difference is 10% or greater, the existing liability is de-recognised and a new financial liability is recognised.

The standard is not clear whether the quantitative analysis (described above) is the definition of 'substantially different', or whether it is only an example such that a broader analysis that considers qualitative factors can also be performed. The ITFG has clarified that where present value of the new cash flows under the new terms is different from the present value of the remaining cash flows of the original liability by less than 10%, a qualitative assessment may be required to be performed to determine whether the modification of the terms that are not captured by the quantitative analysis are substantial.

Determining whether the terms are substantially different, from a qualitative perspective, is judgemental and will depend on the specific facts and circumstances of each case. Changes to the terms of a liability might be significant, on a qualitative basis, if they significantly affect the economic risks of the liability.
Qualitative factors include, but are not limited to, the following:

- A change in the currency in which the liability is denominated.
- A change in the interest basis (such as a change from fixed rate to floating rate, or vice versa).
- A change in any conversion features in the instrument.
- A substantial change in covenants.
- The liability was prepayable at par, with no significant penalty at the date of the renegotiation, which results in the renegotiated rate approximating the current market rate of interest for the new terms and conditions.
- The liability was close to its maturity date at the date of the renegotiation and was extended for a significant additional period, which results in the renegotiated rate approximating the current market rate of interest for the new terms and conditions (including the new maturity date).

5. **Classification of investment in money-market mutual funds (MMFs) units as cash equivalents**
As per Ind AS 7, 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 to value. All the following conditions must be satisfied for an investment to be classified as cash equivalent:
(a) The investment must be for meeting short-term cash commitments;
(b) It must be highly liquid i.e. readily convertible to cash; and
(c) The amount that would be realised from the investment must be known, with no more than an insignificant risk of change in value of the investment.

As a general proposition, the third condition, viz. that the investment must be convertible into a known amount of cash and the risk of change in the value of the investment should not be more than insignificant is usually not expected to be met by units of a money-market (or other) mutual fund which can be put back by the holder to the fund at any time for redemption at net asset value (or can be sold in an active market). The money market instruments have a relatively short life, their value keeps changing primarily due to changes in interest rates. Consequently, the amount of cash that will be received from redemption or sale of the units may not be known at the time of the initial investment and the value of such units may be subject to a more than insignificant risk of change during the period of their holding. However, there may be cases wherein this condition is met e.g. where such units are acquired only for a very brief period before the end of tenure of a mutual fund and the maturity amounts of the fund's investments are pre-determined and known – in such a case, it might be possible to argue that the redemption amount of the units is known and subject only to an insignificant change in value.

PwC Insights:
MMF is generally an open-ended mutual fund that invests in short-term debt instruments such as treasury bills, certificates of deposit, bonds, government gilts and commercial paper. Its main goals are the preservation of principal, high liquidity and a modest incremental return over short-term interest rates or a benchmark rate.

Under IFRS, the IFRIC noted, in an agenda decision, that some MMFs could, in substance, meet the definition of cash equivalents as per IAS 7 *Statement of Cash Flows*, where the purpose is to meet short-term cash commitments, the MMF is convertible into a known amount of cash and is subject to an insignificant risk of changes in value. This means that the cash amount that will be received on redemption should be known at the time of the initial investment. It is not sufficient that the instrument itself is readily convertible into cash and has a determinable market value. Instead, it means that, at the time of the initial investment the entity is satisfied that the risk of changes in value is insignificant and that therefore the amount of cash to be received on redemption is known.

6. **Accounting treatment of demerger of business from parent to subsidiary**
Demerger of business from parent to its subsidiary after the transition date to Ind AS shall be accounted by the subsidiary (acquirer) as common control business combination as per Appendix C of Ind AS 103. Accordingly, in the financial statements of subsidiary, demerger would be accounted for as per 'pooling of interest method'. This would require the subsidiary to recognise assets and liabilities of the acquired business at their respective book values as appearing in the books of the parent and restatement of comparative financial information as if the business combination had occurred from the beginning of the preceding period, irrespective of the actual date of business combination.

Where the accounting treatment of demerger is approved by the court/tribunal in the scheme of demerger, the accounting approved by the court/tribunal needs to be followed. If the accounting treatment approved by the court/NCLT is not in accordance with Ind AS, the financial statements of subsidiary should include appropriate disclosures with respect to such deviation.

An announcement of the Council of the ICAI on "Disclosures in cases where a Court/Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard", states that if an item in the financial statements of a Company is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

(a) A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/ Tribunal Order;

(b) Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company; and

(c) The financial impact, if any, arising due to such a difference.

7. **Accounting of rentals/payment towards lease of land and common infrastructure facilities**
Where an entity obtains land on lease at a nominal value and pays large lump sum payment upfront under contract for common infrastructure facilities of a textile park, the lump sum amount paid also includes an element towards land lease rentals, notwithstanding that the agreement states the lump sum payment is only towards use of common infrastructure

facilities of the park. The entity is required to evaluate whether lease of land is a finance lease or an operating lease based on the definitions of 'finance lease' and 'operating lease' and indicators for classification of lease provided in Ind AS 17.

Where the common infrastructure facilities such as access roads are essential for the entity to be able to utilise the land, right of use of both land and common infrastructure facilities may be viewed as a single set of right unless the terms of agreement such as tenure, renewal option, etc. in respect of land and common infrastructure facilities are different. If two rights are accounted as a single item, the relevant line item in the balance sheet may bring out clearly that it relates to right to use of both land and common infrastructure facilities. If on the other hand the two rights are accounted for separately (because of differences in the terms and underlying benefits relating to the two), accounting for each right should be based on the particular terms and underlying benefits associated with it.

It also needs to be assessed whether the textile park is providing services in the form of common infrastructure facilities. As per Ind AS 17, costs for services are excluded from minimum lease rentals. Where it is concluded that textile park is providing services for tenure of the land, then in such case the upfront payment has to be split between MLPs towards lease of land and prepayment for future services. The amount allocated to MLPs towards lease of land has to be considered for the purpose of determining the classification of lease of land as finance or operating lease.

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An important consideration in determining whether a lease of land is an operating or finance lease is that land normally has an indefinite economic life. A finance lease is defined as "... a lease that transfers substantially all the risks and rewards incidental to ownership of an asset". Thus, a finance lease is an arrangement that has the substance of a financing transaction for the lessee to acquire effective economic ownership of an asset.

The following examples of situations, individually or in combination, would normally lead to a lease being classified as a finance lease:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term.
(b) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.
(c) The lease term is for the major part of the economic life of the asset, even if title is not transferred.
(d) At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
(e) The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

The following situations, individually or in combination, could also lead to a finance lease classification:

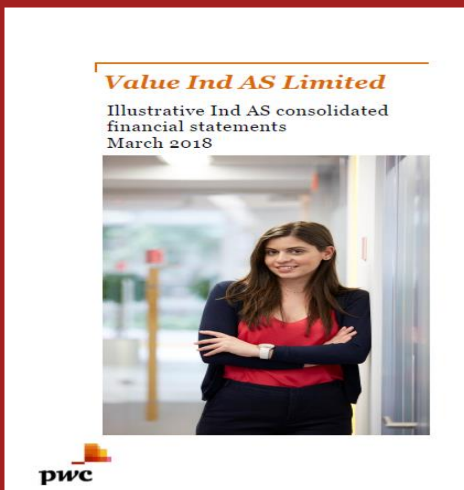
(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
(b) Gains or losses from the fluctuation in the residual's fair value fall to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease).
(c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

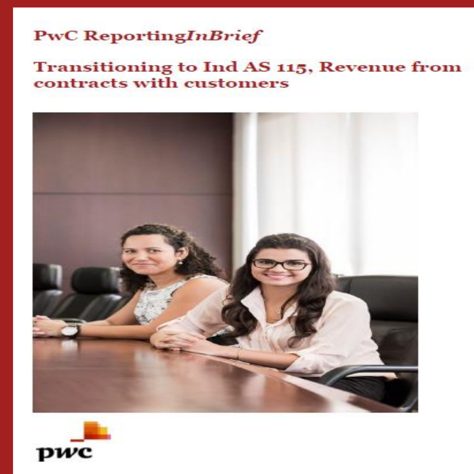
ITFG in its bulletin 7 (issue no. 5) clarified that classification of lease of land as operating or finance lease requires exercise of judgement based on evaluation of facts and circumstances in each case, while considering the indicators envisaged as above.

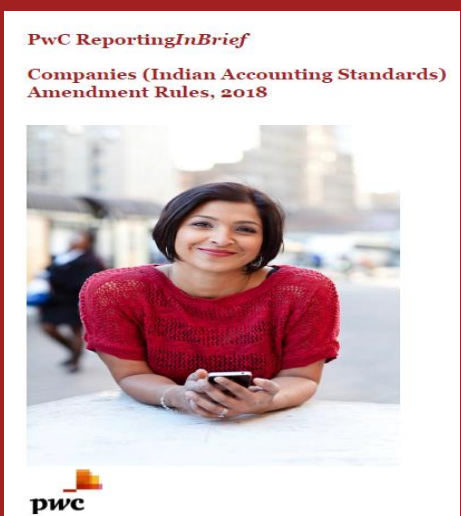
The takeaway

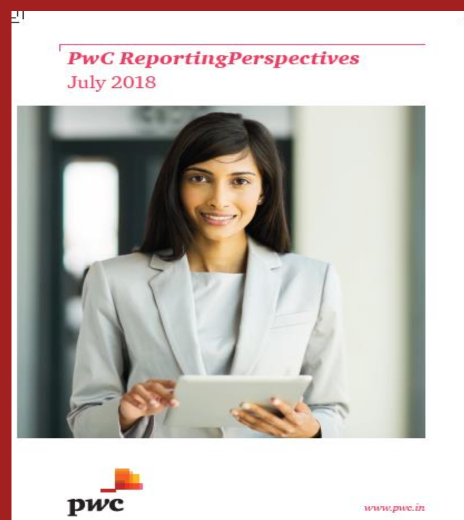
Clarifications by ITFG is useful for the companies and other stakeholders as they navigate their journey through Ind AS. The current bulletin provides clarity on some of the key issues commonly faced by the stakeholders such as accounting of intra-group financial guarantees, common control business combinations, debt modifications, classification of MMFs as cash equivalents and leasing transactions. The clarifications 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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