

PAPER

1

**FINAL COURSE
STUDY MATERIAL
GROUP-I
FINANCIAL
REPORTING
MODULE 2 OF 4**



Board of Studies (Academic)
**The Institute of Chartered
Accountants of India**

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IND AS ON ASSETS OF THE FINANCIAL STATEMENTS



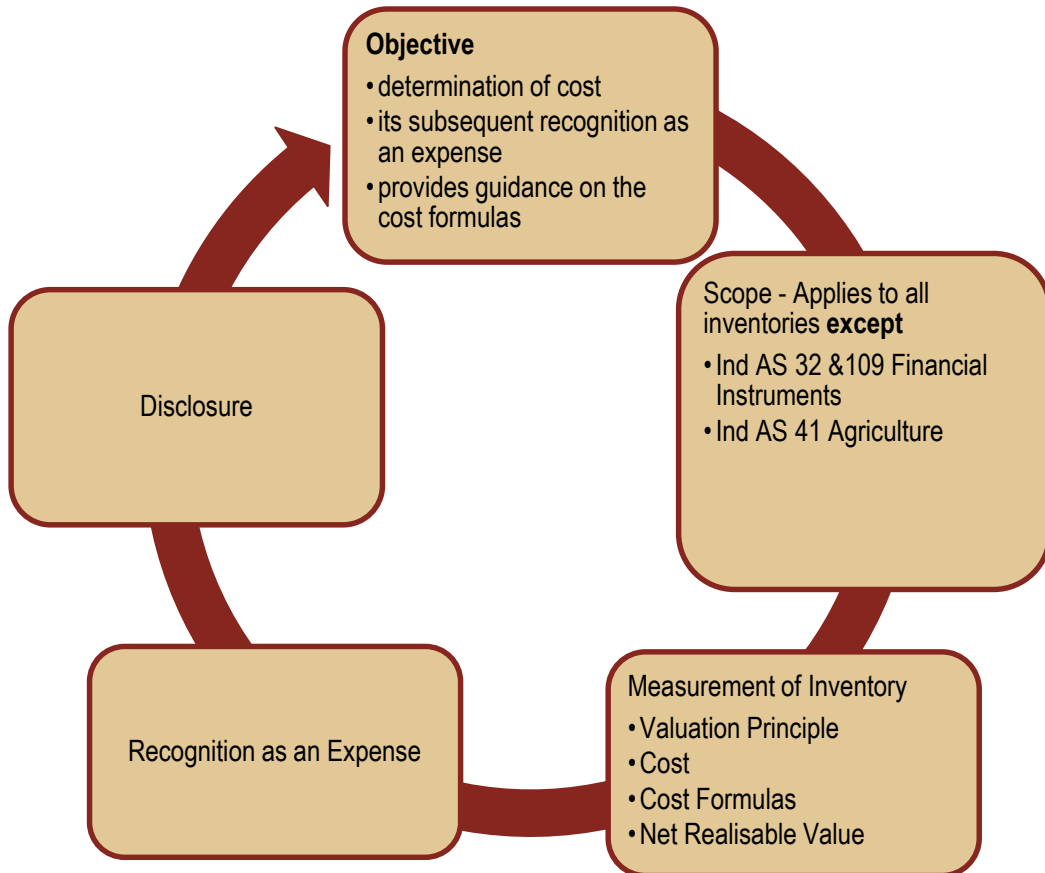
UNIT 1: INDIAN ACCOUNTING STANDARD 2: INVENTORIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ☐ Describe the objective and scope of the standard
- ☐ Define the terms inventories, net realisable value and fair value
- ☐ Determine the inventory cost
- ☐ Apply the cost formula for valuation of inventory
- ☐ Evaluate as to how and when to perform write-downs to net realisable value
- ☐ Recognize the write downs as an expense

UNIT OVERVIEW





1.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for inventories. This Standard provides guidance for determining the cost of inventories and for subsequent recognition as an expense, including any write-down to net realisable value.

It provides guidance on the techniques for the measurement of cost, such as the standard cost method or retail method. It also outlines acceptable methods of determining cost, including specific identification, first-in-first-out and weighted average cost method.



1.2 SCOPE

This Standard is applicable to all inventories, except:

- a) financial instruments (to be accounted under Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments).
- b) biological assets (i.e. living animals or plants) related to agricultural activity and agricultural produce at the point of harvest (to be accounted under Ind AS 41, Agriculture).

Note: In accordance with Ind AS 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 fair value less costs to sell as determined in accordance with Ind AS 41 will become the cost of the inventories at that date for application of Ind AS 2 “Inventories”.

▪ **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 recognized in profit or loss in the period of the change.

- b) commodity broker-traders who measure their inventories at fair value less costs to sell.

When such inventories are measured at net realisable value / fair value less costs to sell, changes in those values are to be recognized in profit or loss in the period of the change.

Broker-traders are those who buy or sell commodities for others or on their own account. They acquire inventories principally 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.

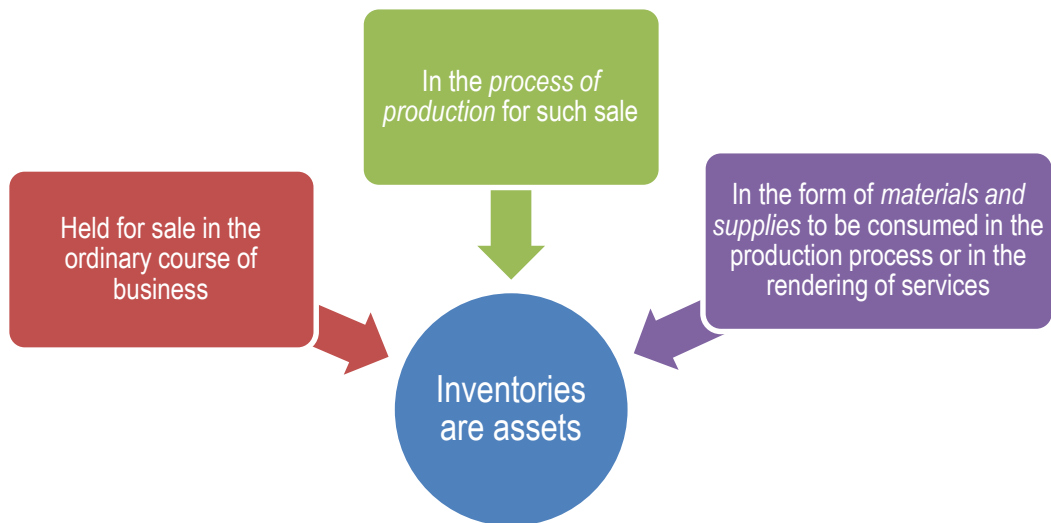


1.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

1) Inventories are assets:

- a) held for sale in the ordinary course of business; (Finished Goods)
- b) in the process of production for such sale; or (Work in progress)
- c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. (Raw material)



2) Inventories encompass of:

- a) goods purchased and held for resale (e.g. merchandise purchased by a retailer and held for resale, or land and other property held for resale);
- b) finished goods produced, or work in progress being produced, by the entity; and includes
- c) materials and supplies awaiting use in the production process.

Costs incurred to fulfill a contract with a customer that do not give rise to inventories are accounted as per Ind AS 115.

Illustration 1

As per Ind AS 2, inventories include 'materials and supplies awaiting use in the production process'. Examine whether the packing material and publicity material are covered by the term 'materials and supplies awaiting use in the production process'.

Solution

While the primary packing material may be included within the scope of the term 'materials and supplies awaiting use in the production process' but the secondary packing material and publicity material cannot be so included, as these are selling costs which are required to be excluded as per Ind AS 2. For this purpose, the primary packing material is one which is essential to bring an item of inventory to its saleable condition, for example, bottles, cans etc., in case of food and beverages industry. Other packing material required for transporting and forwarding the material will normally be in the nature of secondary packing material.

- 3) **Net realisable 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.

Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.

- 4) **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. (Ind AS 113, *Fair Value Measurement*.)

Note: Net realisable value for inventories may not equal fair value less costs to sell.

Example 1

An entity holds inventories of 10,000 units and it could sell the same in the market @ ₹ 10 each. The entity has an order in hand to sell the inventories @ ₹ 11. The incremental selling cost per unit is ₹ 0.50 per unit. In this situation, fair value is ₹ 10 each, but net realisable value is ₹ 10.5 each.

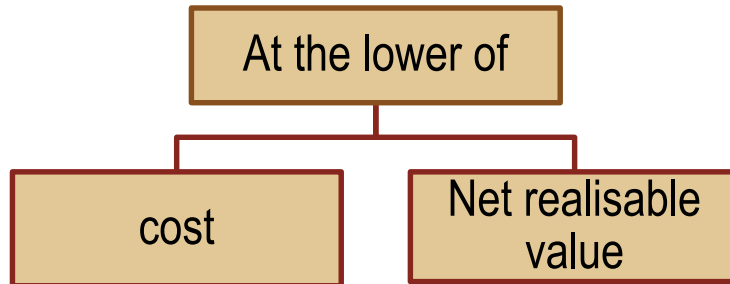
Difference between Net Realisable Value (NRV) and Fair Value (FV)

Basis	NRV	FV
Meaning	NRV refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business.	FV reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date
Measurement base	Entity-specific value i.e. the amount that the entity actually expects to make from selling the particular inventory	Market based measurement



1.4 MEASUREMENT OF INVENTORIES

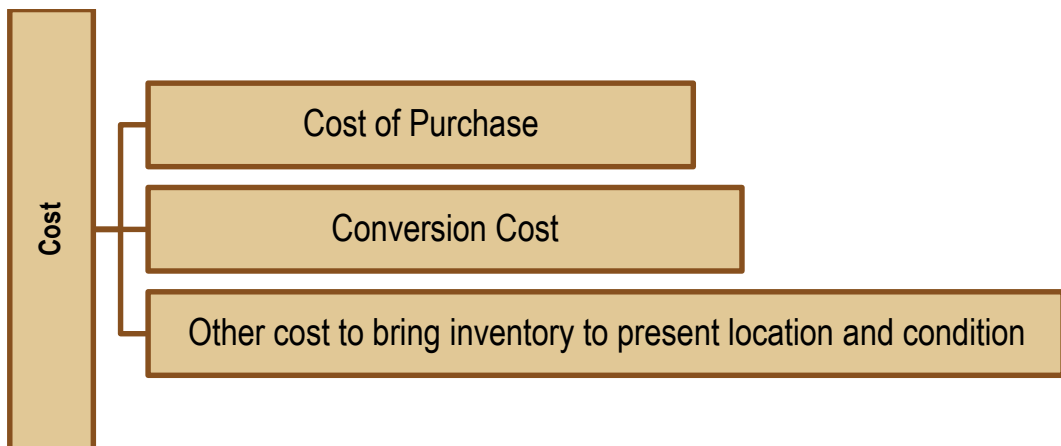
Inventories shall be measured at the lower of cost and net realisable value.



1) Cost of Inventories

Cost of Inventories comprises:

- a) all costs of purchase;
- b) costs of conversion; and
- c) other costs incurred in bringing the inventories to their present location and condition.



2) Cost of purchase

The costs of purchase of inventories include:

- a) the purchase price,
- b) import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities),
- c) transport, handling and

- d) other costs directly attributable to the acquisition of finished goods, materials and services.

Any trade discounts, rebates and other similar items are deducted in determining the costs of purchase of inventory.

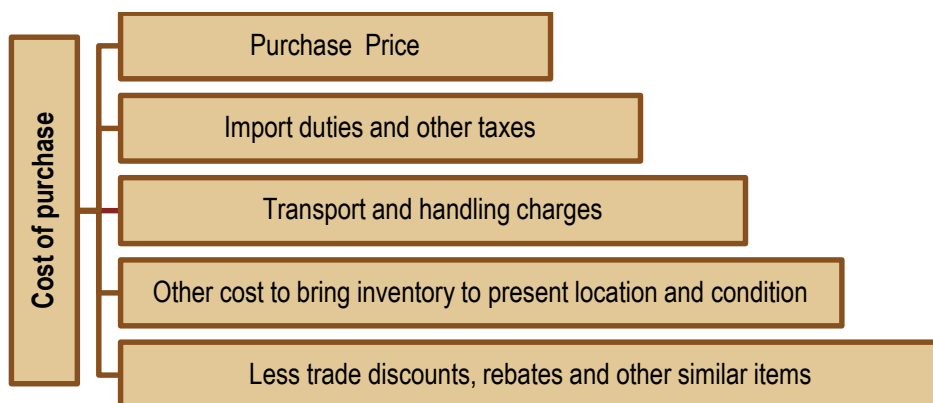


Illustration 2

ABC Ltd. buys goods from an overseas supplier. It has recently taken delivery of 1,000 units of component X. The quoted price of component X was ₹ 1,200 per unit but ABC Ltd. has negotiated a trade discount of 5% due to the size of the order.

The supplier offers an early settlement discount of 2% for payment within 30 days and ABC Ltd. intends to achieve this.

Import duties (basic custom duties) of ₹ 60 per unit must be paid before the goods are released through custom. Once the goods are released through customs, ABC Ltd. must pay a delivery cost of ₹ 5,000 to have the components taken to its warehouse.

Calculate the cost of inventory.

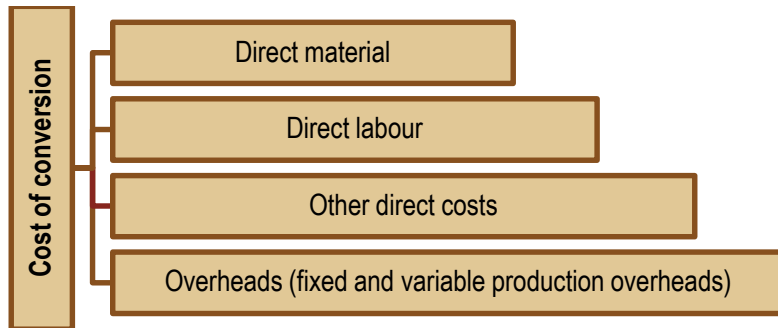
Solution

	₹
Purchase price (1,000 x 1,200 x 95%)	11,40,000
Import duties (1,000 x 60)	60,000
Delivery cost	<u>5,000</u>
Cost of inventory	<u>12,05,000</u>

Note: The intention to take settlement discount is irrelevant.

3) Cost of conversion

- The costs of conversion of inventories include costs directly related to the units of production, such as:
 - a) direct material, direct labour and other direct costs; and
 - b) a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.



- Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings, equipment and right-of-use assets used in the production process, and equipment, and the cost of factory management and administration.
- Allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity.
- When production levels are abnormally low, unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost.
- Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Note: Production overheads must be absorbed based on normal production capacity even if this is not achieved in a period. If production capacity is unusual in a particular period the overheads might be under or over absorbed. Interruptions in production may occur while costs still are being incurred.

Note: The process of allocating costs to units of production is usually called absorption. This is usually done by linking the total production overheads to some production variable, for example, time, wages, materials or simply the number of units expected to be manufactured.

Example 2

Pluto Ltd. has a plant with the normal capacity to produce 5,00,000 unit of a product per annum and the expected fixed overheads is ₹ 15,00,000. Fixed overheads on the basis of normal capacity is ₹ 3 per unit ($15,00,000/5,00,000$).

Case 1:

Actual production is 5,00,000 units. Fixed overhead on the basis of normal capacity and actual overheads will lead to same figure of ₹ 15,00,000. Therefore, it is advisable to include this on normal capacity.

Case 2:

Actual production is 3,75,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 15,00,000, therefore, overheads on actual basis is ₹ 4 p/u ($15,00,000 / 3,75,000$).

Hence by valuing inventory at ₹ 4 each for fixed overheads purpose, it will be overvalued and the losses of ₹ 3,75,000 will also be included in closing inventory leading to a higher gross profit than actually earned.

Therefore, it is advisable to include fixed overheads per unit on normal capacity to actual production ($3,75,000 \times 3$) ₹ 11,25,000 and balance ₹ 3,75,000 ($3,75,000 \times 1$) shall be transferred to Profit & Loss Account as an expense.

Case 3:

Actual production is 7,50,000 units. Fixed overheads is not going to change with the change in output and will remain constant at ₹ 15,00,000, therefore, overheads on actual basis is ₹ 2 ($15,00,000/ 7,50,000$).

Hence by valuing inventory at ₹ 3 each for fixed overheads purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 3 per unit, total fixed overhead comes to ₹ 22,50,000 whereas, actual fixed overhead expense is only ₹ 15,00,000. Therefore, it is advisable to include fixed overhead on actual basis ($7,50,000 \times 2$) ₹ 15,00,000.

Illustration 3: Normal production capacity

A business plans for production overheads of ₹ 10,00,000 per annum.

The normal level of production is 1,00,000 units per annum.

Due to supply difficulties the business was only able to make 75,000 units in the current year. Other costs per unit were ₹ 126.

Calculate the per unit cost and amount of overheads to be expensed during the year.

Solution

Calculation of cost per unit:	₹
Other costs	126
Production overhead (10,00,000/1,00,000 units)	<u>10</u>
Unit cost	<u>136</u>

Overhead to be expensed:	₹
Total production overhead	10,00,000
The amount absorbed into inventory is (75,000 x 10)	<u>(7,50,000)</u>
The amount not absorbed into inventory	<u>2,50,000</u>

₹ 2,50,000 that has not been included in inventory is expensed during the year i.e. recognized in the statement of profit and loss.

Illustration 4: Conversion costs

ABC Ltd. manufactures control units for air conditioning systems.

Each control unit requires the following:

1 component X at a cost of ₹ 1,205 each

1 component Y at a cost of ₹ 800 each

Sundry raw materials at a cost of ₹ 150 each

The company incurs the following monthly expenses:

Factory rent ₹ 16,500

Energy cost ₹ 7,500

Selling and administrative costs ₹ 10,000

Each unit takes two hours to assemble. Production workers are paid ₹ 300 per hour.

Production overheads are absorbed into units of production using an hourly rate. The normal level of production per month is 1,000 hours.

Calculate the cost of inventory.

Solution

<i>The cost of a single control unit:</i>	₹
Materials:	
Component X	1,205
Component Y	800
Sundry raw materials	<u>150</u>
	2,155
Labour (2 hours x 300)	600
Production overhead $[(16,500 + 7,500/1,000 \text{ hours}) \times 2 \text{ hours}]$	<u>48</u>
	<u>2,803</u>

Note: The selling and administrative costs are not part of the cost of inventory.

4) Other costs

- Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.
- Cost to be **excluded** from the cost of inventories and recognized as expenses in the period in which they are incurred are:
 - a) abnormal amounts of wasted materials, labour or other production costs;
 - b) storage costs, unless those costs are necessary in the production process before a further production stage;

Example 3

The production of whiskey involves the distilling of aged whiskey in a cask prior to bottling should be capitalised, as aging is integral to making the finished product saleable.

- c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
 - d) selling costs.
- The extent to which borrowing cost is included in the cost of inventories is determined on the basis of the requirement of Ind AS 23 Borrowing Costs.

Ind AS 23 “requires that the borrowing costs shall be capitalised on qualifying assets but scopes out inventories that are manufactured in large quantities on a repetitive basis. It also clarifies that inventories manufactured over a short period of time are not qualifying assets. However, any manufacturer that is producing small quantities over a long period of time has to capitalise borrowing costs into cost of inventories.

- An entity may acquire inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase prices for normal credit terms and the amount paid, is recognized as interest expense over the period of the financing.

Illustration 5: Conversion costs

A dealer has purchased 1,000 cars costing ₹ 2,80,000 each on deferred payment basis as ₹ 25,000 per month per car to be paid in 12 equal instalments.

At year end 31 March 20X1, twenty cars are in stock. Compute the cost of inventory, finance cost and cost of goods sold.

Solution

	₹
Deferred payment price (25,000 x 12)	3,00,000
Less: Cash price	<u>2,80,000</u>
Interest expense	<u>20,000</u>

		₹
Cost of inventory	20 cars x 2,80,000	56,00,000
Finance cost	1,000 cars x 20,000	2,00,00,000
Cost of goods sold	980 cars x 2,80,000	27,44,00,000

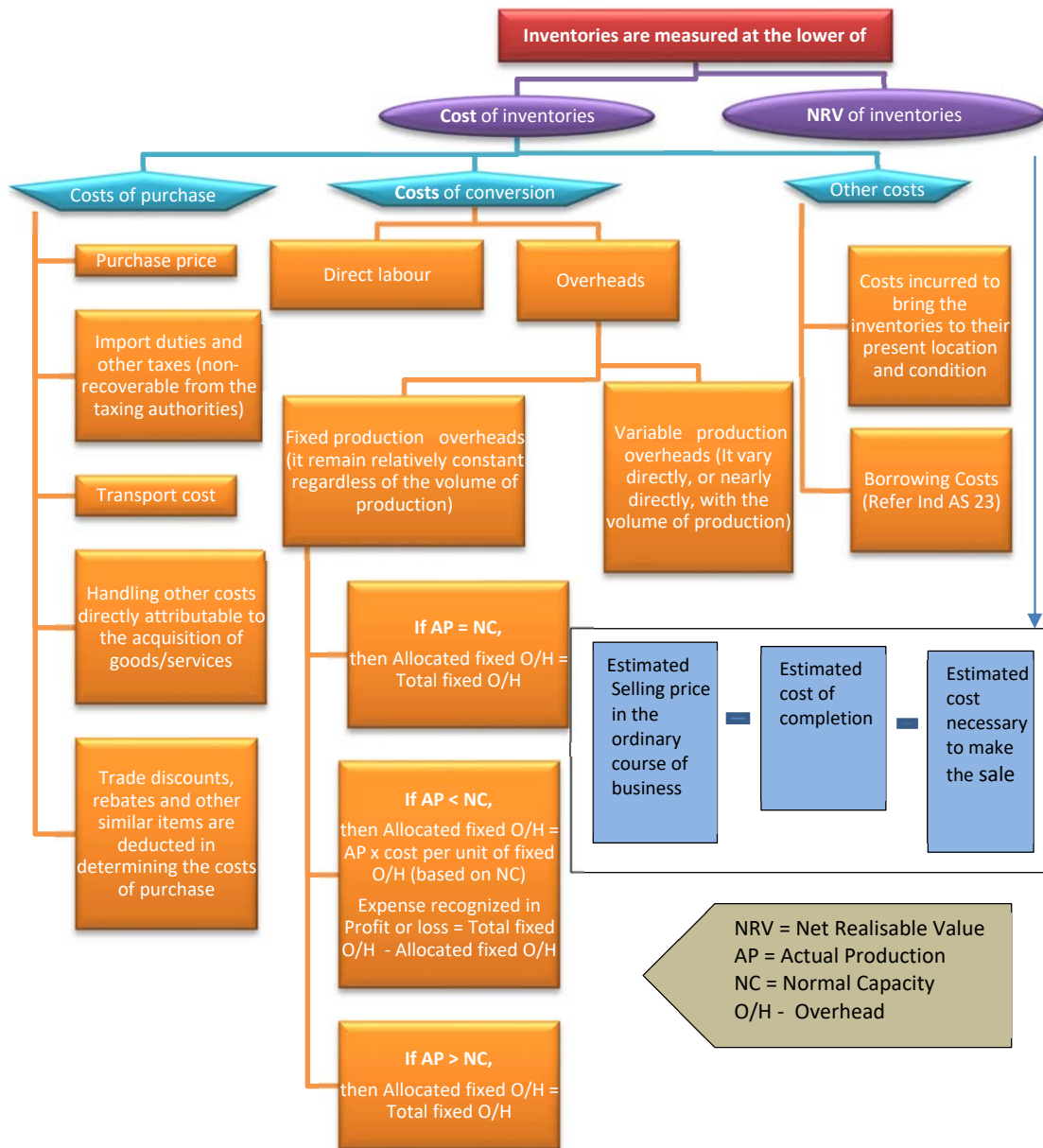


Illustration 6: Cost of Inventory

Venus Trading Company purchases cars from several countries and sells them to Asian countries. During the current year, this company has incurred following expenses:

1. Trade discounts on purchase

2. *Handling costs relating to imports*
3. *Salaries of accounting department*
4. *Sales commission paid to sales agents*
5. *After sales warranty costs*
6. *Import duties*
7. *Costs of purchases (based on supplier's invoices)*
8. *Freight expense*
9. *Insurance of purchases*
10. *Brokerage commission paid to indenting agents*

Evaluate which costs are allowed by Ind AS 2 for inclusion in the cost of inventory in the books of Venus.

Solution

Items number 1, 2, 6, 7, 8, 9, 10 are allowed by Ind AS 2 for the calculation of cost of inventories. Salaries of accounts department, sales commission, and after sale warranty costs are not considered to be the cost of inventory. Therefore, they are not allowed by Ind AS 2 for inclusion in cost of inventory and are expensed off in the profit and loss account.

Illustration 7

As per Ind AS 2, selling costs are excluded from the cost of inventories and are required to be recognized as an expense in the period in which these are incurred. Advise whether the distribution costs would now be included in the cost of inventories under Ind AS 2.

Solution

Selling and distribution costs are generally used as single term because both are related, as selling costs are incurred to effect the sale and the distribution costs are incurred by the seller to complete a sale transaction by making the goods available to the buyer from the point of sale to the point at which the buyer takes possession. Since these costs are not related to bringing the goods to their present location and condition, the same are not included in the cost of inventories. Accordingly, though the word 'distribution costs' is not specifically mentioned in Ind AS 2, these costs would continue to be excluded from the cost of inventories.

5) Allocation of cost to joint products and by-products

- A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product.
- When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production.
- Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

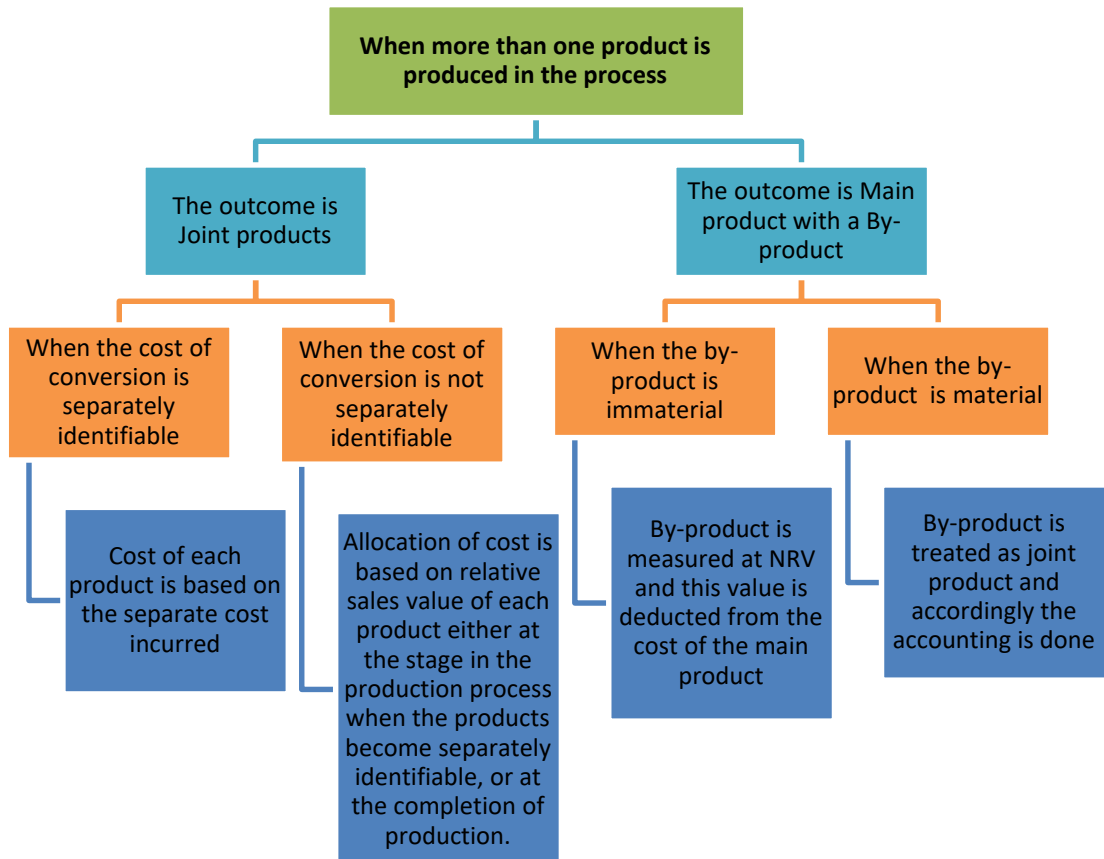


Illustration 8

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

Item	Unit	Amount	Output	Closing Stock 31.3.20X1
Raw material	14,500	1,50,000	MP1 - 5,000 units	250
Wages	-	90,000	MP2 - 4,000 units	100
Fixed overhead	-	65,000	BP- 2,000 units	
Variable overhead	-	50,000		

Average market price of MP1 and MP2 is ₹ 60 per unit and ₹ 50 per unit respectively, by-product is sold @ ₹ 20 per unit. There is a profit of ₹ 5,000 on sale of by-product after incurring separate processing charges of ₹ 8,000 and packing charges of ₹ 2,000, ₹ 5,000 was realised from sale of scrap.

Calculate the value of closing stock of MP1 and MP2 as on 31.3.20X1.

Solution

As per Ind AS 2 'Inventories', most by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realisable value and this value is deducted from the cost of the main product.

1) Calculation of NRV of By-product BP

Selling price of by-product	2,000 units x 20 per unit	40,000
Less: Separate processing charges of by-product BP		(8,000)
Packing charges		<u>(2,000)</u>
Net realisable value of by-product BP		<u>30,000</u>

2) Calculation of cost of conversion for allocation between joint products MP1 and MP2

Raw material		1,50,000
Wages		90,000
Fixed overhead		65,000
Variable overhead		50,000
Less: NRV of by-product BP (See calculation 1)	30,000	
Sale value of scrap	<u>5,000</u>	<u>(35,000)</u>
Joint cost to be allocated between MP1 and MP2		<u>3,20,000</u>

3) **Determination of “basis for allocation” and allocation of joint cost to MP1 and MP2**

	<u>MP 1</u>	<u>MP 2</u>
Output in units (a)	5,000	4,000
Sales price per unit (b)	60	50
Sales value (a x b)	3,00,000	2,00,000
Ratio of allocation	3	2
Joint cost of ₹ 3,20,000 allocated in the ratio of 3:2 (c)	1,92,000	1,28,000
Cost per unit [c/a]	38.4	32

4) **Determination of value of closing stock of MP1 and MP2**

Particulars	MP 1	MP 2
Closing stock in units	250 units	100 units
Cost per unit	38.4	32
Value of closing stock	9,600	3,200

6) **Cost of agricultural produce harvested from biological assets**

In accordance with Ind AS 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.

7) **Techniques for the measurement of cost**

- Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate to actual cost.
- Standard Cost Method: Cost is based on normal levels of materials and supplies, labour efficiency and capacity utilisation. They are regularly reviewed and revised where necessary.

Measurement techniques

- Retail method
- Standard Cost

- Retail Method: Cost is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. This method is

often used in the retail industry for measuring inventories of rapidly changing items that have similar margins.

- The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.
- The percentage has to be carefully determined to ensure that it takes into consideration the circumstances in which inventory has been marked down to below its original selling price. Adjustments have to be made to eliminate the effect of these markdowns so as to prevent any item of inventory being valued at less than both its cost and its net realisable value. An average percentage for each retail department is often used. Judgement is applied in the retail method in determining the margin to be removed from the selling price of inventory in order to convert it back to cost.

Illustration 9: Measurement techniques of Cost

Mars Fashions is a new luxury retail company located in Lajpat Nagar, New Delhi. Kindly advise the accountant of the company on the necessary accounting treatment for the following items:

- (a) *One of Company's product lines is beauty products, particularly cosmetics such as lipsticks, moisturizers and compact make-up kits. The company sells hundreds of different brands of these products. Each product is quite similar, is purchased at similar prices and has a short lifecycle before a new similar product is introduced. The point of sale and inventory system is not yet fully functioning in this department. The sales manager of the cosmetic department is unsure of the cost of each product but is confident of the selling price and has reliably informed you that the Company, on average, make a gross margin of 65% on each line.*
- (b) *Mars Fashions also sells handbags. The Company manufactures their own handbags as they wish to be assured of the quality and craftsmanship which goes into each handbag. The handbags are manufactured in India in the factory which has made handbags for the last fifty years. Normally, Mars manufactures 100,000 handbags a year in their handbag division which uses 15% of the space and overheads of the head office factory. The division employs ten people and is seen as being an efficient division within the overall company.*

In accordance with Ind AS 2, explain how the items referred to in a) and b) should be measured.

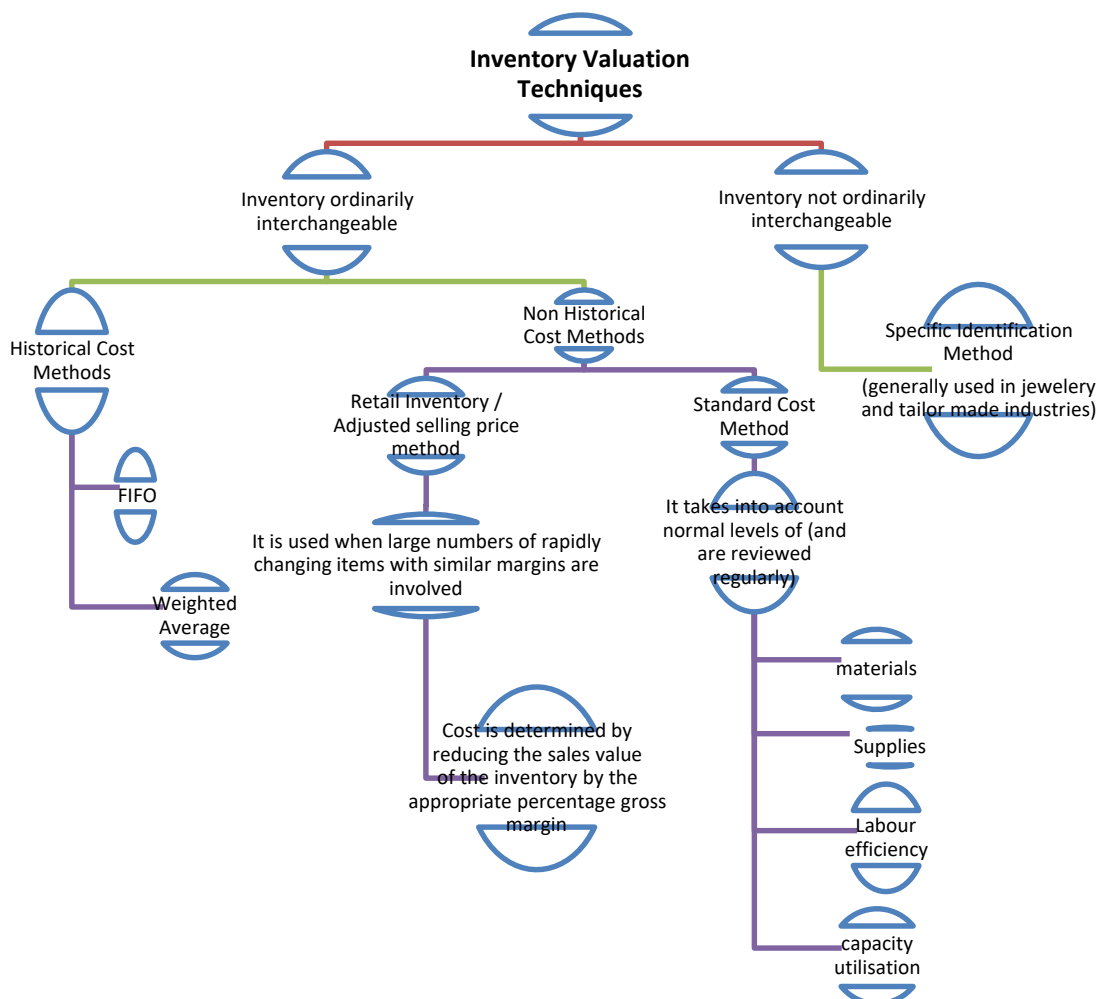
Solution

- (a) The retail method can be used for measuring inventories of the beauty products. The cost of the inventory is determined by taking the selling price of the cosmetics and reducing it by the gross margin of 65% to arrive at the cost.
- (b) The handbags can be measured using standard cost especially if the results approximate cost. Given that the company has the information reliably on hand in

relation to direct materials, direct labour, direct expenses and overheads, it would be the best method to use to arrive at the cost of inventories.

8) Cost Formulas

An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may 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.



9) Inventory not ordinarily interchangeable

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs. Specific identification of cost means that specific costs are attributed to identified items of inventory.

10) Inventory ordinarily interchangeable

- The costs of inventories, other than that are not ordinarily interchangeable and goods or services produced and segregated for specific projects, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula.

First-in, First-out Cost Formula (FIFO) assumes that the items of inventory that were purchased or produced first are sold first. Hence in such a case, the items remaining in inventory at the end of the period are those which were most recently purchased or produced.

For example, in case of a perishable goods business ie food retailers will first sell the goods he had purchased at the earliest.

The FIFO method, by allocating the earliest costs incurred against revenue, matches actual cost flows with the physical flow of goods reasonably accurately. In case of other businesses as well which do not deal in perishable goods, this would reflect what would probably be a sound management policy. In practice, the FIFO method is generally used where it is not possible to value inventory on an actual cost basis.

Weighted Average Cost Formula is suitable where inventory units are identical or nearly identical. It involves the computation of an average unit cost by dividing the total cost of units by the number of units. The average unit cost then has to be revised with every receipt of inventory, or alternatively at the end of predetermined periods. In practice, weighted average systems are widely used in packaged inventory systems that are computer controlled, although its results are not very different from FIFO in times of relatively low inflation, or where inventory turnover is relatively fast.

Formula: Calculation of new weighted average after each purchase

$$\text{New weighted average} = \frac{\text{Cost of inventory currently in store} + \text{Cost of new items received}}{\text{Number of units currently in store} + \text{Number of new units received}}$$

LIFO (last-in, first-out), as its name suggests, is the opposite of FIFO and assumes that the most recent purchases or production are used first. In certain cases, this could represent the physical flow of inventory (e.g. if a store is filled and emptied from the top). **However, it is not an acceptable cost formula under Ind AS 2.**

LIFO is an attempt to match current costs with current revenues so that profit or loss excludes the effects of holding gains or losses. Therefore, LIFO is an attempt to achieve something closer to replacement cost accounting for the statement of profit or loss,

whilst disregarding the statement of financial position. The period-end balance of inventory on hand represents the earliest purchases of the item, resulting in inventories being stated in the statement of financial position at amounts which may bear little relationship to recent cost levels.

Example 4: FIFO and Weighted Average method

Particulars	Units available	Units sold	Actual Cost/unit (₹)	Actual Total Cost (₹)
Opening inventory	100	-	2.10	210
Sale	-	75	-	-
Purchases	150	-	2.80	420
Sale	-	100	-	-
Purchase	50	-	3.00	150
Total	300	175	-	780

Solution:

FIFO Method:

Cost of Goods Sold: $100 \text{ units} \times ₹ 2.10 + 75 \text{ units} \times ₹ 2.80 = ₹ 420$

Closing Inventory: $50 \text{ units} \times ₹ 3.00 + 75 \text{ units} \times ₹ 2.80 = ₹ 360$

Weighted Average Method:

Weighted average cost / units: $780 / 300 \text{ units} = ₹ 2.60$

Cost of Goods Sold: $175 \text{ units} \times ₹ 2.60 = ₹ 455$

Closing Inventory: $125 \text{ units} \times ₹ 2.60 = ₹ 325$

Note: Weighted average method in practice is a moving average so computed after each purchase made and so sales are cost at most recent averages.

Cost of Goods Sold:

$75 \text{ units} @ ₹ 2.10 \text{ and } 100 \text{ units} @ ₹ 2.70 \text{ i.e. total cost} = ₹ 427.50$

Closing Inventory: $125 \text{ units} \times ₹ 2.82 = ₹ 352.50$

- An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Illustration 10

State whether an entity can use different cost formulae for inventories held at different geographical locations having similar nature and use to it.

Solution

Paragraph 25 of Ind AS 2 prescribes that the cost of inventories, other than the items of inventories which are not ordinarily interchangeable as dealt with in paragraph 23, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having similar nature and use to it. In this case, since the inventories held at different geographical location are of similar nature and use to the entity, different cost formula cannot be used for inventory valuation purposes.

- **FIFO formula** assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.
- Under the **weighted average** cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

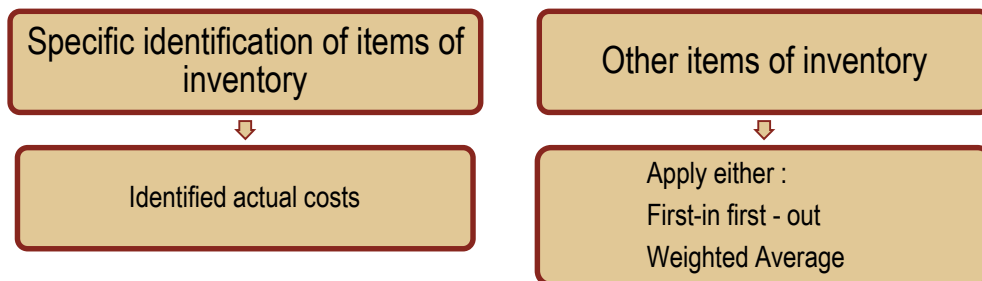


Illustration 11

Mercury Ltd. uses a periodic inventory system. The following information relates to 20X1-20X2.

Date	Particular	Unit	Cost p.u.	Total Cost
April	Inventory	200	10	2,000
May	Purchases	50	11	550
September	Purchases	400	12	4,800
February	Purchases	<u>350</u>	14	<u>4,900</u>
	Total	<u>1,000</u>		<u>12,250</u>

Physical inventory at 31.3.20X2 400 units.

Calculate ending inventory value and cost of sales using:

- (a) *FIFO*
- (b) *Weighted Average*

Solution

FIFO inventory 31.3.20X2	350 @14 =	4,900
	50 @ 12 =	<u>600</u>
		<u>5,500</u>
Cost of Sales	12,250-5,500 =	6,750
Weighted average cost per item	12,250/1000 =	12.25
Weighted average inventory at 31.3.20X2	400 x 12.25 =	4,900
Cost of sales 20X1-20X2	12,250-4,900 =	7,350

11) Net realisable value

Measurement of net realisable value

- Net realisable 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. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined.

Illustration 12

Recommend whether the following costs should be considered while determining the Net Realisable Value (NRV) of the inventories?

- (a) *Costs of completion of work-in-progress;*
- (b) *Trade discounts expected to be allowed on sale; and*
- (c) *Cash discounts expected to be allowed for prompt payment*

Solution

Ind AS 2 defines Net Realisable Value as 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.”

Costs of completion of work-in-progress are incurred to convert the work-in progress into finished goods. Since these costs are in the nature of completion costs, in accordance with the above definition, the same should be deducted from the estimated selling price to determine the NRV of work-in- progress.

Trade discount is a reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

Trade discount is allowed either expressly through an agreement or through prevalent commercial practices in the terms of the trade and the same is adjusted in arriving at the selling price. Accordingly, the trade discount expected to be allowed should be deducted to determine the estimated selling price.

Cash discount is a reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

These types of costs are incurred to recover the sale proceeds immediately or before the end of the specified period or credit period allowed to the customer. In other words, these costs are not incurred to make the sale, therefore, the same should not be considered while determining NRV.

- Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise. **These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.**

Example 5

A loss realised on a sale of a product after the end of the period may well provide evidence of the net realisable value of that product at the end of the period. However, if this product is, for example, an exchange traded commodity, and the loss realised can be attributed to a fall in prices on the exchange after the period end date, then this loss would not, in itself, provide evidence of the net realisable value at the period end date.

Illustration 13

ABC Ltd. manufactures and sells paper envelopes. The stock of envelopes was included in the closing inventory as of 31st March, 20X1, at a cost of ₹ 50 per pack. During the final audit, the auditors noted that the subsequent sale price for the inventory at 15th April, 20X1, was ₹ 40 per pack. Furthermore, enquiry reveals that during the physical stock take, a water leakage has created damages to the paper and the glue. Accordingly, in the following week, ABC Ltd. has spent a total of ₹ 15 per pack for repairing and reapplying glue to the envelopes.

Calculate the net realisable value and inventory write-down (loss) amount.

Solution

The net realisable value is the expected sale price ₹ 40, less cost incurred to bring the goods to its saleable condition ie ₹ 15.

Thus, NRV of envelopes pack = ₹ 40 – ₹ 15 = ₹ 25 per pack.

The loss (inventory write-down) per pack is the difference between cost and net realisable value = ₹ 50 – ₹ 25 = ₹ 25 per pack.

- 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 quantity is based on general selling prices. If there is a firm contract to sell quantities in excess of inventory quantities that the entity holds or is able to obtain under a firm purchase contract, this may give rise to an onerous contract liability that should be provided for in accordance with Ind AS 37 "Provisions, Contingent Liabilities and Contingent Assets".

Illustration 14

At the end of its financial year, Company P has 100 units of inventory on hand recorded at a carrying amount of ₹ 10 per unit. The current market price is ₹ 8 per unit at which these units can be sold. Company P has a firm sales contract with Company Q to sell 60 units at ₹ 11 per unit, which cannot be settled net. Estimated incremental selling cost is ₹ 1 per unit.

Compute Net Realisable Value (NRV) of the inventory of Company P.

Solution

While performing NRV test, the NRV of 60 units that will be sold to Company Q is ₹ 10 per unit (i.e. 11-1).

NRV of the remaining 40 units is ₹ 7 per unit (i.e. 8-1).

Therefore, Company P will write down those remaining 40 units by ₹ 120 (i.e. 40 x 3).

Total cost of inventory would be

Goods to be sold to Company Q	60 units x ₹ 10 +	₹ 600
Remaining goods	40 unit x ₹ 7	<u>₹ 280</u>
		<u>₹ 880</u>

- Inventories are usually written down to net realisable value item by item. It is not appropriate to write inventories down on the basis of a classification of inventory, for example, finished goods, or all the inventories in a particular operating segment. The cost and net realisable value should be compared for each separately identifiable item of inventory, or group of similar inventories, rather than for inventory in total.

Illustration 15

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	Cost	Estimated Sales price	₹ Selling costs
Inventory item A1	8,000	7,800	500
Inventory item A2	14,000	18,000	200
Inventory item B1	16,000	17,000	200
Inventory item C1	6,000	7,500	150

Calculate the value of closing inventory in the financial statements of a business.

Solution

The value of closing inventory in the financial statements:

Item of inventory	Cost	NRV (Estimated Sales price- Selling costs)	Measurement base (lower of cost or NRV)	Value
A1	8,000	(7,800 – 500) 7,300	NRV	7,300
A2	14,000	(18,000 – 200) 17,800	Cost	14,000
B1	16,000	(17,000 – 200) 16,800	Cost	16,000
C1	6,000	(7,500 – 150) 7,350	Cost	<u>6,000</u>
Value of Inventory				<u>43,300</u>

Writing inventories down to net realisable value

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 used are expected to be sold at or above cost. This is the case even if these materials in their present condition have a net realisable value that is below cost and would therefore otherwise require write down.

Example 6

A whisky distiller would not write down an inventory of grain because of a fall in the grain price, so long as it expects to sell the whisky at a price which is sufficient to recover cost.

However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. In other words, if an entity writes down any of its finished goods, the carrying value of any related raw materials should also be reviewed to see if they too need to be written down.

Often raw materials are used to make a number of different products. In these cases, it is normally not possible to arrive at a particular net realisable value for each item of raw material based on the selling price of any one type of finished item. If the current replacement cost of those raw materials is less than their historical cost, a provision is only required to be made if the finished goods into which they will be made are expected to be sold at a loss. **No provision should be made just because the anticipated profit will be less than normal.**

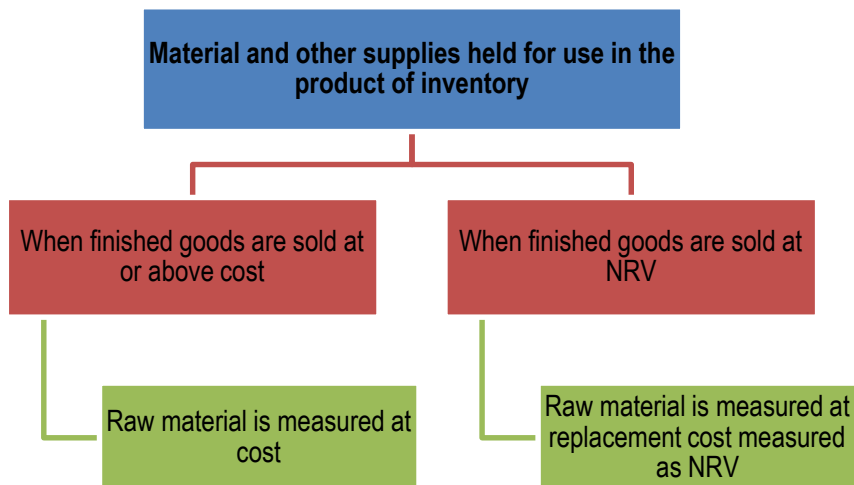


Illustration 16

Particulars		Kg.	
Opening Inventory:	Finished Goods	1,000	25,000
	Raw Materials	1,100	11,000
Purchases		10,000	1,00,000
Labour			76,500
Overheads (Fixed)			75,000

Sales		10,000	2,80,000
Closing Inventory:	Raw Materials	900	
	Finished Goods	1200	

The expected production for the year was 15,000 kg of the finished product. Due to fall in market demand the sales price for the finished goods was ₹ 20 per kg and the replacement cost for the raw material was ₹ 9.50 per kg on the closing day. Calculate the closing inventory as on that date.

Solution

Calculation of cost for closing inventory

Particulars	₹
Cost of Purchase (10,200 x 10)	1,02,000
Direct Labour	76,500
Fixed Overhead $\frac{75,000 \times 10,200}{15,000}$	<u>51,000</u>
Cost of Production	<u>2,29,500</u>
Cost of closing inventory per unit (2,29,500/10,200)	₹ 22.50
Net Realisable Value per unit	₹ 20.00

Since net realisable value is less than cost, closing inventory will be valued at ₹ 20.

As NRV of the finished goods is less than its cost, relevant raw materials will be valued at replacement cost i.e. ₹ 9.50.

Therefore, value of closing inventory: Finished Goods (1,200 x 20)	₹ 24,000
Raw Materials (900 x 9.50)	<u>₹ 8,550</u>
	<u>₹ 32,550</u>

Reversals of write-downs

- A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realisable value.

- This occurs, for example, when an item of inventory that is carried at net realisable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

Illustration 17

Sun Pharma Limited, a renowned company in the field of pharmaceuticals has the following four items in inventory: The cost and net realisable value is given as follows:

Item	Cost	Net Realisable Value
A	2,000	1,900
B	5,000	5,100
C	4,400	4,550
D	<u>3,200</u>	<u>2,990</u>
Total	<u>14,600</u>	<u>14,540</u>

Calculate the value of Inventories:

- On an item by item basis
- On a group basis

Solution

Inventories shall be measured at the lower of cost and net realisable value.

Item by item basis:	
A	1,900
B	5,000
C	4,400
D	<u>2,990</u>
	<u>14,290</u>
Group basis	14,540



1.5 RECOGNITION AS AN EXPENSE

- 1) The amount of inventories recognized as an expense in the period will generally be:

- a) carrying amount of the inventories sold in the period in which related revenue is recognized; and
- b) the amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognized as an expense in the period the write-down or loss occurs;

reduced by

the amount of any reversal in the period of any write-down of inventories, arising from an increase in net realisable value shall be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

- 2) 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 recognized as an expense during the useful life of that asset through charging of depreciation on that asset.

Example 7

An item of inventory costing ₹ 20,000 as covered under Ind AS 2 is consumed in the construction of self-constructed property to be accounted as Property, plant and equipment under Ind AS 16. The cost of such property, plant and equipment other than inventories is ₹ 80,000. Such Inventory needs to be capitalised in the cost of Property, plant and equipment. The useful life of the property is 5 years. The depreciation on such property charged to profit and loss account is ₹ 20,000 per annum (i.e. $1,00,000 / 5$)



1.6 DISCLOSURE

The financial statements shall disclose:

1) Accounting policies

The accounting policies adopted in measuring inventories, including the cost formula used.

2) Analysis of carrying amount

The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity.

Common classifications of inventories are as follows:

- a) Merchandise;
- b) Production supplies;
- c) Materials;

- d) Work in progress; and
- e) Finished goods.

The inventories of a service provider may be described as work in progress

3) Inventories carried at fair value less costs to sell

The carrying amount of inventories carried at fair value less costs to sell.

4) Amounts recognized in profit or loss

- a) the amount of inventories recognized as an expense during the period;
- b) the amount of any write-down of inventories recognized as an expense in the period; and
- c) the amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the period.

In addition, disclosure is required of the circumstances or events that led to the reversal of a write-down of inventories.

5) Inventories pledged as security

The carrying amount of inventories pledged as security for liabilities.

An entity adopts a format for profit or loss that results in amounts being disclosed other than the cost of inventories recognized as an expense during the period. Under this format, the entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognized as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.



1.7 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following are the extracts from the financial statements of the listed entity 'Titan Company Limited' for the financial year 2021-2022 with respect to 'Inventories' and its accounting policy thereon.

Standalone Balance Sheet

as at 31st March 2022

		₹ in crore	
Particulars	Note	As at 31 st March 2022	As at 31 st March 2021
ASSETS			
(1) Non-current assets			
(2) Current assets			
(a) Inventories	10	12,787	7,984
(b) Financial assets			
(i) Investments	11.1	15	2,753
(ii) Trade receivables	11.2	495	291
(iii) Cash and cash equivalents	11.3	117	147

10 Inventories

Particulars	₹ in crore	
	As at 31 st March 2022	As at 31 st March 2021
Raw materials	2,105	1,770
Work-in-progress (refer (a) below)	311	330
Finished goods	8,123	4,433
Stock-in-trade	2,227	1,430
Stores and spares	16	16
Loose tools	5	5
	12,787	7,984
Included above, goods-in-transit		
Raw materials	14	5
Stock-in-trade	9	1
	23	6
a) Details of inventory of work-in-progress		
Watches	154	134
Jewellery	153	194
Others	4	2
	311	330

- (i) The cost of inventories recognised as an expense during the year is ₹ 20,658 crore (Previous year: ₹ 15,769 crore).
- (ii) The cost of inventories recognised as an expense includes ₹ 1 crore (Previous year: ₹ 0.38 crore) in respect of write down of inventory to net-realizable value.
- (iii) The inventory includes Gold purchased on loan from banks amounting to ₹ 5,212 crore (Previous year: ₹ 4,094 crore).
- (iv) Refer note (xvii) under significant accounting policies for mode of valuation.

Standalone Statement of Profit and Loss

for the year ended 31st March 2022

₹ in crore			
Particulars	Note	For the year ended 31 st March 2022	For the year ended 31 st March 2021
I. Revenue from operations	19	27,210	20,602
II. Other income	20	246	181
III. Total income (I +II)		27,456	20,783
IV. Expenses:			
Cost of raw materials and components consumed		20,939	13,143
Purchase of stock-in-trade		4,187	2,462
Changes in inventories of finished goods, stock-in-trade and work-in-progress	21	(4,468)	164

21 Changes in inventories of finished goods, stock-in-trade and work-in-progress

₹ in crore		
Particulars	For the year ended 31 st March 2022	For the year ended 31 st March 2021
Closing stock		
Finished goods	8,123	4,433
Work-in-progress	311	330
Stock-in-trade	2,227	1,430
	10,661	6,193
Opening stock		
Finished goods	4,433	4,514
Work-in-progress	330	308
Stock-in-trade	1,430	1,535
	6,193	6,357
(Increase)/decrease in inventory	(4,468)	164

ACCOUNTING POLICY

Inventories

Inventories [other than quantities of gold for which the price is yet to be determined with the suppliers (Unfixed gold) or where hedge contracts have been entered into for quantities of gold and accounted for as fair value hedge] are stated at the lower of cost and net realisable value determined on an item-by-item basis. Cost is determined as follows:

- Gold is valued on first-in-first-out basis.*
- Stores and spares, loose tools and raw materials are valued on a moving weighted average rate.*
- Work-in-progress and finished goods (other than gold) are valued on full absorption cost method based on the moving average cost of production.*
- Traded goods are valued on a moving weighted average rate/cost of purchases.*

Cost comprises all costs of purchase including duties and taxes (other than those subsequently recoverable by the Company), freight inwards and other expenditure

directly attributable to acquisition. Work-in-progress and finished goods include appropriate proportion of overheads and, where applicable, other taxes.

Unfixed gold and quantities of gold covered under fair value hedge have been entered into is valued at gold prices prevailing on the period closing date.

Net realisable value represents the estimated selling price for inventories less estimated costs of completion and costs necessary to make the sale.

(Source: Annual Report 2021-2022 – Titan Company Limited)



1.8 SIGNIFICANT DIFFERENCES IN IND AS 2 VIS-À-VIS AS 2

S. No.	Particular	Ind AS 2	AS 2
1.	<i>Subsequent Recognition</i>	Ind AS 2 deals with the subsequent recognition of cost / carrying amount of inventories as an expense.	AS 2 does not provide the same.
2.	<i>Inventory held by Commodity Broker-traders</i>	Ind AS 2 does not apply to measurement of inventories held by commodity broker-traders, who measure their inventories at fair value less costs to sell.	This aspect is not there in the AS 2.
3.	<i>Definition of Fair Value and Distinction Between NRV and Fair Value</i>	Ind AS 2 defines fair value and provides an explanation in respect of distinction between 'net realisable value' and 'fair value'.	AS 2 does not contain the definition of fair value and such explanation.
4.	<i>Subsequent Assessment of NRV</i>	Ind AS 2 provides detailed guidance in case of subsequent assessment of net realisable value. It also deals with the reversal of the write-down of inventories to net realisable value to the extent of the amount of original write-down, and the recognition and	AS 2 does not deal with such reversal.

		disclosure thereof in the financial statements.	
5.	<i>Exclusion from its Scope but Guidance given</i>	Ind AS 2 excludes from its scope only the measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products though it provides guidance on measurement of such inventories.	AS 2 excludes from its scope such types of inventories.
6.	<i>Cost Formulae</i>	Ind AS 2 requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity.	AS 2 specifically provides that the formula used in determining the cost of an item of inventory should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. UA Ltd. purchased raw material @ ₹ 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 10,000 kg of raw material in inventory. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realisable value of the raw material for valuation of inventories at the end of the year. However, replacement cost of raw material is ₹ 300 per kg. Compute the value of inventory of raw material?
2. Sun Ltd. has fabricated special equipment (solar power panel) during 20X1-20X2 as per drawing and design supplied by the customer. However, due to a liquidity crunch, the customer has requested the company for postponement in delivery schedule and requested the company to withhold the delivery of finished goods products and discontinue the production of balance items.

As a result of the above, the details of customer balance and the goods held by the company as work-in-progress and finished goods as on 31.3.20X3 are as follows:

Solar power panel (WIP) ₹ 85 lakhs

Solar power panel (finished products) ₹ 55 lakhs

Sundry Debtor (solar power panel) ₹ 65 lakhs

The petition for winding up against the customer has been filed during 20X2-20X3 by Sun Ltd. Advise on provision to be made of ₹ 205 lakh included in Sundry Debtors, Finished goods and work-in-progress in the financial statement of 20X2-20X3.

3. On 31 March 20X1, the inventory of ABC includes spare parts which it had been supplying to a number of different customers for some years. The cost of the spare parts was ₹ 10 million and based on retail prices at 31 March 20X1, the expected selling price of the spare parts is ₹ 12 million. On 15 April 20X1, due to market fluctuations, expected selling price of the spare parts in stock is reduced to ₹ 8 million. The estimated selling expense required to make the sales would ₹ 0.5 million. Financial statements were approved by the Board of Directors on 20th April 20X1.

As at 31st March 20X2, Directors noted that such inventory is still unsold and lying in the warehouse of the company. Directors believe that inventory is in a saleable condition and active marketing would result in an immediate sale. Since the market conditions have improved, estimated selling price of inventory is ₹ 11 million and estimated selling expenses are same ₹ 0.5 million.

Determine the value inventory at the following dates:

- (a) 31st March 20X1
 - (b) 31st March 20X2
4. The following information is gathered from an entity:
- Full capacity is 10,000 labour hours in a year.
 - Normal capacity is 7,500 labour hours in a year.
 - Actual labour hours for current period are 6,500 hours.
 - Total fixed production overhead is ₹ 1,500.
 - Total variable production overhead is ₹ 2,600.
 - Total opening inventory is 2,500 units.
 - Total units produced in a year are 6,500 units.
 - Total units sold in a year are 6,700 units.
 - The cost of inventories is assigned by using FIFO cost formula.

Determine the overhead costs to be allocated to cost of goods sold and closing inventory?

5. Sharp Trading Inc. purchases motorcycles from various countries and exports them to Europe. Sharp Trading has incurred these expenses during 20X1:
- (a) Cost of purchases (based on vendors' invoices) ₹ 5,00,000
 - (b) Trade discounts on purchases ₹ 10,000
 - (c) Import duties ₹ 200
 - (d) Freight and insurance on purchases ₹ 250

- (e) Other handling costs relating to imports ₹ 100
- (f) Salaries of accounting department ₹ 15,000
- (g) Brokerage commission payable to indenting agents for arranging imports ₹ 300
- (h) Sales commission payable to sales agents ₹ 150
- (i) After-sales warranty costs ₹ 600

Advise as to which of the above items is to be included in the cost of inventory and what you want to calculate cost of inventory as per Ind AS 2.

6. On 1 January 20X1 an entity accepted an order for 7,000 custom-made corporate gifts.

On 3 January 20X1 the entity purchased raw materials to be consumed in the production process for ₹ 5,50,000, including ₹ 50,000 refundable purchase taxes. The purchase price was funded by raising a loan of ₹ 5,55,000 (including ₹ 5,000 loan-raising fees). The loan is secured by the inventories.

During January 20X1 the entity designed the corporate gifts for the customer.

Design costs included:

- cost of external designer = ₹ 7,000; and
- labour = ₹ 3,000.

During February 20X1 the entity's production team developed the manufacturing technique and made further modifications necessary to bring the inventories to the conditions specified in the agreement. The following costs were incurred in the testing phase:

- materials, net of ₹ 3,000 recovered from the sale of the scrapped output = ₹ 21,000
- labour = ₹ 11,000
- depreciation of plant used to perform the modifications = ₹ 5,000

During February 20X1 the entity incurred the following additional costs in manufacturing the customised corporate gifts:

- consumable stores = ₹ 55,000
- labour = ₹ 65,000
- depreciation of plant used to manufacture the customised corporate gifts = ₹ 15,000

The customised corporate gifts were ready for sale on 1st March 20X1. No abnormal wastage occurred in the development and manufacture of the corporate gifts.

Compute the cost of the inventory? Substantiate your answer with appropriate reasons and calculations, wherever required.

Answers

1. As per Ind AS 2 "Inventories", 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 realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. Therefore, in this case, UA Ltd. will value the inventory of raw material at ₹ 30,00,000 (10,000 kg. @ ₹ 300 per kg.).
2. From the facts given in the question it is obvious that Sun Ltd. is a manufacturer of solar power panel. As per Ind AS 2 'Inventories', inventories are assets (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. Therefore, solar power panel held in its stock will be considered as its inventory. Further, as per the standard, inventory at the end of the year is to be valued at lower of cost or NRV.

As the customer has postponed the delivery schedule due to liquidity crunch the entire cost incurred for solar power panel which were to be supplied has been shown in Inventory. The solar power panel are in the possession of the Company which can be sold in the market. Hence, the company should value such inventory as per principle laid down in Ind AS 2 i.e. lower of Cost or NRV. Though, the goods were produced as per specifications of buyer the Company should determine the NRV of these goods in the market and value the goods accordingly. Change in value of such solar power panel should be provided for in the books. In the absence of the NRV of WIP and Finished product given in the question, assuming that cost is lower, the company shall value its inventory as per Ind AS 2 for ₹ 140 lakhs [i.e solar power panel (WIP) ₹ 85 lakhs + solar power panel (finished products) ₹ 55 lakhs].

Alternatively, if it is assumed that there is no buyer for such fabricated solar power panel, then the NRV will be Nil. In such a case, full value of finished goods and WIP will be provided for in the books.

As regards Sundry Debtors balance, since the Company has filed a petition for winding up against the customer in 20X2-20X3, it is probable that amount is not recoverable from the party. Hence, the provision for doubtful debts for ₹ 65 lakhs shall be made in the books against the debtor's amount.

3. As per Ind AS 2 'Inventories', inventory is measured at lower of 'cost' or 'net realisable value'. Further, as per Ind AS 10: 'Events after Balance Sheet Date', decline in net realisable value below cost provides additional evidence of events occurring at the balance sheet date and hence shall be considered as 'adjusting events'.

- (a) In the given case, for valuation of inventory as on 31 March 20X1, cost of inventory would be ₹ 10 million and net realisable value would be ₹ 7.5 million (i.e. Expected selling price ₹ 8 million - estimated selling expenses ₹ 0.5 million). Accordingly, inventory shall be measured at ₹ 7.5 million i.e. lower of cost and net realisable value. Therefore, inventory write down of ₹ 2.5 million would be recorded in income statement of that year.
- (b) As per para 33 of Ind AS 2, a new assessment is made of net realisable value in each subsequent period. It *inter alia* states that if there is increase in net realisable value because of changed economic circumstances, the amount of write down is reversed so that new carrying amount is the lower of the cost and the revised net realisable value. Accordingly, as at 31 March 20X2, again inventory would be valued at cost or net realisable value whichever is lower. In the present case, cost is ₹ 10 million and net realisable value would be ₹ 10.5 million (i.e. expected selling price ₹ 11 million – estimated selling expense ₹ 0.5 million). Accordingly, inventory would be recorded at ₹ 10 million and inventory write down carried out in previous year for ₹ 2.5 million shall be reversed.

4. Hours taken to produce 1 unit = 6,500 hours / 6,500 units = 1 hour per unit.

Fixed production overhead absorption rate:

$$\begin{aligned}
 &= \text{Fixed production overhead} / \text{labour hours for normal capacity} \\
 &= ₹ 1,500 / 7,500 \\
 &= ₹ 0.2 \text{ per hour}
 \end{aligned}$$

Management should allocate fixed overhead costs to units produced at a rate of ₹ 0.2 per hour.

Therefore, fixed production overhead allocated to 6,500 units produced during the year (one unit per hour) = 6,500 units x 1 hour x ₹ 0.2 = ₹ 1,300.

The remaining fixed overhead incurred during the year of ₹ 200 (₹ 1500 – ₹ 1300) that remains unallocated is recognized as an expense.

The amount of fixed overhead allocated to inventory is not increased as a result of low production by using normal capacity to allocate fixed overhead.

Variable production overhead absorption rate:

$$\begin{aligned}
 &= \text{Variable production overhead/actual hours for current period} \\
 &= ₹ 2,600 / 6,500 \text{ hours} \\
 &= ₹ 0.4 \text{ per hour}
 \end{aligned}$$

Management should allocate variable overhead costs to units produced at a rate of ₹ 0.4 per hour.

The above rate results in the allocation of all variable overheads to units produced during the year.

$$\begin{aligned}\text{Closing inventory} &= \text{Opening inventory} + \text{Units produced during year} - \text{Units sold during year} \\ &= 2,500 + 6,500 - 6,700 = 2,300 \text{ units}\end{aligned}$$

As each unit has taken one hour to produce (6,500 hours / 6,500 units produced), total fixed and variable production overhead recognized as part of cost of inventory:

$$\begin{aligned}&= \text{Number of units of closing inventory} \times \text{Number of hours to produce each unit} \times (\text{Fixed production overhead absorption rate} + \text{Variable production overhead absorption rate}) \\ &= 2,300 \text{ units} \times 1 \text{ hour} \times (\text{₹ } 0.2 + \text{₹ } 0.4) \\ &= \text{₹ } 1,380\end{aligned}$$

The remaining ₹ 2,720 [(₹ 1,500 + ₹ 2,600) – ₹ 1,380] is recognized as an expense in the income statement as follows:

	₹
Absorbed in cost of goods sold (FIFO basis) (6,500 – 2,300) = 4,200 x ₹ 0.6	2,520
Unabsorbed fixed overheads, not included in the cost of goods sold	<u>200</u>
Total	<u>2,720</u>

5. Items (a), (b), (c), (d), (e), and (g) are permitted to be included in the cost of inventory since these elements contribute to cost of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition, as per Ind AS 2

Statement showing cost of inventory

	₹
Cost of purchases (based on vendors' invoices)	5,00,000
Trade discounts on purchases	(10,000)
Import duties	200
Freight and insurance on purchases	250
Other handling costs relating to imports	100
Brokerage commission payable to indenting agents for arranging imports	<u>300</u>
Cost of inventory under Ind AS 2	<u>4,90,850</u>

Note: Salaries of accounting department, sales commission, and after-sales warranty costs are not considered as part of cost of inventory under Ind AS 2.

6. Statement showing computation of inventory cost

Particulars	Amount (₹)	Remarks
Costs of purchase	5,00,000	Purchase price of raw material [purchase price (₹ 5,50,000) less refundable purchase taxes (₹ 50,000)]
Loan-raising fee	–	Included in the measurement of the liability
Costs of purchase	55,000	Purchase price of consumable stores
Costs of conversion	65,000	Direct costs—labour
Production overheads	15,000	Fixed costs—depreciation
Production overheads	10,000	Product design costs and labour cost for specific customer
Other costs	37,000	Refer working note
Borrowing costs	_____	Recognized as an expense in profit or loss
Total cost of inventories	<u>6,82,000</u>	

Working Note:**Costs of testing product designed for specific customer:**

₹ 21,000 material (ie net of the ₹ 3,000 recovered from the sale of the scrapped output) +
₹ 11,000 labour + ₹ 5,000 depreciation.

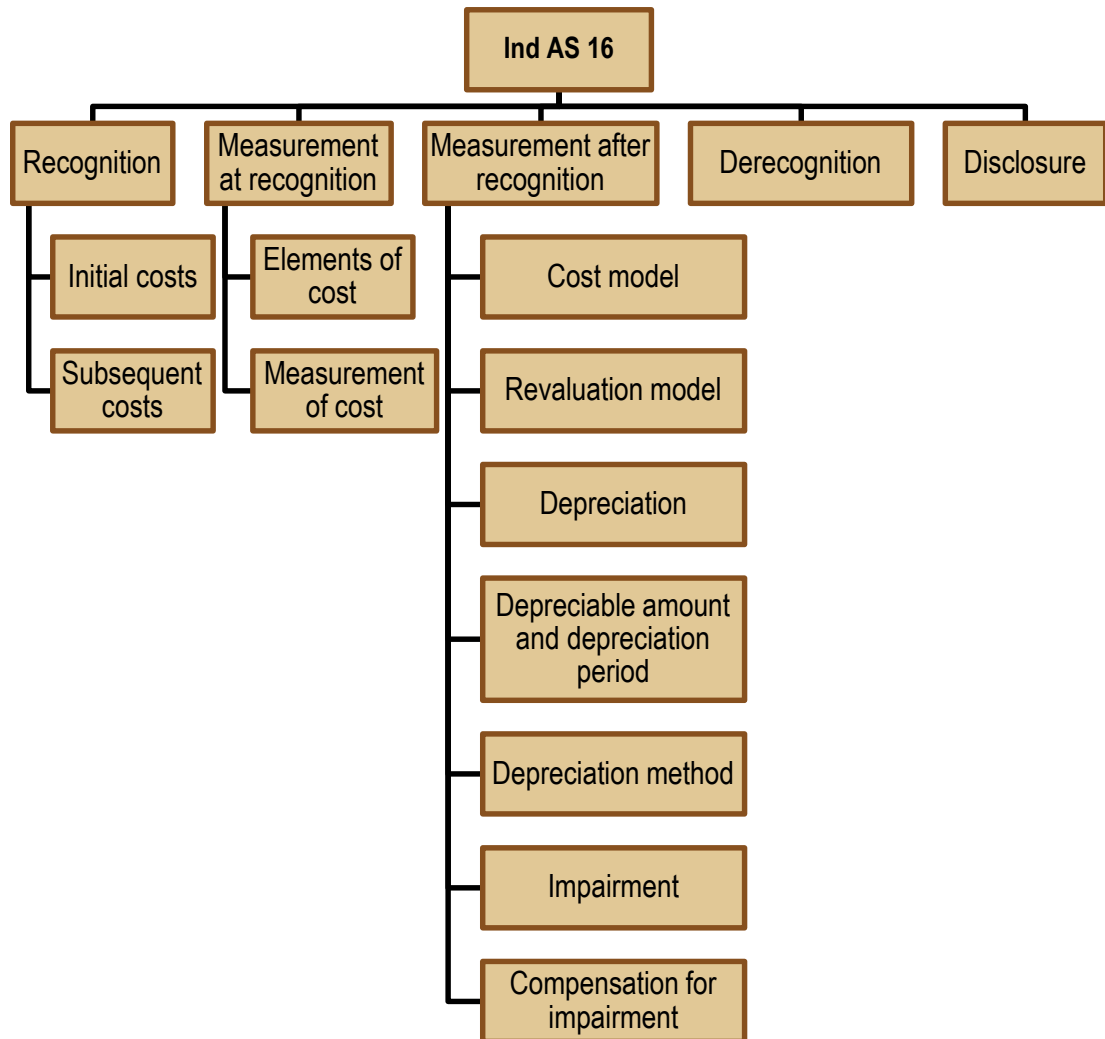
UNIT 2 : INDIAN ACCOUNTING STANDARD 16 : PROPERTY, PLANT AND EQUIPMENT

LEARNING OUTCOMES

After studying this unit, you will be able to

- ❑ State the objective and scope of this standard
- ❑ Define various terms used in the standard
- ❑ Apply the revaluation and cost models of accounting for property, plant and equipment
- ❑ Interpret the differences between repairs and maintenance, replacement and major inspection
- ❑ Account for the changes in depreciation method, useful life and residual value
- ❑ Integrate the accounting for changes in existing, decommissioning, restoration and similar assets

UNIT OVERVIEW





2.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognized in relation to them.



2.2 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) PPE classified as held for sale (as per Ind AS 105)

(b) Biological assets related to agricultural activity other than bearer plants (Ind AS 41)

(c) Recognition and measurement of exploration and evaluation assets (Ind AS 106)

(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 accounting for investment property in accordance with Ind AS 40, *Investment Property*, shall use the cost model in this Standard for owned investment property.

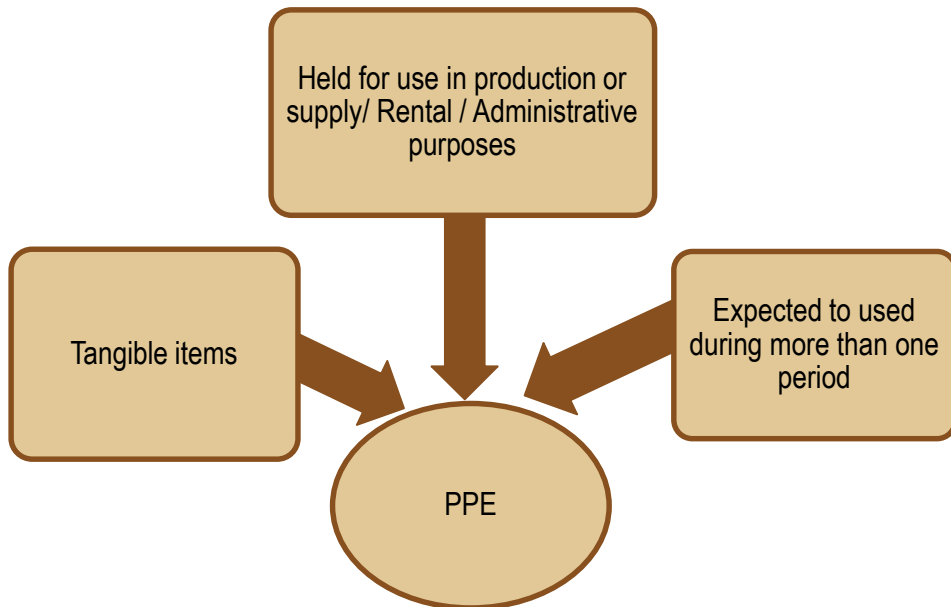


2.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **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.



- 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.
- **Carrying amount** is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.
- **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 Indian Accounting Standards, e.g. Ind AS 102, *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 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. (See Ind AS 113, *Fair Value Measurement*.)
- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- **Recoverable amount** is the higher of an asset's fair value less costs of disposal 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 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.

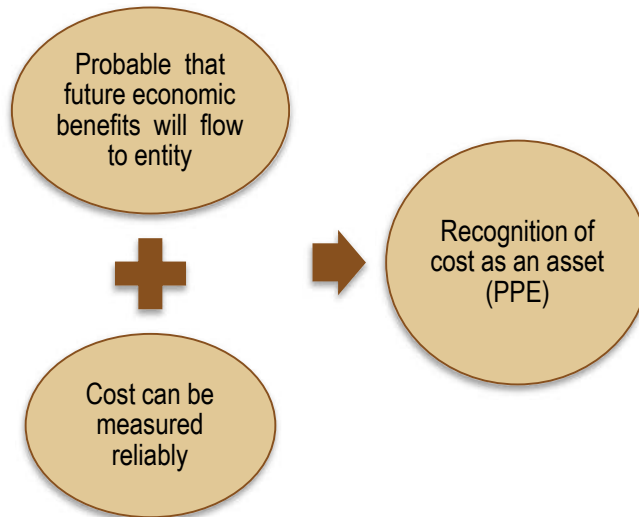


2.4 RECOGNITION

2.4.1 General recognition criteria

The cost of an item of property, plant and equipment shall be recognized as an asset if, and only if:

- a) it is probable that future economic benefits associated with the item will flow to the entity; and
- b) the cost of the item can be measured reliably.



2.4.2 Recognition of Spare parts, stand-by equipment and servicing equipment

Items such as spare parts, stand-by equipment and servicing equipment are recognized in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

2.4.3 Unit of measurement for recognition of PPE and Aggregation of individually insignificant items

This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.

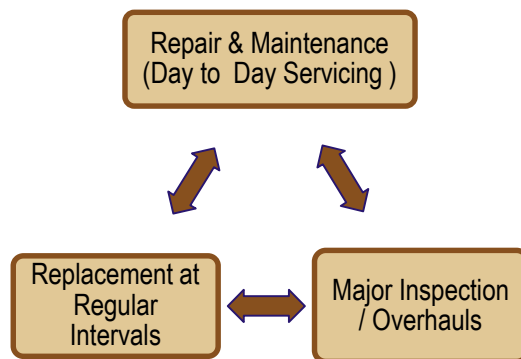
2.4.4 Initial Cost

Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets.

Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

For example: A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognized as an asset because without them the entity is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with Ind AS 36 Impairment of Assets.

2.4.5 Subsequent costs



2.4.5.1 Repair and maintenance

An entity does not recognize in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognized in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables and may include the cost of small parts.

2.4.5.2 Replacement of parts of a property, plant and equipment

- Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.
- Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement.
- Under the recognition principle, an entity recognizes in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is

incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognized in accordance with the derecognition provisions of this Standard.

2.4.5.3 Major inspections or overhauls

- A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced.
- When each major inspection is performed, its cost is recognized 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 is derecognized. 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.

Example - Inspection Cost

A shipping company is required by law to bring all ships into dry dock every five years for a major inspection and overhaul. Overhaul expenditure might at first sight seem to be a repair to ships but it is actually a cost incurred in getting the ship back into a seaworthy condition. As such the costs must be capitalised.

A ship which cost ₹ 20 million with a 20 year life must have major overhaul every five years. The estimated cost of the overhaul at the five-year point is ₹ 5 million.

The depreciation charge for the first five years of the assets life will be as follows:

	Overhaul component (million)	Ship (other than overhaul component) (million)
Cost	5	15
Years	5	20
Depreciation per year	1	0.75

Total accumulated depreciation for the first five years will be ₹ 8.75 million ($₹ (1 + 0.75) \times 5$), and the carrying amount of the ship at the end of year 5 will be ₹ 11.25 million ($₹ 20$ less 8.75).

Assume that the actual overhaul costs incurred at the end of year 5 are ₹ 6 million. This amount will now be capitalised into the costs of the ship, to give a carrying amount of ₹ 17.25 million (being ₹ 11.25 million plus 6 million).

The depreciation charge for years 6 to 10 will be as follows:

	Overhaul component (₹ in million)	Ship (other than overhaul component) (₹ in million)
Cost	6	11.25
Years	5	15
Depreciation per year	1.2	0.75

Annual depreciation for years 6 to 10 will now be ₹ 1.95 million [₹ (1.2 + 0.75)]. This process will be continued for years 11 to 15 and years 16 to 20. By the end of year 20, the capital cost of ₹ 20 million will have been depreciated plus the actual overhaul costs incurred at years 5, 10 and 15.



2.5 MEASUREMENT AT RECOGNITION

2.5.1 Measurement at cost

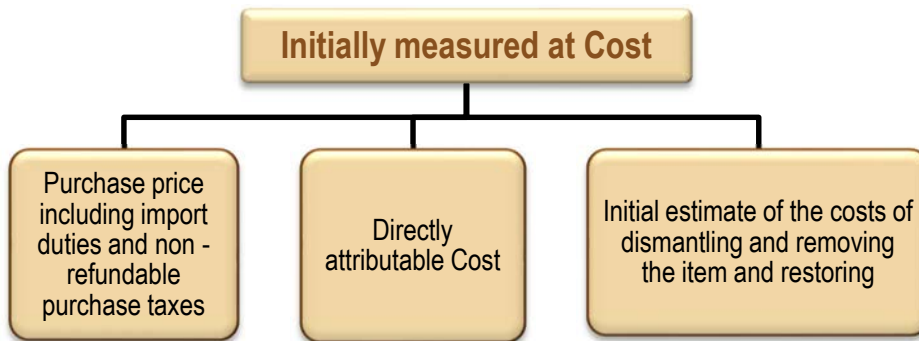
An item of property, plant and equipment that qualifies for recognition as an asset should be initially measured at its cost.

2.5.2 Element of cost

2.5.2.1 Cost of an acquired asset

2.5.2.1.1 Component of cost

- The cost of an item of property, plant and equipment comprises:
 - a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
 - b) any costs 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; and
 - c) the 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.



- **Examples of directly attributable costs are:**

Employee benefits cost arising directly from construction or acquisition of PPE

Cost of Site Preparation

Initial delivery and handling costs

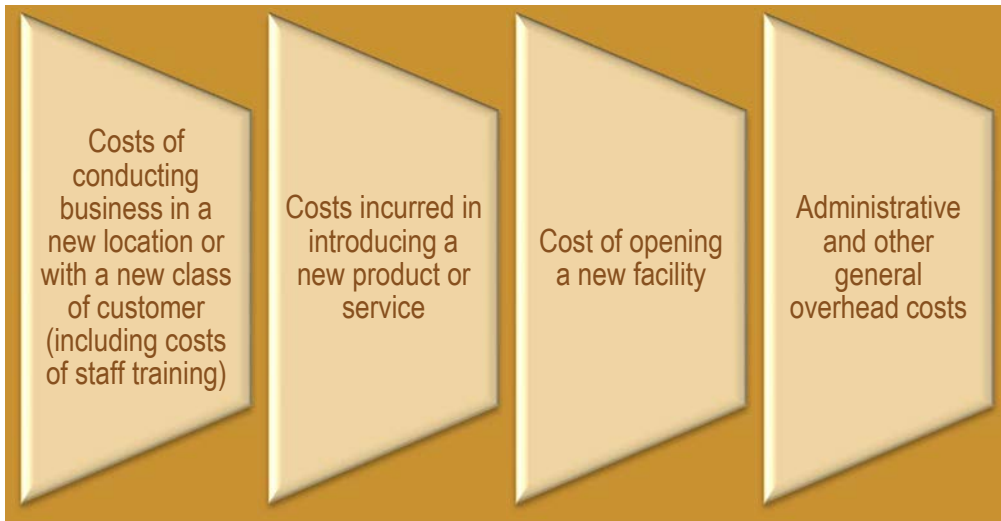
Installation and assembly costs

Professional Fees

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).

Note: Excess of net sale proceeds of items produced over the cost of testing, if any, shall not be recognized in the profit or loss but deducted from the directly attributable costs considered as part of cost of an item of property, plant, and equipment

- **Examples of costs that are not costs of an item of property, plant and equipment are:**



2.5.2.2 Cost of self-constructed asset and Bearer Plants

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale. Therefore, any internal profits are eliminated in arriving at such costs.

Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.

Ind AS 23 'Borrowing Costs', establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

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.

2.5.2.3 Cost of dismantling, removal and site restoration

Cost incurred by an entity in respect of obligation for dismantling, removing and restoring the site on which an item of property, plant and equipment is located are recognized and measured in accordance with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

If the obligations are incurred when the asset is acquired, or during a period when the item is used other than to produce inventories, they are included in the cost of the item property, plant and equipment.

An entity applies Ind AS 2, Inventories, to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.

2.5.2.4 Incidental operations

Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management.

These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts.

Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognized in profit or loss and included in their respective classifications of income and expense.

2.5.2.5 Cessation of capitalisation

Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item.

- **For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:**
 - a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;
 - b) initial operating losses, such as those incurred while demand for the item's output builds up; and
 - c) costs of relocating or reorganizing part or all of an entity's operations.

Example

Moon Ltd incurs the following costs in relation to the construction of a new factory and the introduction of its products to the local market. The below table illustrates which of the items of cost can be capitalised as per Ind AS 16.

Particulars	₹ 000 (Cost incurred)	₹ 000 (As per Ind AS 16)
Site preparation costs	150	150
Direct Material	2,000	2,000
Direct Labour cost, including ₹ 10,000 incurred during an industrial strike	1,160	1,150
Testing of various processes in factory	200	200
Consultancy fees for installation of equipment	300	300
Relocation of staff to new factory	450	-
General overheads	550	-
Estimated Costs to dismantle (at present value)	200	<u>200</u>
Total Cost to be Capitalised as per Ind AS 16		<u>4,000</u>

2.5.3 Measurement of cost

2.5.3.1 Payment 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 recognized as interest over the period of credit unless such interest is capitalised in accordance with Ind AS 23.

Illustration 1 - Deferred Payment Credit

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-year period (payments are made on 1st April, 20X1, 31st March, 20X2 and 31st March, 20X3). Implicit interest rate of 5.36 percent p.a. Pass necessary journal entries for recording the property in accordance with Ind AS 16.

Solution

Ind AS 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 recognize the acquisition of the asset as follows:

<u>On 1st April, 20X1</u>		(₹)	(₹)
Property, Plant and Equipment (W.N. 1)	Dr.	95,00,000	
To Bank A/c			33,33,333
To Accounts Payable (W.N. 2)			61,66,667
<i>(Initial recognition of property)</i>			
<u>On 31st March, 20X2</u>			
Interest Expense (W.N. 2)	Dr.	3,30,533	
Accounts payable (W.N. 2)	Dr.	30,02,800	
To Bank A/c			33,33,333
<i>(Recognition of interest expense and payment of second installment)</i>			
<u>On 31st March, 20X3</u>			
Interest Expense (W.N. 2)	Dr.	1,69,467	
Accounts payable (W.N. 2)	Dr.	31,63,867	
To Bank A/c			33,33,334
<i>(Recognition of interest expense and payment of final installment)</i>			

Working Notes:**1. Calculation of cash price equivalent at initial recognition**

Year	Payment	Discounting factor @ 5.36%	Present value
1.4.20X1	33,33,333	1.000	33,33,333
31.3.20X2	33,33,333	0.949	31,63,333
31.3.20X3	<u>33,33,334</u>	0.901	<u>30,03,334</u>
Initial date cash price equivalent	<u>1,00,00,000</u>		<u>95,00,000</u>

2. Calculation of interest expenses

Year	Opening balance (a)	Interest @ 5.36% (b) = (a) x 5.36%	Total payment at year beginning (c)	Principal amount in the instalment (d) = (c) – (b)	Closing balance (e) = (a) – (d)
1.4.20X1	95,00,000	-	33,33,333	33,33,333	61,66,667
31.3.20X2	61,66,667	3,30,533	33,33,333	30,02,800	31,63,867
31.3.20X3	31,63,867	1,69,467*	33,33,334	31,63,867	Nil

*Difference of ₹ 116 [(31,63,867 x 5.36%) – (33,33,334 - 31,63,867)] is due to approximation.

2.5.3.2 Measurement of PPE acquired in Exchange

- One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an item of property, plant and equipment is measured at fair value (even if an entity cannot immediately derecognize the asset given up) 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.
- If the acquired item is not measured at fair value [because of considerations mentioned in a) and b) above], its cost is measured at the carrying amount of the asset given up.
- 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. An exchange transaction has commercial substance if:
 - a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
 - b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and
 - c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.
- For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows.

- The fair value of an asset is reliably measurable if:
 - a) the variability in the range of reasonable fair value measurements is not significant for that asset or
 - b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.
- 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 the cost of the asset received unless the fair value of the asset received is more clearly evident.
- The carrying amount of an item of property, plant and equipment may be reduced by Government grants in accordance with Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance.

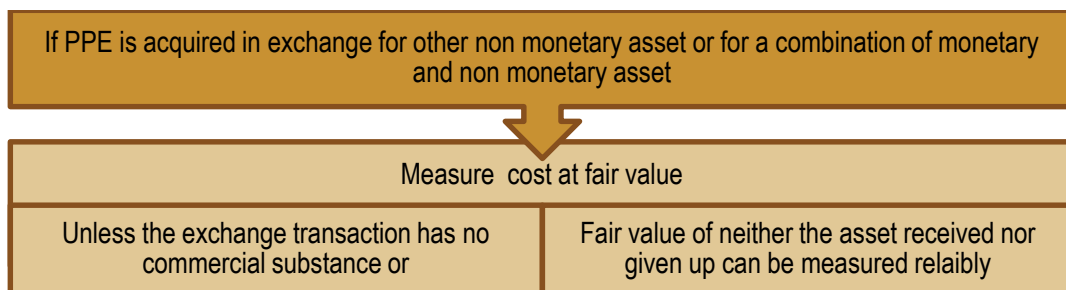


Illustration 2 – Exchange of Assets

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 ₹ 20 million, and pays additional ₹ 3 million in cash.

Apply necessary provisions of Ind AS 16 for the above transactions and pass journal entry for the same.

Solution

Provided that the transaction has commercial substance, the entity should recognize the private jet at a cost of ₹ 18 million (being ₹ 15 million plus 3 million cash) and should recognize a profit on disposal of the land and building of ₹ 5 million, calculated as follow:

	(₹ 000)
Recognition of fair value of asset acquired (15,000 + 3,000)	18,000
Less: Carrying amount of land and building disposed	(10,000)

Cash Paid	<u>(3,000)</u>
Profit on exchange of assets	<u>5,000</u>

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



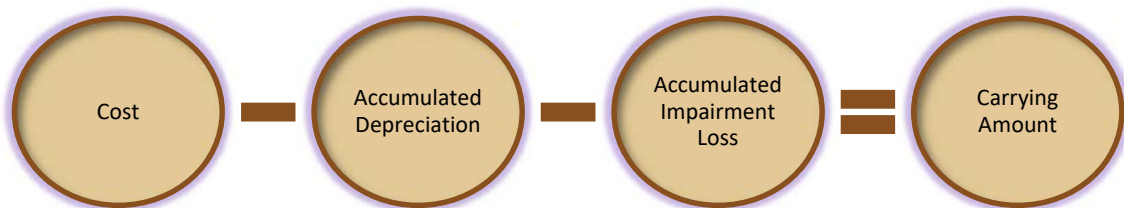
2.6 MEASUREMENT AFTER RECOGNITION

2.6.1 Alternative bases available for measurement after recognition

An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

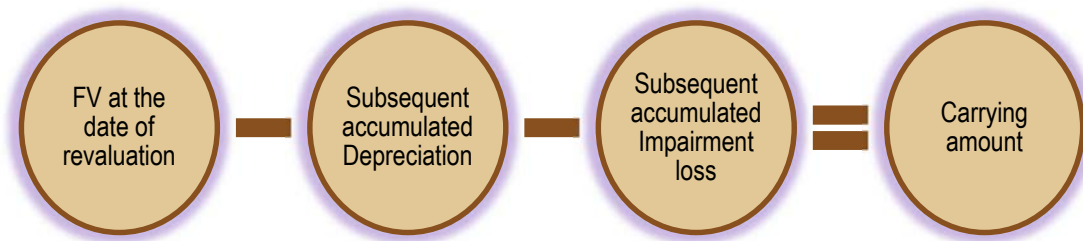
2.6.2 Cost model

After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.



2.6.3 Revaluation model

After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably is 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. Revaluations are required to be carried out with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.



2.6.3.1 Frequency of revaluations

- The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation.
- Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

2.6.3.2 Accumulated depreciation at the date of revaluation

- When an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:
 - a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The 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; or
 - b) the accumulated depreciation is eliminated against the gross carrying amount of the asset.

Illustration 3: Accumulated depreciation at the date of revaluation

Jupiter Ltd. has an item of property, plant and equipment 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.

Prepare the necessary journal entries.

Solution

Method – I: Depreciation Elimination Approach

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: Restatement Approach

Carrying amount (100,000 – 55,000) =	45,000
Fair value (revalued amount)	65,000
Surplus	20,000
% of surplus to the carrying amount (20,000 / 45,000)	44.44%

Entries to be Made:

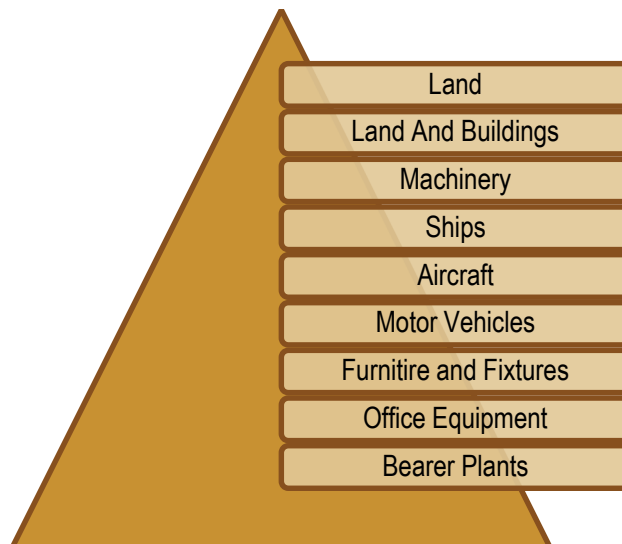
Asset (1,00,000 x 44.44%)	Dr.	44,444	
To Accumulated Depreciation (55,000 x 44.44%)			24,444
To Revaluation Reserve			20,000

(Being the entry to increase both the original cost and the accumulated depreciation by 44.44%)

2.6.3.3 Revaluation to be made for entire class of assets

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:



The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates.

However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

Illustration 4: Revaluation model for entire class

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 wants to apply the Ind AS 16 revaluation model to subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings.

Analyse the accounting treatment to be applied by the management in the light of Ind AS 16.

Solution

Venus's Ltd. 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.

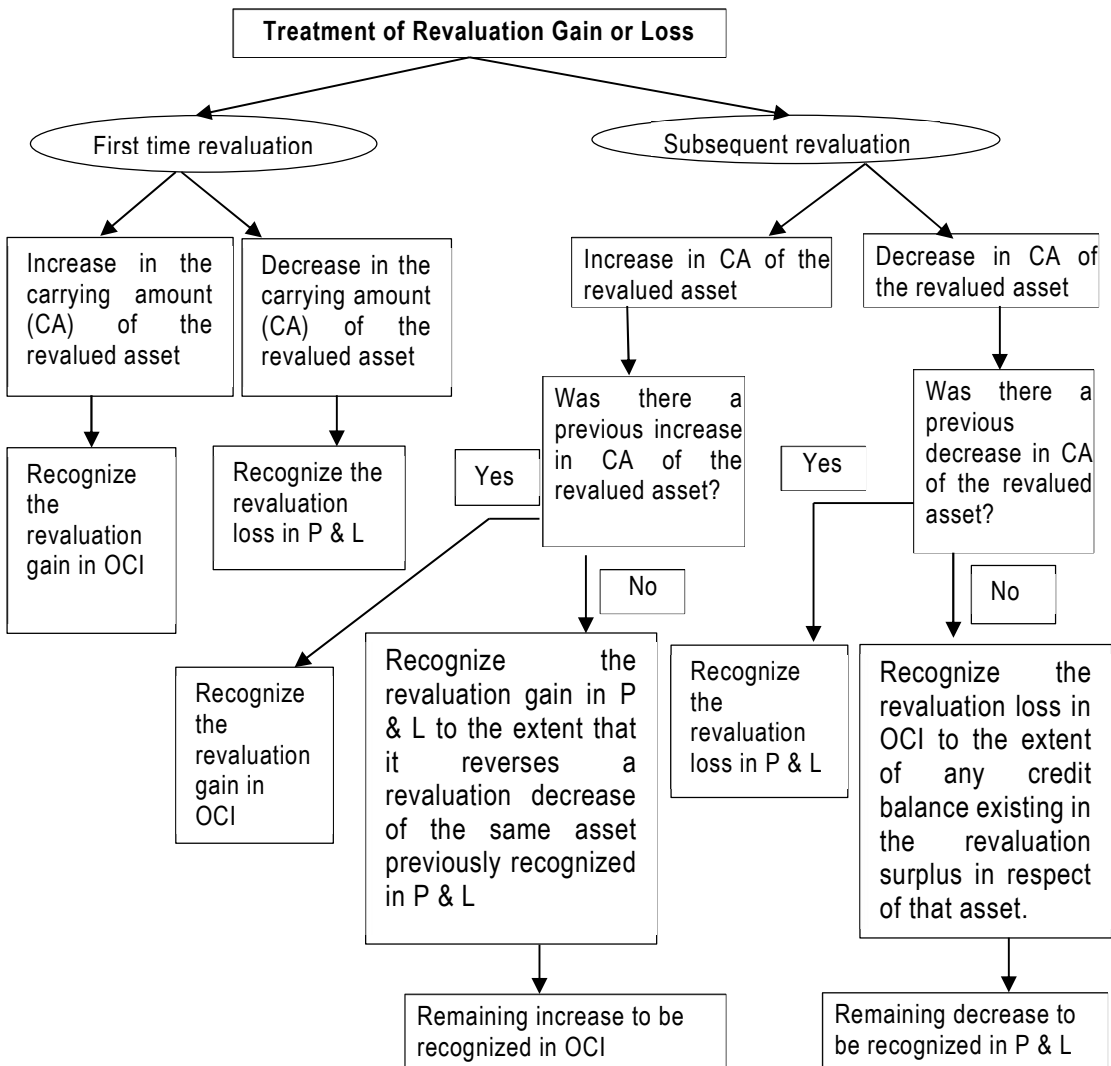
Ind AS 16 permits assets to be revalued on a class-by-class basis.

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 para 73 of Ind AS 16.

2.6.3.4 Treatment of surplus or deficit arising on revaluation

- If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit or loss.
- If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in profit or loss. However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

Treatment of revaluation gain and loss is summarized in the below diagram:



The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognized. 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 depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

The effects of taxes on income, if any, resulting from the revaluation of property, plant and equipment are recognized and disclosed in accordance with Ind AS 12, *Income Taxes*.

Illustration 5: Utilisation of Revaluation Surplus

An item of PPE was purchased for ₹ 9,00,000 on 1st April, 20X1. It is estimated to have a useful life of 10 years and is depreciated on a straight-line basis. On 1st April, 20X3, the asset is revalued to ₹ 9,60,000. The useful life remains unchanged as ten years. Ignore impact of deferred taxes. Calculate depreciation and revaluation surplus for 20X3-20X4 as per Ind AS 16.

Solution

Calculation of Additional Depreciation:	(₹)
Actual depreciation for 20X3-20X4 based on revalued amount (9,60,000/8)	1,20,000
Depreciation for 20X3-20X4 based on historical cost (9,00,000/10)	<u>(90,000)</u>
Additional Depreciation	<u>30,000</u>

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 31st March, 20X4 will therefore be as follows:

Balance arising on revaluation (9,60,000 – 7,20,000)		2,40,000
Transfer to retained earnings		<u>(30,000)</u>
		<u>2,10,000</u>

2.6.4 Depreciation

- The depreciable amount of an asset should be allocated on a systematic basis over its useful life. The depreciation charge for each period should be recognized in profit or loss unless it is included in the carrying amount of another asset.
- Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.
- An entity allocates the amount initially recognized in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft.
- A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of

another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

- To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.
- Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.
- If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.
- In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

2.6.4.1 Residual Value

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Illustration 6: Revision of Useful Life

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 for the years 1,2,3.

Solution:

₹

	Year-1	Year-2	Year-3
Cost	10,000	10,000	10,000
Less: Accumulated Depreciation	(800)	(1,600)	(3,200)

Carrying Amount	9,200	8,400	6,800
Charges for year	$\frac{10,000-2,000}{10} = 800$	$\frac{10,000-2,000}{10} = 800$	$\frac{8,400-2,000}{4} = 1,600$

- The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.
- Depreciation is recognized even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

2.6.4.2 Commencement of depreciation

Depreciation of an asset begins when it 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.

2.6.4.3 Cessation of depreciation

- Depreciation of an asset ceases at the earlier of:
 - a) the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105.
 - b) and the date that the asset is derecognized.
- Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

2.6.4.4 Factors affecting the useful life of an asset

The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

- a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output;
- b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle;

- c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset; and
- d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

2.6.4.5 Impact of an entity's asset management policy

The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset.

Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

2.6.4.6 Depreciation method

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The depreciation method applied to an asset is reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change is accounted for as a change in an accounting estimate in accordance with Ind AS 8.

Illustration 7: Change in Depreciation Method

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.

Calculate the depreciation charge for respective years in accordance with Ind AS 16.

Solution

Change in depreciation method shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8 and hence will have a prospective effect.

Depreciation charges for year 1 to 11 will be as follows:

Year 1	₹ 5,00,000

Year 2	₹ 4,50,000
Year 3	₹ 4,05,000
Year 4 to Year 11 (refer W.N.)	₹ 4,55,625 p.a.

Working Note:

Year	Opening balance of asset (a)	Depreciation @ 10% on (a)	Closing balance of asset (c) = (a) - (b)
1	50,00,000	5,00,000	45,00,000
2	45,00,000	4,50,000	40,50,000
3	40,50,000	4,05,000	36,45,000

Year 3 onwards method of depreciation has been changed from reducing balance method to straight line method for which it is assessed that the remaining useful life is 8 years. Hence revised depreciation would be calculated as follows:

Revised depreciation as per straight line method = (Carrying amount as at the end of the 3rd year – Residual value) / Remaining useful life

$$= 36,45,000 / 8 \text{ years} = ₹ 4,55,625 \text{ per annum (for year 4 to year 11)}$$

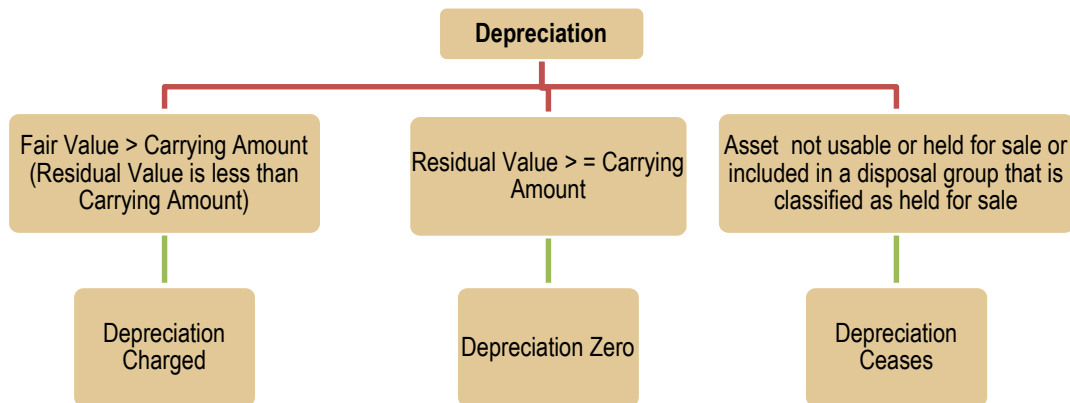
A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include:

- Straight-line depreciation method results in a constant charge over the useful life if the asset's residual value does not change.
- Diminishing balance method results in a decreasing charge over the useful life.
- Units of production method results in a charge based on the expected use or output.

The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset (e.g. revenue is affected by other inputs and processes, selling activities and changes in

sales volumes and prices). The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.



2.6.5 Impairment

2.6.5.1 Identification of an impairment loss

To determine whether an item of property, plant and equipment is impaired, an entity applies Ind AS 36, *Impairment of Assets*. Ind AS 36 explains how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognizes, or reverses the recognition of, an impairment loss.

2.6.5.2 Compensation for impairment

- Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.
- Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:
 - a) impairments of items of property, plant and equipment are recognized in accordance with Ind AS 36;
 - b) derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;

- c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and
- d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.



2.7 DERECOGNITION

2.7.1 Derecognition- general

- The carrying amount of an item of property, plant and equipment should be derecognized:
 - a) on disposal; or
 - b) when no future economic benefits are expected from its use or disposal.
- The gain or loss arising from the derecognition of an item of property, plant and equipment is included in profit or loss when the item is derecognized (unless Ind AS 116 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.
- However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets shall be recognized as revenue in accordance with Ind AS 115, Revenue from Contracts with Customers.
- The date of disposal of an item of property, plant and equipment is the date the recipient obtains control of that item in accordance with Ind AS 115. Ind AS 116 applies to disposal by a sale and leaseback.
- If, under the recognition principle, an entity recognizes in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognizes the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.
- The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

- The date of disposal of an item of property, plant and equipment is the date the recipient obtains control of that item in accordance with the requirements for determining when a performance obligation is satisfied in Ind AS 115. Ind AS 116 applies to disposal by a sale and leaseback.
- The amount of consideration to be included in the gain or loss arising from the derecognition of an item of property, plant and equipment is determined in accordance with the requirements for determining the transaction price in Ind AS 115.
- Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.



2.8 DISCLOSURE

2.8.1 Disclosure- general

- The financial statements shall disclose, for each class of property, plant and equipment:
 - a) the measurement bases used for determining the gross carrying amount;
 - b) the depreciation methods used;
 - c) the useful lives or the depreciation rates used; and
 - d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period.
- Entity is also required to provide a reconciliation of the carrying amount at the beginning and end of the period showing:
 - a) additions;
 - b) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;
 - c) acquisitions through business combinations;
 - d) increases or decreases resulting from revaluations and from impairment losses recognized or reversed in other comprehensive income in accordance with Ind AS 36;
 - e) impairment losses recognized in profit or loss in accordance with Ind AS 36;
 - f) impairment losses reversed in profit or loss in accordance with Ind AS 36;
 - g) depreciation;

- h) the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and
- i) other changes.
- The financial statements shall also disclose:
 - a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
 - b) the amount of expenditures recognized in the carrying amount of an item of property, plant and equipment in the course of its construction;
 - c) the amount of contractual commitments for the acquisition of property, plant and equipment; and
 - d) if it is not disclosed separately in the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.
- Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information that allows them to review the policies selected by management and enables comparisons to be made with other entities. For similar reasons, it is necessary to disclose:
 - (a) depreciation, whether recognized in profit or loss or as a part of the cost of other assets, during a period; and
 - (b) accumulated depreciation at the end of the period.
- In accordance with Ind AS 8 an entity discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:
 - (a) residual values;
 - (b) the estimated costs of dismantling, removing or restoring items of property, plant and equipment;
 - (c) useful lives; and
 - (d) depreciation methods

2.8.2 Items stated at revalued amounts

- If items of property, plant and equipment are stated at revalued amounts, the following should be disclose:
 - a) the effective date of the revaluation;
 - b) whether an independent valuer was involved;
 - c) for each revalued class of property, plant and equipment, the carrying amount that would have been recognized had the assets been carried under the cost model; and
 - d) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

2.8.3 Additional recommended disclosure

- Entities are encouraged but not required, to disclose the following amounts:
 - a) the carrying amount of temporarily idle property, plant and equipment;
 - b) the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;
 - c) the carrying amount of property, plant and equipment retired from active use and not classified as held for sale in accordance with Ind AS 105; and
 - d) when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount.

Illustration 8

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. The discount rate assumed is 5%.

Analyse whether the cost of the new turbine can be recognized as an asset, and, if yes, then apply the accounting treatment relevant to it.

Solution

The new turbine will produce economic benefits to MS Ltd., and the cost is measurable. Hence, the item should be recognized 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 derecognized 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.

Illustration 9

On 1st April, 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 20th April, 20X1.

Compute the cost of the asset to be recognized.

Solution

In accordance with Ind AS 16, all costs required to bring an asset to its present location and condition for its intended use should be capitalized. Therefore, the initial purchase price of the asset should be

	₹
List price	80,00,000
Less: Trade discount (10%)	<u>(8,00,000)</u>
	72,00,000
Import duty	5,00,000
Delivery fees	1,00,000
Electrical installation costs	10,00,000
Pre-production testing	<u>4,00,000</u>
Total amount to be capitalized at 1 st April, 20X1	<u>92,00,000</u>

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.

Illustration 10

X Limited started construction on a building for its own use on 1st April, 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

1st January, 20X1 and brought in use 1st April, 20X1. X Limited had taken a loan of ₹ 40,00,000 on 1st April, 20X0 for construction of the building. The loan carried an interest rate of 8% per annum and is repayable on 1st April, 20X2. Assume that the entity did not consider the construction period as substantial period of time as per Ind AS 23.

Calculate the cost of the building that will be included in tangible non-current asset as an addition?

Solution

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. Cost of abnormal amount of wasted material/ labor or other resources is not included as per para 22 of Ind AS 16. Here, the cost of spoilt materials and faulty designs are assumed to be abnormal costs. Also, it is assumed that the wastages and labor charges incurred are abnormal in nature. Hence, same are also not included in the cost of PPE.

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*	<u>Nil</u>
Total to be capitalized	<u>45,78,000</u>

Illustration 11

XYZ Ltd. purchased an asset on 1st January, 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 1st January, 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.

Account for the asset for the remaining years.

Solution

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 1st January, 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.

Illustration 12

On 1st 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 1st 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 – ₹ 3,00,000.*
- *Costs of the opening ceremony on 31st January, 20X2 – ₹ 1,50,000.*

The factory was completed on 30th November, 20X1 (which is considered as substantial period of time as per Ind AS 23) and production began on 1st 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 f 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 ₹ 0.046.

The construction of the factory was partly financed by a loan of ₹ 17.5 million taken out on 1st April, 20X1. The loan was at an annual rate of interest of 6%. Sun Ltd received investment income of ₹ 100,000 on the temporary investment of the proceeds.

Compute the carrying amount of the factory on the Balance Sheet of Sun Ltd at 31st March, 20X2. Explain the treatment of all the amounts referred to in this part of the answer.

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 recognized 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	612.50	Capitalize the interest cost incurred in a seven-month period (purchase of land would not trigger off capitalization since land is not a qualifying asset. Infact, the construction started from 1 st May, 20X1)
Investment income on temporary investment of the loan proceeds	(100)	offset against the amount capitalized
Demolition cost recognized as a provision	920	Where an obligation must recognize as part of the initial cost
Total	<u>19,912.50</u>	

Computation of accumulated depreciation		
Total depreciable amount	<u>9,912.50</u>	All of the net finance cost of 512.50 (612.50 – 100) has been allocated to the depreciable amount. Also, acceptable to reduce by allocating a portion to the non-depreciable land element principle
Depreciation must be in two parts:		
Depreciation of roof component	49.56	$9,912.50 \times 30\% \times 1/20 \times 4/12$
Depreciation of remainder	<u>57.82</u>	$9,912.50 \times 70\% \times 1/40 \times 4/12$
Total depreciation	<u>107.38</u>	
Computation of carrying amount	<u>19,805.12</u>	$19,912.50 - 107.38$



2.9 CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND SIMILAR LIABILITIES (APPENDIX A)

Many entities have obligations to dismantle, remove and restore items of property, plant and equipment after the end of particular period. The initial estimate of such costs is included in the cost of an item of property, plant and equipment. For instance, a lessee who has taken an office building on lease may do some leasehold improvements and may have an obligation under the lease agreement to dismantle the leasehold improvements at the end of the lease. Such obligations are referred to as 'decommissioning, restoration and similar liabilities'.

Ind AS 37 contains requirements on how to measure decommissioning, restoration and similar liabilities. **Appendix A to Ind AS 16 provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.**

2.9.1 When to apply guidance in Appendix A to Ind AS 16

The guidance in Appendix A to Ind AS 16 applies to changes in the measurement of any existing de-commissioning, restoration or similar liability that is both:

- recognized as part of the cost of an item of property, plant and equipment in accordance with Ind AS 16 or as part of the cost of a right-of-use asset in accordance with Ind AS 116; and
- recognized as a liability in accordance with Ind AS 37.

2.9.2 Issues addressed by Appendix A to Ind AS 16

This Appendix addresses how the **effect of the following events that change the measurement** of an existing decommissioning, restoration or similar liability should be accounted for:

- a) a change in the estimated outflow of resources embodying economic benefits (e.g. cash flows) required to settle the obligation;
- b) a change in the current market-based discount rate as defined in paragraph 47 of Ind AS 37 (this includes changes in the time value of money and the risks specific to the liability); and
- c) an increase that reflects the passage of time (also referred to as the unwinding of the discount).

2.9.3 Accounting guidance in Appendix A to Ind AS 16

- Appendix A to Ind AS 16 offers two different approaches to account for changes in decommissioning **liability depending upon whether the entity follows cost model or revaluation model.**
- If the related asset is measured using the **cost model**:
 - (a) subject to point (b) below, changes in the decommissioning, restoration and similar liability shall be **added to, or deducted from**, the cost of the asset in the current period and related provision for decommissioning and site restoration is accordingly adjusted.
 - (b) **any such decrease** in the decommissioning, restoration and similar liability **cannot exceed** the carrying amount of the asset. In case, the said decrease in the decommissioning liability is more than the carrying amount of the asset, **the excess is recognized immediately as income** in statement of profit and loss.
 - (c) if the changes in the decommissioning liability and the resultant **adjustment results in an addition to the cost** of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, **the entity shall test the asset for impairment** by estimating its recoverable amount, and shall account for any impairment loss, in accordance with Ind AS 36.
- If the asset is measured using the **revaluation model**:
 - (a) **Any increase in liability** arising out of changes in decommissioning liabilities is **adjusted against revaluation surplus to the extent credit balance is available relating to that particular asset through 'other comprehensive income'**. Any excess is, however, recognized in the statement of profit and loss.
 - (b) **Any decrease in liability** arising out of changes in decommissioning liabilities, is **recognized in the revaluation reserve ie equity through 'other comprehensive income'**. However, if there was any revaluation deficit previously charged to profit or loss, to that extent it can be recognized as income in the statement of profit and loss.

- (c) If there is **decrease** in decommissioning liability **in excess of the carrying amount** of the asset, such excess is treated as 'deemed revaluation' and is **recognized immediately in the statement of profit and loss**.
- (d) Any change in liability would require the asset to be tested for impairment to ascertain if there is any change in fair value.
- (e) **Change in the revaluation surplus** arising from a change in the decommissioning liability **shall be presented as a separate line item** in the Statement of Other Comprehensive Income, as required under Ind AS 1.
- The **adjusted depreciable amount** of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognized in profit or loss as they occur. This applies under both the cost model and the revaluation model.
- The **periodic unwinding of the discount** shall be recognized in profit or loss as a finance cost, as it occurs. Capitalisation under Ind AS 23 is not permitted.

Illustration 13

H Limited purchased an item of PPE costing ₹ 100 million which has useful life of 10 years. The entity has a contractual decommissioning and site restoration obligation, estimated at ₹ 5 million to be incurred at the end of 10th year. The current market-based discount rate is 8%.

The company follows SLM method of depreciation. H Limited follows the Cost Model for accounting of PPE.

Determine the carrying value of an item of PPE and decommissioning liability at each year end when

- (a) *There is no change in the expected decommissioning expenses, expected timing of incurring the decommissioning expense and / or the discount rate*
- (b) *At the end of Year 4, the entity expects that the estimated cash outflow on account of decommissioning and site restoration to be incurred at the end of the useful life of the asset will be ₹ 8 million (in place of ₹ 5 million, estimated in the past).*

Determine in case (b), how H Limited need to account for the changes in the decommissioning liability?

Solution

The present value of such decommissioning and site restoration obligation at the end of 10th year is **₹ 2.32 million** [being $5 / (1.08)^{10}$]. H Limited will recognize the present value of decommissioning liability of ₹ 2.32 million as an **addition to cost of PPE** and will also recognize

a corresponding decommissioning liability. Further, the entity will recognize the unwinding of discount as finance charge.

- (a) The following table shows the relevant computations, if there is **no change** in the expected decommissioning expenses, expected timing of incurring the decommissioning expense and / or the discount rate: (₹ in million)

Year	Opening Amount of PPE	Depreciation Charge (on SLM) for 10 Years	Carrying Amount of PPE at the end of the year	Opening Decommissioning Liability	Unwinding of Interest @ 8%	Closing Decommissioning Liability
1	102.32	10.23	92.08	2.32	0.19	2.50
2	92.08	10.23	81.85	2.50	0.20	2.70
3	81.85	10.23	71.62	2.70	0.22	2.92
4	71.62	10.23	61.39	2.92	0.23	3.15
5	61.39	10.23	51.16	3.15	0.25	3.40
6	51.16	10.23	40.93	3.40	0.27	3.68
7	40.93	10.23	30.69	3.68	0.29	3.97
8	30.69	10.23	20.46	3.97	0.32	4.29
9	20.46	10.23	10.23	4.29	0.34	4.63
10	10.23	10.23	-	4.63	0.37	5.00
Total		102.32			2.68	

- (b) The changes to the estimate of expected decommissioning obligation:
- The present value of the decommissioning liability at the end of Year 4 works out to be **₹ 5.04 million** [being $8 / (1.08)^6$].
 - As against this, the carrying amount of decommissioning liability at the end of Year 4 is **₹ 3.15 million** (as computed above).
 - The changes in the decommissioning liability of **₹ 1.89 million** (being ₹ 5.04 million less ₹ 3.15 million) shall be **added to** the cost of the asset in the current period and the related provision for decommissioning liability is also adjusted.

The journal entry will be:

PPE	Dr.	₹ 1.89 million	
To Provision for decommissioning liability			₹ 1.89 million

- The following table shows the calculations for years 5 - 10:

Year	Opening Amount of PPE	Depreciation Charge SLM – 10 Years	Carrying Amount of PPE at end of the year	Opening Decommissioning Liability	Unwinding of Interest @8%	Closing Decommissioning Liability
5	63.28	10.55	52.73	5.04	0.40	5.44
6	52.73	10.55	42.19	5.44	0.44	5.88
7	42.19	10.55	31.64	5.88	0.47	6.35
8	31.64	10.55	21.09	6.35	0.51	6.86
9	21.09	10.55	10.55	6.86	0.55	7.41
10	10.55	<u>10.55</u>	-	7.41	<u>0.59</u>	8.00
Total		<u>63.28</u>			<u>2.96</u>	

Note that in the above table:

- Opening amount of PPE at the beginning of Year 5 is computed as ₹ 63.28 million (being carrying amount of ₹ 61.39 million at the end of Year 4 plus increase of ₹ 1.89 million arising due to increase in the present value of the decommissioning liability at the end of Year 4).
- The revised carrying amount of PPE (at ₹ 63.28 million) at the beginning of Year 5 will be depreciated over the balance 6 years of the useful life).
- Opening decommissioning liability at the beginning of Year 5 is computed as ₹ 5.04 million (being carrying amount of ₹ 3.15 million at the end of Year 4 plus increase of ₹ 1.89 million).

Since the entity has adjusted the increase in the decommissioning liability against the carrying amount of PPE, it needs to evaluate whether the new carrying amount (in this case, ₹ 63.28 million) is recoverable. If not, it will give rise to impairment loss, to be accounted for under Ind AS 36.



2.10 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Cummins India Limited' for the financial year 2021-2022 with respect to 'Property, Plant and Equipment' and its accounting policy thereon.

BALANCE SHEET AS AT MARCH 31, 2022

Particulars	Notes No.	As at March 31, 2022
ASSETS		
Non-current assets		
Property, plant and equipment	2.1	115,362

2.1 Property, plant and equipment (PPE)

Particulars	Gross block				Depreciation and Amortisation					Net block	
	As at April 1, 2021	Additions	Adjustment ***	Deductions / Write-off	As at March 31, 2022	As at April 1, 2021	For the year	Adjustment ***	Deductions / Write-off	As at March 31, 2022	As at March 31, 2022
Freehold land @	3,612	-	-	-	3,612	-	-	-	-	-	3,612
Leasehold Improvements	607	-	-	-	607	55	6	-	-	61	546
Roads	2,993	67	-	-	3,060	2,022	126	(0)	(0)	2,148	912
Buildings #	83,989	910	13	47	84,865	14,230	1,901	13	43	16,101	68,764
Plant and machinery #	100,984	9,548	4,456	8,852	106,136	64,860	5,421	1,995	5,565	66,711	39,425
Furniture and fittings #	5,158	11	5	78	5,096	2,730	452	5	49	3,138	1,958
Vehicles	458	19	(14)	-	463	286	46	(14)	-	318	145
	197,801	10,555	4,460	8,977	203,839	84,183	7,952	1,999	5,657	88,477	115,362

ACCOUNTING POLICY

Property, plant and equipment and investment properties

Property plant and equipment, capital work in progress and investment properties are stated at cost of acquisition or construction net of accumulated depreciation and impairment loss (if any).

All significant costs relating to the acquisition and installation of property plant and equipment/ investment properties are capitalised. Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. All other repairs and maintenance are charged to the Statement of Profit and Loss during the financial period in which they are incurred.

When significant parts of plant and equipment are required to be replaced at intervals, the Company depreciate them separately based on their specific useful lives.

Depreciation is computed on straight line method based on useful lives, determined based on internal technical evaluation, as follows:

Assets	Useful life
Roads	10 years
Office building and investment properties	Upto 60 years
Factory building	30 years
Plant and machinery	3 to 15 years
Furniture and fittings	5 to 10 years
Vehicles	8 to 9 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period.

Freehold land is carried at cost. Losses arising from the retirement of, and gains and losses arising from disposal of property, plant and equipment which are carried at cost are recognized in the Statement of Profit and Loss.

Leasehold improvements are amortised on straight line basis over the period of lease.

Transfers are made to investment properties only when there is a change in use. Transfers between investment property and owner-occupied property do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

(Source: Annual Report 2021-2022 - Cummins India Limited)



2.11 SIGNIFICANT DIFFERENCES IN IND AS 16 VIS-À-VIS AS 10

S. No.	Particular	Ind AS 16	AS 10
1.	<i>Fixed Assets retired from Active Use and Held for Sale</i>	Ind AS 16 does not deal with the assets 'held for sale' because the treatment of such assets is covered in Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations.	AS 10 deals with accounting for items of fixed assets retired from active use and held for sale.
2.	<i>Stripping Costs in the Production Phase of a Surface Mine</i>	Ind AS 16 provides guidance on measuring 'Stripping Costs in the Production Phase of a Surface Mine'.	AS 10 does not contain this guidance.



2.12 CARVE OUT IN IND AS 16 *VIS-À-VIS* IAS 16

Para 17(e) of Ind AS 16 has been amended (through a notification by MCA on 23rd March, 2022) by adding a clarification that the excess of net proceeds from sale of items produced during testing will not be credited to Profit or loss i.e. it will be deducted from the cost of an item of property, plant and equipment.

However, an amendment made in IAS 16 by IASB prohibited deduction of proceeds of items produced during testing from cost of an item of property, plant and equipment.

This differential treatment in IAS 16 and Ind AS 16 has led to a carve out, which will have consequential impact on depreciation, impairment, and deferred tax.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. 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.	Net present value of estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
7.	Operating losses before commercial production	₹ 4,00,000

Advise ABC Ltd. on the costs that can be capitalized in accordance with Ind AS 16.

2. A Ltd. has an item of property, plant and equipment 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.

3. 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.

Analyze how would the above changes in estimates be accounted by B Ltd.

4. X Ltd. has a machine which got damaged due to fire as on 31st January, 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 31st March, 20X1, the compensation proceedings were still in process but the insurance company has confirmed the claim. Compensation of ₹ 50,000 is receivable from the insurance company.

Determine the accounting for the above transaction for X Ltd.

5. An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1st April, 2XX1. 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 31st March. After 10 years, the net present value of the decommissioning liability has decreased by ₹ 8,000. The discount rate has not yet changed.

Examine how the entity will account for the above changes in decommissioning liability in the 11th year, if it adopts cost model.

6. An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1st April, 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 31st March. Assume that a market-based discounted cash flow valuation of ₹ 1,15,000 is obtained at 31st March, 20X4. This valuation is after deduction of an allowance of ₹ 11,600 for decommissioning costs, which represents no change to the original estimate, after the unwinding of three years' discount. On 31st March, 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 31st March, 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.

Examine how will the entity account for the above changes in decommissioning liability if it adopts revaluation model.

7. A Ltd. purchased some Property, Plant and Equipment on 1st April, 20X1, and estimated their useful lives for the purpose of financial statements prepared on the basis of Ind AS. Following were the original cost, and useful life of the various components of property, plant, and equipment assessed on 1st April, 20X1:

Property, Plant and Equipment	Original Cost	Estimated useful life
Buildings	₹ 15,000,000	15 years
Plant and machinery	₹ 10,000,000	10 years
Furniture and fixtures	₹ 3,500,000	7 years

A Ltd. uses the straight-line method of depreciation. On 1st April, 20X4, the entity reviewed the following useful lives of the property, plant, and equipment through an external valuation expert:

Buildings	10 years
Plant and machinery	7 years
Furniture and fixtures	5 years

There were no salvage values for the three components of the property, plant, and equipment either initially or at the time the useful lives were revised.

Examine the impact of revaluation of useful life on the Statement of Profit and Loss for the year ending 31st March, 20X5.

8. Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31st March, 20X1 to the managing director Mr. Y for approval. Mr. Y, who is not an accountant, had raised following query from Mr. X after going through the draft financial statements:

The notes to the financial statements state that plant and equipment is held under the 'cost model'. However, property which is owner occupied is revalued annually to fair value. Changes in fair value are sometimes reported in profit or loss but usually in 'other comprehensive income'. Also, the amount of depreciation charged on plant and equipment as a percentage of its carrying amount is much higher than for owner occupied property. Another note states that property owned by ABC Ltd. but rent out to others is depreciated annually and not fair valued. Mr. Y is of the opinion that there is no consistent treatment of PPE items in the accounts.

Advise the finance controller for resolving the query of the managing director?

9. Company X performed a revaluation of all of its plant and machinery at the beginning of 20X1. The following information relates to one of the machinery:

	Amount ('000)
Gross carrying amount	₹ 200
Accumulated depreciation (straight-line method)	<u>(₹ 80)</u>
Net carrying amount	<u>₹ 120</u>
Fair value	₹ 150

The useful life of the machinery is 10 years and the company uses Straight line method of depreciation. The revaluation was performed at the end of 4 years.

Advise how should the company account for revaluation of plant and machinery and depreciation subsequent to revaluation. Support your answer with journal entries.

10. An entity has the following items of property, plant and equipment:
- Property A — a vacant plot of land on which it intends to construct its new administration headquarters;
 - Property B — a plot of land that it operates as a landfill site;
 - Property C — a plot of land on which its existing administration headquarters are built;
 - Property D — a plot of land on which its direct sales office is built;
 - Properties E1–E10 — ten separate retail outlets and the land on which they are built;
 - Equipment A — computer systems at its headquarters and direct sales office that are integrated with the point of sale computer systems in the retail outlets;
 - Equipment B — point of sale computer systems in each of its retail outlets;
 - Furniture and fittings in its administrative headquarters and its sales office;
 - Shop fixtures and fittings in its retail outlets.

Determine the classes of property, plant and equipment for disclosure by the entity?

11. Heaven Ltd. had purchased a machinery on 1.4.2X01 for ₹ 30,00,000, which is reflected in its books at written down value of ₹ 17,50,000 on 1.4.2X06. The company has estimated an upward revaluation of 10% on 1.4.2X06 to arrive at the fair value of the asset. Heaven Ltd. availed the option given by Ind AS of transferring some of the surplus as the asset is used by an enterprise.

On 1.4.2X08, the machinery was revalued downward by 15% and the company also re-estimated the machinery's remaining life to be 8 years. On 31.3.2X10 the machinery was sold for ₹ 9,35,000. The company charges depreciation on straight line method.

Prepare machinery account in the books of Heaven Ltd. over its useful life to record the above transactions.

Answers

1. According to Ind AS 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.	Net present value of estimated dismantling costs to be incurred after 7 years	<u>₹ 3,00,000</u>
		<u>₹ 43,00,000</u>

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.

2. The entries to be passed would be:

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

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

3. Calculation of accumulated depreciation till 8th year

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 x No. of years (8) = ₹ 1,44,000.

Calculation of carrying amount at the end of the 8th year

The asset has a carrying amount of ₹ 56,000 at the end of year 8 [ie. ₹ 2,00,000 – ₹ 1,44,000]

Accounting of the changes in estimates

Revision of the useful life to 12 years results in a remaining useful life of 4 years (ie 12 years – 8 years).

The revised depreciable amount is ₹ 46,000 (₹ 56,000 – ₹ 10,000)

Thus, depreciation should be charged in future ie from 9th year onwards at ₹ 11,500 per annum (₹ 46,000 / 4 years).

4. As per para 66 of Ind AS 16, 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 31st March, 20X1, X Ltd. should recognize income of ₹ 50,000 against the compensation receivable in its profit or loss.

5. On 31st March, 2X11, the plant is 10 years old. Accumulated depreciation is ₹ 30,000 (₹ 120,000 x 10 / 40 years). Due to unwinding of discount @ 5% over the 10 years, the amount of decommissioning liability has increased from ₹ 10,000 to ₹ 16,300 (approx.).

On 31st March, 2X11, 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 passes the following journal entry to reflect the change:

		₹	₹
Provision for decommissioning liability	Dr.	8,000	
To 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 unwinding of discount will be ₹ 415 (₹ 8,300 × 5 per cent).

6.

At 31 st March, 20X4:	₹
Asset at valuation (1)	1,26,600
Accumulated depreciation	Nil
Decommissioning liability	<u>(11,600)</u>
Net assets	<u>1,15,000</u>
Retained earnings (2)	(10,600)
Revaluation surplus (3)	15,600

Notes:

(1) When accounting for revalued assets to which decommissioning liabilities attach, it is important to understand the basis of the valuation obtained. For example:

- (a) if an asset is valued on a discounted cash flow basis, some valuers may value the asset without deducting any allowance for decommissioning costs (a 'gross' valuation), whereas others may value the asset after deducting an allowance for decommissioning costs (a 'net' valuation), because an entity acquiring the asset will generally also assume the decommissioning obligation. For financial reporting purposes, the decommissioning obligation is recognized as a separate liability, and is not deducted from the asset. Accordingly, if the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability, so that the liability is not counted twice.
- (b) if an asset is valued on a depreciated replacement cost basis, the valuation obtained may not include an amount for the decommissioning component of the asset. If it does not, an appropriate amount will need to be added to the valuation to reflect the depreciated replacement cost of that component.

Since, the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability. Valuation obtained of

₹ 1,15,000 plus decommissioning costs of ₹ 11,600, allowed for in the valuation but recognized as a separate liability = ₹ 1,26,600.

- (2) Three years' depreciation on original cost ₹ 1,20,000 $\times$ $\frac{3}{40}$ = ₹ 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 $\times$ $\frac{1}{37}$) and the discount expense for 20X5 is ₹ 600 (11,600 $\times$ 5% = 580 or 600 (to the nearest 100). On 31st March, 20X5, the decommissioning liability (before any adjustment) is ₹ 12,200. However, as per the 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 recognized 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:

		₹	₹
Provision for decommissioning liability	Dr.	5,000	
To Revaluation surplus			5,000

As at 31st March, 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 recognized 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	<u>(7,200)</u>
Net assets	<u>1,07,000</u>
Retained earnings (1)	(14,620)
Revaluation surplus (2)	11,620

Notes:

- (1) ₹ 10,600 at 31st March, 20X4, plus depreciation expense of ₹ 3,420 and discount expense of ₹ 600 = ₹ 14,620.
- (2) ₹ 15,600 at 31st March, 20X4, plus ₹ 5,000 arising on the decrease in the liability, less ₹ 8,980 deficit on revaluation = ₹ 11,620.

7. The annual depreciation charges prior to the change in useful life were

Buildings	₹ 1,50,00,000/15 =	₹ 10,00,000
Plant and machinery	₹ 1,00,00,000/10 =	₹ 10,00,000
Furniture and fixtures	₹ 35,00,000/7 =	<u>₹ 5,00,000</u>
Total =		<u>₹ 25,00,000 (A)</u>

The revised annual depreciation for the year ending 31st March, 20X5, would be

Buildings	$[\text{₹ } 1,50,00,000 - (\text{₹ } 10,00,000 \times 3)] / 10$	₹ 12,00,000
Plant and machinery	$[\text{₹ } 1,00,00,000 - (\text{₹ } 10,00,000 \times 3)] / 7$	₹ 10,00,000
Furniture and fixtures	$[\text{₹ } 35,00,000 - (\text{₹ } 5,00,000 \times 3)] / 5$	<u>₹ 4,00,000</u>
Total		<u>₹ 26,00,000 (B)</u>

The impact on Statement of Profit and Loss for the year ending 31st March, 20X5

$$= \text{₹ } 26,00,000 - \text{₹ } 25,00,000 = \text{₹ } 1,00,000$$

This is a change in accounting estimate which is adjusted prospectively in the period in which the estimate is amended and, if relevant, to future periods if they are also affected. Accordingly, from 20X4-20X5 onward, excess of ₹ 1,00,000 will be charged in the Statement of Profit and Loss every year till the time there is any further revision.

8. Ongoing through the query raised by the Managing Director Mr. Y, the financial controller Mr. X explained the notes and reasons for their disclosures as follows:

The accounting treatment of most tangible non-current assets is governed by Ind AS 16 'Property, Plant and Equipment'. Ind AS 16 states that the accounting treatment of PPE is determined on a class by class basis. For this purpose, property and plant would be regarded as separate classes. Ind AS 16 requires that PPE is measured using either the cost model or the revaluation model. This model is applied on a class by class basis and must be applied consistently within a class. Ind AS 16 states that when the revaluation model applies, surpluses are recorded in other comprehensive income, unless they are cancelling out a deficit which has previously been reported in profit or loss, in which case it is reported in profit or loss. Where the revaluation results in a deficit, then such deficits are reported in profit or loss, unless they are cancelling out a surplus which has previously been reported in other comprehensive income, in which case they are reported in other comprehensive income.

According to Ind AS 16, all assets having a finite useful life should be depreciated over that life. Where property is concerned, the only depreciable element of the property is the buildings element, since land normally has an indefinite life. The estimated useful life of a building tends to be much longer than for plant. These two reasons together explain why the depreciation charge of a property as a percentage of its carrying amount tends to be much lower than for plant.

Properties which are held for investment purposes are not accounted for under Ind AS 16, but under Ind AS 40 'Investment Property'. As per Ind AS 40, investment properties should be accounted for under a cost model. ABC Ltd. had applied the cost model and thus our investment properties are treated differently from the owner-occupied property.

9. According to paragraph 35 of Ind AS 16, when an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:
- (a) The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The 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.

In such a situation, the revised carrying amount of the machinery will be as follows:

Gross carrying amount	₹ 250	[(200/120) x 150]
Net carrying amount	<u>₹ 150</u>	
Accumulated depreciation	<u>₹ 100</u>	(₹ 250 – ₹ 150)

Journal entry

Plant and Machinery (Gross Block)	Dr.	₹ 50	
To Accumulated Depreciation			₹ 20
To Revaluation Reserve			₹ 30

Depreciation subsequent to revaluation

Since the Gross Block has been restated, the depreciation charge will be ₹ 25 per annum (₹ 250/10 years).

Journal entry

Accumulated Depreciation	Dr.	₹ 25 p.a.	
To Plant and Machinery (Gross Block)			₹ 25 p.a.

- (b) The accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with the paragraphs 39 and 40 of Ind AS 16.

In this case, the gross carrying amount is restated to ₹ 150 to reflect the fair value and accumulated depreciation is set at zero.

Journal entry

Accumulated Depreciation	Dr.	₹ 80	
To Plant and Machinery (Gross Block)			₹ 80
Plant and Machinery (Gross Block)	Dr.	₹ 30	
To Revaluation Reserve			₹ 30

Depreciation subsequent to revaluation

Since the revalued amount is the revised gross block, the useful life to be considered is the remaining useful life of the asset which results in the same depreciation charge of ₹ 25 per annum as per Option A ($\text{₹ } 150 / 6 \text{ years}$).

Journal entry

Accumulated Depreciation	Dr.	₹ 25 p.a.	
	To Plant and Machinery (Gross Block)		₹ 25 p.a.

10. To answer this question one must make a materiality judgement.

A class of assets is defined as a grouping of assets of a similar nature and use in an entity's operations.

The nature of land without a building is different to the nature of land with a building.

Consequently, land without a building is a separate class of asset from land and buildings. Furthermore, the nature and use of land operated as a landfill site is different from vacant land. Hence, the entity should disclose Property A separately. The entity must apply judgement to determine whether the entity's retail outlets are sufficiently different in nature and use from its office buildings, and thus constitute a separate class of land and buildings.

The computer equipment is integrated across the organization and would probably be classified as a single separate class of asset.

Furniture and fittings used for administrative purposes could be sufficiently different to shop fixtures and fittings in retail outlets to be classified in two separate classes of assets.

11. **In the books of Heaven Ltd.**

Machinery A/c

Date	Particulars	Amount	Date	Particulars	Amount
1.4.2X01	To Bank/ Vendor	30,00,000	31.3.2X02	By Depreciation (W.N.1)	2,50,000
			31.3.2X02	By Balance c/d	<u>27,50,000</u>
		<u>30,00,000</u>			<u>30,00,000</u>
1.4.2X02	To Balance b/d	27,50,000	31.3.2X03	By Depreciation	2,50,000
			31.3.2X03	By Balance c/d	<u>25,00,000</u>
		<u>27,50,000</u>			<u>27,50,000</u>
1.4.2X03	To Balance b/d	25,00,000	31.3. 2X04	By Depreciation	2,50,000

		<u> </u>	31.3.2X04	By Balance c/d	<u>22,50,000</u>
		<u>25,00,000</u>			<u>25,00,000</u>
1.4.2X04	To Balance b/d	22,50,000	31.3.2X05	By Depreciation	2,50,000
		<u> </u>	31.3.2X05	By Balance c/d	<u>20,00,000</u>
		<u>22,50,000</u>			<u>22,50,000</u>
1.4.2X05	To Balance b/d	20,00,000	31.3.2X06	By Depreciation	2,50,000
		<u> </u>	31.3.2X06	By Balance c/d	<u>17,50,000</u>
		<u>20,00,000</u>			<u>20,00,000</u>
1.4.2X06	To Balance b/d	17,50,000	31.3.2X07	By Depreciation (W.N.2)	2,75,000
1.4.2X06	To Revaluation Reserve @ 10%	<u>1,75,000</u>	31.3.2X07	By Balance c/d	16,50,000
		<u>19,25,000</u>			<u> </u>
					<u>19,25,000</u>
1.4.2X07	To Balance b/d	16,50,000	31.3.2X08	By Depreciation	2,75,000
		<u> </u>	31.3.2X08	By Balance c/d	<u>13,75,000</u>
		<u>16,50,000</u>			<u>16,50,000</u>
1.4.2X08	To Balance b/d	13,75,000	1.4.2X08	By Revaluation Reserve (W.N.4)	1,25,000
			31.3.2X09	By Profit and Loss A/c (W.N.5)	81,250
			31.3.2X09	By Depreciation (W.N.3)	1,46,094
		<u> </u>	31.3.2X09	By Balance c/d	<u>10,22,656</u>
		<u>13,75,000</u>			<u>13,75,000</u>
1.4.2X09	To Balance b/d	10,22,656	31.3.2X10	By Depreciation	1,46,094
31.3.2X10	To Profit and Loss A/c (balancing figure)	<u>58,438*</u>	31.3.2X10	By Bank A/c	9,35,000
		<u>10,81,094</u>			<u> </u>
					<u>10,81,094</u>

Working Notes:**1. Calculation of useful life of machinery on 1.4.2X01**

Depreciation charge in 5 years = $(30,00,000 - 17,50,000) = ₹ 12,50,000$

Depreciation per year as per Straight Line method = $12,50,000 / 5 \text{ years}$
 $= ₹ 2,50,000$

Remaining useful life = $₹ 17,50,000 / ₹ 2,50,000 = 7 \text{ years}$

Total useful life = 5 years + 7 years = 12 years

2. Depreciation after upward revaluation as on 1.4.2X06

₹

Book value as on 1.4.2X06 17,50,000

Add: 10% upward revaluation 1,75,000

Revalued amount 19,25,000

Remaining useful life 7 years (Refer W.N.1)

Depreciation on revalued amount = $19,25,000 / 7 \text{ years} = ₹ 2,75,000 \text{ lakh}$

3. Depreciation after downward revaluation as on 1.4.2X08

₹

Book value as on 1.4.2X08 13,75,000

Less: 15% Downward revaluation (2,06,250)

Revalued amount 11,68,750

Revised useful life 8 years

Depreciation on revalued amount = $11,68,750 / 8 \text{ years} = ₹ 1,46,094$

4. Amount transferred from revaluation reserve

Revaluation reserve on 1.4.2X06 (A) ₹ 1,75,000

Remaining useful life 7 years

Amount transferred every year $(1,75,000 / 7)$ ₹ 25,000

Amount transferred in 2 years $(25,000 \times 2)$ (B) ₹ 50,000

Balance of revaluation reserve on 1.4.2X08 (A-B) ₹ 1,25,000

5. Amount of downward revaluation to be charged to Profit and Loss Account

Downward revaluation as on 1.4.2X08 (W.N.3) ₹ 2,06,250

Less: Adjusted from Revaluation reserve (W.N.4) (₹ 1,25,000)

Amount transferred to Profit and Loss Account ₹ 81,250

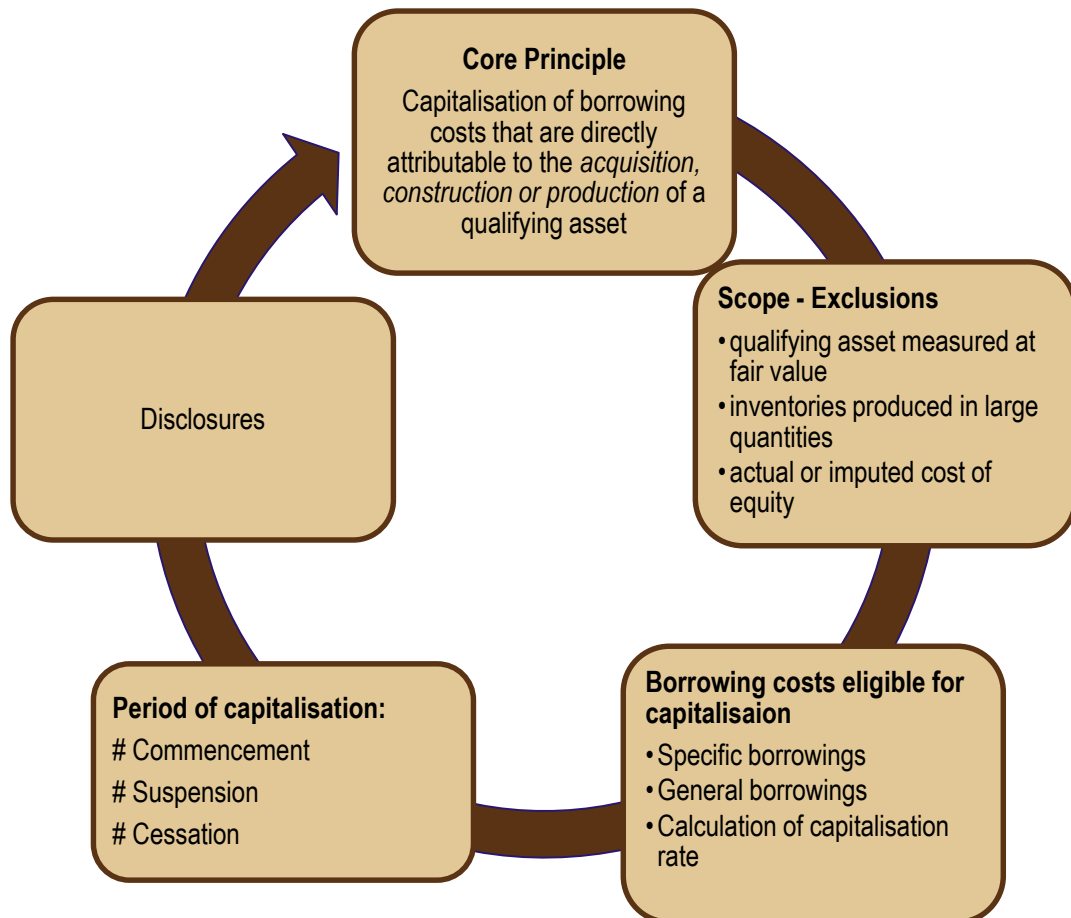
UNIT 3 : INDIAN ACCOUNTING STANDARD 23 : BORROWING COSTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ☐ Identify the core principle and scope of the standard
- ☐ Define borrowing cost, qualifying asset and other related terms
- ☐ Examine various conditions and pre-conditions for capitalisation of borrowing costs
- ☐ Recognize suspension and cessation of capitalization of borrowing cost
- ☐ Comply with the disclosure requirements of the standard
- ☐ Differentiate between Ind AS 23 and AS 16.

UNIT OVERVIEW

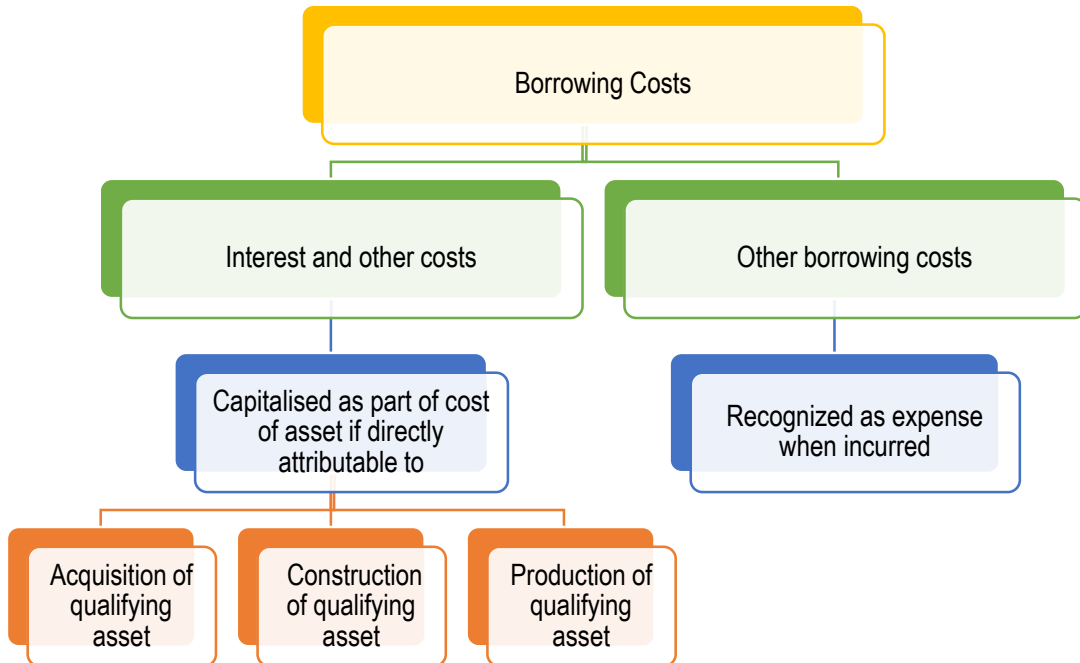




3.1 CORE PRINCIPLE

The core principle of Ind AS 23 states that:

- a. Borrowing costs that are directly attributable to the *acquisition, construction or production* of a qualifying asset are included in the cost of that asset i.e. must be capitalised.
- b. Other borrowing costs are recognized as an expense in the period in which they are incurred.



3.2 SCOPE OF THE STANDARD

- An entity shall apply this standard in accounting for borrowing costs.
- The Standard does not apply to actual or imputed cost of equity, including preferred capital not classified as a liability.

Example 1

Dividend paid on equity shares, cost of issuance of equity shares, cost of preference share capital (not classified as liability as per Ind AS 32) will not be included as borrowing cost within the purview of this standard.

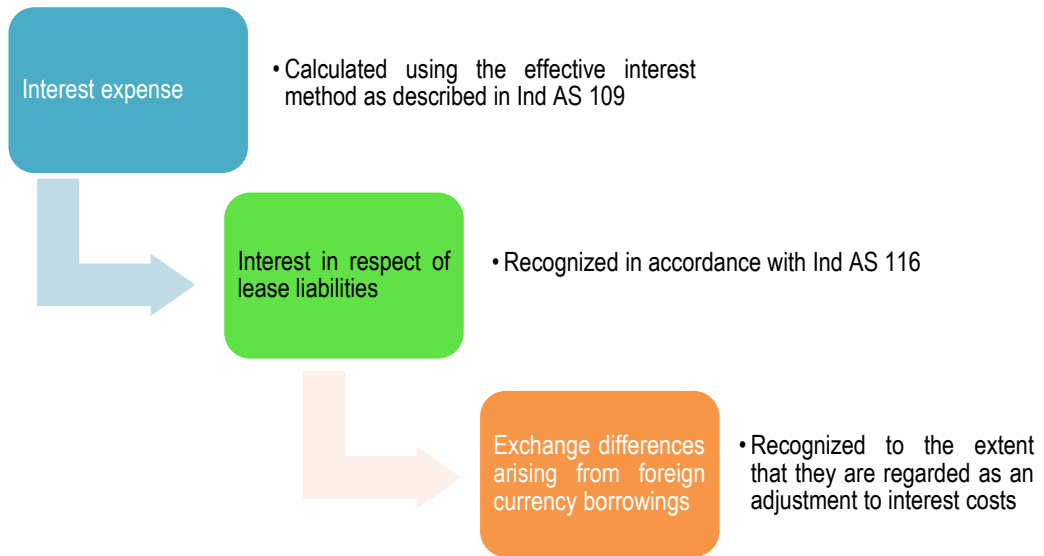
- The general requirement of this standard (to capitalise directly attributable borrowings cost) is not required to be applied to:
 - (a) **qualifying assets that are measured at fair value, for example, a biological asset accounted for under Ind AS 41** - If the assets are held under fair value model with all changes going to statement of profit or loss, then capitalisation would not affect measurement in the balance sheet and would involve only reallocation between finance cost and fair value movement in the Statement of profit and loss.
 - (b) **inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis** – This exemption acknowledges the difficulty both in allocating borrowing costs to such inventories and monitoring those borrowing costs until the inventories are sold.



3.3 KEY DEFINITIONS

Following are the terms defined in the standard:

1. **Borrowing costs:** These are interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs may include:
 - interest expense calculated using the effective interest rate method as described in Ind AS 109 *Financial Instruments*;
 - interest in respect of lease liabilities recognized in accordance with Ind AS 116, *Leases*; and
 - exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs



2. **Qualifying asset:** Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Examples of qualifying assets are manufacturing plants, real estate and infrastructure assets such as bridges and railways etc.

Ind AS 23 does not provide any guidance on what constitutes a 'substantial period of time'. The specific facts and circumstances should be considered in each case. For example, it is likely that a period of twelve months or more might be considered 'substantial'.

Depending on the circumstances, any of the following may be qualifying assets:

- (a) inventories
- (b) manufacturing plants
- (c) power generation facilities
- (d) intangible assets
- (e) investment properties
- (f) bearer plants.

Financial assets and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets.

Assets that are ready for their intended use or sale when acquired are not qualifying assets.

Qualifying asset

- Takes substantial period of time to get ready for its intended use or sale.

Includes

- Inventories
- Manufacturing plant
- Power generation facilities
- Intangible assets
- Bearer plants

Excludes

- Inventories produced in large quantities on repetitive basis
- Assets ready for intended use or sale when acquired
- Financial assets

Illustration 1

A company deals in production of dairy products. It prepares and sells various milk products like ghee, butter and cheese. The company borrowed funds from bank for manufacturing operation. The cheese takes substantial longer period to get ready for sale.

State whether borrowing costs incurred to finance the production of inventories (cheese) that have a long production period, be capitalised?

Solution

Ind AS 23 does not require the capitalisation of borrowing costs for inventories that are manufactured in large quantities on a repetitive basis. However, interest capitalisation is permitted as long as the production cycle takes a 'substantial period of time', as with cheese.

Illustration 2

A company is in the process of developing computer software. The asset has been qualified for recognition purposes. However, the development of computer software will take substantial period of time to complete.

- Evaluate whether computer software can be termed as a 'qualifying asset' under Ind AS 23?*
- Analyse whether management intention should be considered for assessment of the asset as a qualifying asset?*

Solution

- Yes. An intangible asset that takes a substantial period of time to get ready for its intended use or sale is a 'qualifying asset'. This would be the case for an internally generated

computer software in the development phase when it takes a 'substantial period of time' to complete.

- (ii) Yes. Management should assess whether an asset, at the date of acquisition, is 'ready for its intended use or sale'. The asset might be a qualifying asset, depending on how management intends to use it. For example, when an acquired asset can only be used in combination with a larger group of fixed assets or was acquired specifically for the construction of one specific qualifying asset, the assessment of whether the acquired asset is a qualifying asset is made on a combined basis.

Illustration 3

A telecom company has acquired a 3G license. The licence could be sold or licensed to a third party. However, management intends to use it to operate a wireless network. Development of the network starts when the license is acquired.

Identify whether the borrowing costs on the acquisition of the 3G license be capitalised until the network is ready for its intended use.

Solution

Yes. The license has been exclusively acquired to operate the wireless network. The fact that the license can be used or licensed to a third party is irrelevant. The acquisition of the license is the first step in a wider investment project (developing the network). It is part of the network investment, which meets the definition of a qualifying asset under Ind AS 23.

Illustration 4

A real estate company has incurred expenses for the acquisition of a permit allowing the construction of a building. It has also acquired equipment that will be used for the construction of various buildings.

Examine whether the borrowing costs on the acquisition of the permit and the equipment be capitalised until the construction of the building is complete.

Solution

With respect to Permit

Yes, since permit is specific to one building. It is the first step in a wider investment project. It is part of the construction cost of the building, which meets the definition of a qualifying asset.

With respect to Equipment

No, since the equipment will be used for other construction projects. It is ready for its 'intended use' at the acquisition date. Hence, it does not meet the definition of a qualifying asset.

Illustration 5

Is interest on a finance lease of a qualifying asset capitalised as borrowing costs?

Solution

Yes, interest incurred for a finance lease is specific to an asset. Interest is capitalised if the asset is a qualifying asset or is used solely for the construction of a qualifying asset. For example, a crane or a dockyard is leased for the purpose of constructing a ship. The ship is a qualifying asset. The interest on the finance lease of the crane or dockyard is capitalised as borrowing costs. Borrowing costs on the finance lease can only be capitalised up to the point when the construction of the qualifying asset is complete.



3.4 EXCHANGE DIFFERENCE TO BE INCLUDED IN BORROWING COSTS

The extent to which exchange differences can be considered as borrowing cost depends on the terms and conditions of the foreign currency borrowing.

The gains and losses that are an adjustment to interest costs include the interest rate differential between borrowing costs that would be incurred if the entity borrowed funds in its functional currency and borrowing costs actually incurred on foreign currency borrowings. An entity may borrow funds in a currency that is not its functional currency e.g. A Company with INR functional currency may take US dollar loan for financing asset development project in a company.

This may have been done on the basis that, over the period of the development of asset, the borrowing costs, even after allowing for exchange differences, were expected to be less than the interest cost of an equivalent INR loan.

Following approach is to be followed for determining the extent to which the exchange difference should be treated as borrowing costs:

- (i) the adjustment should be of an amount which is equivalent to the extent to which the exchange loss does not exceed the difference between the cost of borrowing in functional currency when compared to the cost of borrowing in a foreign currency.

Example 2

An entity can borrow funds in its functional currency (₹) @ 12%. It borrows \$ 1,000 @ 4% on 1st April, 20X1 when \$ 1 = ₹ 40. The equivalent amount in functional currency is ₹ 40,000. Interest is payable on 31st March, 20X2. On 31st March, 20X2, exchange rate is \$ 1 = ₹ 50. The loan is not due for repayment. The exchange loss in this case is ₹ 10,000 [$\$ 1,000 \times (\text{₹ } 50 - \text{₹ } 40)$]. The borrowing cost is ₹ 2,000 ($\$ 1,000 \times 4\% \times \text{₹ } 50$).

Had the entity borrowed funds in functional currency the borrowing cost would have been ₹ 4,800 ($\text{₹ } 40,000 \times 12\%$).

The entity will treat exchange difference upto ₹ 2,800 ($\text{₹ } 4,800 - \text{₹ } 2,000$) as a borrowing cost that may be eligible for capitalisation under this Standard.

Thus, the total eligible borrowing cost is ₹ 4,800 ($\text{₹ } 2,000 + \text{₹ } 2,800$) equivalent to the borrowing cost in functional currency.

If the exchange rate on 31st March, 20X2, is \$ 1 = ₹ 41. The exchange loss is ₹ 1,000 [$\$ 1,000 - (\text{₹ } 41 - \text{₹ } 40)$]. The entity will treat the entire exchange loss as an eligible borrowing cost as total cost of the borrowing ₹ 2,640 [$(\text{₹ } 1,000 \times 4\% \times 41) + \text{₹ } 1,000$] in foreign currency does not exceed the cost of borrowings in functional currency, i.e., ₹ 4,800.

- (ii) where there is an unrealised exchange loss which is treated as an adjustment to interest and subsequently there is a realised or unrealised gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognized as an adjustment should also be recognized as an adjustment to interest.

Example 3: Continuing with the aforesaid example 2:

If the exchange rate on 31st March, 20X3, is \$ 1 = ₹ 48; the exchange rate on 31st March, 20X2, being \$ 1 = ₹ 50, the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 1,920 ($\$ 1,000 \times 4\% \times \text{₹ } 48$). There is an exchange gain of ₹ 2,000 ($\$ 1,000 \times (\text{₹ } 50 - \text{₹ } 48)$). This will be adjusted in the borrowing cost as there is unrealized exchange loss and the adjustment is less than the exchange loss of ₹ 2,800 recognized in earlier year.

If the exchange rate on 31st March, 20X3, is \$ 1 = ₹ 44; the exchange rate on 31st March, 20X2, being \$ 1 = ₹ 50, the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 1,760 ($\$ 1,000 \times 4\% \times \text{₹ } 44$). There is an exchange gain of ₹ 6,000 [$\$ 1,000 \times (\text{₹ } 50 - \text{₹ } 44)$]. This will be adjusted in the borrowing cost upto ₹ 2,800 as there is unrealized exchange loss and the adjustment of the exchange loss recognized in earlier years is of ₹ 2,800.

If the exchange rate on 31st March, 20X3, is \$ 1 = ₹ 44 and part of loan is repaid; the exchange rate on 31st March, 20X2, being \$ 1 = ₹ 50; \$ 600 of the borrowings was paid on 31st March, 20X2, \$ 400 of the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 704 ($\$ 400 \times 4\% \times ₹ 44$). There is an exchange gain of ₹ 2,400 [$\$ 400 \times (₹ 50 - ₹ 44)$]. The unrealised exchange loss of earlier year is ₹ 4,000 [$\$ 400 \times (₹ 50 - ₹ 40)$] out of which ₹ 1,120 ($₹ 2,800 \times \$ 400 / \$ 1000$) was charged in 31st March, 20X2, as borrowing cost. Thus, there will be an adjustment in the borrowing cost upto ₹ 1,120 as this is unrealised exchange loss.

Illustration 6

ABC Ltd. has taken a loan of USD 20,000 on 1st April, 20X1 for constructing a plant at an interest rate of 5% per annum payable on annual basis.

On 1st April, 20X1, the exchange rate between the currencies i.e. USD vs Rupees was ₹ 45 per USD. The exchange rate on the reporting date i.e. 31st March, 20X2 is ₹ 48 per USD.

The corresponding amount could have been borrowed by ABC Ltd. from State Bank of India in local currency at an interest rate of 11% per annum as on 1st April, 20X1.

Compute the borrowing cost to be capitalized for the construction of plant by ABC Ltd. for the period ending 31st March, 20X2.

Solution

In the above situation, the borrowing cost needs to determine for interest cost on such foreign currency loan and eligible exchange loss difference if any.

- (a) Interest on foreign currency loan for the period:

$$\text{USD } 20,000 \times 5\% = \text{USD } 1,000$$

$$\text{Converted in ₹: } \text{USD } 1,000 \times ₹ 48/\text{USD} = ₹ 48,000$$

- (b) Interest that would have resulted if the loan was taken in Indian Currency:

$$\text{USD } 20,000 \times ₹ 45/\text{USD} \times 11\% = ₹ 99,000$$

- (c) Difference between interest on foreign currency borrowing and local currency borrowing:

$$₹ 99,000 - 48,000 = ₹ 51,000$$

Increase in liability due to change in exchange difference: $\text{USD } 20,000 \times (48 - 45) = ₹ 60,000$

Hence, out of exchange loss of ₹ 60,000 on principal amount of foreign currency loan, only exchange loss to the extent of ₹ 51,000 is considered as borrowing costs.

Total borrowing cost to be capitalized is as under:

(a) Interest cost on borrowing	₹ 48,000
(b) Exchange difference to the extent considered to be an adjustment to Interest cost	₹ 51,000
	<u>₹ 99,000</u>

The exchange difference of ₹ 51,000 has been capitalized as borrowing cost and the remaining ₹ 9,000 will be expensed off in the Statement of Profit and Loss.



3.5 RECOGNITION

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset.
- Such borrowing cost are capitalised when below two conditions are satisfied:
 - it is probable that it will result in future economic benefits to the entity; and
 - the costs can be measured reliably.
- Other borrowing costs are recognized as an expense in the period in which they are incurred.
- When an entity applies Ind AS 29 *Financial Reporting in Hyperinflationary Economies*, it recognizes as an expense the part of borrowing costs that compensates for inflation during the same period.

3.5.1 Borrowing costs eligible for capitalisation

The borrowing costs that are eligible for capitalisation are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

Since it may not always be easy to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided, the standard includes separate requirements for specific borrowings and general borrowings.

3.5.1.1 Specific borrowing costs

- If an entity borrows funds specifically to obtain a qualifying asset, the borrowing costs that are directly related to that qualifying asset can be readily identified.
- The borrowings cost eligible for capitalisation would be the **actual** borrowing costs incurred during the period less any investment income on the temporary investment of those borrowings.

Note: A 'notional' borrowing cost cannot be capitalised. Ind AS 23 limits the amount that can be capitalised to the actual borrowing costs incurred. The standard does not address actual or imputed cost of equity. Where an entity has no borrowings and uses its own cash

resources to finance the construction of property, plant and equipment, the entity cannot assume that interest that could have been earned on that cash represents forgone benefit and could be capitalised.

- An entity may obtain borrowed funds specifically and incur associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

Borrowing costs eligible for capitalisation	=	Actual borrowing costs incurred on that borrowing during the period	-	Investment income on the temporary investment of those borrowings, if any.

Illustration 7

Alpha Ltd. on 1st April, 20X1, borrowed ₹ 30,00,000 @ 9% to finance the construction of two qualifying assets. Construction started on 1st April, 20X1. The loan facility was availed on 1st April, 20X1 and was utilized as follows with remaining funds invested temporarily at 7%:

	Factory Building	Office Building
1st April, 20X1	5,00,000	10,00,000
1st October, 20X1	5,00,000	10,00,000

Calculate the cost of the asset and the borrowing cost to be capitalized.

Solution:

Particulars	Factory Building	Office Building
Borrowing Costs	(10,00,000 x 9%) 90,000	(20,00,000 x 9%) 1,80,000
Less: Investment Income	(5,00,000 x 7% x 6/12) <u>(17,500)</u>	(10,00,000 x 7% x 6/12) <u>(35,000)</u>
	<u>72,500</u>	<u>1,45,000</u>
Cost of the asset:		
Expenditure incurred	10,00,000	20,00,000
Borrowing Costs	<u>72,500</u>	<u>1,45,000</u>
Total	<u>10,72,500</u>	<u>21,45,000</u>

3.5.1.2 General borrowing costs

- All borrowings that are not specific represents general borrowings.
- When funds are borrowed specifically for a qualifying asset, costs in relation to that borrowing are accounted for as specific borrowing costs until the asset is ready for its intended use or sale; if the borrowing remains outstanding after the related asset is ready for its intended use or sale, it becomes part of 'general borrowings'.

Illustration 8

On 1st April, 20X1, A Ltd. took 8% loan of ₹ 50,00,000 for construction of building A which is repayable after 6 years ie on 31st March, 20X7. The construction of building was completed on 31st March, 20X3. A Ltd. started constructing a new building B in the year 20X3-20X4, for which he used his existing borrowings. He has outstanding general-purpose loan of ₹ 25,00,000, interest on which is payable @ 9% and ₹ 15,00,000, interest on which is payable @ 7%.

Recommend whether the specific borrowing should be transferred to the general borrowings pool once the respective qualifying asset is completed.

Solution

Yes. If specific borrowings were not repaid once the relevant qualifying asset was completed, they become general borrowings for as long as they are outstanding.

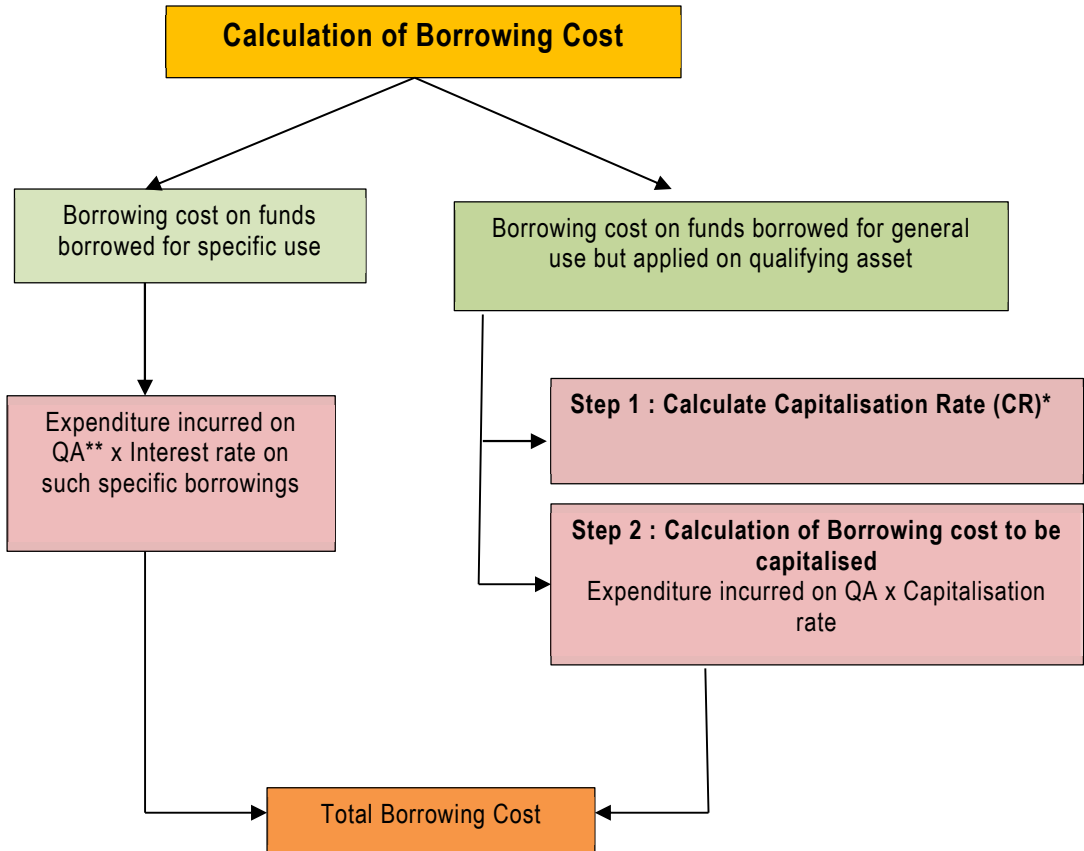
The borrowing costs that are directly attributable to obtaining qualifying assets are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. If cash was not spent on other qualifying assets, it could be directed to repay this specific loan. Thus, borrowing costs could be avoided (that is, they are directly attributable to other qualifying assets).

- When general borrowings are used for qualifying assets, Ind AS 23 requires that, borrowing costs eligible for capitalisation is calculated by applying a capitalisation rate to the expenditures on qualifying assets.
- The amount of borrowing costs eligible for capitalisation is always limited to the amount of actual borrowing costs incurred during the period.

3.5.2 Calculation of capitalisation rate

- When the funds are borrowed generally for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that qualifying asset.

- The capitalisation rate is the weighted average of the borrowing costs applicable to all the general borrowings of the entity that are outstanding during the period.
- Borrowing costs in respect of specific funds borrowed for the purpose of obtaining a qualifying asset shall be excluded from calculation of capitalisation rate until substantially all the activities necessary to prepare that qualifying asset for its intended use or sale are complete.
- The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.



$$*CR = \frac{\text{Weighted average borrowing costs on outstanding borrowings of the entity (excluding specific borrowings cost)}}{\text{Total outstanding borrowings of the entity during the period (excluding specific borrowings)}}$$

**QA = Qualifying Asset

Illustration 9

Beta Ltd. had the following loans in place at the end of 31st March, 20X2:

(Amounts in ₹ 000s)

Loan	1 st April, 20X1	31 st March, 20X2
18% Bank Loan	1,000	1,000
16% Term Loan	3,000	3,000
14% Debentures	-	2,000

14% Debentures were issued to fund the construction of office building on 1st July, 20X1 but the development activities has yet to be started.

On 1st April, 20X1, Beta Ltd. began the construction of a Plant being a qualifying asset using the existing borrowings. Expenditure drawn down for the construction was: ₹ 5,00,000 on 1st April, 20X1 and ₹ 25,00,000 on 1st January, 20X2.

Calculate the borrowing cost that can be capitalised for the plant.

Solution

Capitalisation rate	$\frac{(18\% \times 1,000)}{1,000 + 3,000} + \frac{(16\% \times 3,000)}{1,000 + 3,000}$	16.5%
Borrowing Costs	$(5,00,000 \times 16.5\%) + (25,00,000 \times 16.5\% \times 3/12)$	₹ 1,85,625

Capitalisation rate for above illustration could also be calculated with the following approach by assigning weights to the borrowings:

Particulars	Loan	Weighted average (a)	Interest rate (b)	Capitalisation rate (a*b)
18% Bank Loan	1,000	25%	18%	4.5%
16% Term Loan	3,000	75%	16%	12%
Total	4,000	100%		16.5%

Answer in both the approaches would be same as can be seen from the above two solutions.

3.5.3 Expenditure to which capitalisation rate is applied

- In determining the borrowing costs to be capitalised, the amount of expenditure on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities.
- Expenditures are reduced by any progress payments received and grants received in connection with the asset (see Ind AS 20 *Accounting for Government Grants and Disclosure of Government Assistance*).
- The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

3.5.4 Excess of the carrying amount over recoverable amount

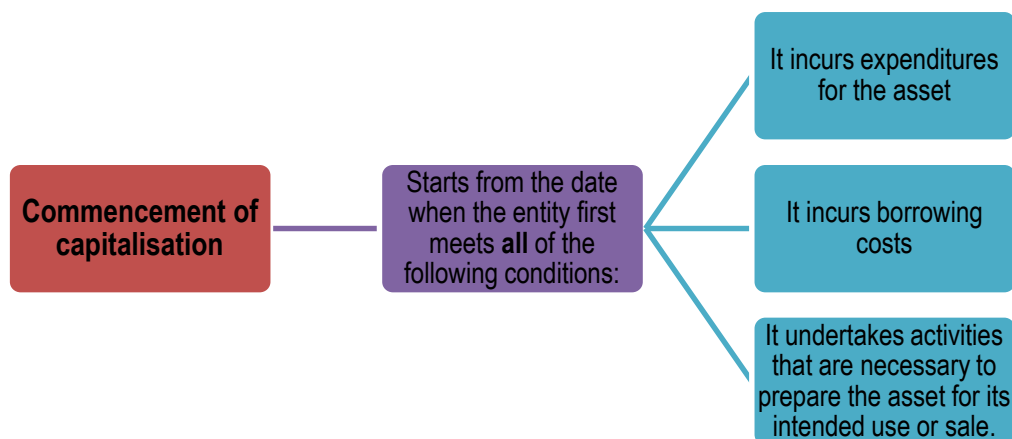
When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Standards.



3.6 PERIOD OF CAPITALISATION

3.6.1 Commencement of capitalisation

- An entity is required to begin the capitalisation of borrowing costs as part of the cost of a qualifying asset on the commencement date.
- The commencement date is the date when the entity first meets all of the following conditions cumulatively on a particular date:
 - (a) it incurs expenditures for the asset;
 - (b) it incurs borrowing costs; and
 - (c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.



Explanation to the three conditions for commencement date

▪ **Expenditures on a qualifying asset include:**

- Those expenditures that have resulted in payments of cash
- transfers of other assets
- assumption of interest-bearing liabilities

Expenditures are reduced by any progress payments received and grants received in connection with the asset.

▪ **Activities necessary to prepare asset for its intended use or sale:**

- Includes technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction.
- excludes the holding of an asset when no production or development that changes the asset's condition is taking place.

For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Illustration 10 : Commencement Date

X Ltd. is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:

- (i) 15th May, 20X1: Loan interest relating to the project started incurring

- (ii) 2nd June, 20X1 : Technical site planning commenced
- (iii) 19th June, 20X1 : Expenditure on the project started incurring
- (iv) 18th July, 20X1 : Construction work commenced

Identify the commencement date for capitalisation of borrowing cost.

Solution

In the above case, the three conditions to be tested for commencement date would be:

Borrowing cost has been incurred on : 15th May, 20X1

Expenditure has been incurred for the asset on : 19th June, 20X1

Activities necessary to prepare asset for its intended use or sale: 2nd June, 20X1

Commencement date would be the date when the above three conditions would be satisfied in all i.e. 19th June, 20X1

3.6.2 Suspension of capitalisation

- Capitalisation of borrowing costs shall be suspended during the extended periods in which the active development of a qualifying asset is suspended. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, the standard distinguishes between extended periods of interruption (when capitalisation would be suspended) and periods of temporary delay that are a necessary part of preparing the asset for its intended purpose (when capitalisation is not normally suspended).
- Capitalisation of borrowing cost is not suspended when temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period when high water levels delay construction of a bridge, if such high-water levels are common during the construction period in the geographical region involved. Similarly, capitalisation continues during periods when inventory is undergoing slow transformation – the example is given of inventories taking an extended time to mature (presumably such products as Scotch whisky or Cognac, although the relevance of this may be limited as these products are likely to meet the optional exemption for 'routinely manufactured' products).

Example 4: Suspension of Capitalisation

- (a) Construction suspended between October, 20X1 to January, 20X2 during which period certain heavy construction equipment under use was shifted to another site.

In this case, capitalization of borrowing costs needs to be suspended since active development is interrupted.

- (b) When Qualifying Asset construction is about to complete, there was temporary delay of 20 days on account of some technical reasons.

In this case, capitalization of borrowing costs shall be continued.

3.6.3 Cessation of capitalisation

- Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
- An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.
- When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

For e.g. A business park comprising several buildings, each of which can be used individually, is a qualifying asset for which each part is capable of being usable while construction continues on other parts.

For a qualifying asset that needs to be complete in its entirety before any part can be used as intended, it would be appropriate to capitalise related borrowing costs until all the activities necessary to prepare the entire asset for its intended use or sale are substantially complete. An example of this is an industrial plant, such as a steel mill, involving several processes which are carried out in sequence at different parts of the plant within the same site.

Example 5

H Limited, a real estate company, gives immovable property on rent. It has completed on 31st May, 20X1, a commercial complex consisting of various offices that could be rented out. It expects that the commercial complex will be completely rented out by 30th June, 20X1. However, due to adverse market conditions, only 10% of the commercial complex could be

rented out by its reporting date of 31st March, 20X2. H Limited wants to capitalise the eligible borrowing costs incurred up to 31st March, 20X2.

H Limited should capitalise borrowing costs only up to 31st May, 20X1. The borrowing cost incurred thereafter cannot be capitalised as the asset was ready for its intended use on 31st May, 20X1. The fact that only a small portion could be rented out by 31st March, 20X2, is not relevant.



3.7 DISCLOSURE

Entities are required to disclose:

- (a) the amount of borrowing costs capitalised during the period; and
- (b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation



3.8 OTHER RELEVANT CONCEPTS

3.8.1 Dividends payable on shares classified as financial liabilities

- An entity might finance its operations in whole or in part by the issue of **preference shares** and in some circumstances these will be **classified as financial liabilities** (as per Ind AS 32). **Dividends payable** on these instruments would **meet the definition of borrowing costs**, subject to the fulfillment of certain conditions.

Example 6

An entity might have funded the development of a qualifying asset by issuing redeemable preference shares that are redeemable at the option of the holder and so are classified as financial liabilities under Ind AS 32. In this case, dividend would be treated as interest and meet the definition of borrowing costs and so should be capitalised following the principles on specific borrowings as discussed in a separate section 4.5.1.1 above.

3.8.2 Capitalising borrowing cost in group financial statements

- There may be a situation when the borrowings are taken by one company and qualifying asset is developed by another company within a group.

- It may be **appropriate to capitalise interest in the group financial statements** on borrowings that appear in the financial statements of a different group entity from that carrying out the development.
- Based on the underlying principle of Ind AS 23, capitalisation in such circumstances would only be appropriate if the amount capitalised fairly reflected the interest cost of the group on borrowings **from third parties** that could have been avoided if the expenditure on the qualifying asset were not made.
- However, **the entity carrying out the development should not capitalise any interest in its own financial statements** as it has no borrowings.
- If, however, the entity has **intra-group borrowings** then interest on such borrowings may be **capitalised in its own financial statements**.

Illustration 11

A subsidiary (or jointly controlled entity or associate) finances the construction of a qualifying asset with an inter-company loan. Are borrowing costs incurred on the inter-company loan capitalised in the separate financial statements of the subsidiary (or jointly controlled entity or associate)?

Solution

Yes. Borrowing costs are capitalised to the extent of the actual costs incurred by the subsidiary (or jointly controlled entity or associate).

3.8.3 Cessation of capitalisation for maturing inventories

- For maturing inventories, it is sometimes difficult to determine when the 'period of production' ends, i.e. when inventories are being held for sale as opposed to being held to mature.

Example 7

Whisky is 'mature' after three years but goes on improving with age for many more years. Provided that it is consistent with the entity's business model to hold such items so that they mature further, it would seem acceptable to continue to add borrowing costs to the value of such maturing inventories for as long as it can be demonstrated that the particular item of

inventory continues to increase in value solely on account of increasing age, rather than because of market fluctuations or inflation.

- If this cannot be demonstrated, then the inventories should be regarded as held for sale and no further borrowing costs should be capitalised.



3.9 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Larsen & Toubro Limited' for the financial year 2021-2022 with respect to 'Borrowing Costs'.

Notes:

- (1) Borrowing cost capitalised in accordance with Ind AS 23 "Borrowing Costs" is as follows:

	₹ crore	
Class of Assets	2021-22	2020-21
Capital work-in-progress		
Property, plant and equipment - building	8.83	27.75
Investment property - building	12.63	13.11
Total	21.46	40.86

- (2) The average borrowing cost used for capitalisation is 7.29% (previous year: 6.56%).

Note in Property, Plant and Equipment & Capital work-in-progress

- Additions during the year and capital work-in-progress of buildings include ` 8.83 crore (previous year: ` 27.75 crore) being borrowing cost capitalised in accordance with Accounting Standard (Ind AS) 23 "Borrowing Costs".
- The rate used to determine the amount of borrowing costs eligible for capitalisation is 6.23% (previous year: 5.71%).

ACCOUNTING POLICY

Borrowing Costs

Borrowing costs include finance costs calculated using the effective interest method, finance charges in respect of assets acquired on lease and exchange differences arising on foreign currency borrowings, to the extent they are regarded as an adjustment to finance costs. In cases where hedging instruments are acquired for protection against exchange rate risk related to borrowings and are accounted as hedging a time-period related hedge item, the borrowing costs also include the amortisation of premium element of the forward contract and foreign currency basis spread as applicable, over the period of the hedging instrument.

Borrowing costs net of any investment income from the temporary investment of related borrowings that are attributable to the acquisition, construction or production of a qualifying asset are capitalised / inventoried as part of cost of such asset till such time the asset is ready for its intended use or sale. A qualifying asset is an asset that necessarily requires a substantial period of time to get ready for its intended use or sale. All other borrowing costs are recognized in profit or loss in the period in which they are incurred..

(Source: Annual Report 2021-2022 - 'Larsen & Toubro Limited')



3.10 SIGNIFICANT DIFFERENCES IN IND AS 23 VIS-À-VIS AS 16

S. No.	Particular	Ind AS 23	AS 16
1.	<i>Qualifying Asset measured at Fair Value</i>	Ind AS 23 does not require an entity to apply this 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	AS 16 does not provide for such scope exclusion
2.	<i>Applicability to Inventories</i>	Ind AS 23 does not require the application of this Standard to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis	AS 16 does not provide for such scope exclusion and is applicable to borrowing costs related to all inventories that require substantial period of time to bring them in saleable condition
3.	<i>Inclusion as Borrowing Costs</i>	Ind AS 23 requires calculation of interest expense using the effective interest rate method as described in Ind AS 109. Items (b) and (c) are not mentioned as some of those components of borrowing costs are	AS 16, <i>Borrowing Costs</i> , <i>inter alia</i> , include the following: (a) interest and commitment charges on bank borrowings and

		considered as the components of interest expense calculated using the effective interest rate method.	other short-term and long-term borrowings; (b) amortisation of discounts or premiums relating to borrowings; (c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings
4.	<i>Interest on leases</i>	Ind AS 23 includes interest in respect of lease liabilities (recognized as per Ind AS 116)	AS 16 includes finance charges in respect of assets acquired under finance lease as part of borrowing costs
5.	<i>Unrealized exchange loss</i>	Ind AS 23 provides that where there is an unrealized exchange loss which is treated as an adjustment to interest and subsequently there is a realized or unrealized gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognized as an adjustment should also be recognized as an adjustment to interest.	AS 16 does not explicitly deal with such scenario.
6.	<i>Explanation of Substantial Period of Time</i>	This explanation is not included in Ind AS 23.	AS 16 gives explanation for meaning of 'substantial period of time' appearing in the definition of the term 'qualifying asset' as twelve months

7.	<i>Reporting in Hyperinflationary Economies</i>	Ind AS 23 provides that when Ind AS 29, ' <i>Financial Reporting in Hyperinflationary Economies</i> ', is applied, part of the borrowing costs that compensates for inflation should be expensed as required by that Standard (and not capitalized in respect of qualifying assets).	AS 16 does not contain a similar clarification because at present, in India, there is no Standard on ' <i>Financial Reporting in Hyperinflationary Economies</i> '.
8.	<i>Borrowings of the Parent and its Subsidiaries for Computing Weighted Average</i>	Ind AS 23 specifically provides that in some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs while in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.	This specific provision is not there in AS 16.
9.	<i>Disclosure of capitalisation rate</i>	Ind AS 23 requires disclosure of capitalization rate used to determine the amount of borrowing costs eligible for capitalization.	AS 16 does not have this disclosure requirement.
10.	<i>Borrowing cost in regard to foreign currency borrowing</i>	For the purpose of computing borrowing cost under Ind AS 23 in regard to foreign currency borrowing, the difference is to be computed with reference to functional currency	Under AS 16 read with AS 11, the difference is between the local currency and foreign currency.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

- Marine Transport Limited ordered 3 ships for its fleet on 1st April, 20X0. It pays a down payment of 25% of the contract value of each of the ship out of long-term borrowings from a scheduled bank. The delivery has to commence from the financial year 20X7. On 1st March, 20X2, the ship builder informs that it has commenced production of one ship. There is no progress on other 2 ships. Marine Transport Limited prepares its financial statements on financial year basis.

Advise whether it is permissible for Marine Transport Limited to capitalise any borrowing costs for the financial year ended 31st March, 20X1 or 31st March, 20X2.

- X Limited has a treasury department that arranges funds for all the requirements of the Company including funds for working capital and expansion programs. During the year ended 31st March, 20X2, the Company commenced the construction of a qualifying asset and incurred the following expenses:

Date	Amount (₹)
1 st July, 20X1	2,50,000
1 st December, 20X1	3,00,000

The details of borrowings and interest thereon are as under:

Particulars	Average Balance (₹)	Interest (₹)
Long term loan @ 10%	10,00,000	1,00,000
Working capital loan	<u>5,00,000</u>	<u>65,000</u>
	<u>15,00,000</u>	<u>1,65,000</u>

Compute the borrowing costs that need to be capitalised.

3. An entity constructs a new head office building commencing on 1st September 20X1, which continues till 31st December 20X1. Directly attributable expenditure at the beginning of the month on this asset are ₹ 1,00,000 in September 20X1 and ₹ 2,50,000 in each of the months of October to December 20X1.

The entity has not taken any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. During the year, the entity had issued 10% debentures with a face value of ₹ 20 lacs and had an overdraft of ₹ 5,00,000, which increased to ₹ 7,50,000 in December 20X1. Interest was paid on the overdraft at 15% until 1 October 20X1, then the rate was increased to 16%.

Calculate the capitalization rate for computation of borrowing cost in accordance with Ind AS 23 'Borrowing Costs'.

4. K Ltd. began construction of a new building at an estimated cost of ₹ 7 lakh on 1st April, 20X1. To finance construction of the building it obtained a specific loan of ₹ 2 lakh from a financial institution at an interest rate of 9% per annum.

The company's other outstanding loans were:

Amount	Rate of Interest per annum
₹ 7,00,000	12%
₹ 9,00,000	11%

The expenditure incurred on the construction was:

April, 20X1	₹ 1,50,000
August, 20X1	₹ 2,00,000
October, 20X1	₹ 3,50,000
January, 20X2	₹ 1,00,000

The construction of building was completed by 31st January, 20X2.

Following the provisions of Ind AS 23 'Borrowing Costs', calculate the amount of interest to be capitalized and pass necessary journal entry for capitalizing the cost and borrowing cost in respect of the building as on 31st January, 20X2.

5. On 1st April, 20X1, entity A contracted for the construction of a building for ₹ 22,00,000. The land under the building is regarded as a separate asset and is not part of the qualifying assets. The building was completed at the end of March, 20X2, and during the period the following payments were made to the contractor:

Payment date	Amount (₹ '000)
1 st April, 20X1	200
30 th June, 20X1	600
31 st December, 20X1	1,200
31 st March, 20X2	<u>200</u>
Total	<u>2,200</u>

Entity A's borrowings at its year end of 31st March, 20X2 were as follows:

- 10%, 4-year note with simple interest payable annually, which relates specifically to the project; debt outstanding on 31st March, 20X2 amounted to ₹ 7,00,000. Interest of ₹ 65,000 was incurred on these borrowings during the year, and interest income of ₹ 20,000 was earned on these funds while they were held in anticipation of payments.
- 12.5% 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,000,000 and remained unchanged during the year; and
- 10% 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,500,000 and remained unchanged during the year.

Determine the amount of the borrowing costs which can be capitalized at the year end as per relevant Ind AS.

6. In a group with Parent Company "P" there are 3 subsidiaries with following business:

"A" – Real Estate Company

"B" – Construction Company

"C" – Finance Company

- Parent Company has no operating activities of its own but performs management functions for its subsidiaries.
- Financing activities and cash management in the group are coordinated centrally.
- Finance Company is a vehicle used by the group solely for raising finance.
- All entities in the group prepare Ind AS financial statements.

The following information is relevant for the current reporting period 20X1-20X2:

Real Estate Company

- Borrowings of ₹ 10,00,000 with an interest rate of 7% p.a.

- Expenditures on qualifying assets during the period amounted to ₹ 15,40,000.
- All construction works were performed by Construction Company. Amounts invoiced to Real Estate Company included 10% profit margin.

Construction Company

- No borrowings during the period.
- Financed ₹ 10,00,000 of expenditures on qualifying assets using its own cash resources.

Finance Company

- Raised ₹ 20,00,000 at 7% p.a. externally and issued a loan to Parent Company for general corporate purposes at the rate of 8%.

Parent Company

- Used loan from Finance Company to acquire a new subsidiary.
- No qualifying assets apart from those in Real Estate Company and Construction Company.
- Parent Company did not issue any loans to other entities during the period.

Compute the amount of borrowing costs eligible for capitalisation in the financial statements of each of the four entities for the current reporting period 20X1-20X2.

7. Examine how will you capitalise the interest, when qualifying assets are funded by borrowings in the nature of bonds that are issued at discount.

Y Ltd. issued at the start of year 1, 10% (interest paid annually and having maturity period of 4 years) bonds with a face value of ₹ 2,00,000 at a discount of 10% to finance a qualifying asset which is ready for intended use at the end of year 2.

Compute the amount of borrowing costs to be capitalized if the company amortizes discount using Effective Interest Rate method by applying 13.39% p.a. of EIR.

8. Nikka Limited has obtained a term loan of ₹ 620 lacs for a complete renovation and modernisation of its Factory on 1st April, 20X1. Plant and Machinery was acquired under the modernisation scheme and installation was completed on 30th April, 20X2. An expenditure of ₹ 510 lacs was incurred on installation of Plant and Machinery, ₹ 54 lacs has been advanced to suppliers for additional assets (acquired on 25th April, 20X1) which were also installed on 30th April, 20X2 and the balance loan of ₹ 56 lacs has been used for working capital purposes. Management of Nikka Limited considers the 12 months period as substantial period of time to get the asset ready for its intended use.

The company has paid total interest of ₹ 68.20 lacs during financial year 20X1-20X2 on the above loan. The accountant seeks your advice how to account for the interest paid in the books of accounts. Will your answer be different, if the whole process of renovation and modernization gets completed by 28th February, 20X2?

Answers

1. As per paragraph 5 of Ind AS 23, a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

As per paragraph 17 of Ind AS 23, an entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

- (a) It incurs expenditures for the asset.
- (b) It incurs borrowing costs.
- (c) It undertakes activities that are necessary to prepare the asset for its intended use or sale.

The ship is a qualifying asset as it takes substantial period of time for its construction. Thus, the related borrowing costs should be capitalised.

Marine Transport Limited borrows funds and incurs expenditures in the form of down payment on 1st April, 20X0. Thus, condition (a) and (b) are met. However, condition (c) is met only on 1st March, 20X2, and that too only with respect to one ship. Thus, there is no capitalisation of borrowing costs during the financial year ended 31st March, 20X1. Even during the financial year ended 31st March, 20X2, borrowing costs relating to the 'one' ship whose construction had commenced from 1st March, 20X2 will be capitalised from 1st March, 20X2 to 31st March, 20X2. All other borrowing costs are expensed.

2. The capitalisation rate is calculated as below:

Total borrowing costs / Weighted average total borrowings: $1,65,000/15,00,000 = 11\%$.

Interest to be capitalised is calculated as under:

- On ₹ 2,50,000 @ 11% p.a. for 9 months = ₹ 20,625
- On ₹ 3,00,000 @ 11% p.a. for 4 months = ₹ 11,000

Total interest capitalised for the year ended 31st March 20X2 is ₹ 31,625

3. Since the entity has only general borrowing hence first step will be to compute the capitalisation rate. The capitalisation rate of the general borrowings of the entity during the period of construction is calculated as follows:

Finance cost on ₹ 20 lacs 10% debentures during September – December 20X1	₹ 66,667
Interest @ 15% on overdraft of ₹ 5,00,000 in September 20X1	₹ 6,250
Interest @ 16% on overdraft of ₹ 5,00,000 in October and November 20X1	₹ 13,333
Interest @ 16% on overdraft of ₹ 7,50,000 in December 20X1	₹ 10,000
Total finance costs in September – December 20X1	₹ 96,250

Weighted average borrowings during period

$$= \frac{(20,00,000 \times 4) + (500,000 \times 3) + (750,000 \times 1)}{4} = ₹ 25,62,500$$

Capitalisation rate = Total finance costs during the construction period / Weighted average borrowings during the construction period

$$= 96,250 / 25,62,500 = 3.756\%$$

4. (i) **Calculation of capitalization rate on borrowings other than specific borrowings**

Amount of loan (₹)	Rate of interest		Amount of interest (₹)
7,00,000	12%	=	84,000
<u>9,00,000</u>	11%	=	<u>99,000</u>
<u>16,00,000</u>			<u>1,83,000</u>
Weighted average rate of interest (1,83,000/16,00,000) x 100		=	11.4375%

- (ii) **Computation of borrowing cost to be capitalized for specific borrowings and general borrowings based on weighted average accumulated expenses**

Date of incurrence of expenditure	Amount of spent	Financed through	Calculation	₹
1 st April, 20X1	1,50,000	Specific borrowing	1,50,000 x 9% x 10/12	11,250

1 st August, 20X1	2,00,000	Specific borrowing	$50,000 \times 9\% \times 10/12$	3,750
		General borrowing	$1,50,000 \times 11.4375\% \times 6/12$	8,578.125
1 st October, 20X1	3,50,000	General borrowing	$3,50,000 \times 11.4375\% \times 4/12$	13,343.75
1 st January, 20X2	1,00,000	General borrowing	$1,00,000 \times 11.4375\% \times 1/12$	<u>953.125</u>
				<u>37,875</u>

Note: Since construction of building started on 1st April, 20X1, it is presumed that all the later expenditures on construction of building had been incurred at the beginning of the respective month.

(iii) **Total expenses to be capitalized for building**

	₹
Cost of building ₹ (1,50,000 + 2,00,000 + 3,50,000 + 1,00,000)	8,00,000
Add: Amount of interest to be capitalized	<u>37,875</u>
	<u>8,37,875</u>

(iv) **Journal Entry**

Date	Particulars	₹	₹
31.1.20X2	Building account Dr.	8,37,875	
	To Bank account		8,00,000
	To Interest payable (borrowing cost)		37,875
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)		

Note: In the above journal entry, it is assumed that interest amount will be paid at the year end. Hence, entry for interest payable has been passed on 31.1.20X2.

Alternatively, following journal entry may be passed if interest is paid on the date of capitalization:

Date	Particulars	₹	₹
31.1.20X2	Building account Dr. To Bank account (Being expenditure incurred on construction of building and borrowing cost thereon capitalized)	8,37,875	8,37,875

5. As per Ind AS 23, when an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity should determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

The amount of borrowing costs eligible for capitalization, in cases where the funds are borrowed generally, should be determined based on the capitalisation rate and expenditure incurred in obtaining a qualifying asset. The costs incurred should first be allocated to the specific borrowings.

Analysis of expenditure:

Date	Expenditure (₹ '000)	Amount allocated in general borrowings (₹ '000)	Weighted for period outstanding (₹ '000)
1 st April 20X1	200	0	0
30 th June 20X1	600	100*	100 × 9/12 = 75
31 st Dec 20X1	1,200	1,200	1,200 × 3/12 = 300
31 st March 20X2	<u>200</u>	200	200 × 0/12 = <u>0</u>
Total	<u>2,200</u>		<u>375</u>

*Specific borrowings of ₹ 7,00,000 fully utilized on 1st April & on 30th June to the extent of ₹ 5,00,000 hence remaining expenditure of ₹ 1,00,000 allocated to general borrowings.

The capitalisation rate relating to general borrowings should be the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

$$\text{Capitalisation rate} = \frac{(10,00,000 \times 12.5\%) + (15,00,000 \times 10\%)}{10,00,000 + 15,00,000} = 11\%$$

Borrowing cost to be capitalized:	Amount (₹)
On specific loan	65,000
On General borrowing (3,75,000 × 11%)	<u>41,250</u>
Total	1,06,250
Less: interest income on specific borrowings	<u>(20,000)</u>
Amount eligible for capitalization	<u>86,250</u>
Therefore, the borrowing costs to be capitalized are ₹ 86,250.	

6. Following is the treatment as per Ind AS 23:

Finance Company

No expenditure on qualifying assets have been incurred, so Finance Company cannot capitalise anything.

Real Estate Company

Total interest costs in the financial statements of Real Estate Company is ₹ 70,000. Expenditures on qualifying assets exceed total borrowings, so the total amount of interest can be capitalised.

Construction Company

No interest expense has been incurred, so Construction Company cannot capitalise anything.

Consolidated financial statements of Parent Company:

Total general borrowings of the group: ₹ 10,00,000 + ₹ 20,00,000 = ₹ 30,00,000

Although Parent Company used proceeds from loan to acquire a subsidiary, this loan cannot be excluded from the pool of general borrowings.

Total interest expenditures for the group = ₹ 30,00,000 × 7% = ₹ 2,10,000

Total expenditures on qualifying assets for the group are added up. Profit margin charged by Construction Company to Real Estate Company is eliminated:

Real Estate Company – ₹ 15,40,000/1.1 = ₹ 14,00,000

Construction Co – ₹ 10,00,000

Total consolidated expenditures on qualifying assets:

₹ (14,00,000 + 10,00,000) = ₹ 24,00,000

Capitalisation rate = 7%

Borrowing costs eligible for capitalisation = ₹ 24,00,000 x 7% = ₹ 1,68,000

Total interest expenditures of the group are higher than borrowing costs eligible for capitalisation calculated based on the actual expenditures incurred on the qualifying assets. Therefore, only ₹ 1,68,000 can be capitalised.

7. Capitalisation Method

As per the Standard, borrowing costs may include interest expense calculated using the effective interest method. Further, capitalisation of borrowing cost should cease where substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Thus, only that portion of the amortized discount should be capitalised as part of the cost of a qualifying asset which relates to the period during which acquisition, construction or production of the asset takes place.

Capitalisation of Interest

Hence, based on the above explanation the amount of borrowing cost of year 1 & 2 are to be capitalised and the borrowing cost relating to year 3 & 4 should be expensed.

Quantum of Borrowing

The value of the bond to Y Ltd. is the transaction price ie ₹ 1,80,000 (2,00,000 – 20,000)

Therefore, Y Ltd will recognize the borrowing at ₹ 1,80,000.

Computation of the amount of Borrowing Cost to be Capitalised

Y Ltd will capitalise the interest (borrowing cost) using the effective interest rate of 13.39% for two years as the qualifying asset is ready for intended use at the end of the year 2, the details of which are as follows:

Year	Opening Borrowing	Interest expense @ 13.39% to be capitalised	Total	Interest paid	Closing Borrowing
	(1)	(2)	(3)	(4)	(5) = (3) – (4)
1	1,80,000	24,102	2,04,102	20,000	1,84,102
2	1,84,102	<u>24,651</u>	2,08,753	20,000	1,88,753
		<u>48,753</u>			

Accordingly, borrowing cost of ₹ 48,753 will be capitalized to the cost of qualifying asset.

8. As per Ind AS 23, Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognized as an expense.

Where, a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Accordingly, the treatment of Interest of ₹ 68.20 lakh occurred during the year 20X1-20X2 would be as follows:

(i) When construction of asset completed on 30th April, 20X2

The treatment for total borrowing cost of ₹ 68.20 lakh will be as follows:

Purpose	Nature	Interest to be capitalised	Interest to be charged to profit and loss account
		₹ in lakh	₹ in lakh
Modernisation and renovation of plant and machinery	Qualifying asset	$[68.20 \times (510/620)] = 56.10$	Nil
Advance to suppliers for additional assets	Qualifying asset	$[68.20 \times (54/620)] = 5.94$	Nil
Working Capital	Not a qualifying asset	_____	$[68.20 \times (56/620)] = 6.16$
		<u>62.04</u>	<u>6.16</u>

(ii) When construction of assets is completed by 28th February, 20X2

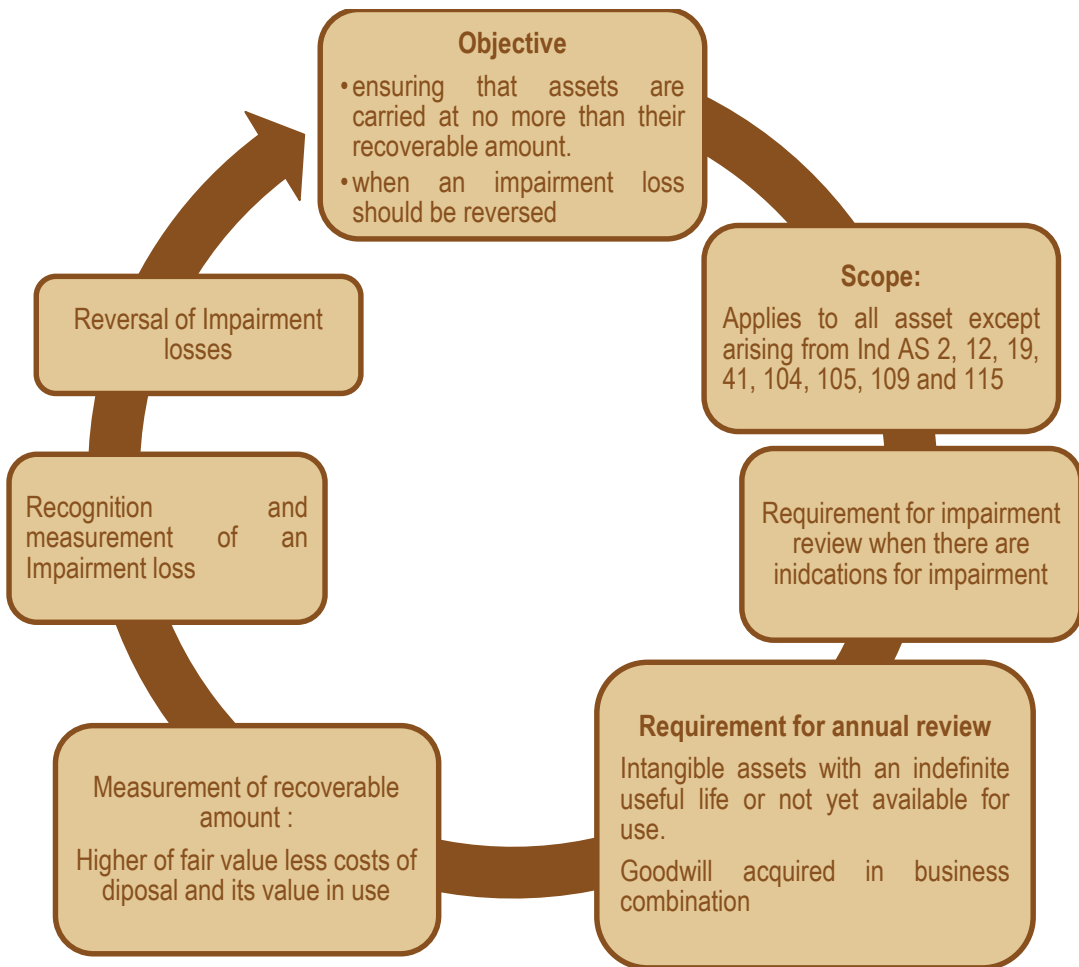
When the process of renovation gets completed in less than 12 months, the plant and machinery and the additional assets will not be considered as qualifying assets (until and unless the entity specifically considers that the assets took substantial period for completing their construction). Accordingly, the whole of interest will be charged off / expensed off to Profit and Loss account.

UNIT 4 : INDIAN ACCOUNTING STANDARD 36 : IMPAIRMENT OF ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to

- ☐ Comprehend the objective and scope of this standard
- ☐ Define the terms impairment loss, cash-generating unit, corporate assets, recoverable amount etc.
- ☐ Examine the criteria for identifying an asset that may be impaired
- ☐ Measure the Recoverable Amount
- ☐ Recognise and Measure the Impairment loss
- ☐ Identify and examine the Cash Generating Unit of the entity and impair the Goodwill
- ☐ Allocate and Reverse the Impairment loss
- ☐ Disclose the facts as per the requirement of the standard
- ☐ Differentiate between Ind AS 36 and AS 28.

UNIT OVERVIEW 



4.1 OBJECTIVE

The objective of this Standard is to prescribe the methodology that an entity applies to ensure that its assets are not carried at more than their recoverable amount (i.e. the higher of fair value less costs of disposal and value in use). With the exception of goodwill and certain intangible assets for which an annual impairment test is required.

An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. In such case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss.

The Standard also specifies when an entity shall reverse an impairment loss and prescribes disclosures.



4.2 SCOPE

- This Standard shall be applied in accounting for the impairment of all assets, other than:

Inventories (as covered in Ind AS 2)

Contract assets and assets arising from costs to obtain or fulfill a contract (Ind AS 115)

Deferred tax assets (Ind AS 12)

Assets arising from employees benefits (Ind AS 19)

Biological Assets measured at fair value less cost to sell (Ind AS 41)

Deferred acquisition costs and intangible assets arising from insurance contracts (Ind AS 104)

Non-current assets (or disposal groups) classified as held for sale (as covered in Ind AS 105)

Financial Assets (within the scope of Ind AS 109)

All of the items excluded from the scope of Ind AS 36 are covered by other Ind AS which contain requirements that are equivalent to impairment assessments in some form. For

example, Ind AS 2 requires inventories to be measured after initial recognition 'at the lower of cost and net realisable value'. It is therefore unnecessary to test inventories for further impairment in accordance with Ind AS 36 as the recoverability of these assets has already been determined through the subsequent measurement requirements of Ind AS 2.

- This Standard applies to financial assets classified as:

Subsidiaries, as defined in Ind AS 110, Consolidated Financial Statements

Associates, as defined in Ind AS 28 Investments in Associates and Joint Ventures

Joint ventures, as defined in Ind AS 111, Joint Arrangements

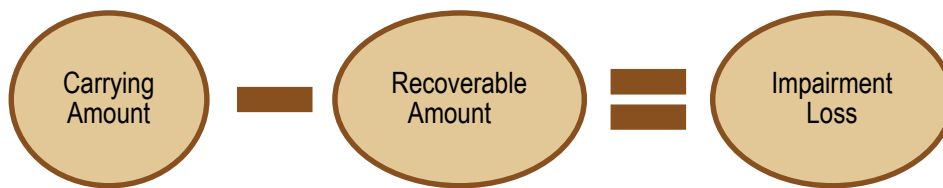
Impairment of other financial assets shall be accounted as per Ind AS 109, Financial Instruments.



4.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

1. **Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.
2. 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.
3. **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.
4. **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.
5. **Depreciable amount** is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.
6. **Depreciation (Amortisation)** is the systematic allocation of the depreciable amount of an asset over its useful life.
7. **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 (refer Ind AS 113 Fair Value Measurement).
8. An **impairment loss** is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.



9. The **recoverable amount** of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use.
10. **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.
11. **Value in use** is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.



4.4 IDENTIFYING AN ASSET THAT MAY BE IMPAIRED

4.4.1 Identifying an asset that may be impaired - General

- An asset is impaired when its carrying amount exceeds its recoverable amount.



- An entity shall **assess** at the end of each reporting period whether there is any **indication** that an asset may be impaired. If any such indication exists, the entity is required to estimate the **recoverable amount** of the asset.
- Irrespective of whether there is any indication of impairment, an entity is required to test following items for impairment at least annually:



For above three assets, the entity should not have wait for Impairment indicators, rather there is mandate of impairment testing. We will discuss this aspect in detail in the next section.

4.4.2 Indications of impairment

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

4.4.2.1 External source of Information

The following are external source of information which may indicate that an asset is impaired:

- a) during the period, an asset's **market value** has **declined significantly** more than would be expected as a result of the passage of time or normal use;
- b) significant changes with an **adverse effect** on the entity have taken place during the period, or will take place in the near future, in the **technological, market, economic or legal environment** in which the entity operates or in the market to which an asset is dedicated;
- c) market **interest rates** or other market rates of return on investments have **increased** during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially; and
- d) the carrying amount of the net assets of the entity is more than its market capitalisation.

4.4.2.2 Internal source of Information

The following are internal source of information which may indicate that an asset is impaired:

- a) evidence is available of **obsolescence or physical damage** of an asset;
- b) significant changes with an **adverse effect** on the entity have taken place during the period or are expected to take place in the near future, in the extent to which, or manner in which, **an asset is used or is expected to be used**. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite;
- c) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. Such evidence may include:
 - (i) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;
 - (ii) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;

- (iii) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or
- (iv) operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future.

4.4.2.3 Dividend from a subsidiary, jointly controlled entity or associate

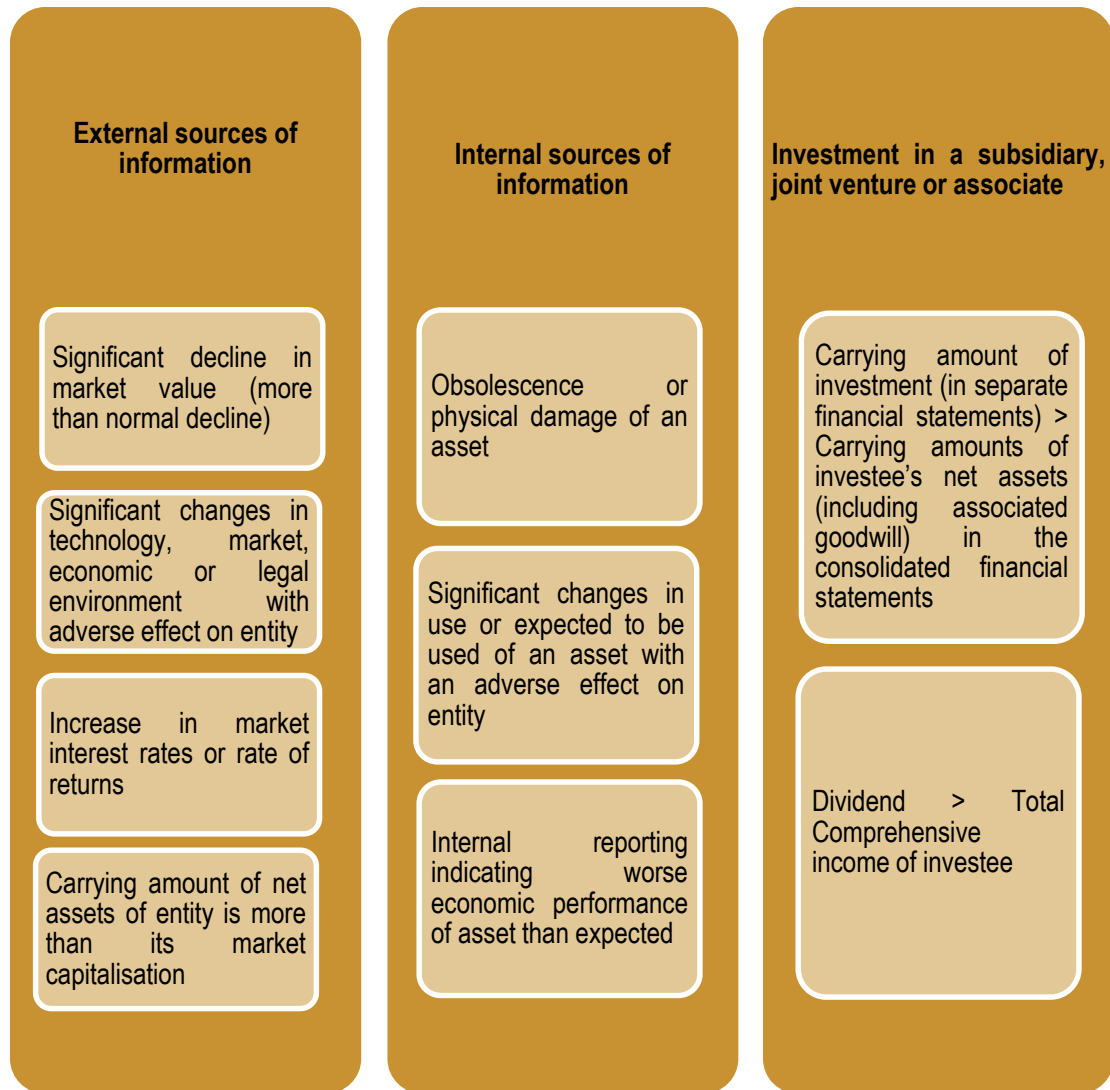
For an investment in a subsidiary, jointly controlled entity or associate, the investor recognises a dividend from the investment and evidence is available that:

- (i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or
- (ii) the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared.

The above list is not exhaustive. An entity may identify other indications that an asset may be impaired and these would also require the entity to determine the asset's recoverable amount or, in the case of goodwill, perform an impairment test.

If market interest rates or other market rates of return on investments have increased during the period, an entity is not required to make a formal estimate of an asset's recoverable amount in the following cases:

- a) if the discount rate used in calculating the asset's value in use is unlikely to be affected by the increase in these market rates. For example, increases in short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life; or
- b) if the discount rate used in calculating the asset's value in use is likely to be affected by the increase in these market rates but previous sensitivity analysis of recoverable amount shows that:
 - (i) it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase (e.g. in some cases, an entity may be able to demonstrate that it adjusts its revenues to compensate for any increase in market rates); or
 - (ii) the decrease in recoverable amount is unlikely to result in a material impairment loss.



4.5 REQUIREMENT FOR ANNUAL REVIEW

4.5.1 Items required to be tested for impairment at least annually

Irrespective of whether there is any indication of impairment, an entity is required to test following items for impairment at least annually:

- intangible asset with an indefinite useful life;
- intangible asset not yet available for use; and
- goodwill acquired in a business combination.

4.5.2 Intangible assets required to be tested for impairment at least annually

Intangible asset with an indefinite useful life and intangible assets not yet available for use to be tested for impairment

- a) annually; and
- b) and whenever there is an indication, at the end of a reporting period, that the asset may be impaired

by comparing its carrying amount with its recoverable amount, irrespective of whether there is any indication that it may be impaired.

- This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year and whenever there is an indication, at the end of a reporting period, that the asset may be impaired.

Example 1

Intellectual Property rights (IPR) having Indefinite useful life has been tested for Impairment in the first quarter of FY 20X1-20X2. Impairment testing on such assets needs to be mandatory done in the same time frame i.e first quarter of FY 20X2-20X3. Suppose there is an indication of impairment in third quarter of FY 20X2-20X3, in such case, the company needs to do impairment testing in third quarter apart from mandatory annual review.

- Different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period.
- However, the most recent detailed calculation of such an asset's recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period, provided all of the following criteria are met:
 - a) if the intangible asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets and is therefore tested for impairment as part of the cash-generating unit to which it belongs, the assets and liabilities making up that unit have not changed significantly since the most recent recoverable amount calculation;
 - b) the most recent recoverable amount calculation resulted in an amount that exceeded the asset's carrying amount by a substantial margin; and
 - c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the asset's carrying amount is remote.

4.5.3 Goodwill

4.5.3.1 CGUs to which goodwill has been allocated

A cash-generating unit to which goodwill has been allocated is tested for impairment both:

- a) annually, and
- b) whenever there is an indication that the unit may be impaired,

by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity recognises an impairment loss in accordance with the requirement of this standard.

4.5.3.2 Timing of impairment tests

- The annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units may be tested for impairment at different times.
- However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period.

4.5.3.3 Individual assets to be tested before CGU to which goodwill has been allocated

- If the assets constituting the CGU to which goodwill has been allocated are tested for impairment at the same time as the unit containing the goodwill, they shall be tested for impairment before the unit containing the goodwill.
- Similarly, if the CGUs constituting a group of CGUs to which goodwill has been allocated are tested for impairment at the same time as the group of units containing the goodwill, the individual units shall be tested for impairment before the group of units containing the goodwill.
- At the time of impairment testing a CGU to which goodwill has been allocated, there may be an indication of an impairment of an asset within the unit containing the goodwill. In such circumstances, the entity tests the asset for impairment first, and recognises any impairment loss for that asset before testing for impairment the cash-generating unit containing the goodwill.
- Similarly, there may be an indication of an impairment of a cash-generating unit within a group of units containing the goodwill. In such circumstances, the entity tests the cash-generating unit for impairment first, and recognises any impairment loss for that unit, before testing for impairment the group of units to which the goodwill is allocated.

4.5.3.4 Rolling forward detailed calculations from a preceding period

The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all the following criteria are met:

- the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;
- the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and
- based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.

4.5.3.5 CGUs to which it has not been possible to allocate goodwill

- When goodwill relates to a CGU but has not been allocated to that unit, the unit shall be tested for impairment, whenever there is an indication that the unit may be impaired, by comparing the unit's carrying amount, excluding any goodwill, with its recoverable amount. Any impairment loss is recognised in accordance with the requirement of this standard.
- If a CGU as described above includes in its carrying amount an intangible asset that has an indefinite useful life or is not yet available for use and that asset can be tested for impairment only as part of the CGU, the unit also to be tested for impairment annually.

4.6 MEASUREMENT OF RECOVERABLE AMOUNT

4.6.1 Recoverable amount

The **recoverable amount** of an asset or a CGU is the higher of its fair value less costs of disposal and its value in use.

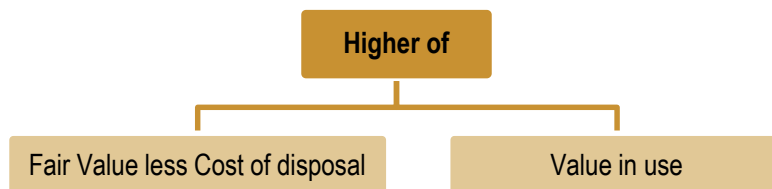


Illustration 1

The carrying value of a building in the books of Sun Ltd. as at 31st March, 20X1 is ₹ 300 lakh. As on that date the value in use is ₹ 250 lakh and fair value less cost of disposal is ₹ 238 lakh.

Calculate the Recoverable Amount.

Solution

Recoverable Amount : Higher of Fair Value less Costs of disposal and Value in Use

Fair Value less costs of disposal : ₹ 250 lakh

Value in Use : ₹ 238 lakh

Therefore, Recoverable value will be ₹ 250 lakh

4.6.2 Circumstances in which it is not necessary to calculate both an asset's fair value less costs of disposal and its value in use

- If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.
- If there is no basis for making a reliable estimate of fair value less costs of disposal, recoverable amount is measured by reference to value in use alone.
- In some cases, estimates, averages and computational short cuts may provide reasonable approximations of the detailed computations (illustrated in this Standard) for determining fair value less costs of disposal or value in use.

4.6.3 Circumstances in which recoverable amount is determined in the context of CGU

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (refer paragraphs 65–103), unless either:

- a) the asset's fair value less costs of disposal is higher than its carrying amount; or
- b) the asset's value in use can be estimated to be close to its fair value less costs of disposal and fair value less costs of disposal can be determined.

Some of the indicators are aimed at individual assets rather than the CGU of which they are a part of. For example, a decline in the value of an asset or evidence that it is obsolete or damaged. Such indicators may also imply that a wider review of the business or CGU is required. However, this is not always the case. For example, if there is a slump in property prices and the market

value of the entity's new head office falls below its carrying value this would constitute an indicator of impairment and trigger a review. At the level of the individual asset, as fair value less cost of disposal is below carrying amount, this might indicate that a write-down is necessary. However, building's recoverable amount may have to be considered in the context of a CGU of which it is a part of. This is an example of a situation where it may not be necessary to re-estimate an asset's recoverable amount because it may be obvious that the CGU has suffered no impairment. In short, it may be irrelevant to the recoverable amount of the CGU that it contains a head office whose market value has fallen.



4.7 FAIR VALUE LESS COSTS OF DISPOSAL

4.7.1 Fair value and costs of disposal – definition

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 (Ind AS 113 Fair Value Measurement).

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.

4.7.2 Cost of disposal to be deducted

Costs of disposal, other than those that have been recognised as liabilities, are deducted in determining fair value less costs of disposal. Examples of such costs are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

However, termination benefits (as defined in Ind AS 19) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

4.7.3 Contrasting fair value and value in use

Fair value differs from value in use. Fair value reflects the assumptions market participants would use when pricing the asset. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to market participants:

- a) additional value derived from the grouping of assets (such as the creation of a portfolio of investment properties in different locations);
- b) synergies between the asset being measured and other assets;

- c) legal rights or legal restrictions that are specific only to the current owner of the asset; and
- d) tax benefits or tax burdens that are specific to the current owner of the asset.

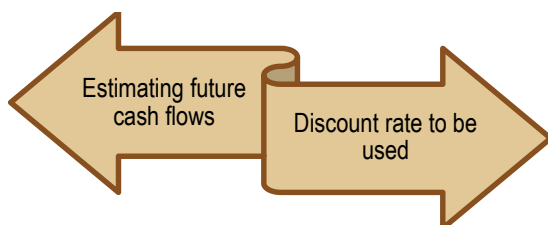


4.8 VALUE IN USE

4.8.1 Value in use – general

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

Primarily two key decisions are involved in determining value in use:



4.8.2 Estimation of expected future cash flows

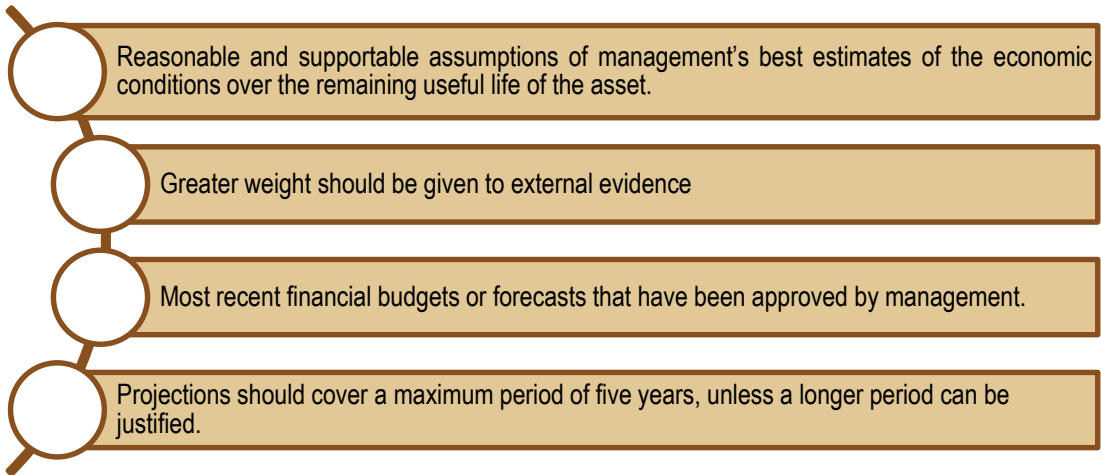
The following elements shall be reflected in the calculation of an asset's value in use:

- a) an estimate of the future cash flows the entity expects to derive from the asset;
- b) expectations about possible variations in the amount or timing of those future cash flows;
- c) the time value of money, represented by the current market risk-free rate of interest;
- d) the price for bearing the uncertainty inherent in the asset; and
- e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

▪ **Estimating the value in use of an asset involves the following steps:**

- a) estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and
 - b) applying the appropriate discount rate to those future cash flows.
- The elements identified above in point (b), (d) and (e) can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate. Whichever approach an entity adopts to reflect expectations about possible variations in the amount or timing of future cash flows, the result shall be to reflect the expected present value of the future cash flows, i.e. the weighted average of all possible outcomes.

■ When estimating expected future cash flows, the following rules apply:



- a) Projections of cash flows shall be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.

Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows. Management shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

- b) Base cash flow projections on the most recent financial budgets/forecasts approved by management but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.
- c) Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.
- d) Estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate

for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

- e) Period beyond the budgets / forecasts period will be the terminal period. The terminal value is an estimate of the present value all the cash flows in the terminal period (as at the end of the forecast period) based on the final cash flow in the forecast period. For example, assume that an entity has a 5 year forecast period, the formula to determine the terminal value as at the end of year 5 is:

Terminal value at the end of year 5 = (Cash flows of 5th year x (1+growth rate)) / (weighted average cost of capital minus growth rate).

- f) Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining, unless an increase in the rate matches objective information about patterns over a product or industry lifecycle. If appropriate, the growth rate is zero or negative.
- g) Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases attributable to general inflation. Therefore, if the discount rate includes the effect of price increases attributable to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases attributable to general inflation, future cash flows are estimated in real terms (but include future specific price increases or decreases).

4.8.2.1 Estimates of future cash flows shall include:

- a) projections of cash inflows from the continuing use of the asset;
- b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset;
- c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life shall be the amount that an entity expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's fair value less costs of disposal, except that, in estimating those net cash flows:

- (i) an entity uses prices prevailing at the date of the estimate for similar assets that have reached the end of their useful life and have operated under conditions similar to those in which the asset will be used; and
- (ii) the entity adjusts those prices for the effect of both future price increases due to general inflation and specific future price increases or decreases. However, if estimates of

future cash flows from the asset's continuing use and the discount rate exclude the effect of general inflation, the entity also excludes this effect from the estimate of net cash flows on disposal;

- d) projections of cash outflows include those for the day-to-day servicing of the asset as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset and
- e) in the same way that corporate assets can be allocated to a CGU's carrying value, the CGU's cash flows shall also include an appropriate apportionment of corporate overheads when calculating value in use. However, care should be taken around internal charges for using the asset.

4.8.2.2 Estimates of future cash flows shall exclude:

- Estimates of future cash flows do not include:
 - (a) cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables);
 - (b) cash outflows that relate to obligations that have been recognised as liabilities (for example, payables, pensions or provisions);
 - (c) future cash outflows or related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future restructuring to which an entity is not yet committed.

Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, contains guidance clarifying when an entity is committed to a restructuring.

When an entity becomes committed to a restructuring, some assets are likely to be affected by this restructuring. Once the entity is committed to the restructuring its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts approved by management) and its estimates of future cash outflows for the restructuring are included in a restructuring provision in accordance with Ind AS 37;

- (d) estimated future cash flows that are expected to arise from improving or enhancing the asset's performance, i.e. the general rule is that future cash flows should be forecasted for CGUs or assets in their current condition.

Estimates of future cash flows do include future cash flows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition.

When a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when

estimating the future cash flows associated with the unit. Similarly, when a single asset consists of components with different estimated useful lives, the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset when estimating the future cash flows generated by the asset;

- (e) cash inflows or outflows from financing activities. Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined. Otherwise, the effect of some assumptions will be counted twice or ignored.

Because the time value of money is considered by discounting the estimated future cash flows, these cash flows exclude cash inflows or outflows from financing activities;

- (f) income tax receipts or payments. Because the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis; and
- (g) when corporate assets have been allocated to a CGU's carrying amount, any internal charges incurred by the CGU for using such assets shall not be included in the CGU's expected future cash flows. To do so would be to double-count the impact of the corporate assets and could result in an impairment loss being recognised incorrectly.

Illustration 2

Saturn India Ltd is reviewing one of its business segments for impairment. The carrying value of its net assets is 40 million. Management has produced two computations for the value-in-use of the business segment. The first value of ₹ 36 million excludes the benefit to be derived from a future reorganization, but the second value of ₹ 44 million includes the benefits to be derived from the future reorganization. There is not an active market for the sale of the business segments.

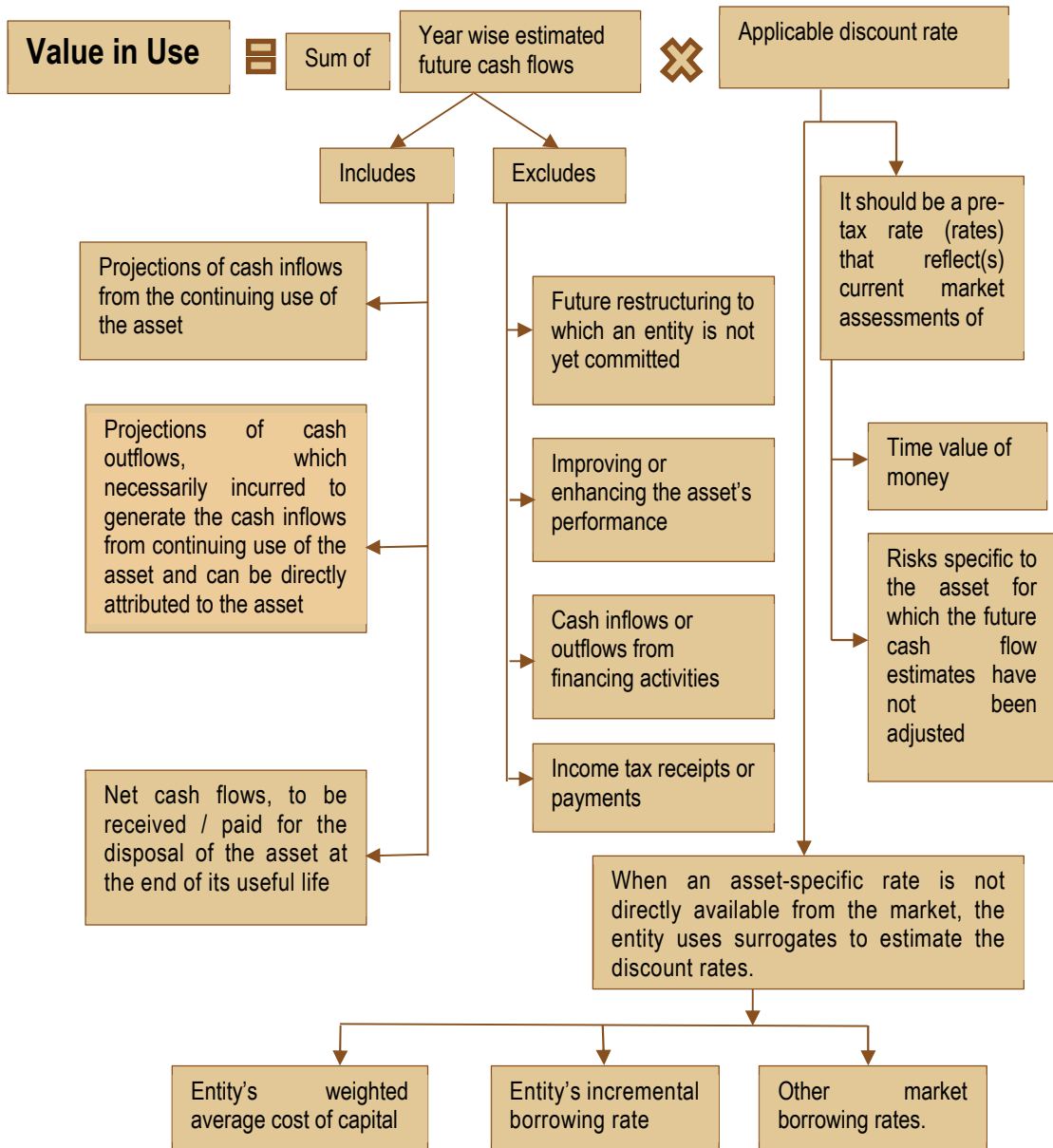
Advise whether the business segment needs to be impaired.

Solution

The benefit of the future reorganization should not be taken into account in calculating value-in-use. Therefore, the net assets of the business segment will be impaired by ₹ 4 million because the value-in-use of ₹ 36 million is lower than the carrying value of ₹ 40 million. The value-in-use can be used as the recoverable amount as there is no active market for the sale of the business segment.

4.8.2.3 Foreign currency future cash flows

Future cash flows are first estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. After that, an entity translates the present value using the spot exchange rate at the date of the value in use calculation. This is to avoid the problems inherent in using forward exchange rates, which are based on differential interest rates. Using such a rate would result in double-counting the time value of money, first in the discount rate and then in the forward rate.



4.8.3 Discount rate

- The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of:
 - a) the time value of money; and
 - b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.

- This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review. However, the discount rate(s) used to measure an asset's value in use shall not reflect risks for which the future cash flow estimates have been adjusted. Otherwise, the effect of some assumptions will be double counted.
- When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate.

Appendix A also gives the following guidelines for selecting the appropriate discount rate:

- it should be adjusted to reflect the specific risks associated with the projected cash flows (such as country, currency, price and cash flow risks) and to exclude risks that are not relevant;
- to avoid double counting, the discount rate does not reflect risks for which future cash flow estimates have been adjusted;
- the discount rate is independent of the entity's capital structure and the way it financed the purchase of the asset;
- if the basis for the rate is post-tax (such as a weighted average cost of capital), it is adjusted for the Value in Use (VIU) calculation to reflect a pre-tax rate; and
- normally, the entity uses a single discount rate but it should use separate discount rates for different future periods if the VIU is sensitive to different risks for different periods or to the term structure of interest rates.
- The discount rate specific for the asset or CGU will take account of the period over which the asset or CGU is expected to generate cash inflows and it may not be sensitive to changes in short-term rates.

Illustration 3

Mars Ltd. gives the following estimates of cash flows relating to property, plant and equipment on 31st March, 20X4. The discount rate is 15%

Year	Cash Flow (₹ in lakh)
20X4-20X5	2,000
20X5-20X6	3,000
20X6-20X7	3,000
20X7-20X8	4,000
20X8-20X9	2,000
Residual Value at 31 st March, 20X9	500

Property, plant & equipment was purchased on 1st April, 20X1 for ₹ 20,000 lakh
Useful Life was 8 Years

Residual Value estimated at the end of 8 years ₹ 500 lakh
 Fair value less cost to disposal ₹ 10,000 lakh
 Calculate impairment loss, if any on the property, plant and equipment. Also calculate the revised carrying amount and revised depreciation of property, plant and equipment.

Solution

(a) Calculation of Carrying Amount on 31st March, 20X4 (₹ in lakh)

Particular	Amount
Original Cost on 1 st April, 20X1	20,000
Less: Depreciation $\frac{(20,000 - 500)}{8} \times 3$	(7,313)
Carrying Amount	<u>12,687</u>

(b) Calculation of Value in Use

Year	Cash Flows	P.V.	Amount
20X4-20X5	2,000	.870	1,740
20X5-20X6	3,000	.756	2,268
20X6-20X7	3,000	.658	1,974
20X7-20X8	4,000	.572	2,288
20X8-20X9 (including residual value)	2,500	.497	<u>1,243</u>
Total			<u>9,513</u>

(c) Calculation of Recoverable Amount

Particular	Amount
Value in Use	9,513
Fair value less costs of disposal	10,000
Recoverable Amount	<u>10,000</u>

(d) Calculation of Impairment Loss

Carrying Amount – Recoverable Amount

$$12,687 - 10,000 = 2,687$$

(e) Calculation of Revised Carrying Amount

Particular	Amount
Carrying Amount	12,687
Less: Impairment Loss	(2,687)
Revised Carrying Amount	<u>10,000</u>

(f) Calculation of Revised DepreciationRevised Carrying Amount – Residual Value

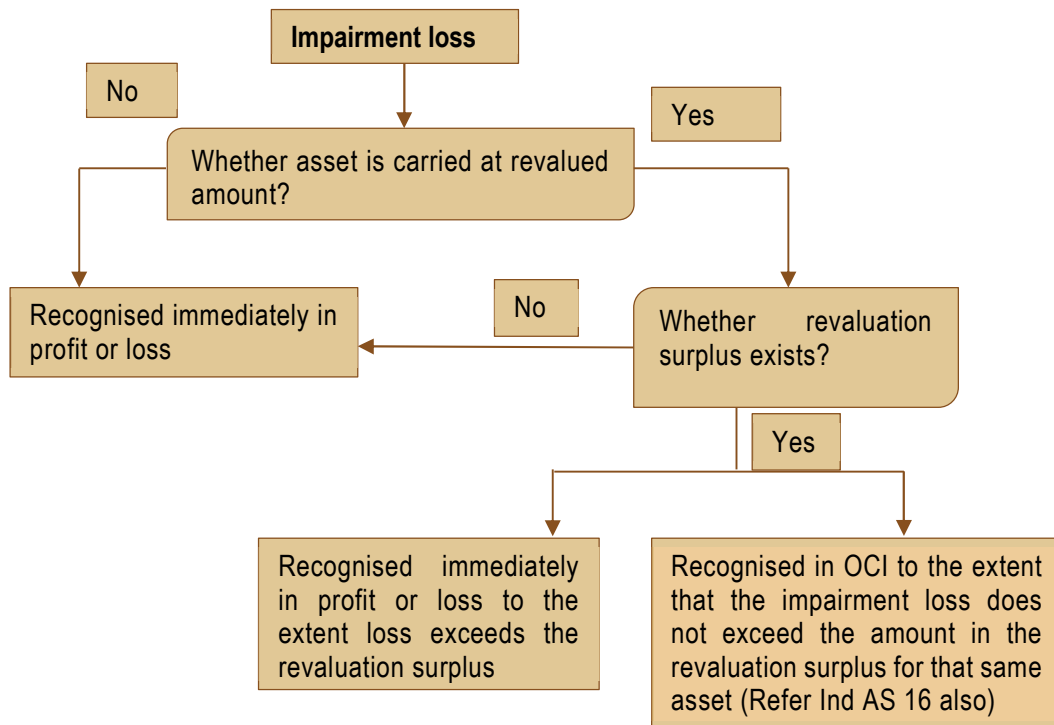
Remaining Life

10,000-500

5 = 1,900

**4.9 RECOGNISING AND MEASURING AN IMPAIRMENT LOSS****4.9.1 Recognition and measurement of an impairment loss - Individual Asset**

If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.



Note:

1. Any impairment loss of a revalued asset shall be treated as a revaluation decrease as per other standard.
2. When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability, if required.
3. After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.
4. If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with Ind AS 12 by comparing the revised carrying amount of the asset with its tax base.

Illustration 4 : Impairment Loss

Jupiter Ltd, a leading manufacturer of steel is having a furnace, which is carried in the balance sheet on 31st March, 20X1 at ₹ 250 lakh. As at that date the value in use and fair value is ₹ 200 lakh. The cost of disposal is ₹ 13 lakh.

Calculate the impairment loss to be recognised in the books of the company?

Solution**Calculation of Impairment Loss:**

Calculation of Impairment Loss	₹ in lakh
Recoverable Amount =	200
Higher of ,	
Fair Value less Cost of Disposal (200 -13)	187
Or	
Value in Use	200
Impairment Loss = Carrying Amount – Recoverable Amount	
= 250 – 200	50

- An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in Ind AS 16).
- Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard. Impairment loss on a revalued asset is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Such an impairment loss on a revalued asset reduces the revaluation surplus for that asset.

- When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another Standard.
- After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset is adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.
- If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with Ind AS 12 by comparing the revised carrying amount of the asset with its tax base.

Illustration 5

Mercury Ltd. has an identifiable asset with a carrying amount of ₹ 1,000. Its recoverable amount is ₹ 650. The tax rate is 30% and the tax base of the asset is ₹ 800. Impairment losses are not deductible for tax purposes. Identify the impact of impairment loss on related deferred tax asset / liability against the revised carrying amount of asset.

Solution

The effect of impairment loss is as follows:

	Identifiable assets before impairment loss	Impairment loss	Identifiable assets after impairment loss
	₹	₹	₹
Carrying amount	1,000	(350)	650
Tax Base	800	-	800
Taxable (deductible) temporary difference	200	(350)	(150)
Deferred tax liability (asset) at 30%	60	(105)	(45)

In accordance with Ind AS 12, the entity recognises the deferred tax asset to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

4.9.2 Recognition and measurement of an impairment loss for a cash-generating unit and goodwill

4.9.2.1 Identification of cash generating units

- 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.

- If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity is required to determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).
- The recoverable amount of an individual asset cannot be determined if:
 - a) the asset's value in use cannot be estimated to be close to its fair value less costs of disposal (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and
 - b) the asset does not generate cash inflows that are largely independent of those from other assets.
- In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.
- If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.
- In Practice, CGUs could represent:
 - a) An entire entity
 - b) Departments or business units within an entity
 - c) Production line within a department, or within an entity
 - d) Groups of items of property, plant and equipment within a production line, or within a department, or within an entity

Examples 2 & 3

2. 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.

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, ie the mine as a whole.

3. A bus company provides services under contract with a municipality that requires minimum service on each of five 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.

Since 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 five routes together. The cash-generating unit for each route is the bus company as a whole.

4.9.2.2 Relevance of internal management reporting to the identification of CGUs

Cash inflows are inflows of cash and cash equivalents received from parties external to the entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including how management monitors the entity's operations or how management makes decisions about continuing or disposing of the entity's assets and operations.

4.9.2.3 Active market exists for the output produced by an asset or group of assets

- If an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit, even if some or all of the output is used internally.
- Even if part or all of the output produced by an asset or a group of assets is used by other units of the entity, this asset or group of assets forms a separate cash-generating unit if the entity could sell the output on an active market. This is because the asset or group of assets could generate cash inflows that would be largely independent of the cash inflows from other assets or groups of assets.
- If the cash inflows generated by any asset or cash-generating unit are affected by internal transfer pricing, an entity shall use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:
 - a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and
 - b) the future cash outflows used to determine the value in use of any other assets or cash-generating units that are affected by the internal transfer pricing.

4.9.2.4 Cash-generating units to be identified consistently from period to period

- Cash-generating units shall be identified consistently from period to period for the same asset or types of assets, unless a change is justified.
- If an entity determines that an asset belongs to a cash-generating unit different from that in previous periods, or that the types of assets aggregated for the asset's cash-generating unit have changed, disclosures are required about the cash-generating unit, if an impairment loss is recognised or reversed for the cash-generating unit.

4.9.2.5 Allocation of assets and liabilities to CGUs

- The **recoverable amount** of a cash-generating unit is the higher of the cash-generating unit's fair value less costs of disposal and its value in use.

- **Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon. The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.
- The carrying amount of a cash-generating unit:
 - a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and
 - b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because fair value less costs of disposal and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised.

- In some cases, although some assets contribute to the estimated future cash flows of a cash-generating unit, they cannot be allocated to the cash-generating unit on a reasonable and consistent basis. This might be the case for goodwill or corporate assets such as head office assets.
- It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs of disposal (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

Illustration 6

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.

Recommend the impairment loss is to be accounted for.

Solution

The cash-generating unit's fair value less costs of disposal is ₹ 800. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating 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.

- For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit (for example, receivables or other financial assets) or liabilities that have been recognised (for example, payables, pensions and other provisions). In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

4.9.2.6 Allocating goodwill to cash-generating units

- Goodwill can only generate cash inflows in combination with other assets which means that an impairment test cannot be carried out on goodwill alone. For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.

Operating synergies fall into two broad groups, those that improve margin (e.g. through cost savings and economies of scale) and those that give an opportunity for future growth (e.g. through the benefits of the combined talent and technology). In all of the following cases, the acquiring entity can identify the synergies and the CGU or CGU group that benefits from them. Goodwill will be allocated to the relevant CGU or CGU group.

Examples 4 - 6

4. An airline is subject to cost pressures common in the sector. It acquires another operation with similar international operations on the basis that it can reduce its workforce and asset base. It will combine its operational management, including its sales, reporting and human resources functions, into one head office and consolidate all aircraft maintenance in a single site that currently has capacity. These cost savings are the synergies of the business combination and goodwill would therefore be allocated to the CGU or group of CGUs that benefit from these cost savings.
 5. A mining entity (group) extracts a metal ore that does not have an active market until it has been through a smelting and refining process. The entity considers the CGU to comprise the smelter together with the individual mines. When the entity acquires a mine, the synergies relate to cost savings as the mine's fixed costs are already covered by the existing refining operations. Goodwill is therefore allocated to the CGU comprising the smelter, the existing mines and the newly acquired mine.
 6. A global consumer products company, which allocates goodwill at the operating segment level, purchases a company best-known for razors and razor blades. It has not previously manufactured razors although its 'grooming products' operating segment does manufacture other shaving products. The acquirer expects that it will be able to increase sales of its shaving products through association with the target company's razors and through branding. No assets of the acquired business are allocated to the grooming products operating segment but this segment will benefit from the synergies of the business combination and therefore goodwill from the acquisition will be allocated to it.
- Goodwill sometimes cannot be allocated on a non-arbitrary basis to individual cash-generating units, but only to groups of cash-generating units. Each unit or group of units to which the goodwill is so allocated:
 - a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
 - b) not be larger than an operating segment as defined by paragraph 5 of Ind AS 108 'Operating Segments' before aggregation.
 - Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. Goodwill does not generate cash flows independently of other assets or groups of assets and, therefore, it will always be tested for impairment as part of a CGU or a group of CGUs.
 - If the initial allocation of goodwill acquired in a business combination cannot be completed before the end of the annual period in which the business combination is effected, that initial

allocation shall be completed before the end of the first annual period beginning after the acquisition date.

- In accordance with Ind AS 103 'Business Combinations', if the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected, the acquirer:
 - a) accounts for the combination using those provisional values; and
 - b) recognises any adjustments to those provisional values as a result of completing the initial accounting within the measurement period, which will not exceed twelve months from the acquisition date.

In such circumstances, it might also not be possible to complete the initial allocation of the goodwill recognised in the combination before the end of the annual period in which the combination is affected. When this is the case, the entity discloses the information required by this standard.

- If goodwill has been allocated to a cash-generating unit and the entity disposes of an operation within that unit, the goodwill associated with the operation disposed of shall be:
 - a) included in the carrying amount of the operation when determining the gain or loss on disposal; and
 - b) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

Example 7

An entity sells for ₹ 100 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.

Since the 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 per cent of the goodwill allocated to the cash-generating unit is included in the carrying amount of the operation that is sold.

If an entity reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated, the goodwill shall be reallocated to the units affected. This reallocation is performed by using a relative value approach similar to that used when an entity disposes of an operation within a cash-

generating unit, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units.

Example 8

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.

Since the 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.

Illustration 7

Entity A acquires Entity B for ₹ 50 million, of which ₹ 35 million is the fair value of the identifiable assets acquired and liabilities assumed. The acquisition of B Ltd. is to be integrated into two of Entity A's CGUs with the net assets being allocated as follows:

₹ in million

	CGU 1	CGU 2	Total
Fair value of acquired identifiable tangible and intangible assets	25	10	35

In addition to the net assets acquired that are assigned to CGU 2, the acquiring entity expects CGU 2 to benefit from certain synergies related to the acquisition (e.g. CGU 2 is expected to realise higher sales of its products because of access to the acquired entity's distribution channels). There is no synergistic goodwill attributable to other CGUs.

Entity A allocated the purchase consideration of the acquired business to CGU 1 and CGU 2 as ₹ 33 million and ₹ 17 million respectively.

Determine the allocation of goodwill to each CGU?

Solution:

If goodwill is allocated to the CGUs based on the difference between the purchase consideration and the fair value of net assets acquired ie direct method, the allocation would be as follows:

(All figures are ₹ in million, unless otherwise specified)

	CGU 1	CGU 2	Total
Allocation of Purchase consideration	33	17	50
Less: Acquired identifiable tangible and intangible assets	(25)	(10)	(35)
Goodwill assigned to CGUs	8	7	15

4.9.2.7 Allocating corporate assets to cash-generating units

- **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. Corporate assets include group or divisional assets such as the building of a headquarters or a division of the entity, EDP equipment or a research centre. The structure of an entity determines whether an asset meets this Standard's definition of corporate assets for a particular cash-generating unit.
- The distinctive characteristics of corporate assets are that:
 - a) they do not generate cash inflows independently of other assets or groups of assets; and
 - b) their carrying amount cannot be fully attributed to the cash-generating unit under review.
- Because corporate assets do not generate separate cash inflows, they are tested for impairment in the context of the CGU or group of CGUs to which the asset belongs. In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:
 - a) can be allocated on a reasonable and consistent basis to that unit, the entity compares the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount. Any impairment loss is recognised in accordance with the requirement of this standard.
 - b) cannot be allocated on a reasonable and consistent basis to that unit, the entity:
 - (i) compares the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognise any impairment loss in accordance with the requirement of this standard;
 - (ii) identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and
 - (iii) compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised in accordance with the requirement of this standard.

Illustration 8

Earth Infra Ltd has two cash-generating units, A and B. 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 an office headquarter and 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.

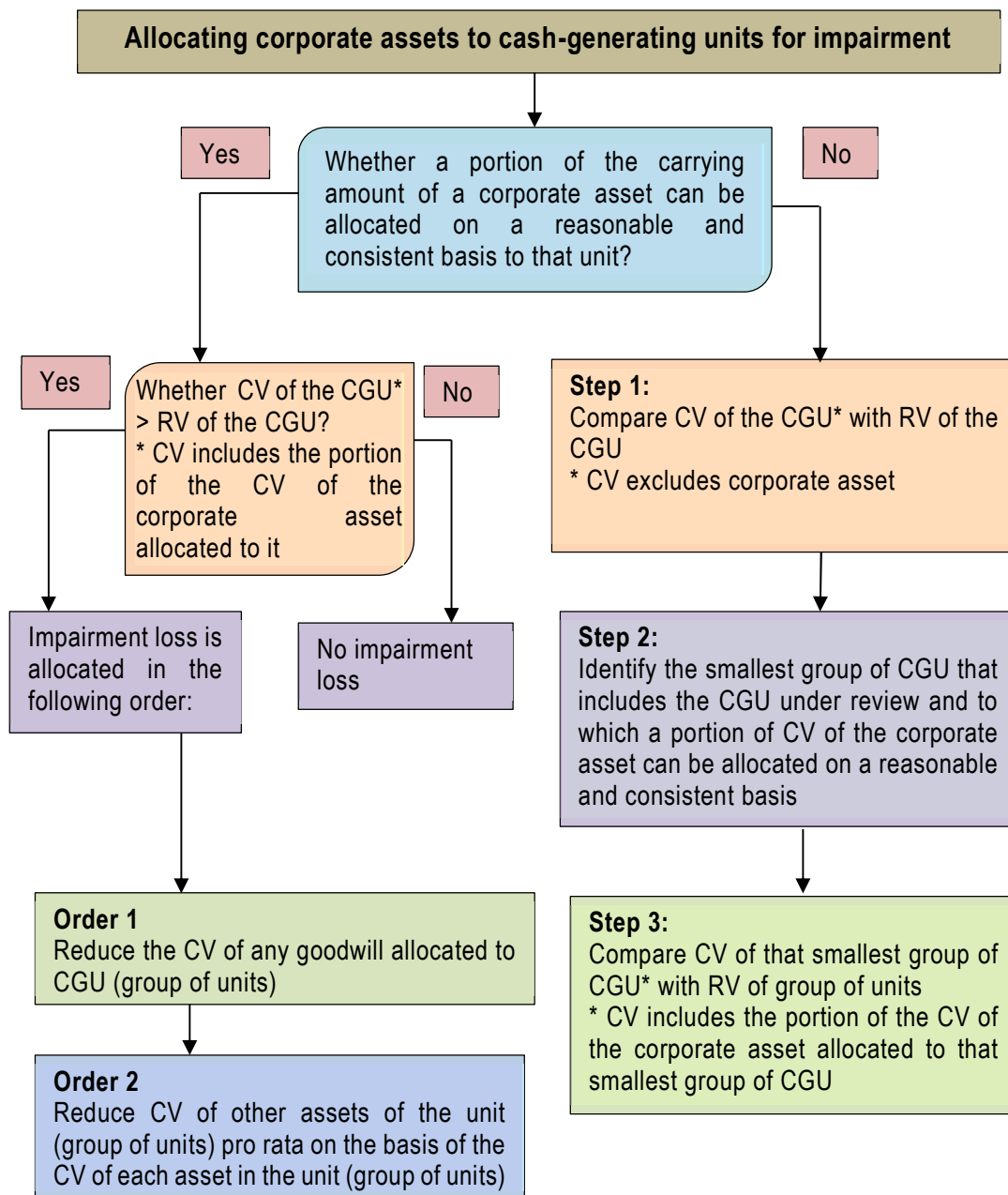
Determine whether the carrying values of CGU A and B are impaired.

Solution

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	4	6	10
(office building is allocated in the ratio of Carrying value of CGU's)	—	—	—
Carrying value of CGU after			
Allocation of corporate asset	24	36	60
Recoverable Amount	<u>18</u>	<u>38</u>	56
Impairment Loss	<u>6</u>	<u>-</u>	

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).



4.9.2.8 Recognition and measurement of an impairment loss for a cash-generating unit

- An impairment loss is recognised for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss is allocated to reduce the carrying amount of the

assets of the unit (group of units) in the following order:

- a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
 - b) 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).
- In allocating an impairment loss to individual assets within a CGU, the carrying amount of an individual shall not be reduced below the highest of:



- The amount of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit (group of units).
- If the recoverable amount of an individual asset cannot be determined:
 - a) an impairment loss is recognised for the asset if its carrying amount is greater than the higher of its fair value less costs of disposal and the results of the allocation procedures described; and
 - b) no impairment loss is recognised for the asset if the related cash-generating unit is not impaired. This applies even if the asset's fair value less costs of disposal is less than its carrying amount.

Illustration 9

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.

Advise the accounting for the impairment loss of machine in above scenarios.

Solution

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.

4.9.3 Two-step approach for goodwill allocated to a group of CGUs

When goodwill is allocated to a group of CGUs for the purpose of impairment testing but cannot be allocated on a non-arbitrary basis to individual CGUs, the individual CGUs must be tested for impairment before the group of CGUs containing the associated goodwill.



4.10 REVERSING AN IMPAIRMENT LOSS

4.10.1 Reversals of impairment losses – general

- An entity is required to assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.
- An impairment loss recognised for goodwill shall not be reversed in a subsequent period.
- An impairment loss recognised in prior periods for an asset other than goodwill shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the

case, the carrying amount of the asset is, except as described in paragraph 117, increased to its recoverable amount.

- A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or from sale, since the date when an entity last recognised an impairment loss for that asset. Examples of changes in estimates include:
 - a) a change in the basis for recoverable amount (ie whether recoverable amount is based on fair value less costs of disposal or value in use);
 - b) if recoverable amount was based on value in use, a change in the amount or timing of estimated future cash flows or in the discount rate; or
 - c) if recoverable amount was based on fair value less costs of disposal, a change in estimate of the components of fair value less costs of disposal.
- An asset's value in use may become greater than the asset's carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. Therefore, 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.

4.10.2 Indications of reversals of impairment loss

In assessing whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased, an entity shall consider, as a minimum, the following indications:

4.10.2.1 External sources of information

- a) there are observable indication that the asset's value has increased significantly during the period;
- b) significant changes with a favorable effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated; and
- c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

4.10.2.2 Internal sources of information

- a) significant changes with a favourable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs; and
- b) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

- If there is an indication that an impairment loss recognised for an asset other than goodwill may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with the Indian Accounting Standard applicable to the asset, even if no impairment loss is reversed for the asset.

4.10.3 Reversing an impairment loss for an individual asset

- The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall 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. Any increase in excess of this amount would be a revaluation and would be accounted for under the appropriate Standard (e.g. Ind AS 16 Property, Plant and Equipment).
- A reversal of an impairment loss for an asset other than goodwill is recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Indian Accounting Standard. Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with that other Indian Accounting Standard.
- A reversal of an impairment loss on a revalued asset is recognised in other comprehensive income and increases the revaluation surplus for that asset. However, to the extent that an impairment loss on the same revalued asset was previously recognised in profit or loss, a reversal of that impairment loss is also recognised in profit or loss.
- After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset is adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

4.10.4 Reversing an impairment loss for a cash-generating unit

- A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised as discussed above.
- 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:
 - a) its recoverable amount (if determinable); and
 - b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.
- The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset is allocated pro rata to the other assets of the unit, except for goodwill.

4.10.5 Reversing an impairment loss for goodwill not permitted

- An impairment loss recognised for goodwill shall not be reversed in a subsequent period.

- Ind AS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill. Any increase in the recoverable amount of goodwill in the periods following the recognition of an impairment loss for that goodwill is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill.

Illustration 10: Reversal of Impairment Loss

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 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 cashflows. This is an indicator that an impairment loss may have reversed. The recoverable amount of Saturn's Ltd net asset is re-estimated. The value in use is expected to be ₹ 3,04,000 and fair value less cost to disposal is expected to be ₹ 2,90,000.

Calculate the impairment loss, if any. Also advise the accounting treatment for reversal of impairment loss and the subsequent depreciation thereon.

Solution

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

	₹		
	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.

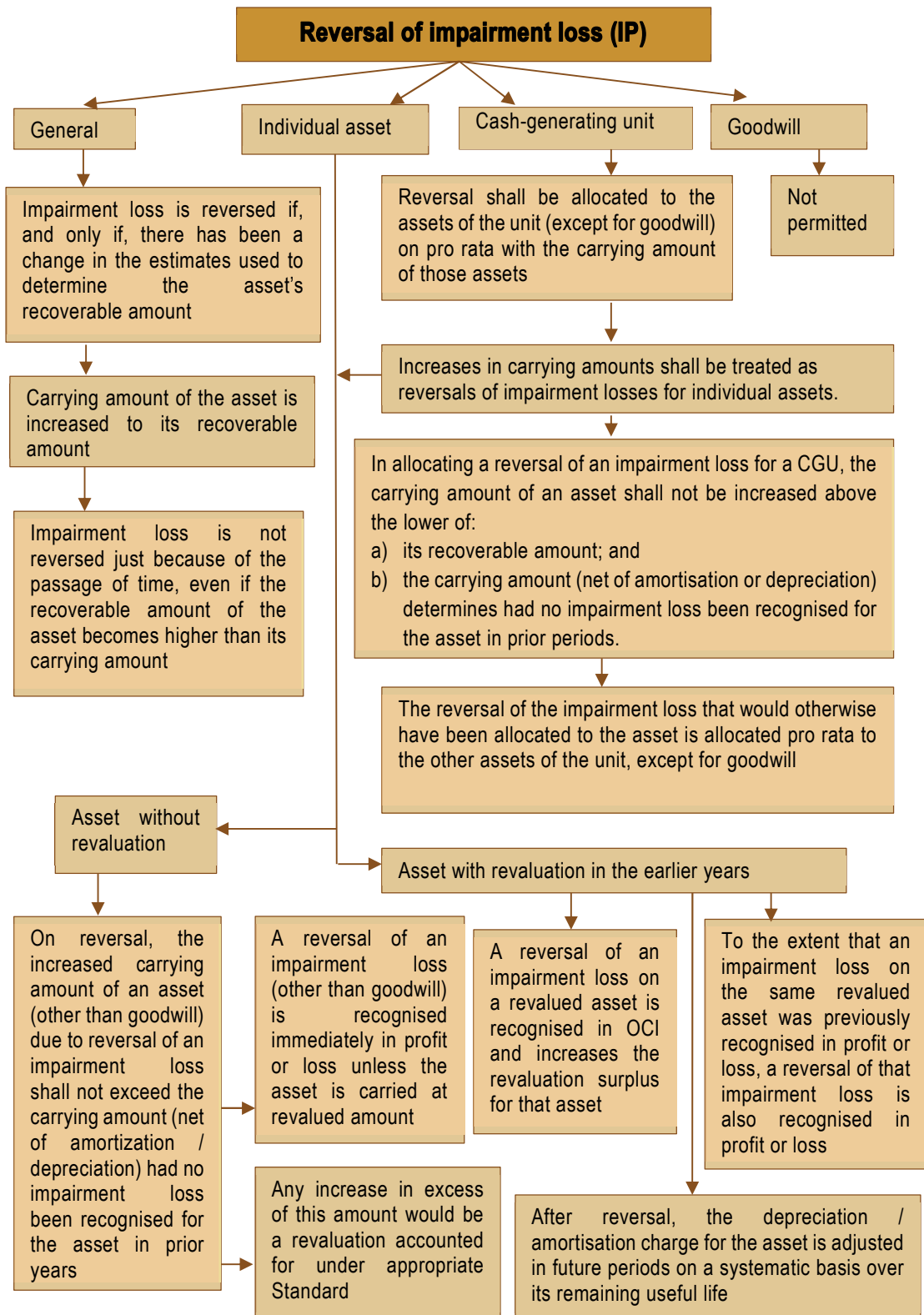
Calculation of carrying amount of identifiable assets had no impairment loss is recognised

	₹
Historical Cost	3,20,000
Accumulated Depreciation for 4 years $(3,20,000/20) \times 4$	<u>(64,000)</u>
Carrying amount had no impairment loss is recognised on 31 st March, 20X5	<u>2,56,000</u>

Carrying amount of other assets after recognition of impairment loss

	₹
Carrying amount on 31 st March, 20X3	2,12,000
Accumulated Depreciation for 2 years $(2,12,000/18) \times 2$ [rounded off to nearest thousand for ease of calculation]	<u>(24,000)</u>
Carrying amount on 31 st March, 20X5	<u>1,88,000</u>

- 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)



4.10.6 Non-controlling interests – the impact on goodwill impairment testing

The amount of goodwill recorded by an entity when it acquires a controlling stake in a subsidiary that is less than 100% of its equity depends on which of the two following methods have been used to calculate it. Under Ind AS 103 'Business Combinations' an entity has a choice between two methods:

- i. Goodwill attributable to the non-controlling interests (NCI) is **not recognised** in the parent's consolidated financial statements **as the non-controlling interest is stated at its proportion of the net fair value of the net identifiable assets** of the acquiree.
- ii. The NCI is measured at its acquisition-date fair value, which means that its share of **goodwill will also be recognised**.

Under method (i) above the carrying amount of that CGU comprises:

- a) both the parent's interest and the non-controlling interest in the identifiable net assets of the CGU; and
- b) the parent's interest in goodwill.

But part of the recoverable amount of the CGU determined in accordance with Ind AS 36 is attributable to the non-controlling interest in goodwill.

Ind AS 103 allows both measurement methods. The choice of method is to be made for each business combination, rather than being a policy choice, and could have a significant effect on the amount recognized for goodwill.

The Standard states that not all of the goodwill arising will necessarily be allocated to a CGU or group of CGUs which includes the subsidiary with NCI.

If an entity measures NCI as its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, goodwill attributable to NCI is included in the recoverable amount of the related cash-generating unit but is not recognised in the parent's consolidated financial statements. As a consequence, an entity shall gross up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to NCI. This adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash generating unit is impaired.

Below is the guidance given on the allocation of impairment losses:

- a) If a subsidiary, or part of a subsidiary, with NCI is itself a CGU, the impairment loss is allocated between the parent and NCI on the same basis as that on which profit or loss is allocated.
- b) If it is part of a larger CGU, goodwill impairment losses are allocated to the parts of the CGU that have a NCI and the parts that do not on the following basis:

- (i) to the extent that the impairment relates to goodwill in the CGU, the relative carrying values of the goodwill of the parts before the impairment; and
- (ii) to the extent that the impairment relates to identifiable assets in the CGU, the relative carrying values of these assets before the impairment. Any such impairment is allocated to the assets of the parts of each unit pro-rata on the basis of the carrying amount of each asset in the part.

In those parts that have NCI, the impairment loss is allocated between the parent and NCI on the same basis as that on which profit or loss is allocated.

If an impairment loss attributable to NCI relates to goodwill that is not recognised in the parent's consolidated financial statements, that impairment is not recognised as a goodwill impairment loss. In such cases, only the impairment loss relating to the goodwill that is allocated to the parent is recognised as a goodwill impairment loss.

Illustration 11 - NCI measurement and Goodwill impairment

A Ltd acquires 80% shares of a subsidiary B Ltd. for ₹ 3,200 thousand. At the date of acquisition, B Ltd.'s identifiable net assets is ₹ 3,000 thousand. A elects to measure NCI at proportionate share of net identifiable assets. It recognises

	₹ in thousand
Purchase Consideration	3,200
NCI (3,000 x 20%)	<u>600</u>
	3,800
Less: Net Assets	<u>(3,000)</u>
Goodwill	<u>800</u>

At the end of next financial year, B Ltd.'s carrying amount is reduced to ₹ 2,700 thousand (excluding goodwill).

Recoverable amount of B Ltd.'s assets is

Case (i) ₹ 2,000 thousand,

Case (ii) ₹ 2,800 thousand

Calculate impairment loss allocable to Parent and NCI in both the cases.

Solution

Case (i)

₹ in thousand

Particulars	Goodwill	Other Asset	Total
Carrying amount	800	2,700	3,500
Unrecognised NCI (notional) [(800 / 80%) x 20%]	<u>200</u>	<u>-</u>	<u>200</u>
Notional Total	<u>1,000</u>	<u>2,700</u>	3,700

Recoverable amount	-	-	<u>2,000</u>
Total Impairment loss	-	-	(1,700)
Impairment loss recognised in CFS	(800)	(700)	(1,500)
Carrying amount after impairment	-	2,000	2,000

Impairment loss on:	Parent	NCI
Goodwill	(800)	-
Other assets	<u>(560)</u>	<u>(140)</u>
Total	<u>(1,360)</u>	<u>(140)</u>

Case (ii)

Particulars	Goodwill	Other Asset	Total
Carrying amount	800	2,700	3,500
Unrecognised NCI (notional) $(800 / 80\% \times 20\%)$	<u>200</u>	<u>-</u>	<u>200</u>
Notional Total	<u>1,000</u>	<u>2,700</u>	3,700
Recoverable amount	-	-	<u>2,800</u>
Total Impairment loss	-	-	(900)
Impairment loss recognised in CFS $(900 \times 80\%)$	(720)	-	(720)
Carrying amount after impairment $(800 - 720)$	80	2,700	2,780

Impairment loss on:	Parent	NCI
Goodwill	(720)	-
Other assets	<u>-</u>	<u>-</u>
Total	<u>(720)</u>	<u>-</u>

It is to be noted that since an entity measures NCI at its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, goodwill attributable to NCI is not recognised in the parent's consolidated financial statements and so the impairment loss on such goodwill not recognised.



4.11 DISCLOSURE

4.11.1 Disclosure – general

- An entity is required to disclose the following for each class of assets:
 - a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;
 - b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;
 - c) the amount of impairment losses on revalued assets recognised in other comprehensive income during the period; and
 - d) the amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.
- The information required as above may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of property, plant and equipment, at the beginning and end of the period, as required by Ind AS 16.

4.11.2 Entities reporting segment information

- An entity that reports segment information in accordance with Ind AS 108 shall disclose the following for each reportable segment:
 - a) the amount of impairment losses recognised in profit or loss and in other comprehensive income during the period; and
 - b) the amount of reversals of impairment losses recognised in profit or loss and in other comprehensive income during the period.

4.11.3 Impairment losses recognised or reversed in the period

- An entity is required to disclose the following for each material impairment loss recognised or reversed during the period for an individual asset, including goodwill, or a cash-generating unit:
 - a) the events and circumstances that led to the recognition or reversal of the impairment loss;
 - b) the amount of the impairment loss recognised or reversed;
 - c) for an individual asset:

- (i) the nature of the asset; and
 - (ii) if the entity reports segment information in accordance with Ind AS 108, the reportable segment to which the asset belongs;
- d) for a cash-generating unit:
 - (i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment as defined in Ind AS 108);
 - (ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance Ind AS 108, by reportable segment; and
 - (iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;
- e) the recoverable amount of the asset or CGU, and whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs of disposal or its value in use;
- f) if recoverable amount is fair value less costs of disposal, the entity shall disclose the following information:
 - (i) the level of the fair value hierarchy (refer Ind AS 113) within which the fair value measurement of the asset (cash-generating unit) is categorised in its entirety (without taking into account whether the 'costs of disposal' are observable);
 - (ii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) used to measure fair value less costs of disposal. If there has been a change in valuation technique, the entity shall disclose that change and the reason(s) for making it; and
 - (iii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the asset's (cash-generating unit's) recoverable amount is most sensitive. The entity shall also disclose the discount rate(s) used in the current measurement and previous measurement if fair value less costs of disposal is measured using a present value technique.
- g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

4.11.4 Other impairment losses/reversals material in aggregate to the financial statements

An entity shall disclose the following information for the aggregate impairment losses and the aggregate reversals of impairment losses recognised during the period for which no information is disclosed in above paragraph:

- a) the main classes of assets affected by impairment losses and the main classes of assets affected by reversals of impairment losses; and
- b) the main events and circumstances that led to the recognition of these impairment losses and reversals of impairment losses.

4.11.5 Unallocated goodwill

If any portion of the goodwill acquired in a business combination during the period has not been allocated to a cash-generating unit (group of units) at the end of the reporting period, the amount of the unallocated goodwill shall be disclosed together with the reasons why that amount remains unallocated.

4.11.6 Information to be disclosed for CGUs to which significant goodwill or indefinite – life intangible assets have been allocated

An entity is required to disclose the following information for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:

- a) the carrying amount of goodwill allocated to the unit (group of units);
- b) the carrying amount of intangible assets with indefinite useful lives allocated to the unit (group of units);
- c) the basis on which the unit's (group of units') recoverable amount has been determined (ie value in use or fair value less costs of disposal);
- d) if the unit's (group of units') recoverable amount is based on value in use:
 - (i) each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.
 - (ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

- (iii) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.
 - (iv) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.
 - (v) the discount rate(s) applied to the cash flow projections.
- e) if the unit's (group of units') recoverable amount is based on fair value less costs of disposal, the valuation technique(s) used to measure fair value less costs of disposal. An entity is not required to provide the disclosures required by Ind AS 113. If fair value less costs of disposal is not measured using a quoted price for an identical unit (group of units), an entity shall disclose the following information:
- (i) each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive;
 - (ii) a description of management's approach to determining the value (or values) assigned to each key assumption, whether those values reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information;
 - (iii) the level of the fair value hierarchy (see Ind AS 113 within which the fair value measurement is categorised in its entirety (without giving regard to the observability of 'costs of disposal'); and
 - (iv) if there has been a change in valuation technique, the change and the reason(s) for making it. If fair value less costs of disposal is measured using discounted cash flow projections, an entity shall disclose the following information:
 - (v) the period over which management has projected cash flows;
 - (vi) the growth rate used to extrapolate cash flow projections; and
 - (vii) the discount rate(s) applied to the cash flow projections.
- f) if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:
- (i) the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount;

- (ii) the value assigned to the key assumption; and
- (iii) the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.

4.11.7 Information to be disclosed for CGUs to which insignificant goodwill or indefinite-life intangible assets have been allocated

- If some or all of the carrying amount of goodwill or intangible assets with indefinite useful lives is allocated across multiple cash-generating units (groups of units), and the amount so allocated to each unit (group of units) is not significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, that fact shall be disclosed, together with the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to those units (groups of units).
- In addition, if the recoverable amounts of any of those units (groups of units) are based on the same key assumption(s) and the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to them is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, an entity shall disclose that fact, together with:
 - a) the aggregate carrying amount of goodwill allocated to those units (groups of units);
 - b) the aggregate carrying amount of intangible assets with indefinite useful lives allocated to those units (groups of units);
 - c) a description of the key assumption(s);
 - d) a description of management's approach to determining the value(s) assigned to the key assumption(s), whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information; and
 - e) if a reasonably possible change in the key assumption(s) would cause the aggregate of the units' (groups of units') carrying amounts to exceed the aggregate of their recoverable amounts:
 - (i) the amount by which the aggregate of the units' (groups of units') recoverable amounts exceeds the aggregate of their carrying amounts;
 - (ii) the value(s) assigned to the key assumption(s); and
 - (iii) the amount by which the value(s) assigned to the key assumption(s) must change, after incorporating any consequential effects of the change on the other variables used to measure recoverable amount, in order for the aggregate of the units' (groups of units') recoverable amounts to be equal to the aggregate of their carrying amounts.

- The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit (group of units) may, in accordance with paragraph 24 or 99, be carried forward and used in the impairment test for that unit (group of units) in the current period provided specified criteria are met. When this is the case, the information for that unit (group of units) that is incorporated into the disclosures required by paragraphs 134 and 135 relate to the carried forward calculation of recoverable amount.

Illustration 12

From the following details of an asset, compute:

- Impairment loss and its treatment.
- Current year depreciation for the year end.

Particulars of assets:

Cost of asset	₹ 56 lakh
Useful life	10 years
Salvage value	Nil
Carrying value at the beginning of the year	₹ 27.30 lakh
Remaining useful life	3 years
Recoverable amount at the beginning of the year	₹ 12 lakh
Upward revaluation done in last year (at the year end)	₹ 14 lakh

Solution

Impairment loss

Impairment loss = Carrying amount of the asset – Recoverable amount

$$= ₹ 27.30 \text{ lakh} - ₹ 12 \text{ lakh} = ₹ 15.30 \text{ lakh}$$

Treatment of impairment loss

As per Ind AS 36, impairment loss (whether of an individual asset or a CGU) is recognised in the following manner:

- 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.
- 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 lakh. The balance amount of ₹ 1.30 lakh will be recognised as an expense in the profit and loss account.

Current year depreciation

Revised carrying amount (after recognising impairment loss)	₹ 12 lakh
Remaining useful life	3 years
Salvage value	Nil
Annual depreciation (12/3)	₹ 4 lakh

Illustration 13

Venus Ltd. has an asset, which is carried in the Balance Sheet on 31st March, 20X1 at ₹ 500 lakh. As at that date the value in use is ₹ 400 lakh and the fair value less costs to sells is ₹ 375 lakh.

From the above data:

- (a) Calculate impairment loss.*
- (b) Prepare journal entries for adjustment of impairment loss.*

Solution

According to Ind AS 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 lakh

Step 2: Value in use: ₹ 400 lakh

Step 3: Recoverable amount, i.e., higher of 'fair value less costs to sell' & 'value in use'.

Thus, recoverable amount is ₹ 400 lakh

Step 4: Carrying amount of the asset ₹ 500 lakh

Step 5: Impairment loss, i.e., excess of amount computed in step 4 over amount computed in Step 3.

₹ 100 lakh (being the difference between ₹ 500 lakh and ₹ 400 lakh).

According to Ind AS 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 lakh will be charged to Profit & Loss Account.

Journal Entries

Date	Particulars	Dr.	Cr.
		₹ in lakh	
31.3.20X1	Impairment Loss A/c Dr. To Assets A/c (Being impairment loss on an asset recognised)	100	100
31.3.20X1	Statement of Profit & Loss Dr. To Impairment Loss A/c (Being impairment loss transferred to statement of profit and loss)	100	100

Illustration 14

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.

Identify the cash-generating unit for an individual magazine title.

Solution

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.

Illustration 15

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.

Recommend whether the entity should determine the recoverable amount for the private railway or for the mining business as a whole.

Solution

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.

Illustration 16

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.

Examine whether the company should determine the recoverable amount for an individual asset or for a cash generating unit.

Solution

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.

Illustration 17

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, evaluate 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

- (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.

Illustration 18

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, evaluate what are the cash-generating units for Plant 1, Plant 2 and Plant 3?

Solution

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.

Illustration 19

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.

Recommend how the goodwill should be reallocated to B, C and D.

Solution

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.

Illustration 20

XYZ Limited has a cash-generating unit 'Plant A' as on 1st April, 20X1 having a carrying amount of ₹ 1,000 crore. Plant A was acquired under a business combination and goodwill of ₹ 200 crore 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 31st March, 20X2, Plant A has a recoverable amount of ₹ 600 crore.

Calculate the impairment loss on Plant A. Also, determine its allocation as per Ind AS 36.

Solution

Particulars	Goodwill (₹ in crore)	Identifiable assets (₹ in crore)	Total (₹ in crore)
Historical cost	200	1,000	1,200
Depreciation (20X1-20X2)	-	(100)	(100)
Carrying amount	200	900	1,100

Since, the recoverable amount is ₹ 600 crore, there is an impairment loss of ₹ 500 crore. The impairment loss of ₹ 500 crore should be allocated to goodwill first, and then to the other identifiable assets, i.e., ₹ 200 crore to goodwill and ₹ 300 crore to identifiable assets of Plant A.

(₹ in crore)			
Particulars	Goodwill	Identifiable assets	Total
Impairment loss	(200)	(300)	(500)
Carrying amount after impairment loss	-	600	600

Illustration 21

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**1. Computation of goodwill on acquisition**

Particular	Amount (₹ '000)
Cost of investment ($8,00,000 \times 2/5 \times ₹ 4$)	1,280
Fair value of non-controlling interest ($2,00,000 \times ₹ 1.4$)	280
Fair value of identifiable net assets at date of acquisition	<u>(1,300)</u>
So goodwill equals	<u>260</u>

Acquisition costs are not included as part of the fair value of the consideration given under Ind AS 103, 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)	<u>(56)</u>
So closing goodwill equals	<u>204</u>

4. Calculation of overall impairment loss

on goodwill (W3)	56
on assets in unit C ($450 - 400$)	<u>50</u>
So total loss equals	<u>106</u>

₹ 21.2 (20%) of the above is allocated to the NCI with the balance allocated to the shareholders of Sun Ltd.



4.12 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Hindustan Unilever Limited' for the financial year 2021-2022 with respect to impairment and the accounting policy thereon.

Impairment

Assessment for impairment is done at each Balance Sheet date as to whether there is any indication that a non-financial asset may be impaired. Indefinite life intangible assets are subject to a review for impairment annually or more frequently if events or circumstances indicate that it is necessary. For the purpose of assessing impairment, the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets is considered as a cash generating unit. Goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Groups's cash-generating units that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

If any indication of impairment exists, an estimate of the recoverable amount of the individual asset/cash generating unit is made. Asset/cash generating unit whose carrying value exceeds their recoverable amount are written down to the recoverable amount by recognising the impairment loss as an expense in the Consolidated Statement of Profit and Loss.

The impairment loss is allocated first to reduce the carrying amount of goodwill (if any) allocated to the cash generating unit and then to the other assets of the unit, pro rata based on the carrying amount of each asset in the unit. Recoverable amount is higher of an asset's or cash generating unit's value in use and its fair value less cost of disposal. Value in use is estimated future cash flows expected to arise from the continuing use of an asset or cash generating unit and from its disposal at the end of its useful life discounted to their present value using a post-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In determining fair value less costs of disposal, recent market transactions are considered. If no such transactions can be identified, an appropriate valuation model is used.

Assessment is also done at each Balance Sheet date as to whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. Basis the assessment a reversal of an impairment loss for an asset other than goodwill is recognised in the consolidated statement of profit and loss.

No impairment was identified in FY 2021-22 (FY 2020-21: Nil).

Significant Cash Generating Units (CGUs)

The Group has identified its reportable segments, i.e. Home Care, Beauty & Personal Care, Foods & Refreshment and Others as the CGUs. The goodwill and indefinite-life intangible assets acquired through business combinations have been allocated to CGU 'Beauty & Personal Care' and "Foods & Refreshment". The carrying amount of goodwill and indefinite-life intangible assets is as under:

	As at 31st March, 2022		As at 31st March, 2021	
	Beauty & Personal Care	Foods and Refreshment	Beauty & Personal Care	Foods & Refreshment
Goodwill	15	17,301	15	17,301
Indefinite life intangible assets	572	27,210	572	27,210
Total	587	44,511	587	44,511

The recoverable amount of each CGU has been calculated based on its value in use, estimated as the present value of projected future cash flows.

Following key assumptions were considered while performing Impairment testing:

	As at 31st March, 2022		As at 31st March, 2021	
	Beauty & Personal Care	Foods & Refreshment	Beauty & Personal Care	Foods & Refreshment
Average Annual Growth rate for 5 years	8.0%	9.5%	8.0%	11.0%
Terminal Growth Rate	5.0%	5.0%	3.5%	3.5%
Weighted Average Cost of Capital % (WACC) post tax (Discount rate)	9.1%	9.1%	8.9%	8.9%
Segmental margins	27.5%	18.6%	28.5%	16.6%

The projections cover a period of five years, as the Group believes this to be the most appropriate timescale over which to review and consider annual performances before applying a fixed terminal value multiple to the final year cash flows. The growth rates and segmental margins used to estimate cash flows for the first five years are based on past performance, and on the Group's five-year strategic plan.

Weighted Average Cost of Capital % (WACC) for the Group = Risk free return + (Market risk premium x Beta for the Holding Company).

The Group has performed sensitivity analysis around the base assumptions and has concluded that there are no reasonably possible changes to key assumptions that would cause the carrying amount of a CGU to exceed its recoverable amount.

(Source: Annual Report 2021-2022 - 'Hindustan Unilever Limited')



4.13 SIGNIFICANT DIFFERENCES IN IND AS 36 VIS-À-VIS AS 28

S. No.	Particular	Ind AS 36	AS 28
1.	Financial Assets	Ind AS 36 applies to financial assets classified as: (a) subsidiaries, as defined in Ind AS 110,	AS 28 does not apply to such assets

		(b) associates as defined in Ind AS 28, (c) joint ventures as defined in Ind AS 111.	
2.	Assets	Ind AS 36 specifically excludes biological assets related to agricultural activity, assets arising from employee benefits and deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts, non-current assets (or disposal groups) held for sale and discontinued operations.	AS 28 does not specifically exclude such assets
3.	<i>Impairment Testing for an Intangible Asset with an Indefinite Useful Life</i>	Ind AS 36 requires annual impairment testing for an intangible asset with an indefinite useful life or not yet available for use and goodwill acquired in a business combination.	AS 28 does not require the annual impairment testing for goodwill unless there is an indication of impairment.
4.	<i>Additional Guidance</i>	Ind AS 36 gives additional guidance on, <i>inter alia</i> , the following aspects: (a) estimating the value in use of an asset; (b) for managements to assess the reasonableness of the assumptions on which cash flows are based; and (c) using present value techniques in measuring an asset's value in use.	AS 28 does not provide such guidance
5.	<i>Reversal of Goodwill</i>	Ind AS 36 prohibits the recognition of reversals of impairment loss for goodwill.	AS 28 requires that the impairment loss recognised for goodwill should be reversed in a subsequent period when it was caused by a specific external event of an exceptional nature that is not expected to recur and subsequent external events

			that have occurred that reverse the effect of that event
6.	<i>Bottom up and Top-Down Test</i>	In Ind AS 36, goodwill is allocated to cash-generating units (CGUs) or groups of CGUs that are expected to benefit from the synergies of the business combination from which it arose. There is no bottom-up or top-down approach for allocation of goodwill	AS 28, goodwill is allocated to CGUs only when the allocation can be done on a reasonable and consistent basis. If that requirement is not met for a specific CGU under review, the smallest CGU to which the carrying amount of goodwill can be allocated on a reasonable and consistent basis must be identified and the impairment test carried out at this level. Thus, when all or a portion of goodwill cannot be allocated reasonably and consistently to the CGU being tested for impairment, two levels of impairment tests are carried out, viz., bottom-up test and top-down test.
7.	<i>Usage for arriving at value in use</i>	Ind AS 36 uses the word 'fair value' for arriving at value in use.	AS 28 uses 'net selling value' for arriving at value in use.
8.	<i>Disclosure</i>	Ind AS 36 requires certain additional disclosures as compared to AS 28.	Disclosures given in AS 28 are less than what is required in Ind AS 36.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

- 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 for on lease for 6 years.

Determine the CGU of the building.

- ABC Ltd. has three cash-generating units: A, B and C, the carrying amounts of which as on 31st March, 20X1 are as follows: **(₹ in crore)**

Cash-generating units	Carrying amount	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 crore)		
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 31st March, 20X1 is as follows:

Cash-generating units	Recoverable amount (₹ in crore)
A	600
B	900
C	1,400
ABC Ltd.	3,200

Calculate the impairment loss, if any. Ignore decimals.

3. Parent acquires an 80% ownership interest in Subsidiary for ₹ 2,100 on 1st April, 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. Since 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 31st March, 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 31st March, 20X2.

4. A Ltd. purchased a machinery of ₹ 100 crore on 1st April, 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 31st March, 20X2:

Financial year	Estimated future cash flows (₹ in crore)
20X2-20X3	15
20X3-20X4	30
20X4-20X5	40
20X5-20X6	10

Discount rate applicable : 10%
 Fair value less costs to sell as on 31st March, 20X2 : ₹ 70 crore

Calculate the impairment loss, if any.

5. Assuming in the above question, as on 31st March, 20X3, there is no change in the estimated future cash flows and discount rate. Fair value less costs to sell as on 31st March, 20X3 is ₹ 40 crore.

Advise, how it should deal with under Ind AS 36.

6. A Ltd. purchased an asset of ₹ 100 lakh on 1st April, 20X0. It has useful life of 4 years with no residual value. Recoverable amount of the asset is as follows:

As on	Recoverable amount
31 st March, 20X1	₹ 60 lakh
31 st March, 20X2	₹ 40 lakh
31 st March, 20X3	₹ 28 lakh

Calculate the amount of impairment loss or its reversal, if any, on 31st March, 20X1, 31st March, 20X2 and 31st March, 20X3.

7. On 31st March, 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
31 st March, 20X1	₹ 45/US \$
31 st March, 20X2	₹ 48/US \$
31 st March, 20X3	₹ 51/US \$
31 st March, 20X4	₹ 55/US \$

Calculate value in use as on 31st March, 20X1.

8. Cash flow is ₹ 100, ₹ 200 or ₹ 300 with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows.
9. Cash flow of ₹ 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.
10. Calculate expected cash flows in each of the following cases:
- (a) the estimated amount falls somewhere between ₹ 50 and ₹ 250, but no amount in the range is more likely than any other amount.

- (b) the estimated amount falls somewhere between ₹ 50 and ₹ 250, and the most likely amount is ₹ 100. However, the probabilities attached to each amount are unknown.
- (c) the estimated amount will be ₹ 50 (10 per cent probability), ₹ 250 (30 per cent probability), or ₹ 100 (60 per cent probability).
11. Elia limited is a manufacturing company which deals in to manufacturing of cold drinks and beverages. It is having various plants across India. There is Machinery A in the Baroda plant which is used for the purpose of bottling. There is one more machinery which is Machinery B clubbed with Machinery A. Machinery A can individually have an output and also sold independently in the open market. Machinery B cannot be sold in isolation and without clubbing with Machine A it cannot produce output as well. The Company considers this group of assets as a Cash Generating Unit and an Inventory amounting to ₹ 2 lakh and Goodwill amounting to ₹ 1.50 lakhs is included in such CGU.

Machinery A was purchased on 1st April 20X3 for ₹ 10 lakhs and residual value is ₹ 50 thousand. Machinery B was purchased on 1st April, 20X5 for ₹ 5 lakhs with no residual value. The useful life of both Machine A and B is 10 years. The Company expects following cash flows in the next 5 years pertaining to Machinery A. The incremental borrowing rate of the company is 10%.

Year	Cash Flows from Machinery A
1	1,50,000
2	1,00,000
3	1,00,000
4	1,50,000
5	<u>1,00,000</u> (excluding Residual Value)
Total	<u>6,00,000</u>

On 31st March, 20X8, the professional valuers estimated that the current market value of Machinery A is ₹ 7 lakhs. The valuation fee was ₹ 1 lakh. There is a need to dismantle the machinery before delivering it to the buyer. The dismantling cost is ₹ 1.50 lakhs. Specialised packaging costs would be ₹ 25 thousand and legal fees would be ₹ 75 thousand.

The Inventory has been valued in accordance with Ind AS 2. The recoverable value of CGU is ₹ 10 Lakh as on 31st March, 20X8. In the next year, the company has done the assessment of recoverability of the CGU and found that the value of such CGU is ₹ 11 Lakhs ie on 31st March, 20X9. The recoverable value of Machine A is ₹ 4,50,000 and combined Machine A and B is ₹ 7,60,000 as on 31st March, 20X9.

Required:

- a) Compute the impairment loss on CGU and carrying value of each asset after charging impairment loss for the year ending 31st March, 20X8 by providing all the relevant working notes to arrive at such calculation.

- b) Compute the prospective depreciation for the year 20X8-20X9 on the above assets.
- c) Compute the carrying value of CGU as at 31st March, 20X9.
12. E Ltd. owns a machine used in the manufacture of steering wheels, which are sold directly to major car manufacturers.
- The machine was purchased on 1st April, 20X1 at a cost of ₹ 5,00,000 through a vendor financing arrangement on which interest is being charged at the rate of 10% per annum.
 - During the year ended 31st March, 20X3, E Ltd. sold 10,000 steering wheels at a selling price of ₹ 190 per wheel.
 - The most recent financial budget approved by E Ltd.'s management, covering the period 1st April, 20X3 – 31st March, 20X8, including that the company expects to sell each steering wheel for ₹ 200 during 20X3-20X4, the price rising in later years in line with a forecast inflation of 3% per annum.
 - During the year ended 31st March, 20X4, E Ltd. expects to sell 10,000 steering wheels. The number is forecast to increase by 5% each year until 31st March, 20X8.
 - E Ltd. estimates that each steering wheel costs ₹ 160 to manufacture, which includes ₹ 110 variable costs, ₹ 30 share of fixed overheads and ₹ 20 transport costs.
 - Costs are expected to rise by 1% during 20X4-20X5, and then by 2% per annum until 31st March, 20X8.
 - During 20X5-20X6, the machine will be subject to regular maintenance costing ₹ 50,000.
 - In 20X3-20X4, E Ltd. expects to invest in new technology costing ₹ 1,00,000. This technology will reduce the variable costs of manufacturing each steering wheel from ₹ 110 to ₹ 100 and the share of fixed overheads from ₹ 30 to ₹ 15 (subject to the availability of technology, which is still under development).
 - E Ltd. is depreciating the machine using the straight line method over the machine's 10 year estimated useful life. The current estimate (based on similar assets that have reached the end of their useful lives) of the disposal proceeds from selling the machine is ₹ 80 000 net of disposal costs. E Ltd. expects to dispose of the machine at the end of March, 20X8.
 - E Ltd. has determined a pre-tax discount rate of 8%, which reflects the market's assessment of the time value of money and the risks associated with this asset.

Assume a tax rate of 30%.

Determine the value in use of the machine in accordance with Ind AS 36?

13. PQR Ltd. is the company which has performed well in the past but one of its major assets, an item of equipment, suffered a significant and unexpected deterioration in performance.

Management expects to use the machine for a further four years after 31st March 20X6, but at a reduced level. The equipment will be scrapped after four years. The financial accountant for PQR Ltd. has produced a set of cash-flow projections for the equipment for the next four years, ranging from optimistic to pessimistic. CFO thought that the projections were too conservative, and he intended to use the highest figures each year. These were as follows:

	₹ '000
Year ended 31 st March 20X7	276
Year ended 31 st March 20X8	192
Year ended 31 st March 20X9	120
Year ended 31 st March 20Y0	114

The above cash inflows should be assumed to occur on the last day of each financial year. The pre-tax discount rate is 9%. The machine could have been sold at 31st March 20X6 for ₹ 6,00,000 and related selling expenses in this regard could have been ₹ 96,000. The machine had been revalued previously, and at 31st March 20X6 an amount of ₹ 36,000 was held in revaluation surplus in respect of the asset. The carrying value of the asset at 31st March 20X6 was ₹ 6,60,000. The Indian government has indicated that it may compensate the company for any loss in value of the assets up to its recoverable amount.

Calculate impairment loss, if any and revised depreciation of asset. Also suggest how Impairment loss, if any would be set off and how compensation from government be accounted for?

14. On 1st January Year 1, Entity Q purchased a machine costing ₹ 2,40,000 with an estimated useful life of 20 years and an estimated zero residual value. Depreciation is computed on straight-line basis. The asset had been re-valued on 1st January Year 3 to ₹ 2,50,000, but with no change in useful life at that date. On 1st January Year 4 an impairment review showed the machine's recoverable amount to be ₹ 1,00,000 and its estimated remaining useful life to be 10 years.

Calculate:

- The carrying amount of the machine on 31st December Year 2 and the revaluation surplus arising on 1 January Year 3.
- The carrying amount of the machine on 31st December Year 3 (immediately before the impairment).
- The impairment loss recognised in the year to 31st December Year 4 and its treatment thereon
- The depreciation charge in the year to 31st December Year 4.

Note: During the course of utilization of machine, the company did not opt to transfer part of the revaluation surplus to retained earnings.

Answers

1. CGU of the building is Apex Ltd. as a whole as the primary purpose of the building is to serve as a corporate asset.
2. **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 crore)				
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%	100%
	(500/4,200)	(1,500/4,200)	(2,200/4,200)	
Allocation of carrying amount of X	72	216	312	600
Carrying amount (after allocation of X)	572	966	1,412	2,950

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 crore)			
Particulars	A	B	C
Carrying amount (after allocation of X)	572	966	1,412
Recoverable amount			
Impairment loss			
	<u>600</u>	<u>900</u>	<u>1400</u>
	<u>-</u>	<u>66</u>	<u>12</u>

- (b) Allocation of the impairment loss between cash-generating units and corporate asset X, on a pro rata basis, as follows

(₹ in crore)				
Allocation to	B		C	
X	15	(66 x 216/966)	3	(12 x 312/1,412)
Other assets in cash-generating units	<u>51</u>	(66 x 750/ 966)	<u>9</u>	(12 x 1,100/ 1,412)
Impairment loss	<u>66</u>		<u>12</u>	

Step II: Impairment losses for the larger cash-generating unit, i.e., ABC Ltd. as a whole

(₹ in crore)						
Particulars	A	B	C	X	Y	ABC Ltd.
Carrying amount	500	750	1,100	600	200	3,150
Impairment loss (Step I)	<u>-</u>	<u>(51)</u>	<u>(9)</u>	<u>(18)</u>	<u>-</u>	<u>(78)</u>
Carrying amount (after Step I)	<u>500</u>	<u>699</u>	<u>1,091</u>	<u>582</u>	<u>200</u>	<u>3,072</u>
Recoverable amount						3,200
Impairment loss for the 'larger' cash-generating unit					Nil	

3. 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. Since 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 31st March, 20X2

On 31 st March, 20X2	Goodwill of subsidiary (₹)	Net identifiable assets (₹)	Total (₹)
Carrying amount	400	1,350	1,750
Unrecognised non-controlling interests	<u>100</u>	<u>-</u>	<u>100</u>
Adjusted carrying amount	<u>500</u>	<u>1,350</u>	<u>1,850</u>
Recoverable amount			<u>1,000</u>
Impairment loss			<u>850</u>

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 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 31st March, 20X2

On 31 st March, 20X2	Goodwill of subsidiary (₹)	Net identifiable assets (₹)	Total (₹)
Carrying amount	400	1,350	1,750
Impairment loss	(400)	(350)	(750)
Carrying amount after impairment loss	-	1,000	1,000

4. Value in use of the machinery as on 31st March, 20X2 can be calculated as follows:

Financial year	Estimated cash flows (₹ in crore)	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	<u>6.83</u>
			<u>75.31</u>

The recoverable amount of the machinery is ₹ 75.31 crore (higher of value in use of ₹ 75.31 crore and fair value less costs to sell of ₹ 70 crore). The carrying of the machinery is ₹ 80 crore (after providing for one year depreciation @ ₹ 20 crore). Therefore, the impairment loss of ₹ 4.69 crore should be provided in the books. Further, the impaired carrying value of ₹ 75.31 crore will be depreciated, on a straight-line basis, over the remaining four years.

5. Value in use of the machinery as on March 31, 20X3 can be calculated as follows:

Financial year	Estimated cash flows (₹ in crore)	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	<u>7.51</u>
			<u>67.84</u>

The recoverable amount of the machinery is ₹ 67.84 crore (higher of value in use of ₹ 67.84 crore and fair value less costs to sell of ₹ 40 crore). Carrying amount of the machinery at the end of the year 20X2 is ₹ 56.48 crore (after providing for two years depreciation (100 – 20 – 4.69) – 18.83).

However, as per paragraph 116 of Ind AS 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. Reason being, the underlying reasons for the original impairment have not been removed, and the service potential of the asset has not increased.

Therefore, the impairment loss of ₹ 4.69 crore should not be reversed.

6. As on 31st March, 20X1

Carrying amount of the asset (opening balance)	₹ 100 lakh
Depreciation (₹ 100 lakh / 4 years)	<u>₹ 25 lakh</u>
Carrying amount of the asset (closing balance)	<u>₹ 75 lakh</u>

Recoverable amount (given)	₹ 60 lakh

Therefore, an impairment loss of ₹ 15 lakh should be recognised as on 31st March, 20X1. Depreciation for subsequent years should be charged on the carrying amount of the asset (after providing for impairment loss), i.e., ₹ 60 lakh.

As on 31st March, 20X2

Carrying amount of the asset (opening balance)	₹ 60 lakh
Depreciation (₹ 60 lakh / 3 years)	<u>₹ 20 lakh</u>
Carrying amount of the asset (closing balance)	<u>₹ 40 lakh</u>

Therefore, no impairment loss should be recognised as on 31st March, 20X2.

As on 31st March, 20X3

Carrying amount of the asset (opening balance)	₹ 40 lakh
Depreciation (₹ 40 lakh / 2 years)	<u>₹ 20 lakh</u>
Carrying amount of the asset (closing balance)	<u>₹ 20 lakh</u>
Recoverable amount (given)	₹ 28 lakh

Since, the recoverable amount of the asset exceeds the carrying amount of the asset by ₹ 8 lakh, 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 31st March, 20X3 had no impairment loss being recognised would have been ₹ 25 lakh. Therefore, the reversal of an impairment loss of ₹ 5 lakh should be done as on 31st March, 20X3.

7.

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	<u>15.03</u>
Total Discounted cash flows in US \$			<u>170.40</u>
Exchange rate as on 31 st March, 20X1, i.e., date of calculating value in use ₹45/US \$			
Value in use as on 31 st March, 20X1			₹ 7,668

8.

Cash flows	Probability	Expected cash flow
100	10%	10
200	60%	120
300	30%	<u>90</u>
Total		<u>220</u>

The expected cash flow is ₹ 220.

9.

Year	Cash flows	P.V.F.	Present value	Probability	Expected cash flows
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%	<u>255.48</u>
Total					<u>892.36</u>

The expected present value is ₹ 892.36.

10. (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 $[(50 \times 0.10) + (250 \times 0.30) + (100 \times 0.60)]$.
11. (a) **Computation of impairment loss and carrying value of each of the asset in CGU after impairment loss**

(i) **Calculation of carrying value of Machinery A and B before impairment**

<u>Machinery A</u>		
Cost	(A)	₹ 10,00,000
Residual Value		₹ 50,000
Useful life		10 years
Useful life already elapsed		5 years
Yearly depreciation	(B)	₹ 95,000
WDV as at 31st March, 20X8 [A- (B x 5)]		₹ 5,25,000
<u>Machinery B</u>		
Cost	(C)	₹ 5,00,000
Residual Value		-
Useful life		10 years
Useful life already elapsed		3 years

Yearly depreciation (D)	₹ 50,000
WDV as at 31st March, 20X8 [C- (D x 3)]	₹ 3,50,000

(ii) Calculation of Value-in-use of Machinery A

Period	Cash Flows (₹)	PVF	PV
1	1,50,000	0.909	1,36,350
2	1,00,000	0.826	82,600
3	1,00,000	0.751	75,100
4	1,50,000	0.683	1,02,450
5	1,00,000	0.621	62,100
5	50,000	0.621	<u>31,050</u>
Value in use			<u>4,89,650</u>

(iii) Calculation of Fair Value less cost of disposal of Machinery A

	₹
Fair Value	7,00,000
Less: Dismantling cost	(1,50,000)
Packaging cost	(25,000)
Legal Fees	<u>(75,000)</u>
Fair value less cost of disposal	<u>4,50,000</u>

(iv) Calculation of Impairment loss on Machinery A

	₹
Carrying Value	5,25,000
Less: Recoverable Value ie higher of Value-in-use and Fair value less cost of disposal	<u>4,89,650</u>
Impairment Loss	<u>35,350</u>

(v) Calculation of Impairment loss of CGU

1. First goodwill will be impaired fully and then the remaining impairment loss of ₹ 75,000 will be allocated to Machinery A and B.
2. If we allocate remaining impairment loss to Machinery A and B on pro-rata basis, it would come to ₹ 45,000 on Machinery A. However, the impairment loss of Machinery A cannot exceed ₹ 35,350. Hence, impairment to CGU will be as follows:

	Carrying value before impairment loss	Impairment loss	Carrying value after impairment loss
	₹	₹	₹
Machinery A	5,25,000	35,350	4,89,650
Machinery B	3,50,000	39,650*	3,10,350
Inventory	2,00,000	-	2,00,000
Goodwill	<u>1,50,000</u>	<u>1,50,000</u>	<u>-</u>
Total	<u>12,25,000</u>	<u>2,25,000</u>	<u>10,00,000</u>

* Balancing figure.

(b) Carrying value after adjustment of depreciation

	₹
Machinery A $[4,89,650 - \{(4,89,650 - 50,000) / 5\}]$	4,01,720
Machinery B $[3,10,350 - (3,10,350 / 7)]$	2,66,014
Inventory	2,00,000
Goodwill	<u>-</u>
Total	<u>8,67,734</u>

(c) Calculation of carrying value of CGU as on 31st March, 20X9

The revised value of CGU is ₹ 11 Lakh. However, impaired goodwill cannot be reversed. Further, the individual assets cannot be increased above the lower of recoverable value or Carrying Value as if the assets were never impaired.

Accordingly, the carrying value as on 31st March, 20X9 assuming that the impairment loss had never incurred, will be:

	Carrying Value	Recoverable Value	Final CV as at 31 st Mar 20X9
Machinery A	4,30,000	4,50,000	4,30,000
Machinery B	3,00,000	(7,60,000 – 4,50,000) 3,10,000	3,00,000
Inventory	2,00,000	2,00,000	2,00,000
Goodwill	<u>-</u>	<u>-</u>	<u>-</u>
Total	<u>9,30,000</u>	<u>9,60,000</u>	<u>9,30,000</u>

Hence, the impairment loss to be reversed will be limited to ₹ 62,266 only (₹ 9,30,000 – ₹ 8,67,734).

Note: It is assumed that value of inventory is same in 20X9 as it was in 20X8.

12. Calculation of the value in use of the machine owned by E Ltd. includes the projected cash inflow (i.e. sales income) from the continued use of the machine and projected cash outflows that are necessarily incurred to generate those cash inflows (i.e. cost of goods sold). Additionally, projected cash inflows include ₹ 80,000 from the disposal of the asset in March, 20X8. Cash outflows include routing capital expenditures of ₹ 50,000 in 20X5-20X6

As per Ind AS 36, estimates of future cash flows shall not include:

- Cash inflows from receivables
- Cash outflows from payables
- Cash inflows or outflows expected to arise from future restructuring to which an entity is not yet committed
- Cash inflows or outflows expected to arise from improving or enhancing the asset's performance
- Cash inflows or outflows from financing activities
- Income tax receipts or payments.

Hence in this case, cash flows do not include financing interest (i.e. 10%), tax (i.e. 30%) and capital expenditures to which E Ltd. has not yet committed (i.e. ₹ 1,00,000). They also do not include any savings in cash outflows from these capital expenditures, as required by Ind AS 36.

The cash flows (inflows and outflows) are presented below in nominal terms. They include an increase of 3% per annum to the forecast price per unit (B), in line with forecast inflation. The cash flows are discounted by applying a discount rate (8%) that is also adjusted for inflation.

Note: Figures are calculated on full scale and then rounded off to the nearest absolute value.

Year ended	20X3-20X4	20X4-20X5	20X5-20X6	20X6-20X7	20X7-20X8	Value in use
Quantity (A)	10,000	10,500	11,025	11,576	12,155	
Price per unit (B)	₹ 200	₹ 206	₹ 212	₹ 219	₹ 225	
Estimated cash inflows (C=A x B)	₹ 20,00,000	₹ 21,63,000	₹ 23,37,300	₹ 25,35,144	₹ 27,34,875	
Misc. cash inflow disposal proceeds (D)					₹ 80 000	
Total estimated cash inflows (E=C+D)	₹ 20,00,000	₹ 21,63,000	₹ 23,37,300	₹ 25,35,144	₹ 28,14,875	
Cost per unit (F)	₹ 160	₹ 162	₹ 165	₹ 168	₹ 171	
Estimated cash outflows	(₹ 16,00,000)	(₹ 17,01,000)	(₹ 18,19,125)	(₹ 19,44,768)	(₹ 20,78,505)	

(G = A x F)						
Misc. cash outflow: maintenance costs (H)			(₹ 50,000)			
Total estimated cash outflows (I=G+H)	(₹ 16,00,000)	(₹ 17,01,000)	(₹ 18,69,125)	(₹ 19,44,768)	(₹ 20,78,505)	
Net cash flows (J=E-I)	₹ 4,00,000	₹ 4,62,000	₹ 4,68,175	₹ 5,90,376	₹ 7,36,370	
Discount factor 8%* (K)	0.9259	0.8573	0.7938	0.7350	0.6806	
Discounted future cash flows (L=J x K)	₹ 3,70,360	₹ 3,96,073	₹ 3,71,637	₹ 4,33,926	₹ 5,01,173	₹ 20,73,169

* Since the future cash flows are estimated on a pre-tax basis, the discount rate is also determined on a pre-tax basis.

13. Carrying amount of asset on 31st March 20X6 = ₹ 6,60,000

Calculation of Value in Use:

Year ended	Cash flow ₹	Discount factor @ 9%	Amount ₹
31 st March, 20X7	2,76,000	0.9174	2,53,202
31 st March, 20X8	1,92,000	0.8417	1,61,606
31 st March, 20X9	1,20,000	0.7722	92,664
31 st March, 20Y0	1,14,000	0.7084	<u>80,758</u>
Total (Value in Use)			<u>5,88,230</u>

Calculation of Recoverable amount:

Particulars	Amount (₹)
Value in use	5,88,230
Fair value less costs of disposal (6,00,000 – 96,000)	5,04,000
Recoverable amount (Higher of value in use and fair value less costs of disposal)	<u>5,88,230</u>

Calculation of Impairment loss:

Particulars	Amount (₹)
Carrying amount	6,60,000
Less: Recoverable amount	<u>(5,88,230)</u>
Impairment loss	<u>71,770</u>

Calculation of Revised carrying amount:

Particulars	Amount (₹)
Carrying amount	6,60,000
Less: Impairment loss	<u>(71,770)</u>
Revised carrying amount	<u>5,88,230</u>

Calculation of Revised Depreciation:

Revised carrying amount – Residual value

Remaining life = $(5,88,230 - 0) / 4 = ₹ 1,47,058$ per annum

Set off of Impairment loss:

The impairment loss of ₹ 71,770 must first be set off against any revaluation surplus in relation to the same asset. Therefore, the revaluation surplus of ₹ 36,000 is eliminated against impairment loss, and the remainder of the impairment loss ₹ 35,770 (₹ 71,770 – ₹ 36,000) is charged to profit and loss.

Treatment of Government compensation:

Any compensation by the government would be accounted for as such when it becomes receivable. At this time, the government has only stated that it may reimburse the company and therefore credit should not be taken for any potential government receipt.

14. (a) Calculation of Carrying amount of machine at the end of Year 2 ₹

Cost of machine	2,40,000
Accumulated depreciation for 2 years $[2 \text{ years} \times (2,40,000 \div 20)]$	<u>(24,000)</u>
Carrying amount of the machine at the end of Year 2	<u>2,16,000</u>

(b) Calculation of carrying amount of the machine on 31 December Year 3 ₹

Carrying amount at the beginning of Year 3	2,16,000
Revaluation done at the beginning of Year 3	2,50,000
Revaluation surplus	34,000

(c) Calculation of Impairment loss at the end of Year 4

When machine is revalued on 1 January Year 3, depreciation is charged on the revalued amount over its remaining expected useful life.

Valuation at 1 January (re-valued amount)	2,50,000
Accumulated depreciation in Year 3 $(2,50,000 / 18)$	(13,889)
Carrying amount of the asset at the end of Year 3	2,36,111
On 1 January Year 4, recoverable amount of the machine	1,00,000

Impairment loss ($2,36,111 - 1,00,000$)	1,36,111

An impairment loss of ₹ 34,000 will be taken to other comprehensive income (reducing the revaluation surplus for the asset to zero)

The remaining impairment loss of ₹ 1,02,111 ($1,36,111 - 34,000$) is recognised in the Statement of Profit and Loss for the Year 4.

(d) Calculation of depreciation charge in the Year 4

Carrying value of the machine at the beginning of Year 4	₹ 1,00,000

Estimated remaining useful life	10 years

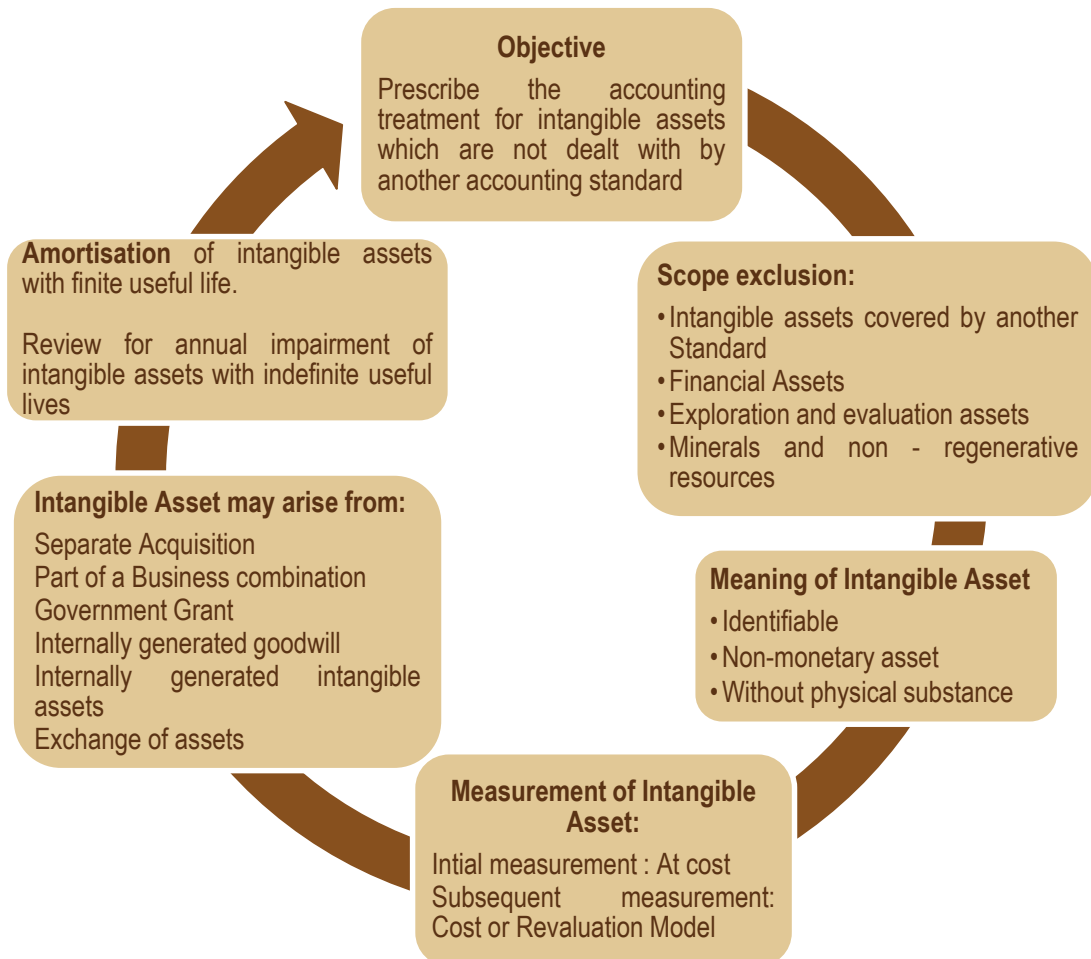
Depreciation charge is (₹ 1,00,000 / 10 years)	₹ 10,000

UNIT 5 : INDIAN ACCOUNTING STANDARD 38 : INTANGIBLE ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to

- ☐ State the scope of the standard
- ☐ Define and identify intangible assets by applying the criteria given in the standard
- ☐ Measure the intangible assets on initial recognition
- ☐ Analyse the principles of measurement under various modes of acquisition
- ☐ Apply the recognition and measurement principles on internally intangible assets
- ☐ Measure the intangible assets on subsequent recognition
- ☐ Interpret the concept of useful life of an intangible asset and its amortisation
- ☐ Examine the principles of de-recognition
- ☐ Produce the disclosures required in the standard

UNIT OVERVIEW 



5.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognize an intangible asset if, and only if, specified criteria are met. This standard specifies the requirement of recognition, measurement and disclosures of Intangible Assets.

The Standard states that intangible assets are initially measured at cost, subsequently measured at cost or using the revaluation model, and amortised on a systematic basis over their useful lives unless the asset has an indefinite useful life, in which case it is not amortised but tested for impairment.



5.2 SCOPE

5.2.1 Applicability

This Standard shall be applied to all intangible assets, except:

(a) intangible assets that are within the scope of another Standard, for example:

Intangible assets held for sale in the ordinary course of business (Ind AS 2)

Deferred tax assets (Ind AS 12)

Leases of intangibles assets (Ind AS 116)

Assets arising from employee benefits (Ind AS 19)

Financial assets (Ind AS 32)

Goodwill arising in a business combination (Ind AS 103)

Deferred acquisition costs and intangible assets arising from insurance contract (Ind AS 104)

Non-current intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) (Ind AS 105)

Assets arising from contracts with customers (Ind AS 115)

(b) financial assets, as defined in Ind AS 32, *Financial Instruments: Presentation*;

- (c) the recognition and measurement of exploration and evaluation assets (see Ind AS 106, *Exploration for and Evaluation of Mineral Resources*); and
- (d) expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.

5.2.2 Intangible assets contained in or on a physical substance

Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film. In determining whether an asset that incorporates both tangible and intangible elements should be treated under Ind AS 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.

The standard is also applicable to expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (eg a prototype), the physical element of the asset is secondary to its intangible component, ie the knowledge embodied in it.

5.2.3 Intangible assets on leases

Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of Ind AS 116 and are within the scope of this Standard.

5.2.4 Intangible assets used in the extractive and insurance industries

This Standard does not apply to expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of insurance contracts. However, 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.

5.2.5 Amortisation method specified in this standard not to apply to intangible assets arising from service concession arrangements in respect of toll roads

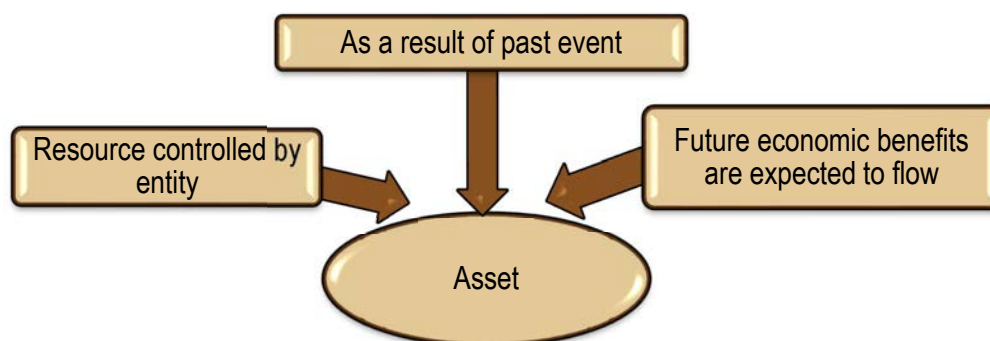
The amortisation method specified in this Standard does not apply to an entity that opts to amortise the intangible assets arising from service concession arrangements in respect of toll roads recognized in the financial statements for the period ending immediately before the beginning of the first Ind AS reporting period as per the optional exemption given in Ind AS 101, First-time Adoption of Indian Accounting Standards.



5.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.
- An **asset*** is a resource:



- (a) controlled by an entity as a result of past events; and
- (b) from which future economic benefits are expected to flow to the entity.
- **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

* The definition of an asset in this Standard is not revised following the revision of the definition of an asset in the *Conceptual Framework for Financial Reporting under Indian Accounting Standards* issued in 2021 by the Institute of Chartered Accountants of India.

requirements of other Indian Accounting Standards, for e.g Ind AS 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** 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. (See Ind AS 113, *Fair Value Measurement*.)
- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- An **intangible asset** is an identifiable non-monetary asset without physical substance.
- **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.

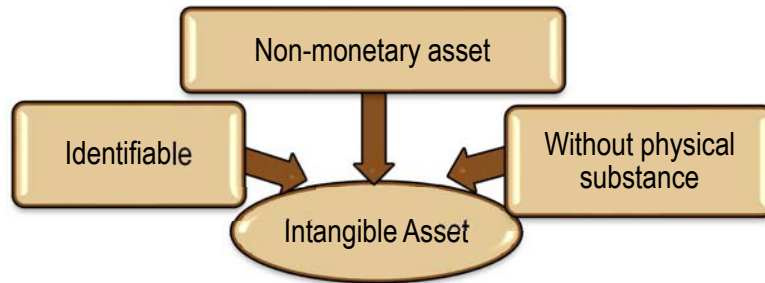


5.4 IDENTIFICATION OF INTANGIBLE ASSETS

5.4.1 Meaning of Intangible asset

An intangible asset is an identifiable non-monetary asset without physical substance. The key components of this definition are:

- (i) Identifiability; and
- (ii) Asset

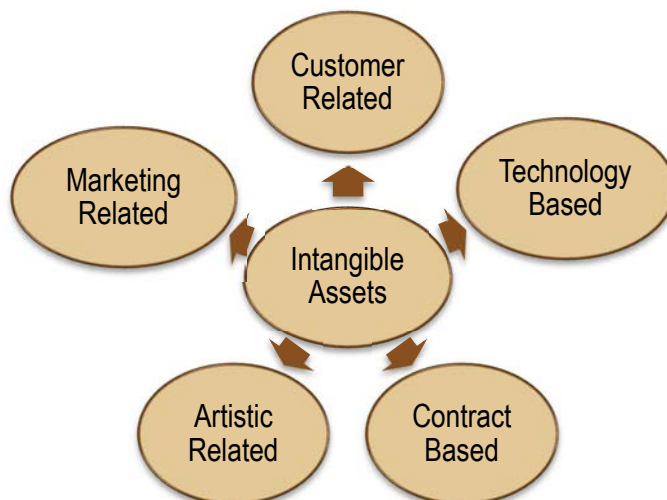


Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as:

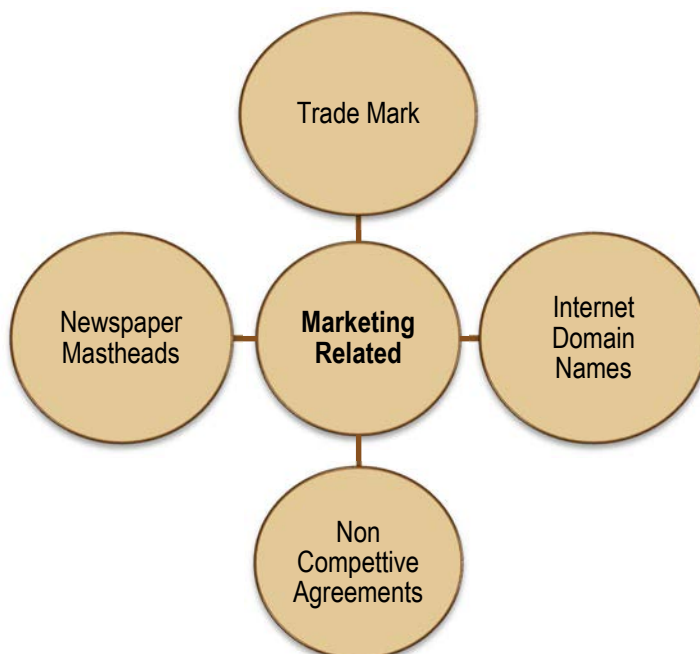
- Scientific or technical knowledge
- Design and implementation of new processes or systems
- Licenses
- Intellectual property
- Market knowledge and trademarks (including brand names and publishing titles).

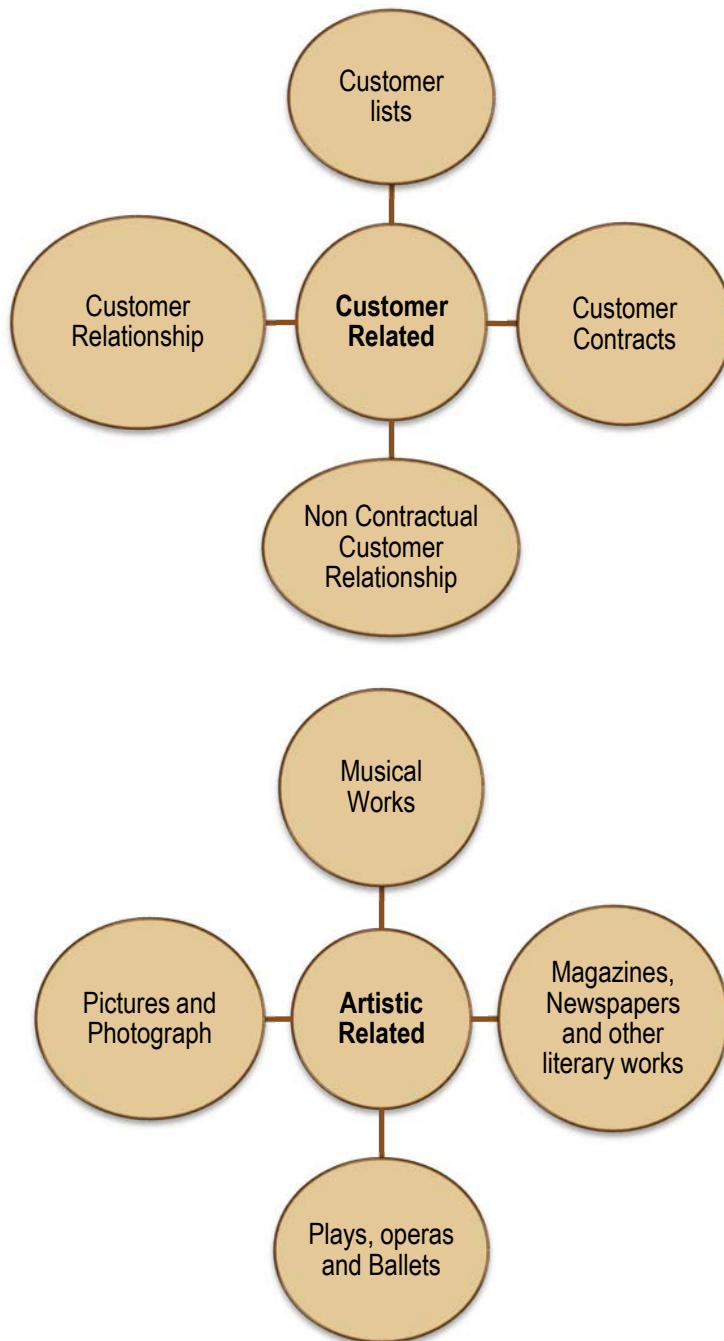
Common examples of items encompassed by these broad headings are:

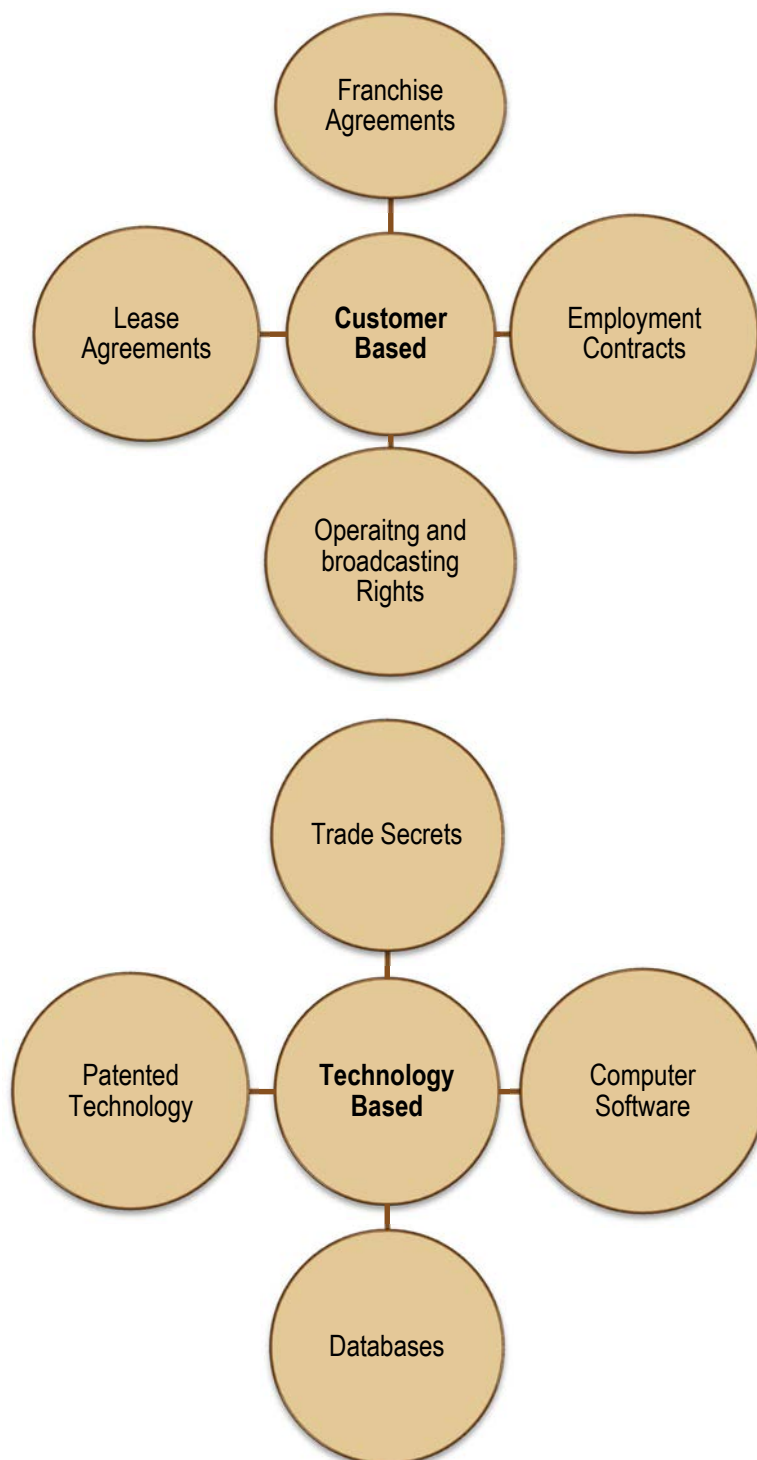
- Computer software
- Patents
- Copyrights
- Motion picture films
- Customer lists
- Mortgage servicing rights
- Fishing licences
- Import quotas
- Franchises
- Customer or supplier relationships
- Customer loyalty
- Market share and marketing rights.



Let's run through some examples of each broad category listed above:







Not necessarily all of the above items meet the conditions of recognizing as an Intangible Assets within purview of this standard:

- Identifiability
- Control over a Resource (Asset) and
- Existence of Future Economic Benefits.

Note: If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognized as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognized at the acquisition date.

Let us understand each concept one by one.

5.4.2 Identifiability

The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognized in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements.

An asset is identifiable if it either:

- (a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
- (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Illustration 1: Identifiability

Sun Ltd. has an expertise in the consulting business. In years gone by, the Company gained a 30% market share for its services business and intends to recognize it as an intangible asset.

Evaluate whether the action taken by the company is justified.

Solution

Market share does not meet the definition of intangible assets as is not identifiable i.e. it is neither separable and nor has arisen from contractual or legal rights.

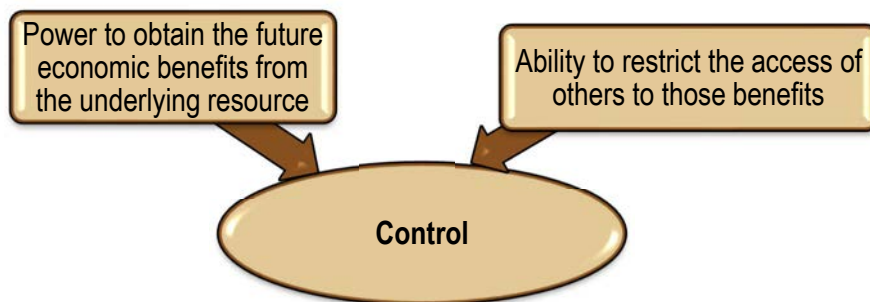
5.4.3 Asset

An asset is a resource:

- (a) controlled by an entity as a result of past events; and
- (b) from which future economic benefits are expected to flow to the entity.

5.4.3.1 Control

An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law.



In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An entity controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

Example 1

An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset.

For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

An entity may have a portfolio of customers or a market share and expect that, because of its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (e.g. portfolio of customers, market shares, customer relationships and customer loyalty) to meet the definition of intangible assets. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.

Illustration 2 : Control

Company XYZ Ltd. has provided training to its staff on various new topics like GST, Ind AS etc. to ensure the compliance as per the required law. Discuss whether the company can recognize such cost of staff training as intangible asset.

Solution

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.

5.4.3.2 Future economic benefits

The future economic benefits flowing from an intangible asset may include:

- (a) Revenue from the sale of products or services;
- (b) Cost savings; or
- (c) Other benefits resulting from the use of the asset by the entity.

For example: The use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Illustration 3: Identifiability of Intangible assets

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 ₹ 8,00,000 for advertisements before 31st March, 20X1. ₹ 7,00,000 of this sum relates to advertisements shown before 31st March, 20X1 and ₹ 1,00,000 to advertisements shown in April, 20X1. Since 31st March, 20X1, the Company has paid for further advertisements costing ₹ 4,00,000.

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.

Analyse the treatment of the above costs in the financial statements for the year ended 31st March, 20X1.

Solution

Under Ind AS 38 – *Intangible Assets* – intangible assets can only be recognized 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, Ind AS 38 specifically prohibits recognizing 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 recognized as expenses.

However, the costs would be recognized on accrual basis. Therefore, of the advertisements paid for before 31st March, 20X1, ₹ 7,00,000 would be recognized as an expense and ₹ 1,00,000 as a pre-payment in the year ended 31st March, 20X1. The cost of advertisements amounting ₹ 4,00,000 paid for since 31st March, 20X1 would be charged as expenses in the year ended 31st March, 20X2.

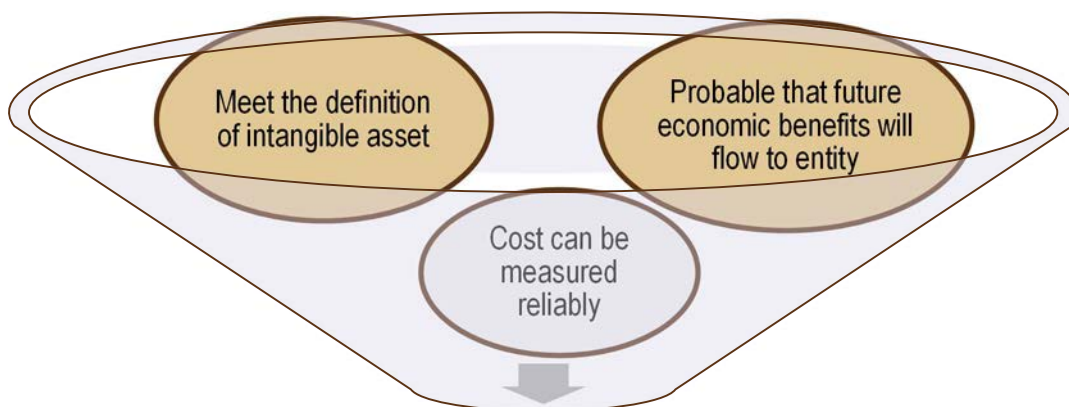


5.5 RECOGNITION OF INTANGIBLE ASSET

5.5.1 Recognition of Intangible assets – general principles

Provided that an item meets the definition of an intangible asset, it should be recognized in the financial statements if, and only if:

- (a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- (b) the cost of the asset can be measured reliably.



Intangible Asset -Recognition Criteria

- **This requirement applies to:**
 - (a) costs incurred initially to acquire or internally generate an intangible asset; and
 - (b) those incurred subsequently to add to, replace part of, or service it.
- An entity should assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.
- The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly, most subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in this Standard.
- In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. Therefore, only rarely will

subsequent expenditure — expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset — be recognized in the carrying amount of an asset.

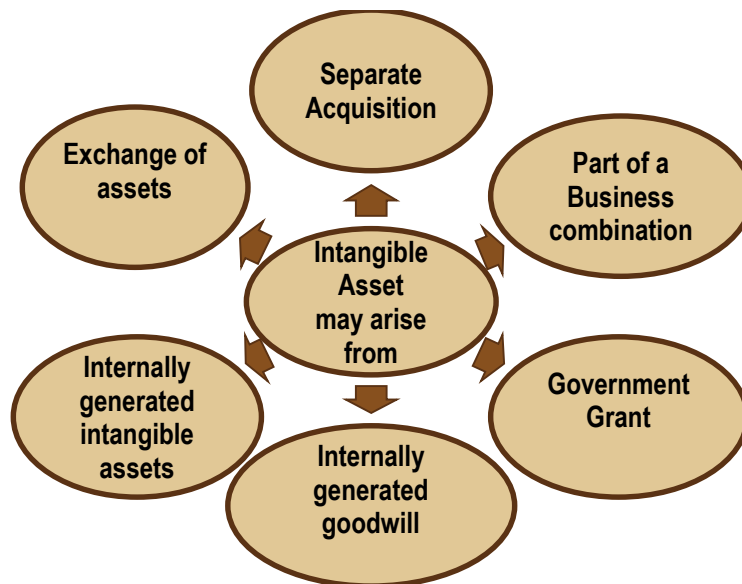
- Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally acquired or internally generated) is always recognized in profit or loss as incurred. This is because such expenditure cannot be distinguished from expenditure to develop the business as a whole.



5.6 MEASUREMENT OF INTANGIBLE ASSET

An intangible asset should be measured initially at cost.

Intangible assets may be acquired or can be self-generated. The below diagram reflects the method and mode by which Intangible assets may arise:



5.6.1 Separate acquisition

5.6.1.1 Recognition criteria for intangible assets acquired separately

Generally, the price an entity pays to acquire separately an intangible asset will reflect expectations about the probability that the expected future economic benefits associated with asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow.

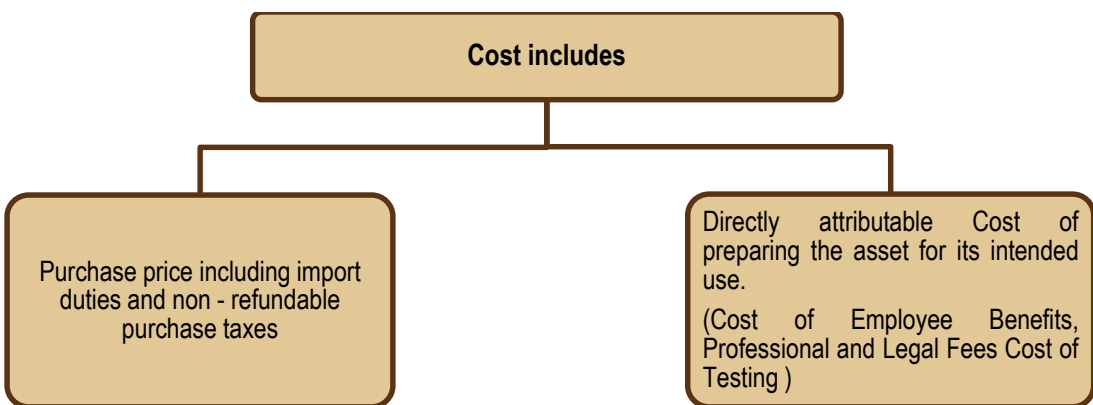
Therefore, the probability recognition criterion specified above is always considered to be satisfied for separately acquired intangible assets.

In addition, the cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

5.6.1.2 Measurement of cost for intangible assets acquired separately

The cost of a separately acquired intangible asset comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
- (b) any directly attributable cost of preparing the asset for its intended use.



Examples of directly attributable costs are:

Employee benefits cost (as defined in Ind AS 19) arising directly from bringing the asset to its working condition

Professional Fees arising directly from bringing the asset to its working condition

Costs of testing - whether the asset is working properly.

Examples of expenditures that are not part of the cost of an intangible asset are:



Deferred Consideration

If payment for an intangible asset is deferred beyond normal credit terms, then cost of such Intangible asset is the cash price equivalent. The difference between this amount and the total payments is recognized as interest expense over the period of credit unless it is capitalised in accordance with Ind AS 23, Borrowing Costs.

Cessation of capitalisation

Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management.

For example, the following costs are not included in the carrying amount of an intangible asset:

- (a) costs incurred in using or redeploying an intangible asset;
- (b) costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and
- (c) initial operating losses, such as those incurred while demand for the asset's output builds up.

Example 2 - Separate Acquisition

Jupiter Ltd acquires new energy efficient technology that will significantly reduce its energy costs for manufacturing.

	Costs incurred include	Cost to be capitalised as per Ind AS 38
Cost of new solar technology	10,00,000	10,00,000

Trade discount provided	(1,00,000)	(1,00,000)
Training course for staff in new technology	50,000	-
Initial testing of new technology	35,000	35,000
Losses incurred while other parts of plant shut down during testing and training	25,000	-
Total	10,10,000	9,35,000

Illustration 4: Separate Acquisition

Venus India Private Ltd. acquired a software for its internal use costing ₹ 10,00,000. The amount payable for the software was ₹ 6,00,000 immediately and ₹ 4,00,000 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 Ind AS 38 Intangible Assets.

Solution

Particulars	Amount in ₹
Cash paid	6,00,000
Deferred consideration (₹ 4,00,000 / 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	<u>1,20,000</u>
Total cost to be capitalised	<u>12,70,636</u>

5.6.2 Acquisition as part of a business combination

5.6.2.1 Recognition criteria for intangible assets acquired as part of a business combination

- In accordance with Ind AS 103, *Business Combinations*, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. The fair value of an intangible asset will reflect market participants' expectations at the acquisition date about the probability that the expected future economic benefits embodied in the asset will flow to the entity.
- In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations.
- An acquirer recognizes at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognized by the acquiree before the business combination.
- This means that the acquirer recognizes as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset. An acquiree's in-process research and development project meets the definition of an intangible asset when it:
 - (a) meets the definition of an asset; and
 - (b) is identifiable, ie is separable or arises from contractual or other legal rights.

Measuring fair value

- If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset.
- When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities that uncertainty enters into the measurement of the asset's fair value.
- An intangible asset acquired in a business combination might be separable, but only together with a related contract, identifiable asset or liability. In such cases, the acquirer recognizes the intangible asset separately from goodwill, but together with the related item.
- The acquirer may recognize a group of complementary intangible assets as a single asset provided the individual assets have similar useful lives. For example, the terms 'brand' and 'brand name' are often used as synonym for trademarks and other marks.

Illustration 5: Business Combination

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:

- Trademark named "GRAND" – valued at ₹ 1,80,000 using a discounted cash flow technique.
- Sole distribution rights to an electronic product; future cash flows from which are estimated to be ₹ 1,50,000 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

Particulars	Amount	Amount
Purchase consideration (A)		50,00,000
Net asset acquired	30,00,000	
Trademark	1,80,000	
Distribution rights (1,50,000 x 4.36)	<u>6,54,000</u>	
Total (B)		<u>(38,34,000)</u>
Goodwill on acquisition		<u>11,66,000</u>

5.6.3 Acquisition by way of a government grant

An intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may happen when a government transfers or allocates to an entity, intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

In accordance with Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, an entity should recognize both the intangible asset and the grant initially at fair value.

If an entity chooses not to recognize the asset initially at fair value, the entity recognizes the asset initially at a nominal amount (the other treatment permitted by Ind AS 20) plus any expenditure that is directly attributable to preparing the asset for its intended use.

5.6.4 Exchange of assets

One or more intangible assets may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an intangible asset is measured at fair value (even if an entity cannot immediately derecognize the asset given up) unless either:

- (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.
- If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.
 - 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. An exchange transaction has commercial substance if:
 - (a) the configuration (ie risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
 - (b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and
 - (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.
 - No intangible asset can be recognized unless its cost can be measured reliably. 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. However, if the fair value of the asset received is more clearly evident, then fair value of the asset received is taken up as cost.
 - The fair value of an intangible asset is reliably measurable if:
 - (a) the variability in the range of reasonable fair value measurements is not significant for that asset; or
 - (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

Illustration 6: Exchange of Asset

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.

Pass 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 measurable. 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

			₹ in '000
Situation	Sun Ltd.	Earth Ltd.	
1	Software Dr. 500 To Telecommunication license 500 To Profit on Exchange Nil	Telecommunication license Dr. 520 To Software 10 To Profit on Exchange 510	
2	Software Dr. 490 Loss on Exchange Dr. 10 To Telecommunication license 500 Note: The company may first recognize Impairment loss and then record an entry. The effect is the same as impairment loss will also be charged to Income Statement.	Telecommunication license Dr. 490 To Software 10 To Profit on Exchange 480	
3	Software Dr. 500 To Telecommunication license 500	Telecommunication license Dr. 10 To Software 10	

5.6.5 Internally generated goodwill

This standard prohibits the recognition of internally generated goodwill as an asset.

Internally generated goodwill is not recognized 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.

In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill.

Differences between the fair value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the fair value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

5.6.6 Internally generated intangible assets

- It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of difficulty in:
 - (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and
 - (b) determining the cost of the asset reliably.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, this standard includes additional recognition criteria for internally generated intangible assets which expand on the general recognition criteria.

- To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:
 - (a) a research phase; and
 - (b) a development phase.
- If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Items that should not be recognized as internally generated intangible assets

This standard prohibits the recognition of internally generated goodwill as an asset. Some other internally generated items that are prohibited to be recognized as intangible assets are brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognized as intangible assets.

Research phase

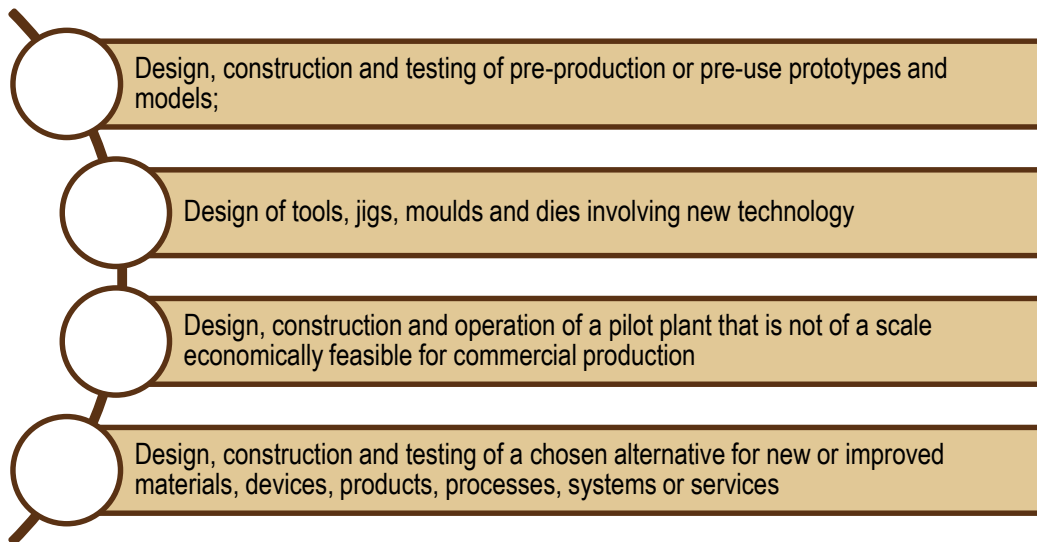
- **Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- No intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.
- 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 recognized as an expense when it is incurred.

- Examples of research activities are:
 - (a) activities aimed at obtaining new knowledge;
 - (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;
 - (c) the search for alternatives for materials, devices, products, processes, systems or services; and
 - (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

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.

- **Examples of development activities are:**



An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an entity can demonstrate all of the following:

Technical feasibility of completion of Intangible asset to make it available for use or sale

Intention to complete the intangible asset and use or sell it

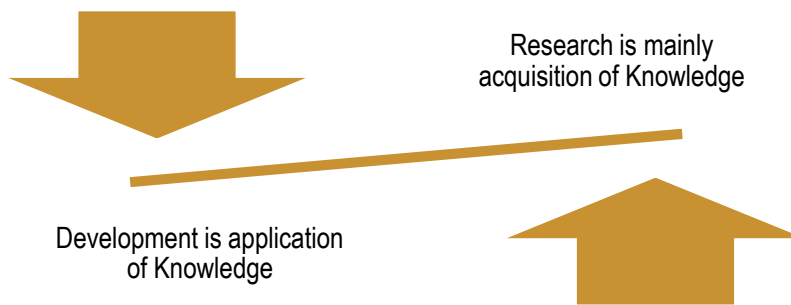
Ability to use or sell the intangible asset.

How the intangible asset will generate probable future economic benefits. Among other things, 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.

Adequate resources (like technical, financial or others) to complete the development.

Ability to measure reliably the expenditure attributable to the intangible asset during its development.

- In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.
- To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in Ind AS 36, *Impairment of Assets*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in Ind AS 36.
- Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, 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.
- 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.



Cost of an internally generated asset

The cost of an internally generated intangible asset for the purpose of initial measurement at recognition is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria including the additional criteria specified above.

Cost -Inclusions

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management.

Examples of directly attributable costs are:

Costs of materials and services used or consumed in generating the intangible asset

Costs of employee benefits (as defined in Ind AS 19) arising from the generation of the intangible asset

Fees to register a legal right

Amortisation of patents and licences that are used to generate the intangible asset

The specific guidance is given for borrowing costs to be capitalized as part of the cost of a self-generated intangible asset.

This standard prohibits reinstatement of expenditure previously recognized as an expense.

Cost - Exclusions

The following are not components of the cost of an internally generated intangible asset:

- (a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

- (b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and
- (c) expenditure on training staff to operate the asset.

Illustration 7

Venus Ltd. is preparing its accounts for the year ended 31st March, 20X2 and is unsure how to treat the following items.

- 1. Company has completed a big marketing and advertising campaign costing ₹ 2,40,000. The finance director had authorised this campaign on the basis that it would create ₹ 5,00,000 of additional profits over the next three years.*
- 2. A new product was developed during the year. The expenditure aggregated ₹ 1,50,000 of which ₹ 1,00,000 was incurred prior to 30th 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 ₹ 70,000.*
- 3. Staff participated in a training programme which cost the company ₹ 3,00,000. The training organization had made a presentation to the directors of Baxter outlining that incremental profits to the business over the next twelve months would be ₹ 5,00,000.*

What amounts should appear as assets in Venus Ltd.'s balance sheet as at 31st March, 20X2?

Solution

The treatment in Venus Ltd.'s balance sheet as at 31st March, 20X2 will be as follows:

- 1. Marketing and advertising campaign:** no asset will be recognized because it is not possible to identify future economic benefits that are attributable only to this campaign. All of the expenditure should be expensed in the statement of profit and loss account.
- 2. New product:** development expenditure appearing in the statement of financial position will be valued at ₹ 50,000. The expenditure prior to the date on which the product becomes technically feasible is recognized in the statement of profit and loss account as an expense.
- 3. Training programme:** no intangible asset will be recognized, because staff are not under the control of Venus Ltd. and when staff leave the benefits of the training, whatever they may be, also leave.

Illustration 8 : Development Phase

Expenditure on a new production process in 20X1-20X2:

	₹
1 st April to 31 st December	2,700
1 st January to 31 st March	<u>900</u>
	<u>3,600</u>

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.

Expenditure incurred for development of the process in financial year 20X2-20X3 is ₹ 6,000. Asset was brought into use on 31st March, 20X3 and is expected to be useful for 6 years.

What is the carrying amount of the intangible asset at 31st March, 20X2 and 31st March, 20X3. Also determine the charge to profit or loss for 20X1-20X2?

At 31st March, 20X4, the amount estimated to be recoverable from the process is ₹ 5,000.

Determine the carrying amount of the intangible asset at 31st March, 20X4 and the charge to profit or loss for 20X3-20X4 on account of impairment loss.

Solution

- 1) **Expenditure to be transferred to profit or loss in 20X1-20X2**

	₹
Total Expenditure	3,600
Less: Expenditure during development phase	<u>(900)</u>
Expenditure to be transferred to profit or loss	<u>2,700</u>
- 2) **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)
- 3) **Carrying amount of intangible asset on 31st March, 20X3**

Carrying amount of intangible asset on 31 st March, 20X2	₹ 900
Add: Further expenditure during development phase	<u>6,000</u>
Total capital expenditure on development phase	<u>6,900</u>
- 4) **Expenditure to be charged to profit or loss in 20X3-20X4**

Opening balance of Intangible Asset	6,900

Less: Amortisation for the year (6,900 / 6)	<u>(1,150)</u>
Carrying amount of intangible asset	5,750
Less: Recoverable amount	<u>(5,000)</u>
Amount charged to profit or loss (Impairment Loss)	<u>750</u>

5) Carrying Amount of Intangible Asset on 31st March, 20X4

Value of intangible asset will be recoverable amount i.e. ₹ 5,000



5.7. RECOGNITION OF AN EXPENSE

- Expenditure on an intangible item should be recognized as an expense when it is incurred unless:
 - (a) it forms part of the cost of an intangible asset that meets the recognition criteria; or
 - (b) the item is acquired in a business combination and cannot be recognized as an intangible asset. In such case, it forms part of the amount recognized as goodwill at the acquisition date.
- This standard states that the following types of expenditure should always be recognized as an expense:
 - (a) expenditure on research (except when it is acquired as part of a business combination);
 - (b) 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 Ind AS 16. Start-up costs may consist of:
 - (i) establishment costs such as legal and secretarial costs incurred in establishing a legal entity;
 - (ii) expenditure to open a new facility or business (ie pre-opening costs);
 - (iii) expenditures for starting new operations or launching new products or processes (ie pre-operating costs);
 - (c) expenditure on training activities;
 - (d) expenditure on advertising and promotional activities (including mail order catalogues); and
 - (e) expenditure on relocating or reorganizing part or all of an entity.

- More generally, if expenditure does not give rise to an intangible asset:
 - (a) for the supply of goods, an expense is recognized when the entity has a right to access those goods. An entity has a right to access goods when it owns them. Similarly, it has a right to access goods when they have been constructed by a supplier in accordance with the terms of a supply contract and the entity could demand delivery of them in return for payment.
 - (b) for a supply of services, the entity recognizes the expenditure as an expense when it receives the services. Services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service, for example, to deliver an advertisement to customers.
- This does not preclude an entity from recognizing a prepayment as an asset when payment for goods has been made in advance of the entity obtaining a right to access those goods or in advance of the entity receiving those services.
- Expenditure on an intangible item that was initially recognized as an expense should not be recognized as part of the cost of an intangible asset at a later date.



5.8 MEASUREMENT AFTER RECOGNITION

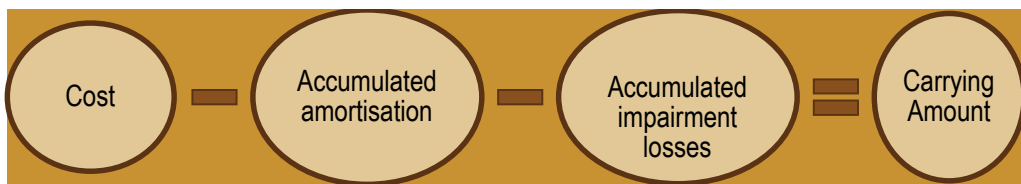
An entity should choose either the cost model or the revaluation model as its accounting policy.

Cost Model

Revaluation Model

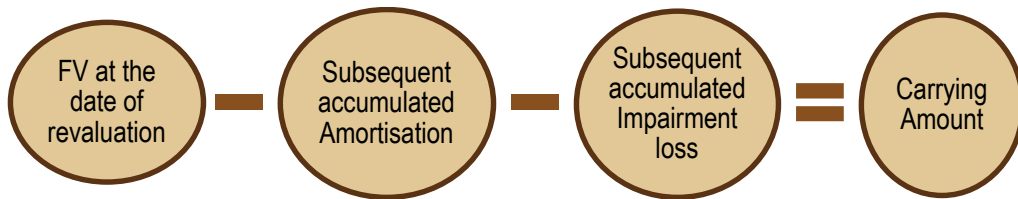
5.8.1 Cost model

After initial recognition, an intangible asset is carried at its cost less any accumulated amortisation and any accumulated impairment losses.



5.8.2 Revaluation model

After initial recognition, an intangible asset is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.



- For the purpose of revaluations under this Standard, fair value is measured by reference to an active market.
- The revaluation model does not allow:
 - (a) the revaluation of intangible assets that have not previously been recognized as assets; or
 - (b) the initial recognition of intangible assets at amounts other than cost.
- The revaluation model is applied after an asset has been initially recognized at cost. However, if only part of the cost of an intangible asset is recognized as an asset because the asset did not meet the criteria for recognition until part of the way through the process, the revaluation model may be applied to the whole of that asset.
- Also, the revaluation model may be applied to an intangible asset that was received by way of a Government grant and recognized at a nominal amount.

Frequency of revaluations

- Revaluations should be made with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value.
- The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued. If the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary.
- Some intangible assets may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for intangible assets with only insignificant movements in fair value.

Scope of revaluations

- If an intangible asset is accounted for using the revaluation model, all the other assets in its class should also be accounted for using the same model, unless there is no active market for those assets.
- If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset is carried at its cost less any accumulated amortisation and impairment losses.

- A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations.
- If the fair value of a revalued intangible asset can no longer be measured by reference to an active market, the carrying amount of the asset is its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.
- The fact that an active market no longer exists for a revalued intangible asset may indicate that the asset may be impaired and that it needs to be tested in accordance with Ind AS 36. If the fair value of the asset can be measured by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date.

Accumulated amortisation at the date of revaluation

- When an intangible asset is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:
 - (a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated amortisation 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; or
 - (b) the accumulated amortisation is eliminated against the gross carrying amount of the asset.

Treatment of surplus or deficit arising on revaluation

- If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus.
- However, the increase shall be recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit or loss.
- If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in profit or loss.
- However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.
- The cumulative revaluation surplus included in equity may be transferred directly to retained

earnings when the surplus is realised. The whole surplus may be realised on the retirement or disposal of the asset. Some realisation of the revaluation surplus may occur, however, through the use of the intangible asset.

- The amount of the surplus realised is the difference between amortisation based on the revalued carrying amount of the asset and amortisation that would have been recognized based on the asset's historical cost. The transfer from revaluation surplus to retained earnings is not made through profit or loss.

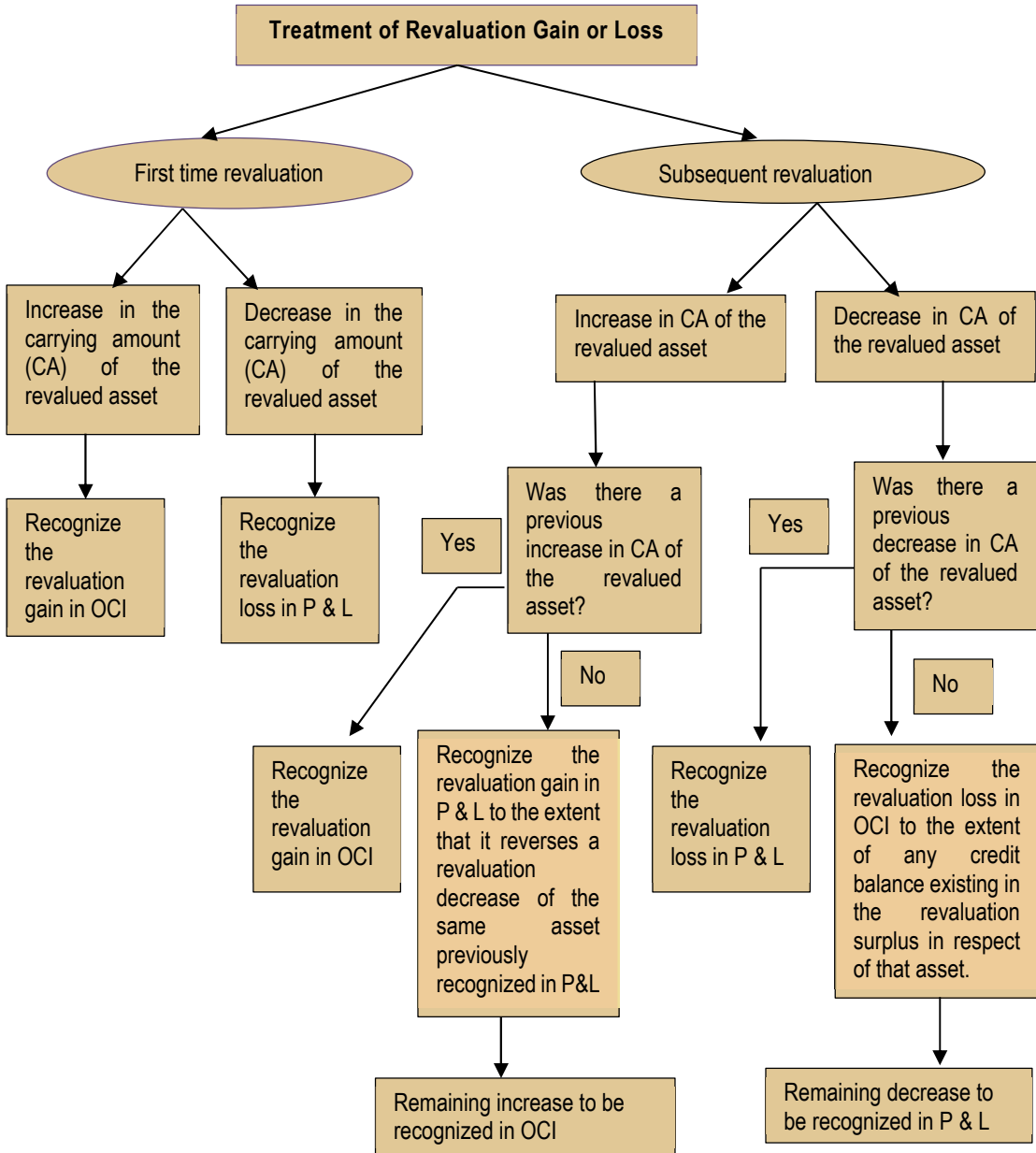


Illustration 9 : Revaluation Model

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, 20X2 and ₹ 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.

For both the companies, the year ends on 31st March, and they both use the revaluation model.

Recommend how each of these transactions should be dealt with in the financial statements. Discuss the treatment for revaluation of intangible asset. Ignore computation of amortization on them for ease of understanding.

Solution**Saturn Ltd.**

₹ 20,000 revaluation increase on 31st March, 20X2 should be credited to the revaluation reserve and recognized 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 recognized as an expense.

Jupiter Ltd.

₹ 15,000 revaluation decrease on 31st March, 20X2 should be recognized as an expense in the Statement of Profit and loss. ₹ 15,000 out of the ₹ 20,000 increase on 31st March, 20X3 should be recognized as income. The remaining ₹ 5,000 should be credited to revaluation reserve and recognized in other comprehensive income.

Note: The above amount will be different if amortization of intangible asset is taken into consideration.

**5.9 USEFUL LIFE**

- The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not amortised and tested for impairment.

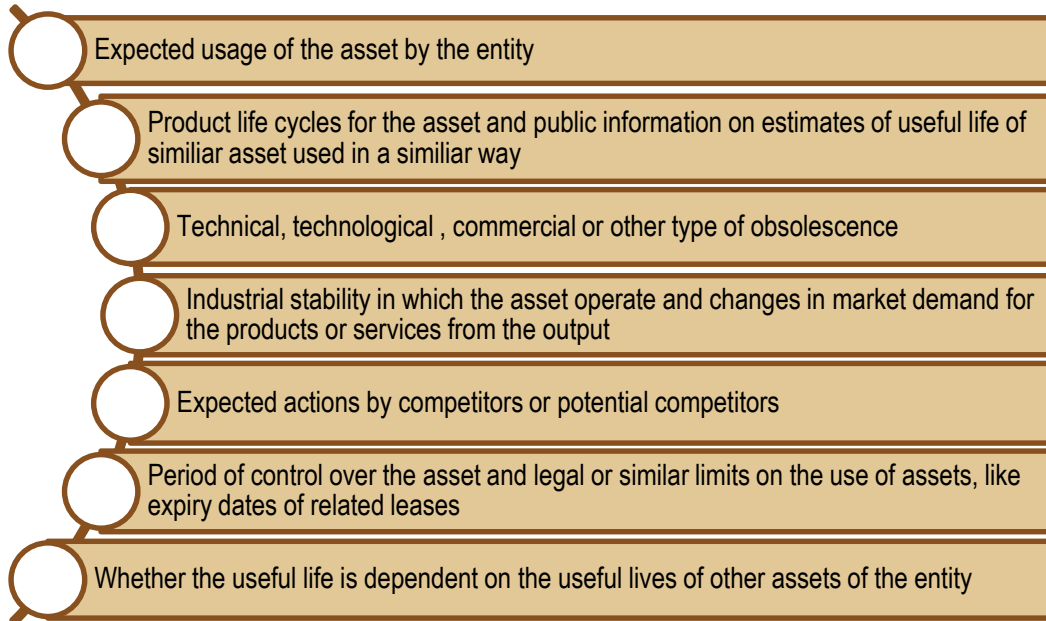
Finite or indefinite useful life

- Entities are required to assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life.

- An intangible asset should be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Factors for consideration in determining useful life

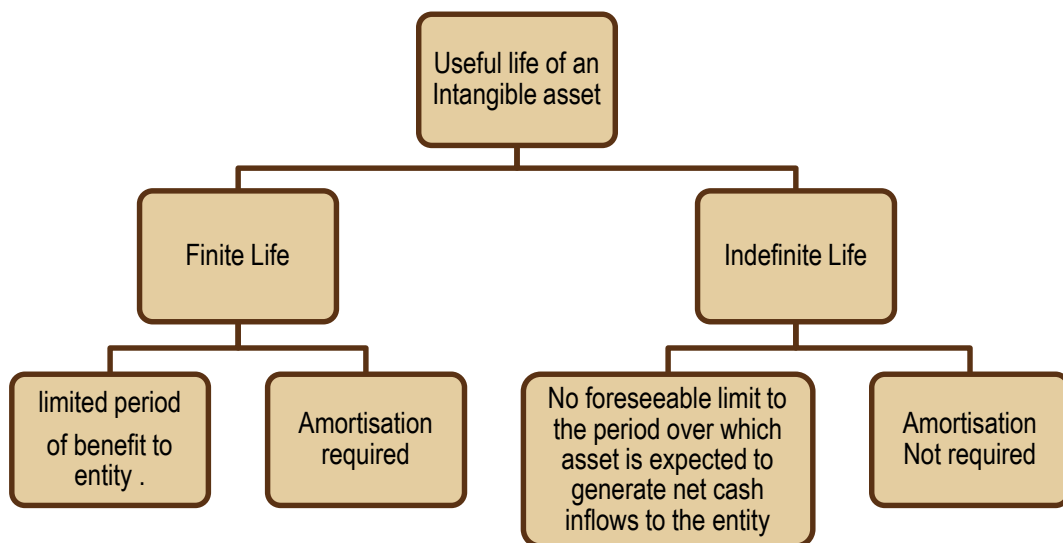
- Many factors are considered in determining the useful life of an intangible asset, including:



- The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level.
- A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.
- This standard notes that, given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it will often be the case that their useful life is short. Expected future reductions in the selling price of an item that was produced using an intangible asset could indicate the expectation of technological or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.
- The useful life of an intangible asset may be very long or even indefinite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

Intangible asset arising from contractual or other legal rights

- 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.
- Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:
 - (a) there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;
 - (b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and
 - (c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.
- If the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.
- The useful life of a reacquired right recognized as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.





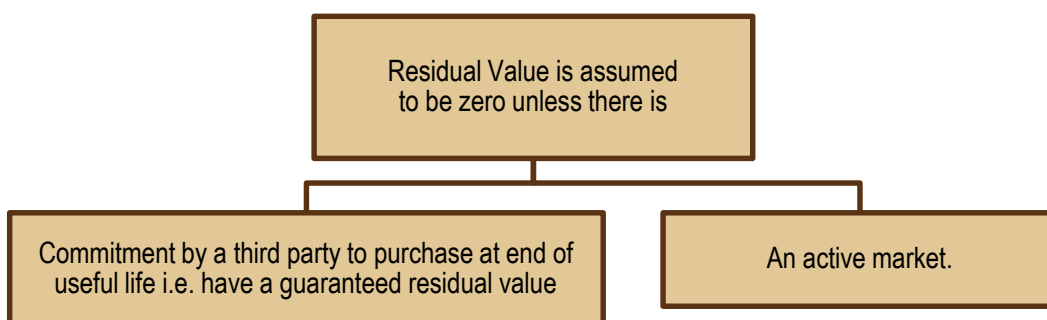
5.10 INTANGIBLE ASSETS WITH FINITE USEFUL LIVES

5.10.1 Depreciable amount to be amortised over the asset's useful life

- The depreciable amount of an intangible asset with a finite useful life is allocated on a systematic basis over its useful life. The depreciable amount of an asset is defined as the cost of an asset, or other amount substituted for cost, less its residual value.
- Amortisation is usually recognized in profit or loss. However, sometimes the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the amortisation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see Ind AS 2, *Inventories*).

5.10.2 Residual Value

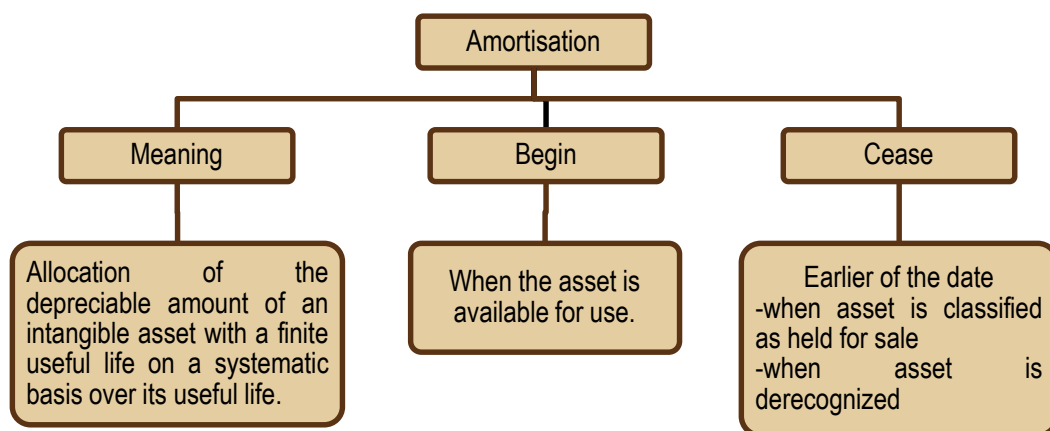
- The residual value of an intangible asset with a finite useful life should be assumed to be zero unless:
 - (a) there is a commitment by a third party to purchase the asset at the end of its useful life; or
 - (b) there is an active market (as defined in Ind AS 113) for the asset and:
 - (i) residual value can be determined by reference to that market; and
 - (ii) it is probable that such a market will exist at the end of the asset's useful life.



- The residual value is reviewed at least at each financial year-end. An estimate of an asset's residual value is based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used.

- A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.
- The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

5.10.3 Amortisation period



Commencement of amortisation

Amortisation commences from the date 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.

Cessation of amortisation

Amortisation ceases at the earlier of:

- the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105; and
- the date that the asset is derecognized.

Amortisation of an intangible asset with a finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105.

Review of amortisation period

The amortisation period for an intangible asset with a finite useful life should be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period should be changed accordingly. Such change is accounted for as a change in accounting estimates in accordance with Ind AS 8.

5.10.4 Amortisation method

The amortisation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method should be used.

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method.

In choosing an appropriate amortisation method, an entity could determine the predominant limiting factor that is inherent in the intangible asset. For example, the contract that sets out the entity's rights over its use of an intangible asset might specify the entity's use of the intangible asset as a predetermined number of years (i.e. time), as a number of units produced or as a fixed total amount of revenue to be generated.

Identification of such a predominant limiting factor could serve as the starting point for the identification of the appropriate basis of amortisation, but another basis may be applied if it more closely reflects the expected pattern of consumption of economic benefits.

The amortisation method for an intangible asset with a finite useful life should be reviewed at least at each financial year-end. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method should be changed to reflect the changed pattern. Such change is accounted for as a change in accounting estimates in accordance with Ind AS 8.

Amortisation method based on revenue

There is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate.

The revenue generated by an activity that includes the use of an intangible asset typically reflects factors that are not directly linked to the consumption of the economic benefits embodied in the intangible asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

This presumption can be overcome only in the limited circumstances:

- (a) in which the intangible asset is expressed as a measure of revenue, as described in paragraph 98C; or
- (b) when it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated.

In the circumstance in which the predominant limiting factor that is inherent in an intangible asset is the achievement of a revenue threshold, the revenue to be generated can be an appropriate basis for amortisation. For example, an entity could acquire a concession to explore and extract gold from a gold mine. The expiry of the contract might be based on a fixed amount of total revenue to be generated from the extraction (for example, a contract may allow the extraction of gold from the mine until total cumulative revenue from the sale of gold reaches ₹ 2 billion) and not be based on time or on the amount of gold extracted.

In another example, the right to operate a toll road could be based on a fixed total amount of revenue to be generated from cumulative tolls charged (for example, a contract could allow operation of the toll road until the cumulative amount of tolls generated from operating the road reaches ₹ 100 lakh). In the case in which revenue has been established as the predominant limiting factor in the contract for the use of the intangible asset, the revenue that is to be generated might be an appropriate basis for amortising the intangible asset, provided that the contract specifies a fixed total amount of revenue to be generated on which amortisation is to be determined.

Example 3 - An acquired customer list

A direct-mail marketing company acquires a customer list and expects that it will be able to derive benefit from the information on the list for at least one year, but no more than three years.

The customer list would be amortised over management's best estimate of its useful life, say 18 months. Although the direct-mail marketing company may intend to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date it was acquired. The customer list also would be reviewed for impairment in accordance with Ind AS 36, *Impairment of Assets*, by assessing at the end of each reporting period whether there is any indication that the customer list may be impaired.

Example 4 - An acquired patent that expires in 15 years

The product protected by the patented technology is expected to be a source of net cash inflows for at least 15 years. The entity has a commitment from a third party to purchase that patent in five years for 60 per cent of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in five years.

The patent would be amortised over its five-year useful life to the entity, with a residual value equal to the present value of 60 per cent of the patent's fair value at the date it was acquired. It may be noted that the estimated useful life has to be considered with reference to the entity only though the total life of the patent is much higher i.e., 15 years. The patent would also be reviewed for impairment in accordance with Ind AS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example 5 - An acquired copyright that has a remaining legal life of 50 years

An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.

It needs to be noted that although the remaining legal life of the patent is 50 years, however the useful life from the entity's perspective is only 30 years. The copyright would be amortised over its 30-years estimated useful life. The copyright also would be reviewed for impairment in accordance with Ind AS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example 6 - An acquired broadcasting licence that expires in five years

The broadcasting licence is renewable every 10 years if the entity provides at least an average level of service to its customers and complies with the relevant legislative requirements. The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition. The acquiring entity intends to renew the licence indefinitely and evidence supports its ability to do so. Historically, there has been no compelling challenge to the licence renewal. The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future. Therefore, the licence is expected to contribute to the entity's net cash inflows indefinitely.

The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity's net cash inflows indefinitely. Therefore, the licence would not be amortised until its useful life is determined to be finite. The licence would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 7 - The broadcasting licence in Example 6

The licensing authority subsequently decides that it will no longer renew broadcasting licences, but rather will auction the licences. At the time the licensing authority's decision is made, the entity's broadcasting licence has three years until it expires. The entity expects that the licence will continue to contribute to net cash inflows until the licence expires.

Because the broadcasting licence can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired licence would be amortised over its remaining three-year useful life and immediately tested for impairment in accordance with Ind AS 36.

Example 8 - An acquired airline route authority between two European cities that expires in three years

The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals are routinely granted at a minimal cost and historically have been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service indefinitely between the two cities from its hub airports and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.

Since the facts and circumstances support the acquiring entity's ability to continue providing air service indefinitely between the two cities, the intangible asset related to the route authority is treated as having an indefinite useful life. Therefore, the route authority would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 9 An acquired trademark used to identify and distinguish a leading consumer product that has been a market-share leader for the past eight years

The trademark has a remaining legal life of five years but is renewable every 10 years at little cost. The acquiring entity intends to renew the trademark continuously and evidence supports its ability to do so. An analysis of (1) product life cycle studies, (2) market, competitive and environmental trends, and (3) brand extension opportunities provide evidence that the trademarked product will generate net cash inflows for the acquiring entity for an indefinite period.

The trademark would be treated as having an indefinite useful life because it is expected to contribute to net cash inflows indefinitely. Though the remaining legal life is five years, the possibility that it can be renewed every ten years and the entity's intention to renew the same leads to the conclusion that the trademark has an indefinite useful life. Therefore, the trademark would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 10- A trademark acquired 10 years ago that distinguishes a leading consumer product

The trademark was regarded as having an indefinite useful life when it was acquired because the trademarked product was expected to generate net cash inflows indefinitely. However, unexpected competition has recently entered the market and will reduce future sales of the product. Management estimates that net cash inflows generated by the product will be 20 per cent less for the foreseeable future. However, management expects that the product will continue to generate net cash inflows indefinitely at those reduced amounts.

As a result of the projected decrease in future net cash inflows, the entity determines that the estimated recoverable amount of the trademark is less than its carrying amount, and an

impairment loss is recognized. Since it is still regarded as having an indefinite useful life, the trademark would continue not to be amortised but would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example 11 - Trademark for a line of products that was acquired several years ago in a business combination

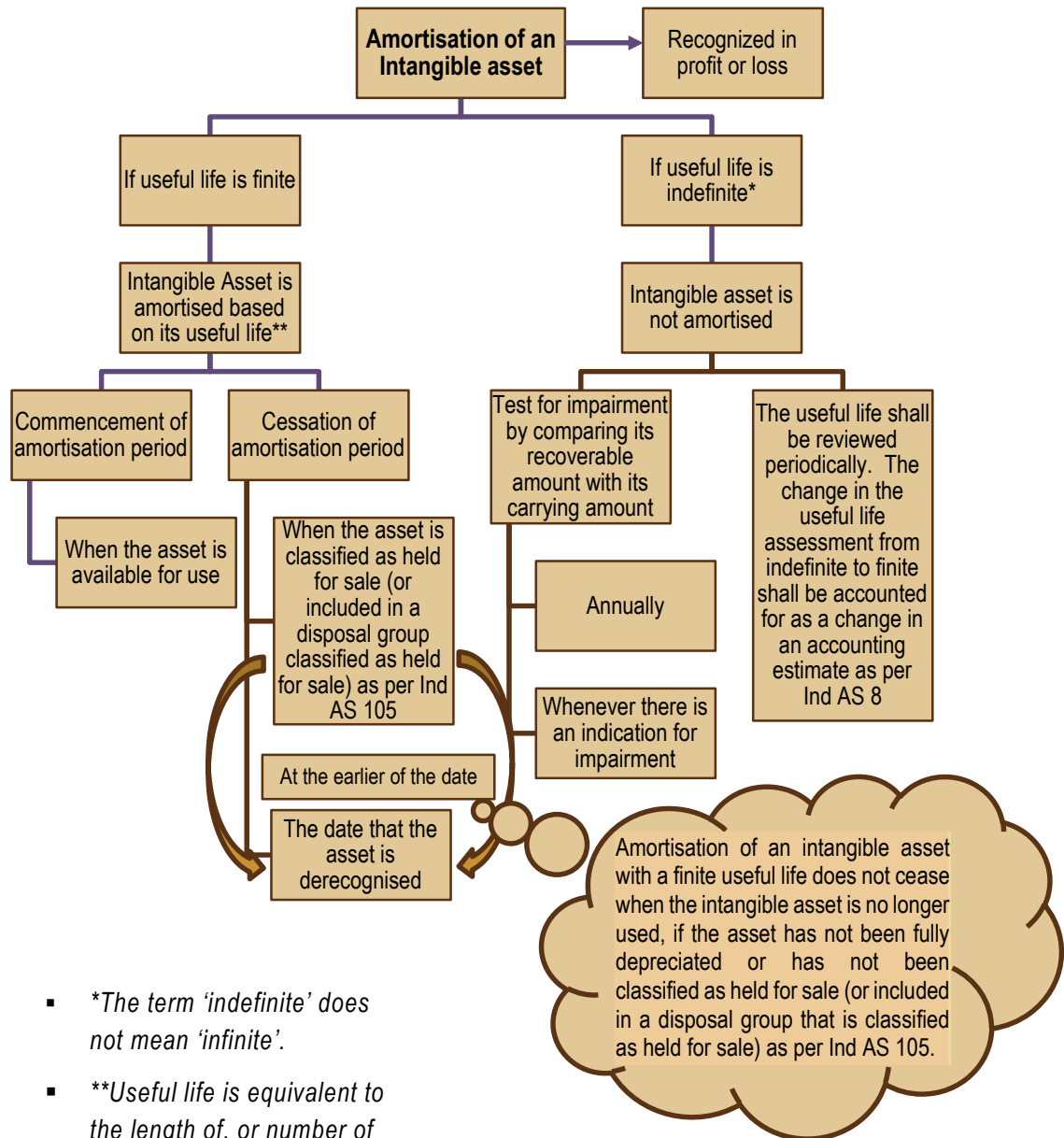
At the time of the business combination the acquiree had been producing the line of products for 35 years with many new models developed under the trademark. At the acquisition date the acquirer expected to continue producing the line, and an analysis of various economic factors indicated there was no limit to the period the trademark would contribute to net cash inflows. Consequently, the trademark was not amortised by the acquirer. However, management has recently decided that production of the product line will be discontinued over the next four years.

Since the useful life of the acquired trademark is no longer regarded as indefinite, the carrying amount of the trademark would be tested for impairment in accordance with Ind AS 36 and amortised over its remaining four-year useful life.



5.11 INTANGIBLE ASSETS WITH INDEFINITE USEFUL LIVES

- An intangible asset with an indefinite useful life should not be amortised.
- In accordance with Ind AS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount
 - (a) annually; and
 - (b) whenever there is an indication that the intangible asset may be impaired.
- The useful life of an intangible asset that is not being amortised should be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite is accounted for as a change in an accounting estimate in accordance with Ind AS 8.
- In accordance with Ind AS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment by comparing its recoverable amount, determined in accordance with Ind AS 36, with its carrying amount, and recognizing any excess of the carrying amount over the recoverable amount as an impairment loss.



- **The term 'indefinite' does not mean 'infinite'.*
- ***Useful life is equivalent to the length of, or number of production or similar units*



5.12 IMPAIRMENT

- To determine whether an intangible asset is impaired, an entity applies Ind AS 36. That Standard explains when and how an entity reviews the carrying amount of its assets, how it

determines the recoverable amount of an asset and when it recognizes or reverses an impairment loss.

- For an intangible asset with indefinite useful lives, an impairment review is required at least annually.

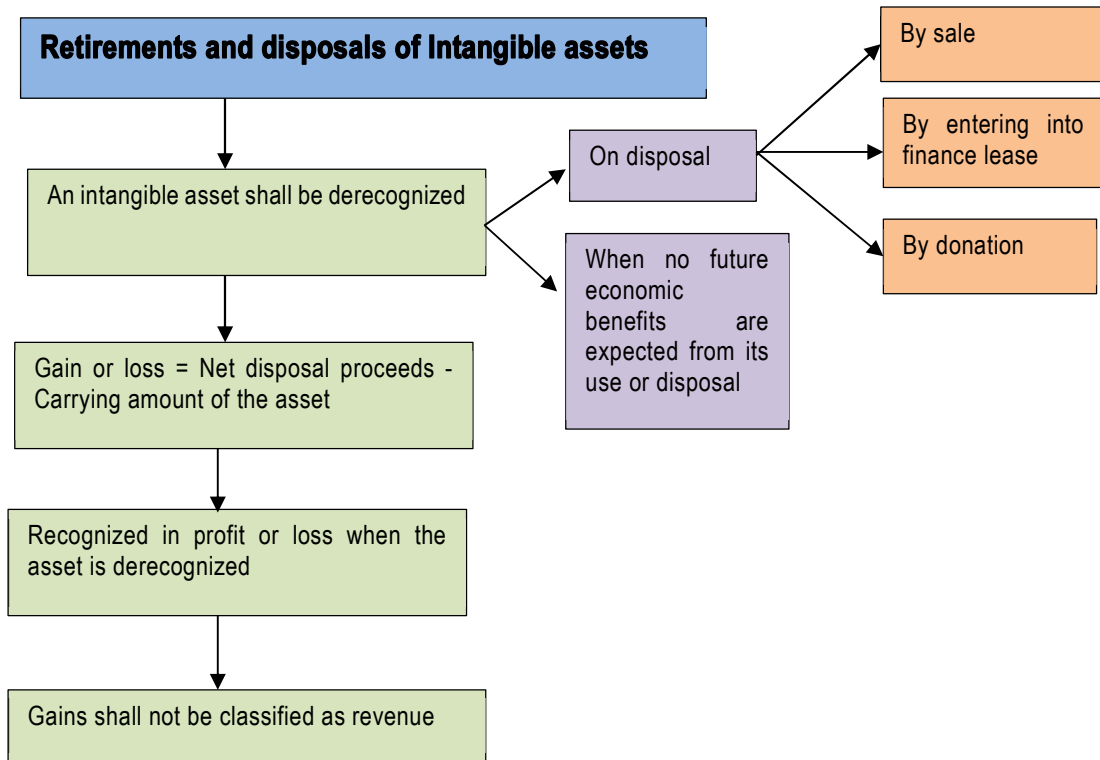


5.13 RETIREMENTS AND DISPOSALS

- An intangible asset should be derecognized:
 - (a) on disposal; or
 - (b) when no future economic benefits are expected from its use or disposal.

The disposal of an intangible asset may occur in a variety of ways (e.g. by sale, by entering into a finance lease, or by donation).

- The gain or loss arising from the derecognition of an intangible asset should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It is to be recognized in profit or loss when the asset is derecognized (unless Ind AS 116 requires otherwise on a sale and leaseback). Gains should not be classified as revenue.
- If in accordance with the recognition principle an entity recognizes in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognizes the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.
- The date of disposal of an intangible asset is the date that the recipient obtains control of that asset in accordance with the requirements for determining when a performance obligation is satisfied as per Ind AS 115. Ind AS 116 applies to disposal by a sale and leaseback.
- In the case of a reacquired right in a business combination, if the right is subsequently reissued (sold) to a third party, the related carrying amount, if any, should be used in determining the gain or loss on reissue.
- The amount of consideration to be included in the gain or loss arising from the derecognition of an intangible asset is determined in accordance with the requirements for determining the transaction price (as per Ind AS 115). Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.



5.14 DISCLOSURE

1) Disclosure – general

An entity should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;
- the amortisation methods used for intangible assets with finite useful lives;
- the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;
- the line item(s) of the statement of profit and loss in which any amortisation of intangible assets is included; and
- a reconciliation of the carrying amount at the beginning and end of the period showing:
 - additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;

- (ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;
- (iii) increases or decreases during the period resulting from revaluations and from impairment losses recognized or reversed in other comprehensive income;
- (iv) impairment losses recognized in profit or loss during the period;
- (v) impairment losses reversed in profit or loss during the period;
- (vi) any amortisation recognized during the period;
- (vii) net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and
- (viii) other changes in the carrying amount during the period.

2) Intangible assets having an indefinite useful life

For an intangible asset assessed as having an indefinite useful life, financial statement should disclose the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.

3) Intangible assets that are individually material

Financial statement should disclose a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.

4) Intangible assets acquired by way of government grant

For intangible assets acquired by way of a government grant and initially recognized at fair value, the financial statement should disclose:

- a) the fair value initially recognized for these assets;
- b) their carrying amount; and
- c) whether they are measured after recognition under the cost model or the revaluation model.

5) Title restrictions and capital commitments

The financial statement should also disclose:

the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and the amount of contractual commitments for the acquisition of intangible assets.

6) Intangible assets carried at revalued amounts

If intangible assets are accounted for at revalued amounts, an entity should 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 recognized 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.

If necessary, it is acceptable to aggregate the classes of revalued assets into larger classes for disclosure purposes. However, classes are not aggregated if this would result in the combination of a class of intangible assets that includes amounts measured under both the cost and revaluation models.

7) Research and development expenditure

An entity should disclose the aggregate amount of research and development expenditure recognized as an expense during the period.

8) Other information

An entity is encouraged, but not required, to disclose the following information:

- a) a description of any fully amortised intangible asset that is still in use; and
- b) a brief description of significant intangible assets controlled by the entity but not recognized as assets because they did not meet the recognition criteria in this Standard or because they were acquired or generated before this standard was effective.

Illustration 10

X Limited engaged in the business of manufacturing fertilisers entered into a technical collaboration agreement with a foreign company 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 Limited 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.

Advise how X Limited will amortise the technical know-how fees as per Ind AS 38.

Solution

Based on the above data, it may be suitable for X Ltd. to use unit of production method for amortisation of technical 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 in future are 3,70,000 MT (i.e. 65,000 + 85,000 + 1,05,000 + 1,15,000).

The amortisation for second year will be 65,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111)

$$\text{ie } 1,56,15,615.$$

Amortisation for remaining years (unless the estimates are again revised):

Year 3 = 85,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) ie. ₹ 2,04,20,420

Year 4 = 1,05,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) ie. ₹ 2,52,25,225

Year 5 = 1,15,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) ie. ₹ 2,76,27,628

Illustration 11

X Ltd. purchased a patent right on 1st April, 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 1st April, 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 1st April, 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**Value as on 31st March, 20X2**

Original cost	₹ 3,00,000
Less: Amortisation (3,00,000 x 1/5)	<u>(₹ 60,000)</u>
Net Value	<u>₹ 2,40,000</u>

Value as on 31st March, 20X3

On 1st April, 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 31st March, 20X4

As of 1st April, 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.

Amortisation provided for the financial year 20X3-20X4 is ₹ 75,000 (₹ 3,00,000 / 4)

Net value is = ₹ 3,00,000 – ₹ 75,000 = ₹ 2,25,000.

Similarly, Value as on March 31, 20X5 = ₹ 2,25,000 – ₹ 75,000 = ₹ 1,50,000

Value as on March 31, 20X6 = ₹ 1,50,000 – ₹ 75,000 = ₹ 75,000

Value as on March 31, 20X7 = ₹ 75,000 – ₹ 75,000 = Nil

Illustration 12

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, X Pharmacy Ltd. acquired a brand with a fair value 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 31st March, 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 31st March, 20X2. The technological feasibility has not yet been established.*

Advise how the above transactions will be accounted for in the books of account of X Pharmaceutical Ltd.

Solution

X Pharmaceutical Ltd. is advised as under:

- 1. It should recognize 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 recognize 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 31st March, 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.



5.15 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Reliance Industries Limited' for the financial year 2021-2022 with respect to Intangible assets and Intangible assets under development and accounting policy with respect to Intangible assets.

Balance Sheet

As at 31st March, 2022

(₹ in crore)			
	Notes	As at 31st March 2022	As at 31st March 2021
Assets			
Non-Current Assets			
Property, Plant and Equipment	1	2,23,824	2,92,092
Capital Work-in-Progress	1	19,267	20,765
Intangible Assets	1	15,802	14,741
Intangible Assets Under Development	1	15,395	12,070
Financial Assets			
Investments	2	3,30,493	2,52,620
Loans	3	41,951	64,073
Other Financial Assets	4	2,247	1,625
Other Non-Current Assets	5	7,297	4,968
Total Non-Current Assets		6,56,276	6,62,954

1. Property, Plant & Equipment, Capital Work-in-Progress, Intangible Assets and Intangible Assets under Development

(* in crore)

Description	Gross Block			Depreciation / Amortisation and Depletion				Net Block		
	As at 01-04-2021	Additions / Adjustments	Deductions / Adjustments ^A	As at 31-03-2022	As at 01-04-2021	For the Year [#]	Deductions / Adjustments ^A	As at 31-03-2022	As at 31-03-2022	As at 31-03-2021
Property, Plant and Equipment										
Own Assets:										
Land	38,968	38	45	38,961	-	-	-	-	38,961	38,968
Buildings	19,600	1,198	4	20,794	7,756	751	1	8,506	12,288	11,844
Plant & Machinery	3,26,321	8,546	72,630	2,62,237	1,13,275	5,164	3,413	1,15,026	1,47,211	2,13,046
Electrical Installations	10,186	439	3,102	7,523	4,336	695	624	4,407	3,116	5,850
Equipments [†]	5,246	907	103	6,050	3,358	580	40	3,898	2,152	1,888
Furniture & Fixtures	623	42	6	659	446	33	3	476	183	177
Vehicles	693	102	17	778	490	78	13	555	223	203
Ships	505	3	-	508	345	16	-	361	147	160
Aircrafts & Helicopters	46	-	-	46	40	1	-	41	5	6
Sub-Total	4,02,188	11,275	75,907	3,37,556	1,30,046	7,318	4,094	1,33,270	2,04,286	2,72,142
Right-of-Use Assets:										
Land	17,693	1	5	17,689	1,704	170	- *	1,874	15,815	15,989
Plant & Machinery	4,630	-	-	4,630	669	238	-	907	3,723	3,961
Ships	10	-	-	10	10	-	-	10	-	-
Sub-Total	22,333	1	5	22,329	2,383	408	-	2,791	19,538	19,950
Total (A)	4,24,521	11,276	75,912	3,59,885	1,32,429	7,726	4,094	1,36,061	2,23,824	2,92,092
Intangible Assets **										
Technical Knowhow Fees	5,119	34	477	4,676	3,324	139	27	3,436	1,240	1,795
Software	976	39	1	1,014	869	45	- *	914	100	107
Development Rights	43,014	3,868	-	46,882	30,208	2,278	-	32,486	14,396	12,806
Others	1,084	192	-	1,276	1,051	159	-	1,210	66	33
Total (B)	50,193	4,133	478	53,848	35,452	2,621	27	38,046	15,802	14,741
Total (A + B)	4,74,714	15,409	76,390	4,13,733	1,67,881	10,347	4,121	1,74,107	2,39,626	3,06,833
Previous Year	4,68,723	11,053	5,062	4,74,714	1,62,245	9,270	3,634	1,67,881	3,06,833	3,06,478
Capital Work-in-Progress									19,267	20,765
Intangible Assets under Development									15,395	12,070

ACCOUNTING POLICY

Intangible assets:

Intangible Assets are stated at cost of acquisition net of recoverable taxes, trade discount and rebates less accumulated amortisation/depletion and impairment losses, if any. Such cost includes purchase price, borrowing costs, and any cost directly attributable to bringing the asset to its working condition for the intended use, net charges on foreign exchange contracts and adjustments arising from exchange rate variations attributable to the Intangible Assets.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the entity and the cost can be measured reliably.

Other Indirect Expenses incurred relating to project, net of income earned during the project development stage prior to its intended use, are considered as pre-operative expenses and disclosed under Intangible Assets Under Development.

Gains or losses arising from derecognition of an Intangible Asset are measured as the difference between the net disposal proceeds and the carrying amount of the asset and are recognized in the Statement of Profit and Loss when the asset is derecognized. The Company's intangible assets comprises assets with finite useful life which are amortised on a straight-line basis over the period of their expected useful life.

A summary of amortisation/depletion policies applied to the Company's Intangible Assets to the extent of depreciable amount is as follows:

- *Technical Know-How - Over the useful life of the underlying assets ranging from 5 years to 35 years.*
- *Computer Software - Over a period of 5 years.*
- *Development Rights - Depleted using the unit of production method. The cost of producing wells along with its related facilities including decommissioning costs are depleted in proportion of oil and gas production achieved vis-à-vis Proved Developed Reserves. The cost for common facilities including its decommissioning costs are depleted using Proved Reserves*
- *Others - In case of Jetty, the aggregate amount amortised to date is not less than the aggregate rebate availed by the Company*

The Company assesses at each reporting date as to whether there is any indication that any Intangible Assets may be impaired. If any such indication exists, the recoverable

amount of an intangible asset is estimated to determine the extent of impairment, if any.

An impairment loss is recognized in the Statement of Profit and Loss to the extent, asset's carrying amount exceeds its recoverable amount. The recoverable amount is higher of an asset's fair value less cost of disposal and value in use. Value in use is based on the estimated future cash flows, discounted to their present value using pre-tax discount rate that reflects current market assessments of the time value of money and risk specific to the assets

The impairment loss recognized in prior accounting period is reversed if there has been a change in the estimate of recoverable amount.

(Source: Annual Report 2021-2022 - 'Reliance Industries Limited')



5.16 SIGNIFICANT DIFFERENCES IN IND AS 38 VIS-À-VIS AS 26

S. No.	Particular	Ind AS 38	AS 26
1.	Exclusions	Ind AS 38 does not include any such exclusion specifically as these are covered by other accounting standards. Ind AS 38 contains a scope exclusion with regard to the amortisation method for intangible assets arising from service concession arrangements in respect of toll roads recognized in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP	Paragraph 5 of AS 26, does not apply to accounting issues of specialised nature that arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares.
2.	Definition of intangible assets	In Ind AS 38, the requirement for the asset to be held for use in the production or supply of goods or services, for rental to others, or for	AS 26 defines an intangible asset as an identifiable non-monetary asset without physical substance held for use in the production or

		administrative purposes has been removed from the definition of an intangible asset. (Para 8 of Ind AS 38)	supply of goods or services, for rental to others, or for administrative purposes
3.	Identifiability	Ind AS 38 requires an asset to be treated as meeting the identifiability criterion in the definition of an intangible asset when it is separable (ie it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so), or when it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.	AS 26 does not define 'identifiability', but states that an intangible asset could be distinguished clearly from goodwill if the asset was separable, but that separability was not a necessary condition for identifiability.
4.	Separately acquired intangible assets	As per Ind AS 38, in the case of separately acquired intangibles, the criterion of probable inflow of expected future economic benefits is always considered satisfied, even if there is uncertainty about the timing or the amount of the inflow.	There is no such provision in AS 26.
5.	Revenue based amortisation method	In Ind AS 38 there is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate. Ind AS 38 allows use of revenue-	AS 26 does not specifically deal with revenue-based amortisation method.

		based method of amortisation of intangible asset, in a limited way.	
6.	Payment deferred beyond normal credit terms	Under Ind AS 38, if payment for an intangible asset is deferred beyond normal credit terms, the difference between this amount and the total payments is recognized as interest expense over the period of credit unless it is capitalised as per Ind AS 23.	There is no such provision in AS 26
7.	Intangible assets acquired in business combination	Ind AS 38 deals in detail in respect of intangible assets acquired in a business combination.	AS 26 refers only to intangible assets acquired in an amalgamation in the nature of purchase and does not refer to business combinations as a whole.
8.	Subsequent expenditure on in process research and development project	Ind AS 38 gives guidance for the treatment of such expenditure. (Paragraphs 42 and 43 of Ind AS 38)	AS 26 is silent regarding the treatment of subsequent expenditure on an in-process research and development project acquired in a business combination
9.	Intangible assets acquired free of charge or for a nominal consideration by way of government grant	As per Ind AS 38, when intangible assets are acquired free of charge or for nominal consideration by way of government grant, an entity should, in accordance with Ind AS 20, record both the grant and the intangible asset at fair value. An alternative course that is sometimes followed is to record both asset and grant at a nominal amount. (Paragraph 44 of Ind AS 38)	As per AS 26, intangible assets acquired free of charge or for nominal consideration by way of government grant is recognized at nominal value or at acquisition cost, as appropriate plus any expenditure that is attributable to making the asset ready for intended use. (Paragraph 33 of AS 26).
10.	Useful life of an intangible asset	The rebuttable presumption is not there in Ind AS 38. Ind AS 38 recognizes that the useful life of an	AS 26 is based on the assumption that the useful life of an intangible asset is always finite, and includes

		intangible asset can even be indefinite subject to fulfillment of certain conditions, in which case it should not be amortised but should be tested for impairment.	a rebuttable presumption that the useful life cannot exceed ten years from the date the asset is available for use
11.	Guidance on certain issues	In Ind AS 38, guidance is available on cessation of capitalisation of expenditure (Paragraph 30 of Ind AS 38), de-recognition of a part of an intangible asset (Paragraph 115 of Ind AS 38) and useful life of a reacquired right in a business combination (Paragraph 94 of Ind AS 38).	There is no such guidance in AS 26 on these aspects.
12.	Valuation model as accounting policy	Ind AS 38 permits an entity to choose either the cost model or the revaluation model as its accounting policy	In AS 26, revaluation model is not permitted.
13.	Intangible assets recognized as an expense	Ind AS 38 provides more guidance on recognition of intangible items recognized as expense. Ind AS 38 clarifies that in respect of prepaid expenses, recognition of an asset would be permitted only upto the point at which the entity has the right to access the goods or upto the receipt of services.	Further, unlike AS 26 mail order catalogues have been specifically identified as a form of advertising and promotional activities which are required to be expensed.
14.	Amortisation lower than under SLM	Ind AS 38 does not contain any such provision.	As per AS 26 (paragraph 73), there will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under straight-line method.
15.	Subsequent increase of	Under Ind AS 38, the residual value is reviewed at least at each	However, AS 26 specifically requires that the residual value is

	residual value for changes in prices or value	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.	not subsequently increased for changes in prices or value.
16.	Intangible assets retired from use and held for sale	Ind AS 38 does not include such intangible assets since they would be covered by Ind AS 105.	Intangible assets retired from use and held for sale are covered by AS 26.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. X Ltd. is engaged in the business of publishing Journals. They acquired 100% 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 assets acquired is ₹ 8,50,00,000. The purchase consideration includes payment for the following as well:
 - (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.

However, the above items (a) and (b) are not forming part of the net assets acquired of ₹ 8,50,00,000.

Determine how the above transactions be accounted for by X Ltd.

2. 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.

Advise whether the franchise rights be treated as an intangible asset under Ind AS 38.

3. 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 recognize an asset in respect of the expected future economic benefits to be derived from the list.

Evaluate whether the customer list be treated as an intangible asset under Ind AS 38.

4. 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 recognize these set of engineers as a human resources asset in the form of an intangible asset.

Advise X Ltd. on the above issue.

5. X Ltd. has acquired a telecom license from Government to operate mobile telephony in two states of India.

Recommend the cost of acquisition to be capitalised as an intangible asset under Ind AS 38.

6. 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. also purchased a 5-year maintenance contract with the vendor company of ₹ 2,00,000.

Identify at what cost the intangible asset will be recognized.

7. X Limited in a business combination, purchased the net assets of Y Limited for ₹ 4,00,000 on 31st March, 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.

Recommend how would X Limited account for the net assets acquired from Y Limited.

8. X Ltd. acquired Y Ltd. on 30th April, 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 and development 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 and development 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.

Determine at what amount the intangible asset be measured under Ind AS 38.

9. 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.

Compute the value of patent right for initial recognition 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.
10. 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.

Advise how the entity should account for the above cost incurred on promoting such show.

11. An entity is developing a new production process. During 20X1-20X2, expenditure incurred was ₹ 1,000, of which ₹ 900 was incurred before 1st March, 20X2 and ₹ 100 was incurred between 1st March, 20X2 and 31st March, 20X2. The entity is able to demonstrate that at 1st March, 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.

Tabulate the accounting treatment of expenditure incurred in 20X1-20X2 and 20X2-20X3 as per relevant Ind AS. Ignore effects of amortisation.

12. X Ltd. is engaged in 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) 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.

On 15th March, 20X1, the development phase was complete, and a cash flow budget was prepared. Net profit for the year was estimated to be equal ₹ 40,00,000.

Interpret how X Ltd. should account for the above-mentioned cost.

13. X Ltd. has started developing a new production process in financial year 20X1-20X2. Total expenditure incurred till 30th September, 20X1, was ₹ 1,00,00,000. The expenditure on the development of the production process meets the recognition criteria on 1st July, 20X1. The records of X Ltd. show that, out of total ₹ 1,00,00,000, ₹ 70,00,000 were incurred during July to September, 20X1. X Ltd. publishes its financial results quarterly.

Determine how X Ltd. should account for the development expenditure.

14. X Ltd. decides to revalue its intangible assets on 1st April, 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.

Analyse how should X Ltd. account for the revalued intangible assets in its books of account.

15. One of the senior engineers at XYZ has been working on a process to improve manufacturing efficiency and, consequently, reduce manufacturing costs. This is a major project and has the full support of XYZ's board of directors. The senior engineer believes that the cost reductions will exceed the project costs within twenty-four months of their implementation. Regulatory testing and health and safety approval was obtained on 1st June 20X5. This removed uncertainties concerning the project, which was finally completed on 20th April 20X6. Costs of ₹ 18,00,000, incurred during the year till 31st March 20X6, have been recognized as an intangible asset. An offer of ₹ 7,80,000 for the new developed technology has been

received by potential buyer but it has been rejected by XYZ. Utkarsh believes that the project will be a major success and has the potential to save the company ₹ 12,00,000 in perpetuity. Director of research at XYZ, Neha, who is a qualified electronic engineer, is seriously concerned about the long-term prospects of the new process and she is of the opinion that competitors would have developed new technology at some time which would require to replace the new process within four years. She estimates that the present value of future cost savings will be ₹ 9,60,000 over this period. After that, she thinks that there is no certainty about its future.

Advise the appropriate accounting treatment for the aforesaid issue for the year ended 31st March, 20X6.

Answers

1. X Ltd. should recognize 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 the same should be expensed. The entity has insufficient control over the expected future economic benefits arising from the team of skilled staff.

Therefore, ₹ 50,00,000 will be separately recognized as an intangible asset, whereas amount paid for obtaining skilled staff does not meet the recognition criteria for being identified as a separate intangible asset. However, since it is acquired as part of a business combination, it forms part of the goodwill recognized at the acquisition date.

The value of goodwill would be ₹ 1,00,00,000 (₹ 1,50,00,000 – ₹ 50,00,000).

2. The franchise rights meets the identification criterion 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 recognize 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.

3. 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 recognize the asset because the cost of generating the customer list internally cannot be distinguished from the cost of developing the business as

a whole. It does not meet the conditions specified to recognize an internally generated intangible asset.

4. 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 recognized as an intangible asset.
5. Cost of acquisition of the telecom license can be capitalised as an intangible asset under the head Licenses, as the cost is ascertainable, and it will lead to future economic benefits for X Ltd.
6. In accordance with Ind AS 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%)	<u>(1,50,000)</u>
	28,50,000
Non-refundable purchase tax	50,000
Customisation cost	<u>7,00,000</u>
Total cost	<u>36,00,000</u>

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.

7. 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:

$$\text{Goodwill} = ₹ 4,00,000 - ₹ (1,50,000 + 70,000 + 30,000 + 1,30,000 - 50,000) = ₹ 70,000.$$

8. X Ltd. should initially recognize the acquired “in house research and development 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 recognized at ₹ 17,00,000 (₹ 10,00,000 + ₹ 7,00,000).

9. 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).

10. 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.

11. At the end of the financial year 20X2, the production process is recognized as an intangible asset at a cost of ₹ 100 (expenditure incurred since the date when the recognition criteria were met, i.e., 1st March, 20X2). ₹ 900 expenditure incurred before 1st March, 20X2 is recognized as an expense because the recognition criteria were not met until 1st March, 20X2. This expenditure does not form part of the cost of the production process recognized in the balance sheet.

At the end of 20X3, the cost of the production process is ₹ 2,100 (₹ 100 expenditure recognized at the end of 20X2 plus ₹ 2,000 expenditure recognized in 20X3). The entity recognizes 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 Ind AS 36 are met.

12. 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 in Profit and Loss since it belongs to research phase.

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 and testing cost of ₹ 2,00,000 will be capitalised.

The cost of software capitalised is = ₹ (7,00,000 + 2,00,000) = ₹ 9,00,000.

13. X Ltd. should recognize the intangible asset at ₹ 70,00,000 and ₹ 30,00,000 which was already recognized as an expense in first quarter should not be capitalised.
14. The intangible assets are revalued to ₹ 1,50,00,000 on an amortised replacement cost basis, which is a 2.5 times increase from its net value. 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.

Alternatively, the net block can be increased by ₹ 90,00,000.

15. Ind AS 38 'Intangible Assets' requires an intangible asset to be recognized if, and only if, certain criteria are met. Regulatory approval on 1st June 20X5 was the last criterion to be met, the other criteria have been met as follows:
- Intention to complete the asset is apparent as it is a major project with full support from board
 - Finance is available as resources are focused on project
 - Costs can be reliably measured
 - Benefits are expected to exceed costs – (in 2 years)

Since the project was completed on 20th April, 20X6, on 31st March, 20X6, the amount of ₹ 15,00,000 (₹ 18,00,000 x 10/12) should be capitalised in the balance sheet of year ending 20X5-20X6 representing expenditure since 1st June 20X5.

The expenditure incurred prior to 1st June 20X5 which is ₹ 3,00,000 (2/12 x ₹ 18,00,000) should be recognized as an expense, retrospective recognition of expense as an asset is not allowed.

Ind AS 36 'Impairment of assets' requires an intangible asset not yet available for use to be tested for impairment annually.

Cash flow of ₹ 12,00,000 in perpetuity would clearly have a present value in excess of ₹ 12,00,000 and hence there would be no impairment. However, the research director is technically qualified, so impairment tests should be based on her estimate of a four-year remaining life and so present value of the future cost savings of ₹ 9,60,000 should be considered in that case.

₹ 9,60,000 is greater than the offer received (fair value less costs to sell) of ₹ 7,80,000 and so ₹ 9,60,000 should be used as the recoverable amount.

So, the carrying amount should be consequently reduced to ₹ 9,60,000.

Calculation of Impairment loss of intangible asset under development:

Particulars	₹
Carrying amount	15,00,000
Less: Recoverable amount	<u>9,60,000</u>
Impairment loss	<u>5,40,000</u>

Impairment loss of ₹ 5,40,000 is to be recognised in the profit and loss for the year 20X5-20X6.

Necessary adjusting entry to correct books of account will be:

		₹	₹
Operating expenses- Development expenditure	Dr.	3,00,000	
Operating expenses–Impairment loss	Dr.	5,40,000	
To Intangible asset under development			8,40,000

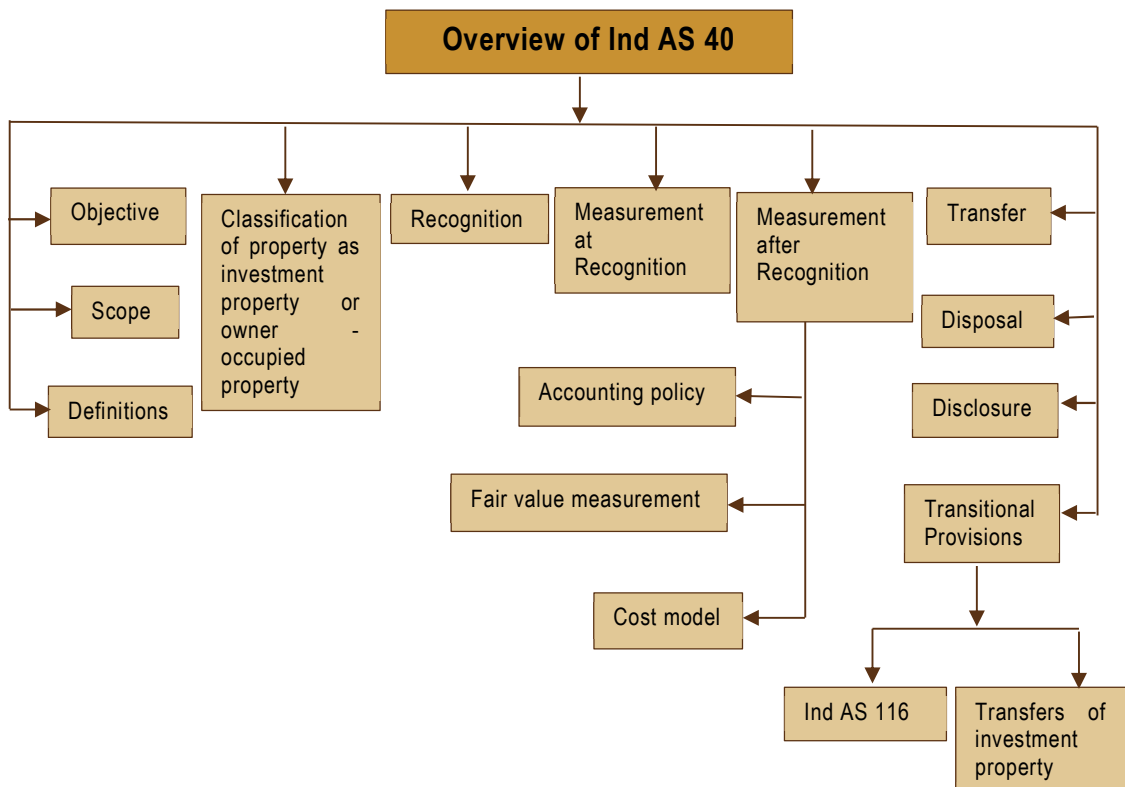
UNIT 6 : INDIAN ACCOUNTING STANDARD 40 : INVESTMENT PROPERTY

LEARNING OUTCOMES

After studying this unit, you will be able to

- ☐ List the objective and scope of this standard.
- ☐ Define the terms like investment property and owner-occupied property.
- ☐ Identify and recognize an investment property.
- ☐ Measure the investment property in accordance with the standard.
- ☐ Comply with disclosure requirements.

UNIT OVERVIEW





6.1 OBJECTIVE

The objective of this standard is to prescribe the accounting treatment for property (land and/or buildings) held to earn rentals or for capital appreciation (or both) and related disclosure requirements. Ind AS 40 prescribes the cost model for accounting for investment property.



6.2 SCOPE

- 1) Ind AS 40 should be applied in the recognition, measurement and disclosure of investment property.
- 2) This Standard does not apply to:
 - a) biological assets related to agricultural activity (see Ind AS 41 '*Agriculture*' and Ind AS 16 '*Property, Plant and Equipment*'); and
 - b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.



6.3 RELEVANT DEFINITIONS

The following are the key Investment Property-related definitions:

- 1) **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.

Property mentioned in (a) above would be covered under Ind AS 16 '*Property, Plant and Equipment*' and property specified in (b) above would be dealt with under Ind AS 2 '*Inventories*'.

- 2) **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.

Ind AS 16 '*Property, Plant and Equipment*' applies to owner-occupied property and Ind AS 116 '*Leases*' applies to owner-occupied property held by a lessee as a right-of-use asset.

- 3) **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. (See Ind AS 113 '*Fair Value Measurement*').

- 4) **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 recognized in accordance with the specific requirements of other Ind AS, e.g. Ind AS 102, *Share Based Payment*.
- 5) **Carrying amount** is the amount at which an asset is recognized in the balance sheet.



6.4 CLASSIFICATION OF PROPERTY AS INVESTMENT PROPERTY OR OWNER-OCCUPIED PROPERTY

1) Nature of Investment property

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independent of the other assets held by an entity. This distinguishes investment property from owner-occupied property. Accordingly, investment properties could represent a cash generating unit since they generate cash inflows that are largely independent of the cash inflows from other assets or group of assets, thus meeting the definition of cash generating unit laid down in Ind AS 36, '*Impairment of Assets*'.

The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. Ind AS 16 '*Property, Plant and Equipment*' applies to owner-occupied property and Ind AS 116 applies to owner-occupied property held by a lessee as a right-of-use asset.

2) Examples of investment property

The following are examples of investment property:

- a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
- b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)
- c) 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.
- d) a building that is vacant but is held to be leased out under one or more operating leases.

- e) property that is being constructed or developed for future use as investment property.

3) Examples of items which are not investment property

The following are examples of items that are not investment property and are therefore outside the scope of this Standard:

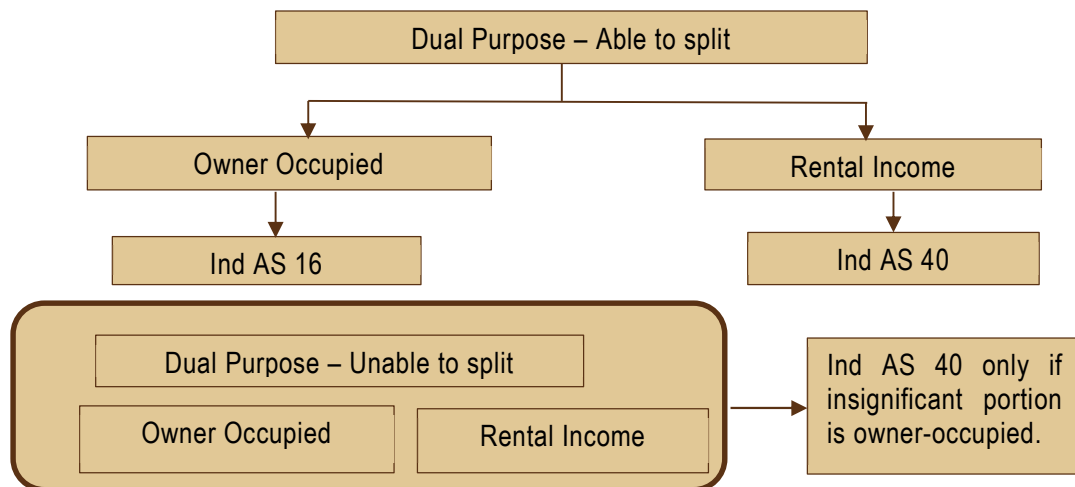
- a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see Ind AS 2, *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.
- b) owner-occupied property (see Ind AS 16 and Ind AS 116), including, (among other things)
 - (i) property held for future use as owner-occupied property,
 - (ii) property held for future development and subsequent use as owner-occupied property,
 - (iii) property occupied by employees (whether or not the employees pay rent at market rates) and
 - (iv) owner-occupied property awaiting disposal.
- c) property leased to another entity under a finance lease.

Not Investment Property

Sale in the ordinary course of business Ind AS 2	Owner - occupied property Ind AS 16	Employee occupied property Ind AS 16

4) Property held for more than one purpose

In circumstances when property is held partly for capital appreciation and/or rentals, and partly for production or supply of goods or services or for administrative purposes, the two parts are accounted for separately if they could be sold, or leased out separately under a finance lease, separately. If they could not be sold (or leased out under a finance lease) separately, the property is accounted for as an investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.



Examples 1 - 3

1. Sun Ltd owns a building having 15 floors of which it uses 5 floors for its office; the remaining 10 floors are leased out to tenants under operating leases. According to law company could sell legal title to the 10 floors while retaining legal title to the other 5 floors.

In the given scenario, the remaining 10 floors should be classified as investment property since they are able to split the title between the floors.

2. Moon Ltd uses 35% of the office floor space of the building as its head office. It leases the remaining 65% to tenants, but it is unable to sell the tenant's space or to enter into finance leases related solely to it.

Therefore, the company should not classify the property as an investment property as the 35% of the floor space used by the company is significant.

3. An entity owns a hotel, which includes a health and fitness centre, housed in a separate building that is part of the premises of the entire hotel. The owner operates the hotel and other facilities on the hotel with the exception of the health and fitness centre, which can be sold or leased out under a finance lease. The health and fitness centre will be leased to an independent operator. The entity has no further involvement in the health and fitness centre. In this scenario, management should classify the hotel and other facilities as property, plant and equipment in accordance with Ind AS 16 and the health and fitness centre as investment property under Ind AS 40.

If the health and fitness centre could not be sold or leased out separately on a finance lease, then because the owner-occupied portion is not insignificant, the whole property would be treated as an owner-occupied property.

5) Ancillary services

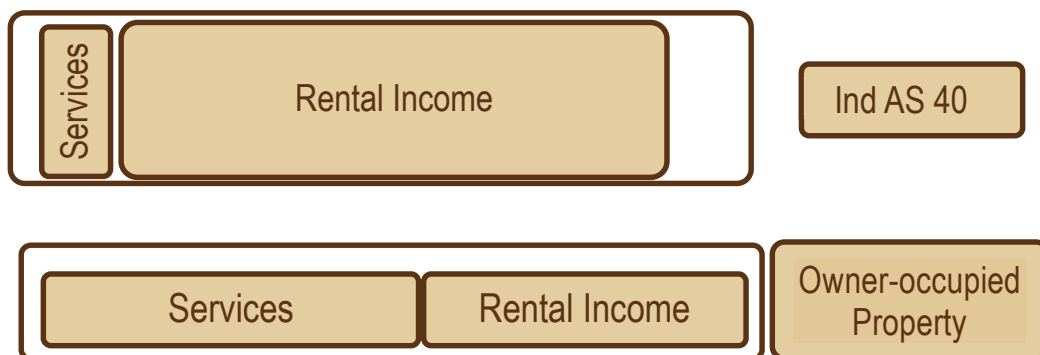
In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

In other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

Example 4

The owner of an office building provides security and maintenance services to the lessees who occupy the building. In such a case, since the services provided are insignificant, the property would be treated as an investment property.

If an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. In such a case, an owner-managed hotel is owner-occupied property, rather than investment property.



6) Difficulty in deciding classification under investment property

It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract. The terms of such contracts vary widely. At one end of the spectrum, the owner's position may, in

substance, be that of a passive investor. At the other end of the spectrum, the owner may simply have outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

Judgement is needed to determine whether a property qualifies as investment property. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and with the related guidance as discussed above. The standard requires an entity to disclose these criteria based upon which it distinguishes investment property from owner-occupied property and from property held from sale in the ordinary course of business when classification is difficult.

Judgement is also required 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 Ind AS 103, *Business Combinations*. Reference should be made to Ind AS 103 to determine whether it is a business combination. The discussion in the above points relates to whether or not property is owner-occupied property or investment property and not to determining whether or not the acquisition of property is a business combination as defined in Ind AS 103. Determining whether a specific transaction meets the definition of a business combination as defined in Ind AS 103 and includes an investment property as defined in this Standard requires the separate application of both Standards.

7) Property leased to other group members – treatment of same asset differently in the individual financial statements and the consolidated financial statements

In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary. The property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group. However, from the perspective of the entity that owns it, the property is investment property if it meets the definition of Investment Property. Therefore, the lessor treats the property as investment property in its individual financial statements.

Tabular summarisation

S. No.	Property	Does it meet definition of investment property	Which Ind AS is Applicable
1.	Owned by a company and leased out under an operating lease	Yes	Ind AS 40

2.	Held as a right-to-use asset and leased out under an operating lease	Yes	Ind AS 40
3.	Held as a right-to-use asset and leased out under finance lease	No	Ind AS 116
4.	Property acquired with a view for development and resale	No	Ind AS 2
5.	Property partly owner occupied and partly leased out under operating lease	Depends	Ind AS 16 Ind AS 40
6.	Land held for currently undetermined use	Yes	Ind AS 40
7.	Property occupied by employees paying rent at less than market rate	No	Ind AS 16
8.	Investment property held for sale	No	Ind AS 105
9.	Existing investment property that is being redeveloped for continued use as investment property	Yes	Ind AS 40



6.5 RECOGNITION

1) General principle

An owned investment property shall be recognized as an asset when, and only when:

- it is probable that the 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.

This general principle is used to consider whether capitalisation is appropriate both in respect of the cost incurred initially to acquire or construct an owned investment property and costs incurred subsequently to add to, replace part of, or service a property.

An investment property held by a lessee as a right-of-use asset shall be recognized in accordance with Ind AS 116.

2) Subsequent costs

Day-to-day servicing costs

Under the recognition principle set out above, an entity does not recognize in the carrying amount of an investment property the costs of the day-to-day servicing of such a property. Rather, these costs are recognized in the profit or loss as incurred. Costs of day-to-day servicing are primarily the cost of labour and consumables and may include the cost of minor parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the property.

Replacement costs

Parts of investment properties may have been acquired through replacement. Under the recognition principle, an entity recognizes costs incurred to replace parts of the original property in the carrying amount of investment property if they meet the recognition criteria. The carrying amount of those parts that are replaced is derecognized in accordance with the derecognition provisions of this Standard.

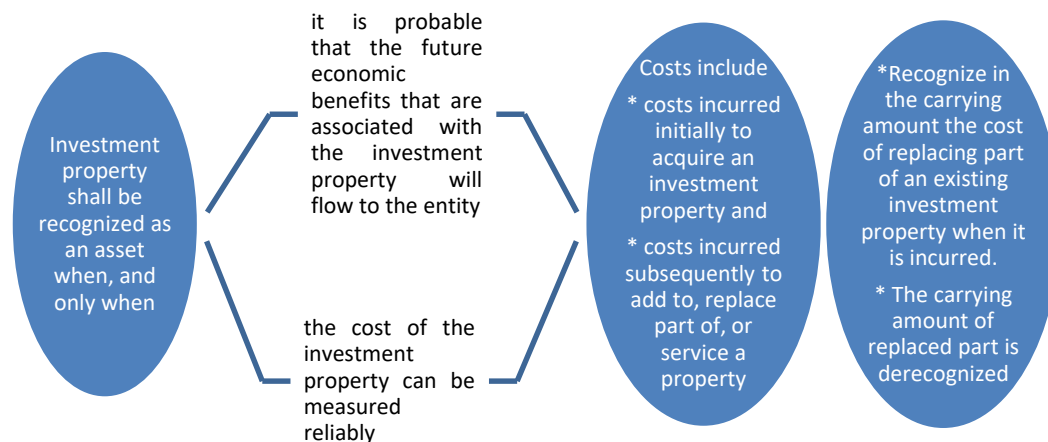


Illustration 1

X Limited owns a building which is used to earn rentals. The building has a carrying amount of ₹ 50,00,000. X Limited recently replaced interior walls of the building and the cost of new interior walls is ₹ 5,00,000. The original walls have a carrying amount of ₹ 1,00,000.

Advise, how X Limited should account for the above costs.

Solution

Under the recognition principle, an entity recognizes in the carrying amount of an investment property the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met and the carrying amount of those parts that are replaced is derecognized.

So, X Limited should add the cost of new walls and remove the carrying amount of old walls.

The new carrying amount of the building = ₹ 50,00,000 + ₹ 5,00,000 – ₹ 1,00,000
= ₹ 54,00,000.



6.6 MEASUREMENT AT RECOGNITION

1) Measurement at recognition - general

An owned investment property should be measured initially at its cost. Transaction costs are included in the initial measurement.

Cost Inclusions

The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure (e.g. professional fees for legal services, property transfer taxes and other transaction costs).

Cost Exclusions

The cost of an investment property is not increased by:

- start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),
- operating losses incurred before the investment property achieves the planned level of occupancy, or
- abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

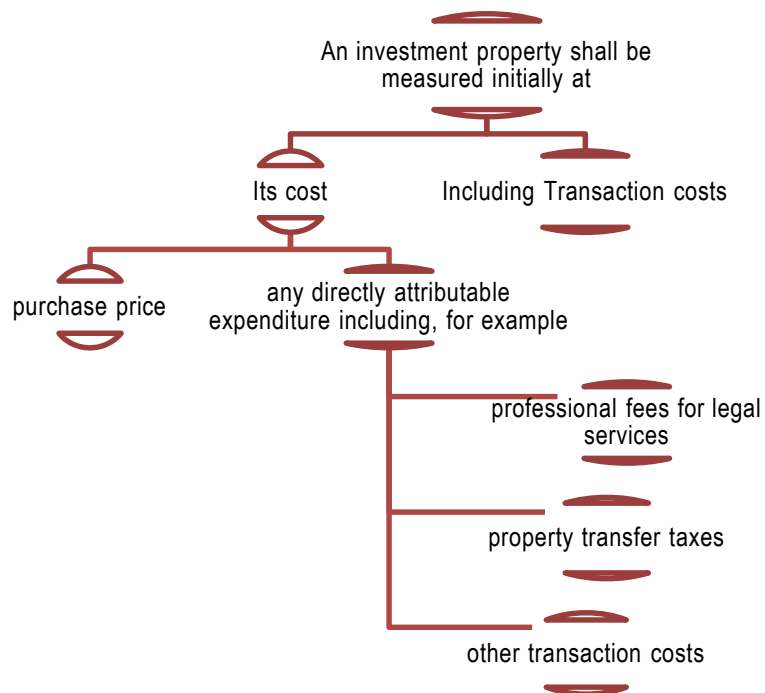


Illustration 2

Netravati Ltd. purchased a commercial office space as an Investment Property, in the Global Trade Centre Commercial Complex, for ₹ 5 crores. However, for purchasing the same, the Company had to obtain membership of the Global Trade Centre Commercial Complex Association by paying ₹ 6,25,000 as a one-time joining fee. Netravati Ltd. wants to write off the one-time joining fees paid as an expense under Membership and Subscription Charges and value the investment property at ₹ 5 crores. Advise.

Comment whether your answer will change if the office space was purchased with the intention of using it as an administrative centre of the company.

Solution**Cost of Investment Property**

As per Ind AS 40, the cost of a purchased investment property comprises its purchase price and any directly attributable expenditure (e.g. professional fees for legal services, property transfer taxes and other transaction costs). Accordingly, on initial recognition, the one-time joining fee of ₹ 6,25,000 should be added to the purchase price. Therefore, the investment property should be measured at ₹ 5,06,25,000 (i.e. cost of the commercial office space + one-time joining fee). Writing off the amount of ₹ 6,25,000 to the P&L is not appropriate.

Use as Administrative Office

If the property is used as an administrative centre, it is not an investment property, but rather an 'owner occupied property'. Hence, Ind AS 16 will be applicable.

Even under Ind AS 16, all direct costs relating to the acquisition of the asset should be added to the purchase price. Hence, cost of the asset under Ind AS 16 would be ₹ 5,06,25,000.

Illustration 3

X Limited purchased a building for ₹ 30,00,000 on 1st May, 20X1 with an intention to earn rentals. The purchase price was funded by a loan, interest on which is payable @ 5%. Property transfer taxes and direct legal costs of ₹ 1,00,000 and ₹ 20,000 respectively were incurred in acquiring the building. 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 purchase taxes)

The building does not qualify the substantial period criteria for redevelopment of property under Ind AS 23.

Compute the cost of the building as per Ind AS 40.

Solution

As per Ind AS 40, the cost of a purchased investment property comprises its purchase price and any directly attributable expenditure (e.g. professional fees for legal services, property transfer taxes and other transaction costs).

Accordingly, cost of the building is arrived at as under:

Particulars	Amount in ₹	Total ₹
Purchase price		30,00,000
Add: Property transfer taxes		1,00,000
Direct legal costs		20,000
Fee for planning permission		2,00,000
Construction costs	7,00,000	
Less: Refundable purchase taxes	<u>40,000</u>	6,60,000
Cost of the building as per Ind AS 40		39,80,000

Note: Since the building does not qualify the substantial period criteria for redevelopment of property under Ind AS 23, borrowing cost of loan fund has not been capitalised.

2) Deferred payments

If payment for an investment property is deferred, its cost is the cash price equivalent. The difference between this amount and the total payments is recognized as interest expense over the period of credit.

Illustration 4

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.

Determine the cost of the building under both the payment methods.

Solution

Using either payment method, the cost will be ₹ 1,00,00,000. If the second payment option is used, ₹ 20,00,000 will be treated as interest expenses over the credit period of 2 years.

3) Investment property acquired through exchange of another asset

One or more investment properties may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an investment property 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.

The acquired asset is measured in this way even if an entity cannot immediately derecognize the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

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. An exchange transaction has commercial substance if:

- a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred, or
- b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange, and
- c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

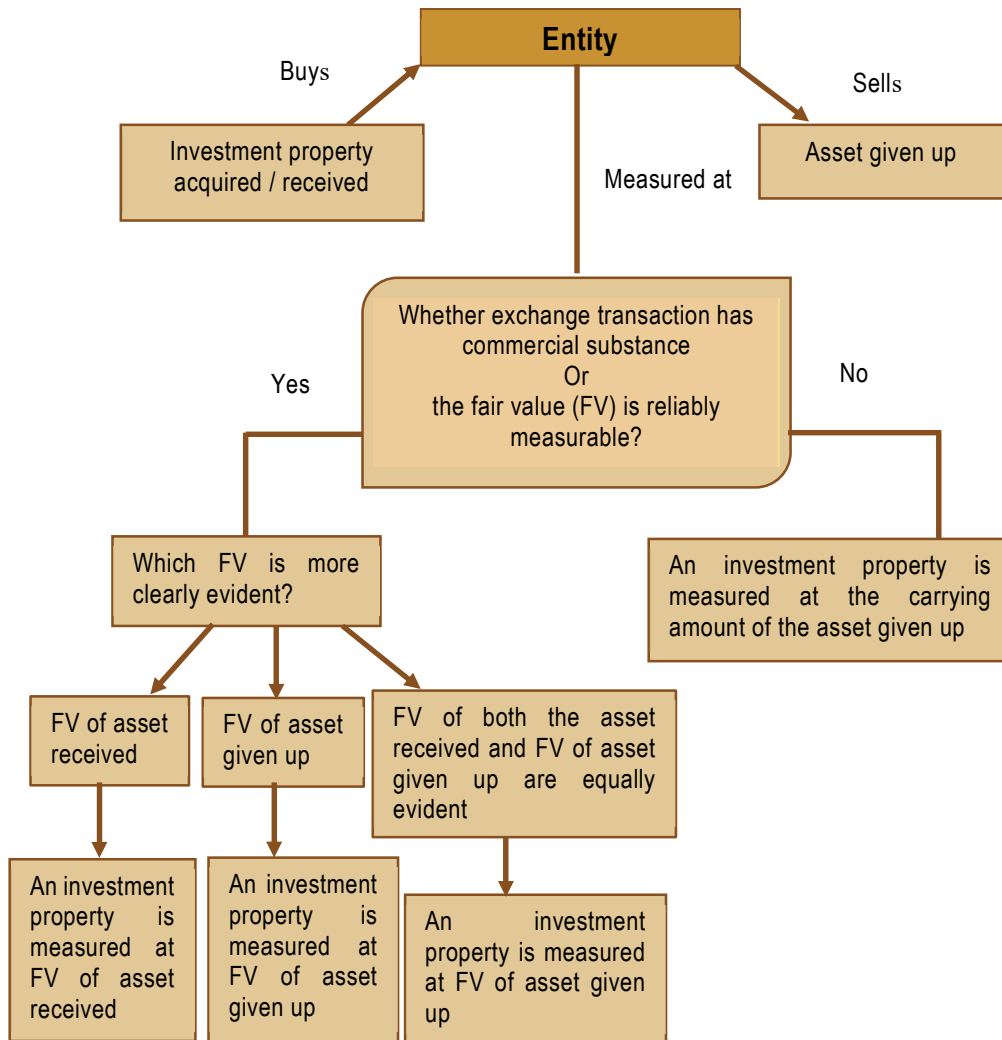
For determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction as mentioned above shall reflect the post-tax cash flows. The result of these analysis may be clear without an entity having to perform detailed calculations.

The fair value of an asset is reliably measurable if:

- a) the variability in the range of reasonable fair value measurements is not significant for that asset or
- b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

If the 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.

An investment property held by a lessee as a right-of-use asset shall be measured initially at its cost in accordance with Ind AS 116.

**Example 5**

Sun Ltd acquired a building in exchange of a warehouse whose fair value is ₹ 5,00,000 and payment of cash is ₹ 2,00,000. The fair value of the building received by the Company is ₹ 8,00,000. The company decided to keep that building for rental purposes.

The building is acquired with the purpose to earn rentals. Hence, it is a case of Investment Property acquired in exchange for a combination of monetary and non-monetary asset.

Therefore, **Journal entry at the time of acquisition is :**

Investment Property (Building) (5,00,000 + 2,00,000)	Dr.	7,00,000	
To Cash			2,00,000
To PPE (Property, Plant and Equipment) i.e. Warehouse			5,00,000

Note: When the fair value of both the asset given up and acquired is mentioned, it is presumed that both the fair values are equally evident. In such a case, the fair value of the asset given up is considered as the cost of the asset purchased.

However, if the fair value of property acquired is more clearly evident, then the fair value of the asset acquired is considered. In such a situation, the Journal Entry at the time of acquisition (taking information given in the above example) would be

Investment Property (Building)	Dr.	8,00,000	
To Cash			2,00,000
To PPE (Warehouse)			5,00,000
To Gain on Sale of PPE			1,00,000



6.7 MEASUREMENT AFTER RECOGNITION

1) Accounting Policy

An entity shall adopt as its accounting policy the cost model for all of its investment property.

Cost Model

After initial recognition, an entity shall measure investment property:

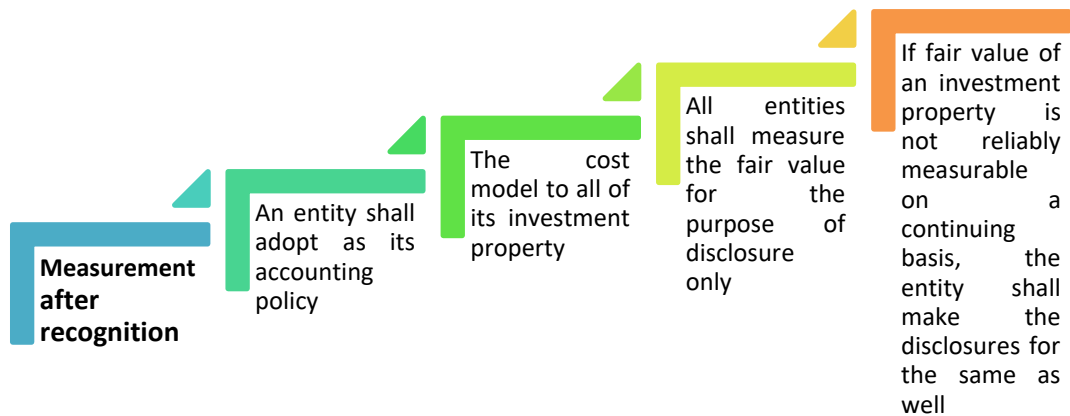
- in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*, if it meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale);
- in accordance with Ind AS 116 if it is held by a lessee as a right-of-use asset and is not held for sale in accordance with Ind AS 105; and
- in accordance with the requirements in Ind AS 16 for cost model in all other cases.

Entities are required to measure the fair value of investment property, for the purpose of disclosure even though they are required to follow the cost model. An entity is encouraged, but not required, to measure the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognized and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

2) Fair Value Measurement

While measuring the fair value of investment property in accordance with Ind AS 113, an entity should ensure that the fair value reflects, among other things, rental income from current leases and other assumptions that market participants would use when pricing investment property under current market conditions.

When a lessee measures fair value of an investment property that is held as a right-of-use asset, it shall measure the right-of-use asset, and not the underlying property at fair value.



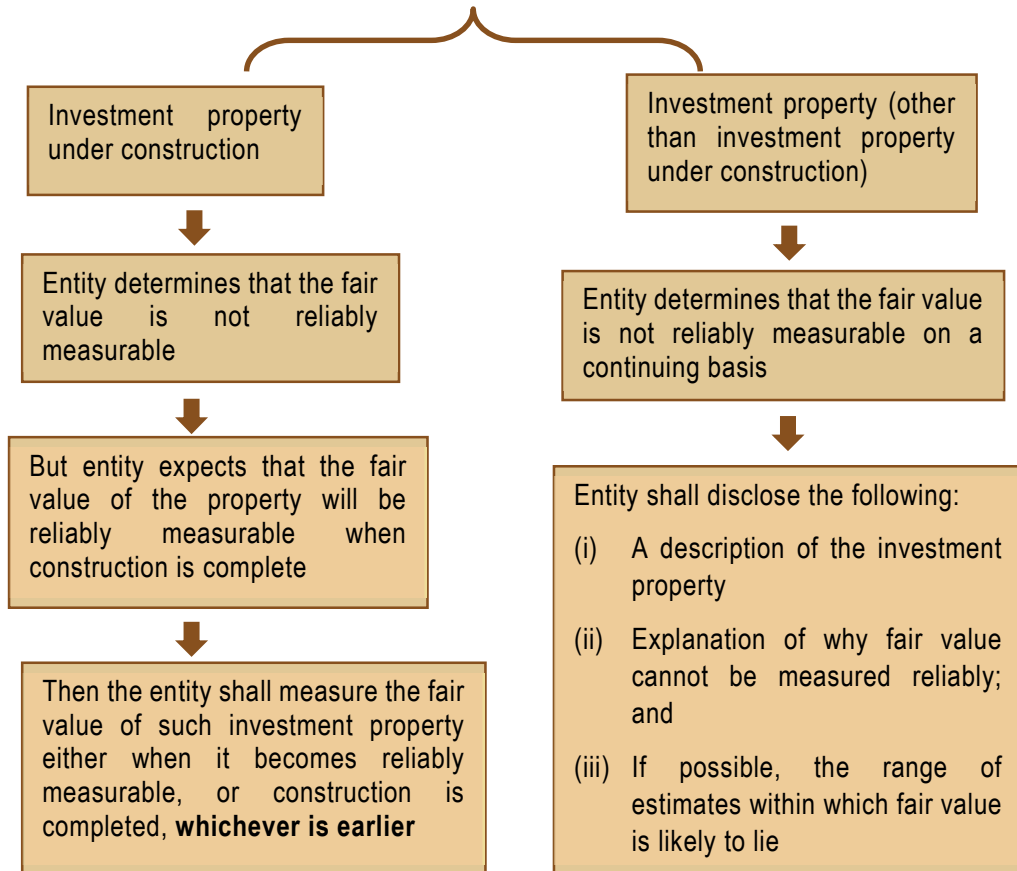
3) Inability to measure fair value reliably

There is a rebuttable presumption that an entity can reliably measure the fair value of an investment property on a continuing basis.

Situations when fair value is not reliably measurable:

- ❖ In **exceptional** cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property after a change in use) that the fair value of the property will **not** be reliably measurable on a continuing basis.
- ❖ The usefulness of a single point measure of fair value which is required gets negated in the above exceptional cases due to – (a) great variability in the range of reasonable fair value measurements, and (b) high difficulty in the assessment the probabilities of the various outcomes.
- ❖ This arises when, and only when
 - (a) the market for comparable properties is inactive (e.g. there are few recent transactions, price quotations are not current or observed transaction prices indicate that the seller was forced to sell) and
 - (b) alternative reliable measurements of fair value (for example, based on discounted cash flow projections) are not available.

Treatment when Fair Value is not reliably measurable



Important Points:

- ❖ Once an entity becomes able to measure reliably the fair value of an investment property under construction for which the fair value was not previously measured, it should measure the fair value of that property.
- ❖ Once construction of that property is complete, it is presumed that fair value can be measured reliably. If this is not the case, the entity should make the disclosures as mentioned under investment property (other than investment property under construction) above.
- ❖ The presumption that the fair value of investment property under construction can be measured reliably can be rebutted only on initial recognition. An entity that has measured the fair value of an item of investment property under construction may not conclude that the fair value of the completed investment property cannot be measured reliably.

- ❖ In the exceptional cases when an entity is compelled, for the reason given above to make the disclosures, it should determine the fair value of all its other investment property, including investment property under construction. In these cases, although an entity may make the disclosures as required for one investment property, the entity should continue to determine the fair value of each of the remaining properties for disclosure as required.
- ❖ If an entity has previously measured the fair value of an investment property, it shall continue to measure the fair value of that property until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available.



6.8 TRANSFERS

- 1) An entity shall transfer a property to, or from, investment property when, and only when, there is a change in use. A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use. Examples of evidence of a change in use include:
 - a) commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;

Ind AS 40
➡
Ind AS 16
 - b) commencement of development with a view to sale, for a transfer from investment property to inventories;

Ind AS 40
➡
Ind AS 2
 - c) end of owner-occupation, for a transfer from owner-occupied property to investment property; or

Ind AS 16
➡
Ind AS 40
 - d) inception of an operating lease to another party, for a transfer from inventories to investment property.

Ind AS 2
➡
Ind AS 40
- 2) When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognized (eliminated from the balance sheet) and does not reclassify it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment.

- 3) Transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

Illustration 5

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.

Determine the value of the building on reclassification as investment property.

Solution

	(₹ Million)
Carrying amount of the building after depreciation of 4 years (10-10/10 x 4)	6
The company has applied cost model under Ind AS 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 Ind AS 16)	---
Building initially recognized as Investment Property (Cost model Ind AS 40)	6

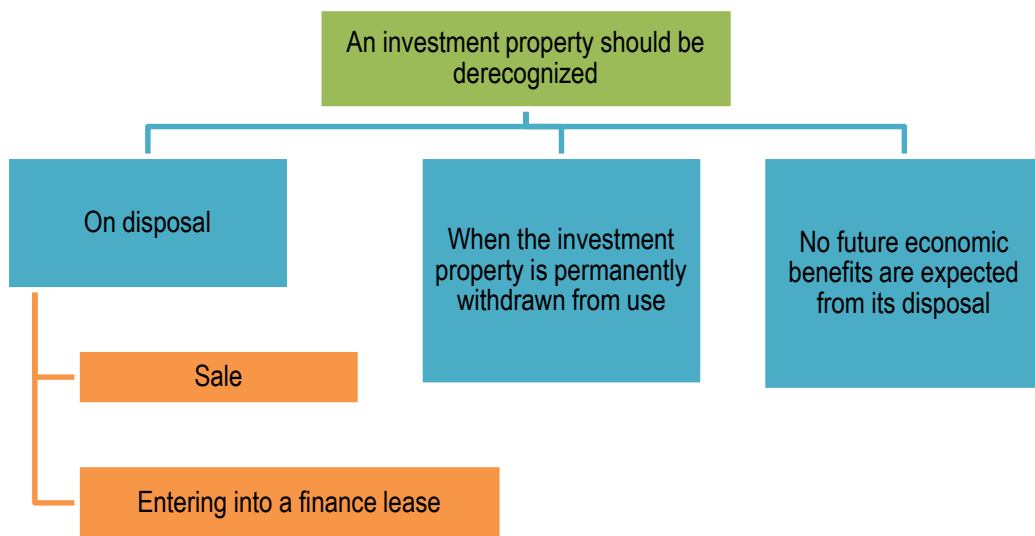


6.9 DISPOSALS

- 1) An investment property should be derecognized (eliminated from the balance sheet)
 - a. on disposal or
 - b. when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.
- 2) The disposal of an investment property may be achieved by:
 - a. sale or
 - b. entering into a finance lease.
- 3) 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 Ind AS 115. Ind AS 116 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

- 4) De-recognition of replaced parts:
 - a. If, in accordance with the recognition principle in paragraph 16, an entity recognizes in the carrying amount of an asset the cost of a replacement for part of an investment property, it derecognizes the carrying amount of the replaced part.
 - b. A replaced part may not be a part that was depreciated separately.
 - c. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.
- 5) Gains or losses arising from the retirement or disposal of investment property should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognized in profit or loss (unless Ind AS 116 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.
- 6) The amount of consideration to be included in the gain or loss arising from the derecognition of an investment property is determined in accordance with the requirements for determining the transaction price as per Ind AS 115. Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.
- 7) An entity applies Ind AS 37 or other Standards, as appropriate, to any liabilities that it retains after disposal of an investment property.
- 8) 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.
- 9) Impairments or losses of investment property, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

Items	Treatment
Impairments of investment property	Recognized in accordance with Ind AS 36
Retirements or disposals of investment property	Recognized in accordance with Ind AS 40
Compensation from third parties for investment property that was impaired, lost or given up	Recognized in profit or loss when it becomes receivable
The cost of assets restored, purchased or constructed as replacements	Determined in accordance with Ind AS 40



S. No.	Particular	Detail
1.	Date of disposal for investment property	- The date is when the recipient obtains control of the investment property for determining when a performance obligation is satisfied. - Ind AS 116 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.
2.	Measurement of consideration receivable on disposal	- The consideration receivable on disposal of an investment property is recognized initially at fair value - If payment for an investment property is deferred, the consideration received is recognized initially at the cash price equivalent. - The difference between the nominal amount of the consideration and the cash price equivalent is recognized as interest revenue
3.	Compensation	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.

Example 6

Sun Ltd, an aeronautics company is having a building which is given on an operating lease. The book value of such building in the books is ₹ 2,00,000.

Case -A

Pluto Ltd. offers to buy the building at ₹ 4,00,000.

Bank	Dr.	4,00,000	
	To Investment Property		2,00,000
	To Gain on disposal		2,00,000

Case-B

Pluto Ltd. offers to take the building on finance lease for 10 years at a lease rental of ₹ 80,000 p.a. The present value of minimum lease payments is ₹ 3,20,000.

Lease Receivable	Dr.	3,20,000	
	To Investment Property		2,00,000
	To Gain on Disposal		1,20,000

**6.10 DISCLOSURE**

The disclosures below apply in addition to those in Ind AS 116. In accordance with Ind AS 116, the owner of an investment property provides lessors' disclosures about leases into which it has entered. A lessee that holds an investment property as a right-of-use asset provides lessees' disclosures as required by Ind AS 116 and lessors' disclosures as required by Ind AS 116 for any operating leases into which it has entered.

An entity should disclose:

- 1) its accounting policy for measurement of investment property.
- 2) when classification is difficult, the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.
- 3) the extent to which the fair value of investment property (as measured for disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognized 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.
- 4) the amounts recognized in profit or loss for:
 - a) rental income from investment property;
 - b) direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period; and
 - c) direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period.
- 5) the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.

- 6) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.
- 7) In addition to the general disclosures required above, an entity is required to disclose:
 - a) the depreciation methods used;
 - b) the useful lives or the depreciation rates used;
 - c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;
- 8) An entity is also required to provide a reconciliation of the carrying amount 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 recognized as 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 Ind AS 105 and other disposals;
 - d) depreciation;
 - e) the amount of impairment losses recognized, and the amount of impairment losses reversed, during the period in accordance with Ind AS 36;
 - f) 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;
 - g) transfers to and from inventories and owner-occupied property; and
 - h) other changes.
- 9) An entity is also required to disclose the fair value of investment property. In the exceptional cases when an entity cannot measure the fair value of the investment property reliably, it should disclose:
 - a) a description of the investment property;
 - b) an explanation of why fair value cannot be measured reliably; and
 - c) if possible, the range of estimates within which fair value is highly likely to lie.



6.11 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'GMR Infrastructure Limited' for the financial year 2021-2022 with respect to 'Investment Property' and its accounting policy thereon.

Consolidated balance sheet as at March 31, 2022

(₹ in crore)

Particulars	Notes	March 31, 2022	March 31, 2021
ASSETS			
Non-current assets			
Property, plant and equipment	3	9,400.91	9,021.22
Capital work-in-progress	3	10,162.63	6,615.65
Investment properties	4	-	534.51

4. Investment property

(₹ in crore)

Particulars	Investment property		Investment property under construction	Total
	Land	Buildings		
Gross carrying amount				
As at April 01, 2020	202.74	39.76	3,252.56	3,495.06
Acquisitions during the year	1.68	-	-	1.68
Expenses capitalised during the year	-	-	291.52	291.52
Disposals (refer note 48(i))	(51.12)	(13.07)	(2,945.48)	(3,009.67)
Asset classified as held for sale (refer note 34(b) and (c))	(64.93)	-	(171.63)	(236.56)
Other adjustments	-	-	(5.00)	(5.00)
As at March 31, 2021	88.37	26.69	421.97	537.03
Acquisitions during the year	1.33	-	-	1.33
Expenses capitalised during the year	0.10	-	35.16	35.26
Disposals	(0.80)	-	-	(0.80)
Transfer on account of composite scheme of arrangement (refer note 34(d))	(89.00)	(26.69)	(457.13)	(572.82)
As at March 31, 2022	-	-	-	-
Accumulated depreciation				
As at April 01, 2020	-	3.78	-	3.78
Charge for the year	-	0.90	-	0.90
Disposals	-	(2.16)	-	(2.16)
As at March 31, 2021	-	2.52	-	2.52
Charge for the year	-	0.34	-	0.34
Transfer on account of composite scheme of arrangement (refer note 34(d))	-	(2.86)	-	(2.86)
As at March 31, 2022	-	-	-	-
Net carrying amount				
As at March 31, 2021	88.37	24.17	421.97	534.51
As at March 31, 2022	-	-	-	-

Notes :

(a) Information regarding income and expenditure of investment property (included in discontinued operations):

(₹ in crore)

Particulars	March 31, 2022	March 31, 2021
Rental income derived from investment property	2.24	4.71
Less: Direct operating expenses (including repairs and maintenance) generating rental income	(0.84)	(2.53)
Less: Direct operating expenses (including repairs and maintenance) that did not generate rental income	(0.01)	(2.52)
Profit/ (loss) arising from investment property before depreciation	1.39	(0.34)
Less: Depreciation for the year	(0.34)	(0.90)
Profit/ (loss) arising from investment property	1.05	(1.24)

- (b) *Investment property under construction including land as at March 31, 2022 represents Nil acres (March 31, 2021 : 1,284 acres) of land held by the Group consisting of Nil acres (March 31, 2021 : 814 acres) of land held by GKSIR for the purpose of SEZ at Krishnagiri and Nil acres (March 31, 2021 : 470 acres) of land held by various other entities.*
- (c) *Investment property of the Group has been pledged for the borrowing taken by the Group. Refer note 18 and note 23.*
- (d) *Certain investment properties are leased to tenants under long-term operating leases with rentals payable monthly. Refer note 40 for details on future minimum lease rentals.*
- (e) *Refer to note 39 (b) for disclosure of other commitments for investment property.*
- (f) *Fair value hierarchy disclosures for investment property have been provided in note 50.*

ACCOUNTING POLICY

Investment property

Investment properties are measured initially at cost, including transaction costs. Subsequent to initial recognition, investment properties are stated at cost less accumulated depreciation and accumulated impairment loss, if any.

The cost includes borrowing costs for long-term construction projects if the recognition criteria are met.

Depreciation is recognized using straight line method so as to write off the cost of the investment property less their residual values over their useful lives specified in Schedule II to the Companies Act, 2013, or in the case of assets where the useful life was determined by technical evaluation, over the useful life so determined. Depreciation method is reviewed at each financial year end to reflect the expected pattern of consumption of the future benefits embodied in the investment property. The estimated useful life and residual values are also reviewed at each financial year end and the effect

of any change in the estimates of useful life/ residual value is accounted on prospective basis. Freehold land and properties under construction are not depreciated.

Investment properties are derecognized either when they have been disposed off or when they are permanently withdrawn from use and no future economic benefit is expected from their disposal.

The difference between the net disposal proceeds and the carrying amount of the asset is recognized in profit or loss in the period of derecognition.

Investment property under construction

Investment property under construction represents expenditure incurred in respect of capital projects and are carried at cost. Cost includes land, related acquisition expenses, development/construction costs, borrowing costs and other direct expenditure.

(Source: Annual Report 2021-2022 - GMR Infrastructure Limited)

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. On 1st April, 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 31st March, 20X2?
2. X Limited has an investment property (building) which is carried in Balance Sheet on 31st March, 20X1 at ₹ 15,00,000. During the year X Limited has stopped letting out the building and used it as its office premise. On 31st March, 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 31st March, 20X1?
3. 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 1st April, 20X1 - Purchase cost of the property ₹ 1,80,00,000.

On 1st April, 20X1 – Non-refundable transfer taxes ₹ 20,00,000 (not included in the purchase cost).

On 2nd April, 20X1- Legal cost related to property acquisition ₹ 5,00,000.

On 6th April, 20X1- Advertisement campaign to attract tenants ₹ 3,00,000.

On 8th April, 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?

4. X Ltd. is engaged in the construction industry and prepares its financial statements up to 31st March each year. On 1st April, 20X1, X Ltd. purchased a large property (consisting of land) for ₹ 2,00,00,000 and immediately began to lease the property to Y Ltd. on an operating lease. Annual rentals were ₹ 20,00,000. On 31st March, 20X5, the fair value of the property was ₹ 2,60,00,000. Under the terms of the lease, Y Ltd. was able to cancel the lease by giving six months' notice in writing to X Ltd. Y Ltd. gave this notice on 31st March, 20X5 and vacated the property on 30th September, 20X5. On 30th September, 20X5, the fair value of the property was ₹ 2,90,00,000. On 1st October, 20X5, X Ltd. immediately began to convert the property into ten separate flats of equal size which X Ltd. intended to sell in the ordinary course of its business. X Ltd. spent a total of ₹ 60,00,000 on this conversion project between 30th September, 20X5 to 31st March, 20X6. The project was incomplete at 31st March, 20X6 and the directors of X Ltd. estimate that they need to spend a further ₹ 40,00,000 to complete the project, after which each flat could be sold for ₹ 50,00,000.

Examine and show how the three events would be reported in the financial statements of X Ltd. for the year ended 31st March, 20X6 as per Ind AS.

5. Shaurya Limited owns a Building A which is specifically used for the purpose of earning rentals. The Company has not been using the building A or any of its facilities for its own use for a long time. The company is also exploring the opportunities to sell the building if it gets the reasonable amount in consideration.

Following information is relevant for Building A for the year ending 31st March, 20X2:

Building A was initially purchased at the cost of ₹ 10 crores. At that time, the useful life of the building was estimated to be 20 years; out of which 5 years have been expired as on 1st April, 20X1. The company follows straight line method for depreciation.

During the year, the company has invested in another Building B with the purpose to hold it for capital appreciation. The property was purchased on 1st April, 20X1 at the cost of

₹ 2 crores. Expected life of the building is 40 years. As usual, the company follows straight line method of depreciation.

Further, during the year 20X1-20X2 the company earned/incurred following direct operating expenditure relating to Building A and Building B:

Rental income from Building A	=	₹ 75 lakhs
Rental income from Building B	=	₹ 25 lakhs
Sales promotion expenses	=	₹ 5 lakhs
Fees & Taxes	=	₹ 1 lakhs
Ground rent	=	₹ 2.5 lakhs
Repairs & Maintenance	=	₹ 1.5 lakhs
Legal & Professional	=	₹ 2 lakhs
Commission and brokerage	=	₹ 1 lakhs

The company does not have any restrictions and contractual obligations against Property - A and B. For complying with the requirements of Ind AS, the management sought an independent report from the specialists so as to ascertain the fair value of buildings A and B. The independent valuer has valued the fair value of property as per the valuation model recommended by International valuation standards committee. Fair value has been computed by the method by streamlining present value of future cash flows namely, discounted cash flow method.

The other key inputs for valuation are as follows:

The estimated rent per month per square feet for the period is expected to be in the range of ₹ 50 - ₹ 60. And it is further expected to grow at the rate of 10 percent per annum for each of 3 years. The weighted discount rate used is 12% to 13%.

Assume that the fair value of properties based on discounted cash flow method is measured at ₹ 10.50 crores. The treatment of fair value of properties is to be given in the financials as per the requirements of Indian accounting standards.

What would be the treatment of Building A and Building B in the balance sheet of Shaurya Limited? Provide detailed disclosures and computations in line with relevant Indian accounting standards. Treat it as if you are preparing a separate note or schedule, of the given assets in the balance sheet.

6. X Ltd owned a land property whose future use was not determined as at 31st March 20X1. How should the property be classified in the books of X Ltd as at 31st March 20X1?

During June 20X1, X Ltd commenced construction of office building on it for own use. Presuming that the construction of the office building will still be in progress as at 31st March 20X2

- (a) How should the land property be classified by X Ltd in its financial statements as at 31st March 20X2?
- (b) Will there be a change in the carrying amount of the property resulting from any change in use of the investment property?
- (c) Whether the change in classification to, or from, investment properties is a change in accounting policy to be accounted for in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors?
- (d) Would your answer to (a) above be different if there were to be a management intention to commence construction of an office building for own use; however, no construction activity was planned by 31st March 20X2?

Answers

1. 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.

2. At 31st March, 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 31st March, 20X1 is ₹ 10,00,000, impairment loss ₹ 5,00,000 should be recognized in the Statement of Profit and Loss. So, the carrying amount of Investment property at 31st March, 20X1 would be ₹ 10,00,000.

The entity must disclose the reclassification.

From April, 20X1, X Limited will depreciate the building over its remaining useful life of 20 years.

3. 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 expenses, ceremony expenses and repair maintenance expenses will be expensed off as and when incurred.

4. From 1st April, 20X1, the property would be regarded as an investment property since it is being held for its investment potential rather than being owner occupied or developed for sale.

The property would be measured under the cost model. This means it will be measured at ₹ 2,00,00,000 at each year end.

On 30th September, 20X5, the property ceases to be an investment property. X Ltd. begins to develop it for sale as flats.

As per para 59 of Ind AS 40, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes. Hence, the carrying value of the reclassified property will be ₹ 2,00,00,000.

Since the lease of the property is an operating lease, rental income of ₹ 10,00,000 (₹ 20,00,000 x 6/12) would be recognized in P/L for the year ended 31st March, 20X6.

The additional costs of ₹ 60,00,000 for developing the flats which were incurred up to and including 31st March, 20X6 would be added to the 'cost' of inventory to give a closing cost of ₹ 2,60,00,000.

The total selling price of the flats is expected to be ₹ 5,00,00,000 (10 x ₹ 50,00,000). Since the further costs to develop the flats total ₹ 40,00,000, their net realisable value is ₹ 4,60,00,000 (₹ 5,00,00,000 – ₹ 40,00,000), so the flats will be measured at a cost of ₹ 2,60,00,000.

The flats will be shown in inventory as a current asset.

5. Investment property is held to earn rentals or for capital appreciation or both. Ind AS 40 shall be applied in the recognition, measurement and disclosure of investment property. An investment property shall be measured initially at its cost. After initial recognition, an entity

shall measure all of its investment properties in accordance with Ind AS 16's requirements for cost model.

The measurement and disclosure of Investment property as per Ind AS 40 in the balance sheet would be depicted as follows:

INVESTMENT PROPERTIES:	
Particulars	Period ended 31 st March, 20X2 (₹ in crores)
Gross Amount:	
Opening balance (A)	10.00
Additions during the year (B)	2.00
Closing balance (C) = (A) + (B)	12.00
Depreciation:	
Opening balance (D)	2.50
Depreciation during the year (E) (0.5 + 0.05)	<u>0.55</u>
Closing balance (F) = (D) + (E)	<u>3.05</u>
Net balance (C) - (F)	<u>8.95</u>

The changes in the carrying value of investment properties for the year ended 31st March, 20X2 are as follows:

Amount recognized in Profit and Loss with respect to Investment Properties

Particulars	Period ending 31 st March, 20X2 (₹ in crores)
Rental income from investment properties (0.75 + 0.25)	1.00
Less: Direct operating expenses generating rental income (5 + 1 + 2.5 + 1.5 + 2 + 1)	<u>(0.13)</u>
Profit from investment properties before depreciation and indirect expenses	0.87
Less: Depreciation	<u>(0.55)</u>
Profit from earnings from investment properties before indirect expenses	<u>0.32</u>

Disclosure Note on Investment Properties acquired by the entity

The investment properties consist of Property A and Property B. As at 31st March, 20X2, the fair value of the properties is ₹ 10.50 crores. The valuation is performed by independent valuers, who are specialists in valuing investment properties. A valuation model as recommended by International Valuation Standards Committee has been applied. The Company considers factors like management intention, terms of rental agreements, area leased out, life of the assets etc. to determine classification of assets as investment properties.

The Company has no restrictions on the realisability of its investment properties and no contractual obligations to purchase, construct or develop investment properties or for repairs, maintenance and enhancements.

Description of valuation techniques used and key inputs to valuation on investment properties:

Valuation technique	Significant unobservable inputs	Range (Weighted average)
Discounted cash flow (DCF) method	- Estimated rental value per sq. ft. per month - Rent growth per annum - Discount rate	- ₹ 50 to ₹ 60 - 10% every 3 years - 12% to 13%

6. As per paragraph 8(b) of Ind AS 40, any land held for currently undetermined future use, should be classified as an investment property. Hence, in this case, the land would be regarded as held for capital appreciation. Hence the land property should be classified by X Ltd as investment property in the financial statements as at 31st March 20X1.

As per Para 57 of the Standard, an entity can change the classification of any property to, and from, an investment property when and only when evidenced by a change in use. A change occurs when the property meets or ceases to meet the definition of investment property and there is evidence of the change in use. Mere management's intention for use of the property does not provide evidence of a change in use.

- Since X Ltd has commenced construction of office building on it for own use, the property should be reclassified from investment property to owner occupied as at 31st March 20X2.
- As per Para 59, transfers between investment property, owner occupied and inventories do not change the carrying amount of the property transferred and they do not change the cost of the property for measurement or disclosure purposes.

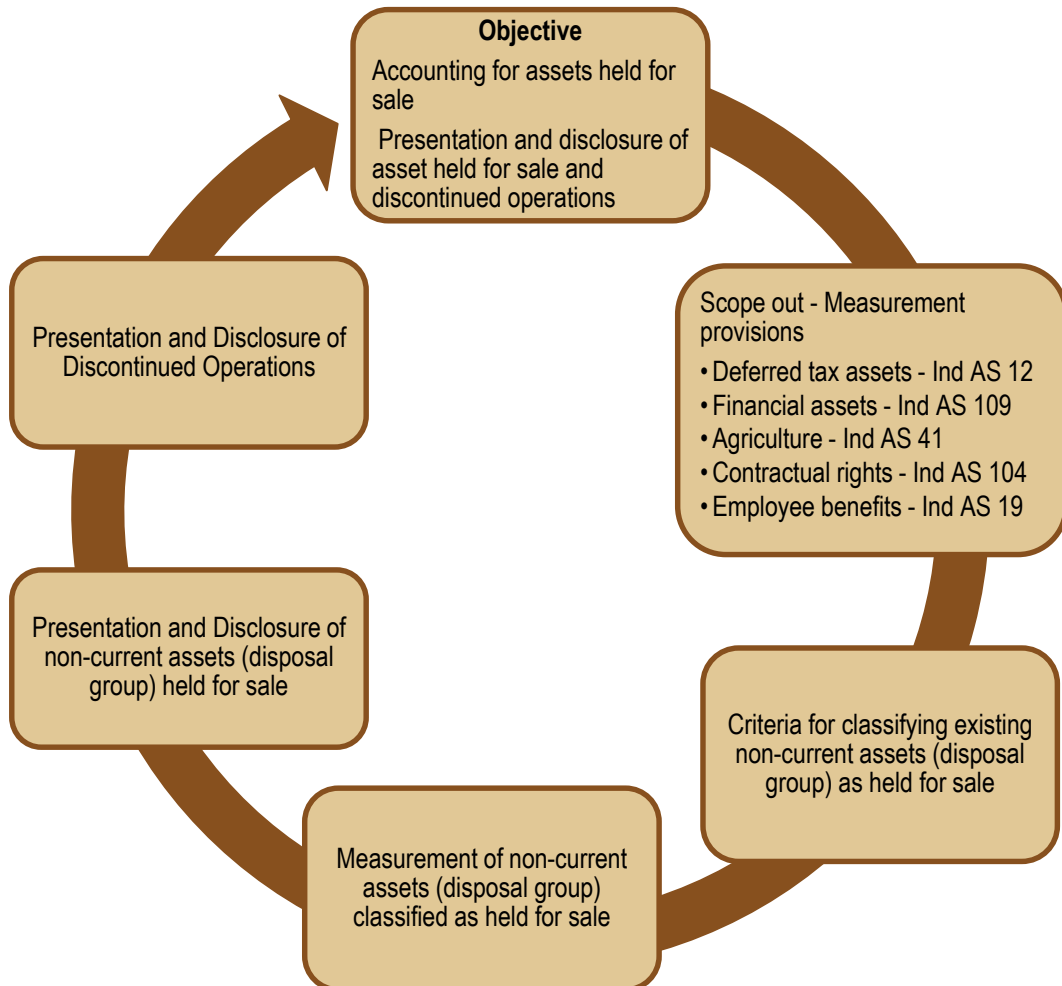
- (c) No. The change in classification to, or from, investment properties is due to change in use of the property. No retrospective application is required and prior period's financial statements need not be re-stated.
- (d) Mere management intentions for use of the property do not evidence change in use. Since X Ltd. has no plans to commence construction of the office building during 20X1-20X2, the property should continue to be classified as an investment property by X Ltd. in its financial statements as at 31st March 20X2.

UNIT 7 : INDIAN ACCOUNTING STANDARD 105 : NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

LEARNING OUTCOMES

After studying this unit, you will be able to

- ☐ List out the objective and scope of the standard
- ☐ Define the terms non-current asset, disposal group, cash generating unit and discontinued operations
- ☐ Examine the criteria for classifying non-current assets (or disposal group) as held for sale
- ☐ Measure non-current assets (or disposal group) classified as held for sale
- ☐ Present and disclose non-current assets (or disposal group) classified as held for sale
- ☐ Present and disclose discontinued operations as per the standard.
- ☐ Elaborate significant differences between Ind AS 105 and AS 24

UNIT OVERVIEW

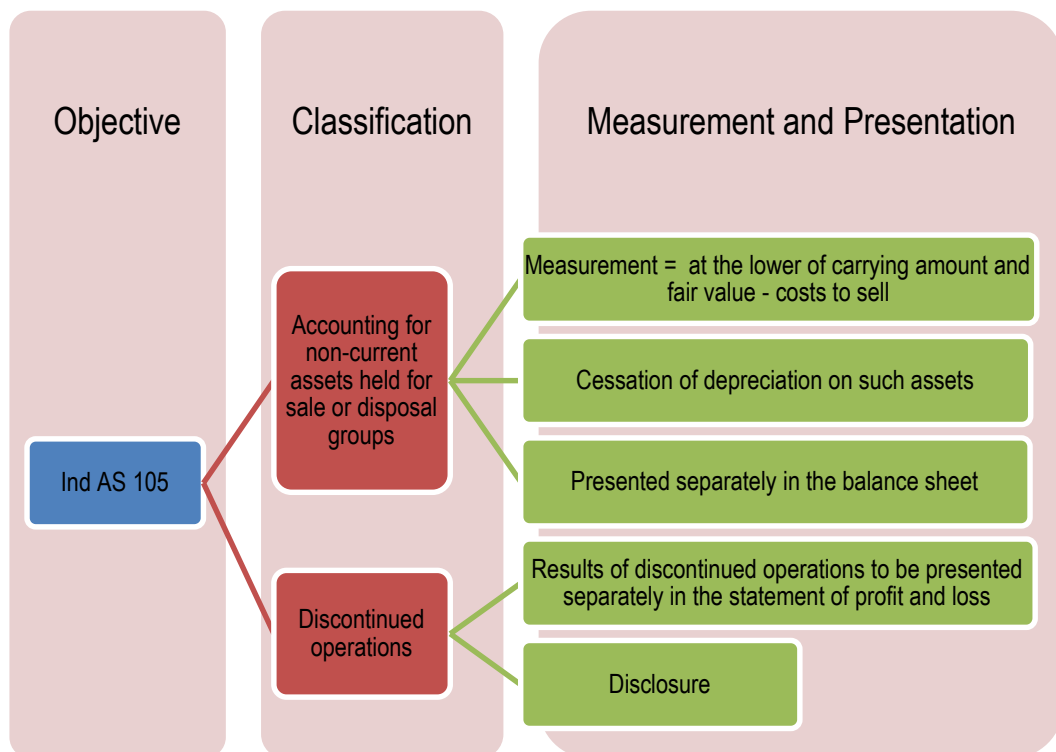


7.1 OBJECTIVE

- Non-Current assets held for sale are presented separately from other assets in the Balance Sheet as their classification will change and the value will be principally recovered through sale transaction rather than through continuous use in operations of the entity. This standard specifies the accounting for assets held for sale.
- Results of Discontinuing Operations should be separately presented in the Statement of Profit and loss as it affects the ability of the entity to generate future cash flows. This standard specifies the presentation and disclosure of discontinued operations.

The disclosure information provided in the standard enhances the ability of users of financial statements to make projections of an entity's cash flows, earnings-generating capacity, and financial position by segregating information about held for sale assets and discontinued operations from the information about continuing operations.

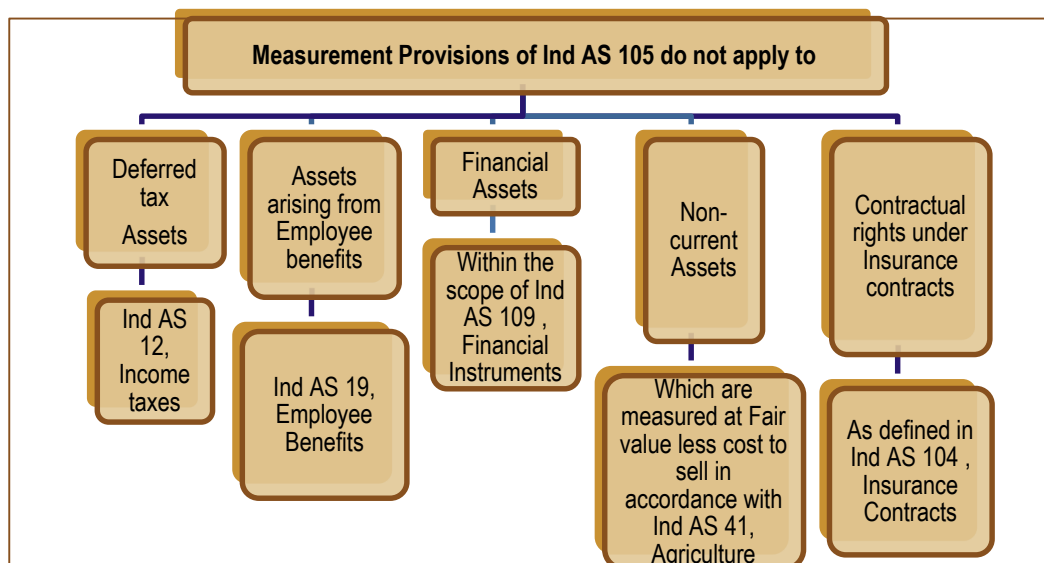
Hence, two core objectives of the standard are as follows:





7.2 SCOPE

- The classification and presentation requirements of this Ind AS apply to all recognised non-current assets and to all disposal groups of an entity.
- The measurement requirements of this Ind AS also apply to all recognised non-current assets and to all disposal groups of an entity except few exceptions mentioned below.
- Assets classified as non-current in accordance with Ind AS 1, Presentation of Financial Statements, shall not be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with this Ind AS.
- The classification, presentation and measurement requirements in this Ind AS applicable to a non-current asset (or disposal group) that is classified as held for sale apply also to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners.
- Scoped out non-current assets: The measurement provisions of this Ind AS do not apply to the following assets (which are covered by the Ind AS listed either as individual assets or as part of a disposal group):



- Disposal groups may include both scoped-in and scoped-out non-current assets. If a disposal group includes any scoped-in non-current asset(s), the measurement requirements of this Ind AS apply to the group as a whole, so that the group is measured at the lower of its carrying amount and fair value less costs to sell.

- The disclosure requirements of this Ind AS, for non-current assets held for sale and discontinued operations, remove the need to provide disclosures in accordance with other standards, unless that standard has specific disclosure requirements:
 - for non-current assets (or disposal group) classified held for sale or discontinued operations; or
 - for measurement of assets or liabilities within a disposal group that are not within the measurement scope of Ind AS 105.

However, this does not remove the need to provide additional disclosures to comply with Ind AS.



7.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **Cash-generating unit** is a smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- **Component of an entity comprises** operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.
- **Costs to distribute** are the incremental costs directly attributable to the distribution, excluding finance costs and income tax expense.
- **Costs to sell** are the incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.
- **Current asset** - An entity classifies an asset as current when:
 - (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
 - (b) it holds the asset primarily for the purpose of trading;
 - (c) it expects to realise the asset within twelve months after the reporting period; or
 - (d) the asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.
- A **discontinued operation** is a component of an entity that either has been disposed of or is classified as held for sale and:
 - (a) represents a separate major line of business or geographical area of operations; or

(b) is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or

(c) is a subsidiary acquired exclusively with a view to resale.

- **Disposal group** is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. A disposal group may be a group of *cash-generating units*, a single cash-generating unit, or part of a cash-generating unit.

The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with Ind AS 36 'Impairment of Assets', or if it is an operation within such a cash generating unit.

- **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. (Ind AS 113)
- **Firm purchase commitment** is an agreement with an unrelated party, binding on both parties and usually legally enforceable, that (a) specifies all significant terms, including the price and timing of the transactions, and (b) includes a disincentive for non-performance that is sufficiently large to make performance highly probable.
- **Highly Probable** Significantly more likely than probable. (Probable means more likely than not)
- **Non-current assets** are assets that do not meet the definition of current assets.
- **Recoverable amount** is the higher of an asset's fair value less costs of disposal and its value in use.
- **Value in use** is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.



7.4 CLASSIFICATION OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) AS HELD FOR SALE OR AS HELD FOR DISTRIBUTION TO OWNERS

An entity is required to classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

Asset must be

- **available for immediate sale in its present condition** and
- **Sale must be highly probable**

are the two key requirements to classify a non-current asset as held for sale.

It may be noted that if an asset is being sold individually, Ind AS 105 applies **only if it is a non-current asset**. A current asset being sold as an individual asset (i.e. not as part of a disposal group) is never classified as held for sale. Where a group of assets is being disposed of in a single transaction, its classification and presentation requirements apply to the disposal group as a whole, including current assets and liabilities forming part of the group.

7.4.1 Available for Immediate Sale

The asset (or disposal group) must be available for **immediate sale** in its **present condition**. The terms that are usual and customary for sale of similar assets (or disposal group) doesn't disqualify to being classified as held for sale.

However, they will not be considered as available for immediate sale if they continue to be vital for the entity's ongoing operations or being refurbished to enhance their value. Thus, an asset (or disposal group) cannot be classified as a non-current asset (or disposal group) held for sale, if the entity intends to sell it in a **distant future**.

Examples 1- 5- Available for Immediate Sale

1. A property being used as a headquarters by the entity needs to be vacated before it can be sold. The time required to vacate the building is usual and customary for sale of such assets. Hence the property can be considered as available for immediate sale.

However, if property can be vacated only after a replacement is available then this may indicate that the property is not available for immediate sale, but only after the replacement becomes available.

2. An entity can't classify a manufacturing facility as held for sale if prior to selling the facility it needs to clear a backlog of uncompleted orders.

However, if entity intends to sell the manufacturing facility along with the uncompleted orders it can be considered as available for immediate sale.

3. An entity plans to renovate some of its property to increase its value prior to selling it to a third party. The entity is already searching for a buyer at current market values. But due to the plans to renovate the property prior to sale, the property may not be meeting the condition of available for immediate sale.

4. A company has put a property on the market and expects that all the conditions of classification as held for sale are met. Any buyer will undertake searches and valuations

before making an offer and exchanging contracts: Such conditions are normal for properties and any delays that might arise from such legal processes do not preclude the property from being classified as held for sale.

5. When minor pre-selling activities are outstanding, and those activities are usually performed immediately before an asset is transferred, the asset could nevertheless be appropriately treated as available for immediate sale.

However, when an asset is still in the course of construction, and significant activities will need to be performed before it can be transferred, it is unlikely that it could be regarded as available for immediate sale.

7.4.2 Sale must be highly probable

This Standard defines 'highly probable' as 'significantly more likely than probable' where probable means more likely than not.

Ind AS 105 prescribes following five conditions to be satisfied for the sale to qualify as highly probable:

1. The appropriate level of management must be committed to a plan to sell the asset (or disposal group).
2. An active programme to trace a buyer and complete the selling plan must have been initiated.
3. The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
4. The sale transaction is expected to be completed within one year from the date of classification (subject to exception specified in section 7.4.3.2 below)
5. Significant changes to or withdrawal from the plan to sell the asset are unlikely.

The likelihood of shareholders' approval should also be considered as part of assessment if it is required in the jurisdiction.

Examples 6 & 7- Requiring shareholder's approval

6. At the end of the reporting period, ABC Company's board of directors has approved a plan to sell a non-current asset. The eventual disposal requires approval by a majority of company's shareholders through a formal vote which will take place after the reporting period. At the end of the reporting period, a majority of the company's shareholders have provided the company with signed irrevocable agreements stating that they will vote in favour of the disposal. The 'highly probable' test is met because the shareholders have irrevocably committed to approving the transaction and, therefore, the vote by the shareholders is merely a formality.
7. Company XYZ holds an 85 per cent interest in a subsidiary, Company ABC. At the year end, the board of directors of Company ABC has approved a plan to sell a non-current asset to Company XYZ. The eventual disposal requires approval by a majority of Company ABC's

shareholders through a formal vote which will take place after the reporting period. For a transaction with a major shareholder (in this case, the parent), the minority shareholders are given protection in law if the value of the transaction exceeds a specified threshold. The law prevents Company XYZ from participating in the formal vote on such a transaction. Company ABC has not received any undertakings to vote in a particular manner from any of the shareholders. It is possible that the proposed transaction may be controversial, and the outcome of the shareholder vote is uncertain. From Company ABC's perspective, the 'highly probable' test is not met at the end of the reporting period because the outcome of the formal vote by the remaining shareholders is too uncertain.

7.4.3 Other Key Points

7.4.3.1 Loss of Control in Subsidiary

An entity which has committed to a sale plan which involves loss of control of subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements when the criteria set out above is met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

7.4.3.2 Exception to the period of One year

An entity can still classify an asset (or disposal group) as held for sale, even if the timeframe of one year to conclude the sale transaction has lapsed. For this:

- (i) the delay must have been caused by the events or circumstances which are beyond the control of the entity; and
- (ii) there must be sufficient evidence that the entity is still committed to its selling plan.

Examples 8 - 10

8. An entity is committed to its selling plan of a manufacturing facility in its present condition and so classifies it as held for sale. After a firm purchase commitment, the buyer's inspection identifies environmental damages not previously known to exist. The entity is required by the buyer to make good the damage, which will extend the period required to complete the sale beyond one year. However, the entity has initiated actions to make good the damage and satisfactory rectification is highly probable. In this situation, exception to one-year requirement will be met.
9. An entity in the mining industry is committed to a plan to sell a disposal group that represents a significant portion of its regulated operations. The sale requires regulatory approval, which could extend the period required to complete the sale beyond one year. Actions necessary to obtain approval cannot be initiated until after a buyer is known and a firm purchase commitment is obtained. However, a firm purchase commitment is highly probable within one year. In this situation, the exception to the one-year requirement will be met.

10. A company is committed to a plan to sell a non-current asset and classifies the asset as held for sale. During the initial one-year period, the market conditions deteriorated and, as a result, the asset could not be sold by the end of that period. During that period, the company actively solicited but did not receive any reasonable offers to purchase the asset and, in response, the Company reduced its asking price. The asset continues to be actively marketed at a price that is reasonable given the change in market conditions. In this situation, the exception to the one-year requirement will be met. At the end of the initial one-year period, the asset would continue to be classified as held for sale.

7.4.3.3 Sale includes exchange

Sale transaction includes exchange of non-current assets for other non-current assets when the exchange has commercial substance in accordance with Ind AS 16 Property, Plant and Equipment.

7.4.3.4 Asset acquired exclusively with a view to subsequent disposal

When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, the non-current asset (or disposal group) is classified as held for sale at the acquisition date if both of the following conditions are satisfied:

- a) The one-year requirement is met subject to exceptions mentioned in section 7.4.3.2 above; and
- b) It is highly probable that any other criteria (refer section 7.4.1 and 7.4.2 above) that is not met at the acquisition date will be met within a short period following the acquisition (usually within three months).

Example 11

An entity has acquired a building exclusively with a view of its subsequent disposal. The management is highly confident that the property can be sold in one year. The property requires refurbishing it to enhance its value which is highly probable to be completed in less than a period of three months. The building will be classified as held for sale on the date of acquisition itself even though it is not immediately available for sale.

7.4.3.5 Criteria met after reporting period

If the criteria of held for sale are met after the reporting period, an entity should not classify a non-current asset (or disposal group) as held for sale in those financial statements when issued. However, when those criteria are met after the reporting period but before the approval of the financial statements for issue, the entity shall disclose the information specified in section 7.6.3 – Disclosures.

7.4.3.6 Classification as held for distribution

A non-current asset (or disposal group) is classified as held for distribution to owners when the entity is committed to distribute the asset (or disposal group) to the owners. The assets must be available for immediate distribution in their present condition and the distribution must be highly probable. For the distribution to be highly probable, actions to complete the distribution must have been initiated and should be expected to be completed within one year from the date of classification. Actions required to complete the distribution should indicate that it is unlikely that significant changes to the distribution will be made or that the distribution will be withdrawn.

The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the distribution is highly probable. For an entity to classify a non-current asset (or disposal group) as held for distribution to its owner, it is necessary to follow the same criteria as required for classification as held for sale.

7.4.3.7 Non-current assets to be abandoned

Non-current assets (or disposal group) that need to be abandoned will not qualify to classify as held for sale because their carrying amount will be principally recovered through continuing use in the entity's operation rather through the sale. However, if the disposal group to be abandoned meets the criteria as prescribed in Ind AS 105 to be classified as a discontinued operation, then the disclosure regarding discontinued operation must be presented.

Example 12

In February 20X2, PQR Limited decides to abandon all of its coal mines, which constitute a major line of business. All work stops at the coal mines during the year ended 31st March 20X2. In the financial statements for the year ended 31st March 20X1, results and cash flows of the coal mines are treated as continuing operations. In the financial statements for the year ended 31st March 20X2, the results and cash flows of the coal mines are treated as discontinued operations and PQR Limited is required to make the disclosures as per Ind AS 105.

Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be used to the end of their economic life and non-current assets (or disposal groups) that are to be closed rather than sold.

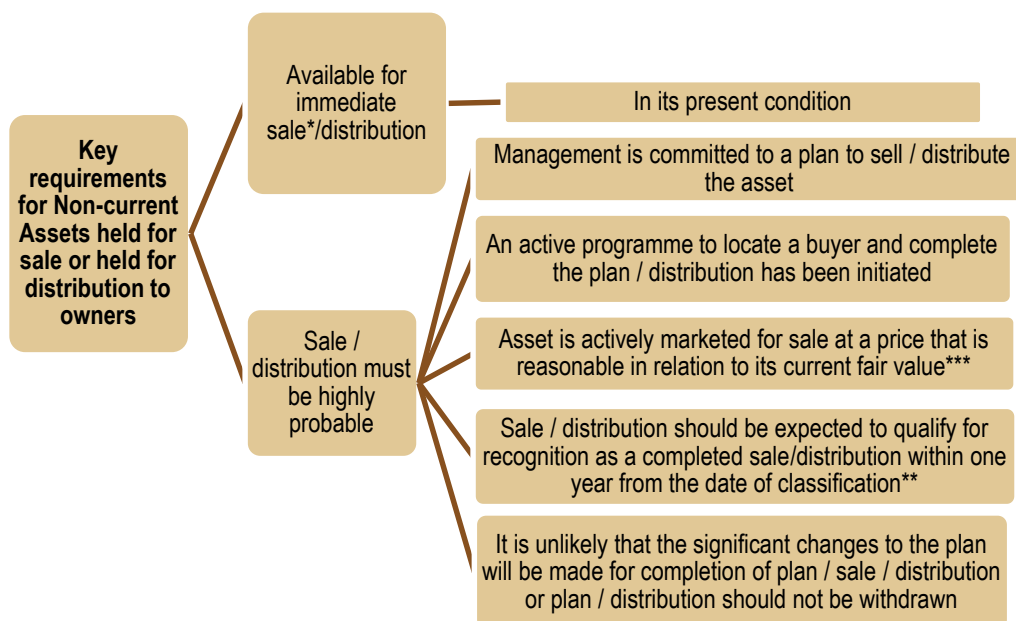
Assets that are temporarily taken out of use are not to be accounted for as abandoned.

Example 13

Entity ceases to use a manufacturing plant because demand has declined. However, the plant is maintained in a workable condition and it is expected to be brought back into use in future when demand picks up.

It is neither to be treated as abandoned asset nor as held for sale because its carrying amount will be principally recovered through continuous use, therefore the entity will not stop charging depreciation or treat it as held for sale. This is because its carrying amount will be recovered principally through continuing use to the end of its economic life.

An entity shall classify a non-current asset (or disposal group) as held for sale **if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.**



*Sale transactions include exchanges of non-current assets for other non-current assets when the exchange has commercial substance

** If the entity remains committed to its plan to sell the asset (or disposal group), events or circumstances beyond the entity's control may extend the period to complete the sale beyond one year

*** Not applicable for non-current assets held for distribution to owners.

Note:

S.N.	Particular	Details
1.	Acquisition of non-current asset (or disposal group) with intention to subsequent sale within a year	Classify the non-current asset (or disposal group) as held for sale subject to the conditions specified in the above chart
2.	Non-current assets that are to be abandoned	It shall not be classified as held for sale since its carrying amount will be recovered principally through continuing use and not from sale



7.5 MEASUREMENT OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) CLASSIFIED AS HELD FOR SALE

7.5.1 Measurement at the lower of carrying amount and fair value less cost to sell

- An entity should measure a non-current asset (or disposal group) classified as held for sale at the **lower** of its **carrying amount** and **fair value less costs to sell**.
- An entity shall measure a non-current asset (or disposal group) classified as held for distribution to owners at the lower of its carrying amount and fair value less costs to distribute.
- If a newly acquired asset (or disposal group) meets the criteria to be classified as held for sale, it will be measured on initial recognition at the lower of its carrying amount had it not been so classified (for example, cost) and fair value less costs to sell. Hence, if the asset (or disposal group) is acquired as part of a business combination, it will be measured at fair value less costs to sell.
- Immediately **before the initial classification** of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) is measured in accordance with **applicable Ind AS**.
- On subsequent remeasurement of a disposal group, the carrying amounts of any assets and liabilities that are not within the scope of the measurement requirements of this Ind AS but are included in a disposal group classified as held for sale, should be remeasured in accordance with applicable Ind AS before the fair value less costs to sell of the disposal group is remeasured.
- When the sale is expected to occur beyond one year, the entity should measure the costs to sell at their present value. Any increase in the present value of the costs to sell that arises from the passage of time shall be presented in profit or loss as a financing cost.

7.5.2 Recognition of impairment losses and reversals

- An entity should recognise an impairment loss for any initial or subsequent write-down of the asset (or disposal group) to fair value less costs to sell, to the extent that it has not been recognised in accordance with subsequent remeasurement of scoped out assets and liabilities as mentioned above.
- An entity should recognise a gain for any subsequent increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognised either in accordance with this Ind AS or previously in accordance with Ind AS 36.

- Depreciation and amortization shall be immediately stopped from the moment the asset has been classified as held for sale.
- Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be recognised.
- An entity should recognise a gain for any subsequent increase in fair value less costs to sell of a disposal group:
 - (a) to the extent that it has not been recognised in the remeasurement of scoped out non-current assets, current assets and liabilities; but
 - (b) not in excess of the cumulative impairment loss that has been recognised, either in accordance with this Ind AS or previously in accordance with Ind AS 36, on the non-current assets that are within the scope of the measurement requirements of this Ind AS.
- The impairment loss (or any subsequent gain) recognised for a disposal group should reduce (or increase) the carrying amount of the non-current assets in the group that are within the scope of the measurement requirements of this Ind AS. The impairment loss shall be allocated to disposal groups in the following order:
 - (i) first, to reduce the carrying amount of any goodwill allocated to the disposal group; and
 - (ii) then to the other assets of the disposal group pro rata on the basis of the carrying amount of each asset in the group.
- A gain or loss not previously recognised through remeasurement by the date of the sale of a non-current asset (or disposal group) should be recognised at the date of derecognition.

Requirements relating to derecognition are set out in:

- (a) paragraphs 67–72 of Ind AS 16 '*Property, Plant and Equipment*'; and
- (b) paragraphs 112–117 of Ind AS 38, '*Intangible Assets*', for intangible assets.

Illustration 1 - Measurement prior to classification as held for sale

Entity ABC owns an item of property and it was stated at the following amounts in its last financial statements:

31st March, 20X1	₹
Cost	12,00,000
Depreciation	<u>(6,00,000)</u>
Net book value	<u>6,00,000</u>

The asset is depreciated at an annual rate of 10% i.e. ₹ 1,20,000 p.a.

Entity ABC closes its books as on 31st March each year. During July, 20X1, entity ABC decides to sell the asset and on 1st August it meets the conditions to be classified as held for sale.

Analyse what will be the treatment of the property in the books for the year 20X1-20X2.

Solution

At 31st July, entity ABC should ensure that the asset is measured in accordance with Ind AS 16. It should be depreciated by further ₹ 40,000 (₹ 1,20,000 x 4/12) and should be carried at ₹ 5,60,000 before it is measured in accordance with Ind AS 105.

Note: From the date the asset is classified as held for sale no further depreciation will be charged.

Example 14 - Classification as held for sale

A Ltd. acquired a property for ₹ 2,00,000. After few years, the cumulative depreciation on the property of ₹ 80,000 has been recognised and subsequently the property is classified as held for sale under Ind AS 105.

At the time of classification as held for sale it will be measured at lower of its carrying amount which is ₹ 1,20,000 (2,00,000 – 80,000) and fair value less costs to sell as estimated at ₹ 1,00,000.

Accordingly, there is a write-down on initial classification of property as held for sale and accordingly the property is carried at ₹ 1,00,000. A loss of ₹ 20,000 is recognised in profit or loss.

On next reporting date, the property's fair value less costs to sell is estimated at ₹ 85,000. Accordingly, a loss of ₹ 15,000 is recognised in profit or loss and the property is carried at ₹ 85,000.

Subsequently, the property is sold for ₹ 90,000. A gain of ₹ 5,000 will be recognised.

Example 15 - Disposal group classified as Held for Sale:

Disposal Group	Carrying amount at the reporting date before classification as held for sale ₹	Carrying amount as remeasured immediately before classification as held for sale ₹
Goodwill	1,500	1,500

Property, Plant and Equipment (carried at revalued amounts)	4,600	4,000
Building (carried at cost)	5,700	5,700
Inventory	2,400	2,200
Investment in Equity Instruments	<u>1,800</u>	<u>1,500</u>
Total	<u>16,000</u>	<u>14,900</u>

The entity should recognise the loss of ₹ 1,100 (₹ 16,000 - ₹ 14,900), in accordance with applicable Ind AS, immediately before classifying it as held for sale. This difference of ₹ 1,100 reflects routine accounting entries (such as revaluation). This amount shall not be considered as impairment loss.

The entity estimated that fair value less costs to sell of the disposal group amounts to ₹ 13,000.

Since the entity has classified a disposal group as held for sale it should measure it at the lower of its carrying amount ₹ 14,900 and fair value less costs to sell ₹ 13,000 which comes to ₹ 13,000.

The entity should recognise an impairment loss of ₹ 1,900 (₹ 14,900 – 13,000) when the disposal group is initially classified as held for sale.

The Inventory and Investment is remeasured as per Ind AS 2 and Ind AS 109 at not more than fair value at the date of remeasurement i.e. immediately before classified as held for sale.

This impairment loss of ₹ 1,900 is allocated to remaining assets in the proportion of their carrying value other than inventory and investment in equity instrument.

The allocation of impairment loss can be illustrated as follows:

Disposal Group	Carrying amount as remeasured immediately before classification as held for sale (as per applicable Ind AS) ₹	Allocated Impairment Loss ₹	Carrying amount after allocation of Impairment Loss ₹
Goodwill	1,500	(1,500)	-
Property, Plant and Equipment			

(carried at revalued amounts)	4,000	(165)	3,835
Building (carried at cost)	5,700	(235)	5,465
Inventory	2,200	-	2,200
Investments in equity instruments	<u>1,500</u>	<u>-</u>	<u>1,500</u>
Total	<u>14,900</u>	<u>(1,900)</u>	<u>13,000</u>

Firstly, the impairment loss reduces the amount of goodwill in the disposal group. Then, the remaining impairment loss is recognised to other assets pro-rata based on the carrying amount of those assets.

Suppose, at the end of reporting period the fair value less cost to sell is increased and estimated at ₹ 15,500.

The maximum impairment loss reversal allowed will be ₹ 1,900 being impairment loss recognised earlier.

Reversal of impairment loss on Goodwill is not allowed under Ind AS 36 'Impairment of Assets'.

Example 16 - Reversal of Impairment Losses

A freehold property was originally acquired for ₹ 40,00,000. Some years later, after cumulative depreciation of ₹ 11,00,000 has been recognised, an impairment loss of ₹ 3,50,000 is recognised, taking the carrying amount to ₹ 25,50,000, which represents the estimated value in use of the property. Shortly thereafter, as a consequence of a proposed move to new premises, the freehold property is classified as held for sale.

At the time of classification as held for sale:

- carrying amount is ₹ 25,50,000; and
- fair value less costs to sell is assessed at ₹ 25,00,000.

Accordingly, the initial write-down on classification as held for sale is ₹ 50,000 and the property is carried at ₹ 25,00,000. Following classification as held for sale, no further depreciation is recognised.

At the next reporting date, the property market has improved and fair value less costs to sell is reassessed at ₹ 26,50,000. The gain of ₹ 1,50,000 is less than the cumulative impairment losses recognised to date (₹ 3,50,000 + ₹ 50,000 = ₹ 4,00,000). Accordingly, it is credited in profit or loss and the property is carried at ₹ 26,50,000.

Six months after that, the property market has continued to improve, and fair value less costs to sell is now assessed at ₹ 30,00,000. This further gain of ₹ 3,50,000 is, however, in excess of the

cumulative impairment losses recognised to date ($\text{₹ } 3,50,000 + \text{₹ } 50,000 - \text{₹ } 1,50,000 = \text{₹ } 2,50,000$). Accordingly, a restricted gain of ₹ 2,50,000 is credited in profit or loss and the property is carried at ₹ 29,00,000.

Subsequently, the property is sold for ₹ 30,00,000, at which time a gain of ₹ 1,00,000 is recognised.

7.5.3 Changes to a plan of sale

- If an entity has classified an asset (or disposal group) as held for sale, but the held for sale criteria is no longer met, the entity should cease to classify the asset (or disposal group) as held for sale.
- The entity shall measure a non-current asset that ceases to be classified as held for sale (or ceases to be included in a disposal group classified as held for sale) at the lower of:
 - (a) its carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been classified as held for sale; and
 - (b) its recoverable amount at the date of the subsequent decision not to sell.
- The entity shall include any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held for sale in profit or loss from continuing operations in the period in which the held for sale criteria is no longer met.
- Financial statements for the periods since classification as held for sale / distribution to owners shall be amended accordingly if the disposal group or non-current asset that ceases to be classified as held for sale / distribution to owners is a subsidiary, joint operation, joint venture, associate, or a portion of an interest in a joint venture or an associate.
- If an entity removes an individual asset or liability from a disposal group classified as held for sale, the remaining assets and liabilities of the disposal group will continue to be measured as a group only if the group meets the criteria for classification as held for sale. Otherwise:
 - (a) the remaining non-current assets of the group that individually meet the criteria to be classified as held for sale shall be measured individually at the lower of their carrying amounts and fair values less costs to sell at that date; and
 - (b) any non-current assets that do not meet the criteria shall cease to be classified as held for sale.

Example 17: Remeasuring non-current assets that are no longer held for sale

Company ABC has several operations including the manufacture and sale of leisure equipment.

Company ABC financial year ends on 31 March. In April, Company ABC adopts a plan to sell all of the assets and liabilities of the leisure equipment operations. Having met the requirements of Ind AS 105 at the end of the first quarter, Company ABC appropriately classifies those assets and liabilities as a disposal group held for sale.

In September, Company ABC decides not to sell certain existing trademarks and licence arrangements associated with the leisure equipment operations. Subsequent to the sale of the other assets and liabilities, Company ABC will continue to generate revenue (and incur the associated costs) from its trademarks and licences.

Company ABC should reclassify the trademarks and licence arrangements out of assets held for sale and remeasure them at the lower of (1) their carrying amounts before being classified as held for sale less any amortisation expense that would have been recognised if they had not been classified as held for sale, and (2) their recoverable amount at the date of the subsequent decision not to sell.

If this requirement triggers an adjustment to the carrying amounts of the trademarks and licences, assuming that the assets were not revalued in accordance with Ind AS 38 before classification as held for sale, the adjustment should be included in profit or loss from continuing operations in the period in which the held for sale criteria are no longer met. The adjustment should be included in the same caption in the statement of profit and loss used to present other gains or losses, if any, on held for sale items not meeting the definition of discontinued operations.

If the remaining assets and liabilities of the leisure equipment operations continue to meet the conditions to be accounted for as held for sale, Company ABC should continue to classify those remaining assets and liabilities as held for sale.

Illustration 2

S Ltd purchased a property for ₹ 6,00,000 on 1st April, 20X1. The useful life of the property is 15 years. On 31st March, 20X3, S Ltd classified the property as held for sale. The impairment testing provides the estimated recoverable amount of ₹ 4,70,000.

The fair value less cost to sell on 31st March, 20X3 was ₹ 4,60,000. On 31st March, 20X4 management changed the plan, as property no longer met the criteria of held for sale. The recoverable amount as at 31st March, 20X4 is ₹ 5,00,000.

Recommend the accounting treatment of events for the year ending 31st March, 20X3 and 31st March, 20X4 and value the property at the end of 20X3 and 20X4.

Solution

- (a) Value of property immediately before the classification as held for sale as per Ind AS 16 as on 31st March, 20X3 ₹

Purchase Price	6,00,000	
Less: Accumulated Depreciation	80,000	(for two years)
Less: Impairment loss	50,000	(5,20,000-4,70,000)
Carrying Amount	4,70,000	

On initial classification as held for sale on 31st March, 20X3, the value will be lower of:

Carrying amount after impairment ₹ 4,70,000

Fair Value less Cost to sell ₹ 4,60,000

On 31st March, 20X3, Non-current asset classified as held for sale

will be recorded at ₹ 4,60,000.

Depreciation of ₹ 40,000 and Impairment Loss of ₹ 60,000 (50,000 + 10,000) is charged in profit or loss for the year ended 31st March, 20X3.

- (b) On 31st March, 20X4, held for sale property is reclassified as criteria is not met. The value will be lower of:

Carrying amount immediately before classification on 31st March, 20X3 ₹ 4,70,000

Less: Depreciation based on 13 years balance life (₹ 36,154)

Carrying amount had the asset is not classified as held for sale ₹ 4,33,846

Recoverable Amount ₹ 5,00,000

Property will be valued at ₹ 4,33,846 on 31st March, 20X4

Adjustment to the carrying amount of ₹ 26,154 (₹ 4,60,000 - 4,33,846) is charged to the profit or loss.



7.6 PRESENTATION AND DISCLOSURES OF A NON-CURRENT ASSET (OR DISPOSAL GROUP) CLASSIFIED AS HELD FOR SALE

7.6.1 Non – current assets and disposal groups classified as held for sale

- Entity shall present and disclose information about non- current asset (or disposal group) classified as held for sale in such a manner that enable the user of financial statements to evaluate financial effects of non-current asset (or disposal group) classified as held for sale.

7.6.2 Presentation

- An entity is required to present a non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the balance sheet.
- The liabilities of a disposal group classified as held for sale should be presented separately from other liabilities in the balance sheet. Those assets and liabilities should not be offset and presented as a single amount.
- The major classes of assets and liabilities classified as held for sale should be separately disclosed either in the balance sheet or in the notes, except when the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition.
- An entity should present separately any cumulative income or expense recognised in other comprehensive income relating to a non-current asset (or disposal group) classified as held for sale.
- If the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition, disclosure of the major classes of assets and liabilities is not required.
- Comparative amounts for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the balance sheets for prior periods are not reclassified or re-presented to reflect the classification in the balance sheet for the latest period presented. For example, if an asset qualifies as held for sale during 20X2, it should be classified as such in the balance sheet at the end of 20X2, but not in the 20X1 comparative balance sheet.
- Any gain or loss on the remeasurement of a non-current asset (or disposal group) classified

as held for sale that does not meet the definition of a discontinued operation shall be included in profit or loss from continuing operations.

Example 18: Presentation of Disposal group

Property, Plant and Equipment	4,900
Inventory	1,700
Investment in equity instruments	1,400
Liabilities	<u>(3,300)</u>
Net Carrying Amount	<u>4,700</u>

An amount of ₹ 400 relating to these assets has been recognised in other comprehensive income and accumulated in equity.

The presentation of disposal group in entity's Balance Sheet is as follows:

Assets	20X1-20X2	20X2-20X3
Non –Current Assets		
AAA	X	X
BBB	X	X
CCC	<u>X</u>	<u>X</u>
	X	X
Current Assets		
DDD	X	X
EEE	<u>X</u>	<u>X</u>
	X	X
Assets Classified as Held for Sale	<u>8,000</u>	<u>-</u>
	X	X
Total Assets	<u>X</u>	<u>X</u>
Equity and Liabilities		
Equity attributable to equity holders of the parent		
FFF	X	X
GGG	X	X
Amounts recognised in other comprehensive income and accumulated in equity relating to assets held for sale	<u>400</u>	<u>-</u>
	X	X

Non-Controlling Interests	X	X
Total Equity	<u>X</u>	<u>X</u>
Non-Current Liabilities		
HHH	X	X
III	X	X
	<u>X</u>	<u>X</u>
Current Liabilities		
KKK	X	X
LLL	X	X
MMM	<u>X</u>	<u>X</u>
Liabilities directly associated with assets classified as held for sale	<u>3,300</u>	<u>-</u>
	<u>X</u>	<u>X</u>
Total liabilities	<u>X</u>	<u>X</u>
Total Equity and liabilities	<u><u>X</u></u>	<u><u>X</u></u>

7.6.3 Disclosures

An entity should disclose the following information in the notes to the financial statements in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

- Description of the non-current asset (or disposal group);
- Description of facts and circumstances of the sale, or leading to the expected disposal and the expected manner and timing of that disposal;
- Gain or loss recognised and if not presented separately on the face of the statement of profit and loss, the caption in the statement of profit and loss that includes that gain or loss.
- If applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance of Ind AS 108 Operating Segments.
- If there is a change of plan to sell, a description of facts and circumstances leading to the decision and the effect of the decision on the results of operations for the period and any prior periods presented.



7.7 DISCONTINUED OPERATIONS

7.7.1 Discontinued operation – definition

- Ind AS 105 defines Discontinued Operation as a component of an entity that either has been disposed of or is classified as held for sale and:
 - (a) represents a separate major line of business or geographical area of operations; or
 - (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
 - (c) is a subsidiary acquired exclusively with a view to resale.

Examples 19-22 – Discontinued Operations

19. Company XYZ has 5 different operating segments, one of which solely produces consumer goods. All of the consumer goods production facilities are situated in Central Europe. XYZ also has other operations in Central Europe for other operating segments. In April 20X1, XYZ disposed of its consumer goods segment which meets the definition of a component of a business and represents a separate major line of business and would therefore be considered as a discontinued operation.
20. A group has announced that it is closing an engineering contracting segment. Although no new contracts are being undertaken, all existing contracts will be completed and the business will be run down accordingly. In this situation, the operation will have ceased to be used when the contracting activity has been completed (that is, at the end of the last contract). In the period during which existing contracts are completed, the group is continuing to carry out a revenue-earning activity, albeit that the activity is being wound down, and so it does not qualify as a discontinued operation.
21. A company carried out a merchandise wholesaling business that is operated from several leasehold premises throughout the country. The business has been closed, all stocks have been disposed of, and employees have been made redundant before the end of three months into the next financial year. At that time, some debtors remain to be collected, and costs will continue to be incurred in respect of the vacated premises until the leases are disposed of. In this case, the former activity of merchandise wholesaling has ceased. The outstanding future transactions do not constitute the continuation of the activity and, consequently, the operation has been discontinued.
22. XYZ Company has one business segment, and it operates in the UK, the US and Australia. Each of these operations represents a component of XYZ and a major geographical area of operations. Management has decided to sell the US operation, which met the criteria to be classified as held for sale during the year. The US operation

should be disclosed in XYZ's financial statements as a discontinued operation, despite the fact that there has been no change to the number of business segments.

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. In other words, a component of an entity will be a cash-generating unit or a group of cash-generating units while being held for use.

Illustration 3

Identify whether each of the following scenarios give rise to a discontinued operation and/or classification of assets as held for sale:

S. No	Particulars
1	MNO disposes of a component of the entity by selling the underlying assets. The sales transaction is incomplete at the reporting date.
2	PQR has ceased activities that meet the definition of a discontinued operation without selling any assets.
3	STU ceases activities and has already completed the sale of the underlying assets at the reporting date.
4	VWX will sell or has sold assets that are within the scope of Ind AS 105 but does not discontinue any of its operations.

Solution

Discontinued operations and assets held for sale

S. No	Particulars	Discontinued operation Yes/No	Assets held for sale Yes/No
1	MNO disposes of a component of the entity by selling the underlying assets. The sales transaction is incomplete at the reporting date.	Yes	Yes
2	PQR has ceased activities that meet the definition of a discontinued operation without selling any assets.	Yes	No
3	STU ceases activities and has already completed the sale of the underlying assets at the reporting date.	Yes	No

4	VWX will sell or has sold assets that are within the scope of Ind AS 105 but does not discontinue any of its operations.	No	Yes

Illustration 4

Sun Ltd is a retailer of takeaway food like burger and pizzas. It decides to sell one of its outlets located in Chandani Chowk in New Delhi. The company will continue to run 200 other outlets in New Delhi.

All criteria mentioned in Ind AS 105 for classification of assets as held for sale were first met on 1st October, 20X1. The outlet will be sold in June, 20X2.

Management believes that outlet is a discontinued operation and wants to present the results of outlet as 'discontinued operations'.

Analyse the opinion of the management with respect to the accounting treatment of the outlet.

Solution

The Chandani Chowk outlet is a disposal group; it is not a discontinued operation as it is only one outlet. It is not a major line of business or geographical area, nor a subsidiary acquired with a view to resale.

7.7.2 Separate presentation of discontinued operations

An entity should present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

This allows the user to distinguish between the operations which will continue in the future and those which will not and make it more predictable the ability of entity to generate future cash flows.

When the amounts relating to discontinued operations are presented separately, the comparative figures for prior periods are also re-presented, so that the disclosures relate to all operations that have been discontinued by the end of the reporting period for the latest period presented.

7.7.3 Presentation in the statement of profit and loss

- An entity shall disclose a single amount in the statement of profit and loss comprising the total of:

- (a) the post-tax profit or loss of discontinued operations; and
 - (b) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.
- In addition, this single amount must be analysed into:
 - (a) the revenue, expenses and pre-tax profit or loss of discontinued operations;
 - (b) the related income tax expense as required by paragraph 81(h) of Ind AS 12;
 - (c) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and
 - (d) the related income tax expense as required by paragraph 81(h) of Ind AS 12.
 - The analysis may be presented in the notes or in the statement of profit and loss. If it is presented in the statement of profit and loss it should be presented in a section identified as relating to discontinued operations, i.e. separately from continuing operations. The analysis is not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition.
 - Entities are required to disclose the amount of income from continuing operations and from discontinued operations attributable to owners of the parent. These disclosures may be presented either in the notes or in the statement of profit and loss.

7.7.4 Disclosures in the statement of cash flows

Disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either in the notes or in the financial statements. These disclosures are not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition.

7.7.5 Disclosures of Earnings per share

Earnings per share amounts should be shown separately when an entity reports discontinued operations. Paragraph 68 of Ind AS 33 requires an entity that reports discontinued operations to present basic and diluted per share amounts for discontinued operations, either in the statement of profit and loss or in the notes to the financial statements. This disclosure is required in addition to the presentation of basic and diluted per share amounts for profit or loss from continuing operations and profit or loss for the year, both of which should be shown in the statement of profit and loss with equal prominence.

7.7.6 Adjustment to prior period disposals

Adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period should be classified separately in discontinued operations. The nature and amount of such adjustments are disclosed. Examples of circumstances in which these adjustments may arise include the following:

- (a) the resolution of uncertainties that arise from the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser;
- (b) the resolution of uncertainties that arise from and are directly related to the operations of the component before its disposal, such as environmental and product warranty obligations retained by the seller; and
- (c) the settlement of employee benefit plan obligations, provided that the settlement is directly related to the disposal transaction.

7.7.7 Change to a plan of sale

If an entity ceases to classify a component of an entity as held for sale, the results of operations of the component previously presented in discontinued operations should be reclassified and included in income from continuing operations for all periods presented. The amounts for prior periods should be described as having been re-presented.

7.7.8 Loss of Control in Subsidiary

An entity that is committed to a sale plan involving loss of control of a subsidiary should disclose the information as above when the subsidiary is a disposal group that meets the definition of a discontinued operation.

Example 23: Presentation of Discontinued Operations in the Statement of profit and loss.

Statement of profit and loss for the year ended 31st March, 20X3

	20X1-20X2	20X2-20X3
Continuing Operations		
Revenue	XX	XX
Cost of Sales	<u>(XX)</u>	<u>(XX)</u>
Gross Profit	XX	XX
Other Income	XX	XX
Distribution Costs	(XX)	(XX)

Administrative Expenses	(XX)	(XX)
Other Expenses	(XX)	(XX)
Finance Costs	(XX)	(XX)
Share of Profit of Associates	<u>XX</u>	<u>XX</u>
Profit before Tax	XX	XX
Income Tax Expense	<u>(XX)</u>	<u>(XX)</u>
Profit for the period from Continuing Operation	XX	XX
Discontinued Operations		
Profit for the period from discontinued Operations*	<u>XX</u>	<u>XX</u>
Profit for the period	<u>XX</u>	<u>XX</u>
Attributable to:		
Owner of the parent		
Profit for the period from continuing operations	XX	XX
Profit for the period from discontinued operations	<u>XX</u>	<u>XX</u>
Profit for the period attributable to owners of the parent	XX	XX
Non-Controlling Interests		
Profit for the period from continuing operations	XX	XX
Profit for the period from discontinued operations	<u>XX</u>	<u>XX</u>
Profit for the period attributable to non-controlling interests	XX	XX
	<u>XX</u>	<u>XX</u>

* the required analysis would be given in the notes.



7.8 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Hindustan Unilever Limited' for the financial year 2021-2022 with respect to 'Assets held for Sale' and its accounting policy thereon.

Standalone Balance Sheet

as at 31st March, 2022

(All amounts in ₹ crores, unless otherwise stated)

Particulars	Note	As at 31st March, 2022	As at 31st March, 2021
ASSETS			
Non-current assets			
Current assets			
Inventories	11	3,890	3,383
Financial assets			
Investments	6	3,510	2,683
Loans	7	34	34
Trade receivables	12	1,932	1,648
Cash and cash equivalents	13	988	1,740
Bank balances other than cash and cash equivalents mentioned above	14	2,630	2,581
Other financial assets	8	1,070	1,116
Other current assets	15	580	438
Assets held for sale	16	13	17
Total - Current assets (B)		14,647	13,640
TOTAL ASSETS [(A) + (B)]		69,737	68,116

NOTE 16 ASSETS HELD FOR SALE

Non-current assets or disposal groups comprising of assets and liabilities are classified as 'held for sale' when all the following criteria are met: (i) decision has been made to sell, (ii) the assets are available for immediate sale in its present condition, (iii) the assets are being actively marketed and (iv) sale has been agreed or is expected to be concluded within 12 months of the Balance Sheet date.

Subsequently, such non-current assets and disposal groups classified as 'held for sale' are measured at the lower of its carrying value and fair value less costs to sell. Non-current assets held for sale are not depreciated or amortised.

	As at 31st March, 2022	As at 31st March, 2021
Groups of assets held for sale		
Land	2	3
Buildings	11	14
Plant and equipment	-	0
Furniture and fixtures	0	0
	13	17

The Company has sold land with net book value (NBV) of ₹1 crore (31st March, 2021: ₹0 crore), buildings with NBV of ₹3 crores (31st March, 2021: ₹1 crore) and plant & equipment with NBV of ₹0 crore (31st March, 2021: Nil). The gain on such sale has been credited to the standalone statement of profit and loss under exceptional items.

(Source: Annual Report 2021-2022 - 'Hindustan Unilever Limited')



7.9 SIGNIFICANT DIFFERENCES IN IND AS 105 VIS-À-VIS AS 24

S.No.	Particular	Ind AS 105	AS 24
1.	Scope and Objective	Ind AS 105 specifies the accounting for non-current assets held for sale, and the	AS 24 establishes principles for reporting information about <i>discontinuing operations</i> . But

		presentation and disclosure of <i>discontinued operations</i>. Ind AS 105 applies to all recognised non-current assets and to all disposal groups of an entity. (Paragraph 1 of Ind AS 105)	in AS 24, there is no concept of discontinued operations. It does not deal with the non-current assets held for sale; property, plant and equipment retired from active use and held for sale, which are dealt in AS 10 'Property, Plant and Equipment'. ('Objective' of AS 24)
2.	<i>Discontinued vs Discontinuing Operations</i>	Under Ind AS 105, a discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale and represents a separate major line of business or geographical area of operations, is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or is a subsidiary acquired exclusively with a view to resale. The standard lays down criteria for classifying an asset as held for sale. (Paragraph 32 of Ind AS 105)	Under AS 24, a discontinuing operation is a component of an entity that it is disposing off substantially in its entirety or in piecemeal or abandoning and represents the major line of business or geographical area of operations and that can be distinguished operationally and for financial reporting purposes. (Paragraph 3 of AS 24)
3.	<i>Time Period</i>	As per Ind AS 105, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification with certain exceptions.	AS 24 does not specify any time period in this regard as it relates to discontinuing operations
4.	<i>Initial Disclosure Event</i>	Ind AS 105 does not mention so as it relates to discontinued operation.	AS 24 specifies about the disclosure information required in respect to a discontinuing operation in financial

5.	<i>Measurement</i>	Under Ind AS 105, non-current assets (disposal groups) held for sale are measured at the lower of carrying amount and fair value less costs to sell and are presented separately in the balance sheet.	statements for the period in which the initial disclosure event occurs. (Paragraph 15 of AS 24) AS 24 requires to apply the principles set out in other relevant Accounting Standards, e.g., AS 10 requires that the items of property, plant and equipment retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.
6.	<i>Abandonment of Assets</i>	Ind AS 105 specifically mentions that abandonment of assets should not be classified as held for sale. (Paragraph 13 of Ind AS 105)	In AS 24, abandonment of assets is classified as a discontinuing operation; however, changing the scope of an operations or the manner in which it is conducted is not abandonment and hence not a discontinuing operation. (Paragraph 7 of AS 24)
7.	<i>Guidance Regarding Measurement of Changes to a Plan of Change</i>	Ind AS 105 provides guidance regarding changes to the plan to sell non-current assets (or disposal groups) which are classified as held for sale. (Paragraphs 26-29 of Ind AS 105)	AS 24 does not give any specific guidance regarding this aspect.

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TEST YOUR KNOWLEDGE

Questions

1. On 28th February, 20X1, Entity X becomes committed to a plan to sell a property. However, it plans certain renovations to increase its value prior to selling it. The renovations are expected to be completed within a short span of time i.e., 2 months.

Comment whether the property can be classified as held for sale at the reporting date i.e. 31st March, 20X1.

2. On 1st March, 20X1, entity R decides to sell one of its factories. An agent is appointed and the factory is actively marketed. As on 31st March, 20X1, it is expected that the factory will be sold by 28th February, 20X2. However, in May 20X1, the market price of the factory deteriorated. Entity R believed that the market would recover and thus did not reduce the price of the factory. The company's accounts are authorised for issue on 26th June, 20X1.

Recommend whether the factory should be shown as held for sale as on 31st March, 20X1.

3. On 1st June, 20X1, entity X plans to sell a group of assets and liabilities, which is classified as a disposal group. On 31st July, 20X1, the Board of Directors approves and becomes committed to the plan to sell the manufacturing unit by entering into a firm purchase commitment with entity Y. However, since the manufacturing unit is regulated, the approval from the regulator is needed for sale. The approval from the regulator is customary and highly probable to be received by 30th November, 20X1 and the sale is expected to be completed by 31st March, 20X2. Entity X follows December year end.

The assets and liabilities attributable to this manufacturing unit are as under:

(Amount in ₹)

Particulars	Carrying value as on 31 st December, 20X0	Carrying value as on 31 st July, 20X1
Goodwill	500	500
Plant and Machinery	1,000	900
Building	2,000	1,850
Debtors	850	1,050
Inventory	700	400
Creditors	(300)	(250)
Loans	<u>(2,000)</u>	<u>(1,850)</u>
	<u>2,750</u>	<u>2,600</u>

The fair value of the manufacturing unit as on 31st December, 20X0 is ₹ 2,000 and as on 31st July, 20X1 is ₹ 1,850. The cost to sell is ₹ 100 on both these dates. The disposal group is not sold at the period end i.e., 31st December, 20X1. The fair value as on 31st December, 20X1 is lower than the carrying value of the disposal group as on that date.

Required:

1. Assess whether the manufacturing unit can be classified as held for sale and reasons there for. If yes, then at which date?
2. Measure the manufacturing unit on the date of classification as held for sale.
3. Measure the manufacturing unit at the end of the year.
4. Following is the extract of the consolidated financial statements of A Ltd. for the year ended on:

Asset/ (liability)	Carrying amount as on 31 st March, 20X1 (In ₹ '000)
Attributed goodwill	200
Intangible assets	950
Financial asset measured at fair value through other comprehensive income	300

Property, plant & equipment	1,100
Deferred tax asset	250
Current assets – inventory, receivables and cash balances	600
Current liabilities	(850)
Non-current liabilities – provisions	<u>(300)</u>
Total	<u>2,250</u>

On 15th September 20X1, Entity A decided to sell the business. It noted that the business meets the condition of disposal group classified as held for sale on that date in accordance with Ind AS 105. However, it does not meet the conditions to be classified as discontinued operations in accordance with that standard.

The disposal group is stated at the following amounts immediately prior to reclassification as held for sale.

Asset/ (liability)	Carry amount as on 15th September 20X1 (In ₹ '000)
Attributed goodwill	200
Intangible assets	930
Financial asset measured at fair value through other comprehensive income	360
Property, plant & equipment	1,020
Deferred tax asset	250
Current assets – inventory, receivables and cash balances	520
Current liabilities	(870)
Non-current liabilities – provisions	<u>(250)</u>
Total	<u>2,160</u>

Entity A proposed to sell the disposal group at ₹ 19,00,000. It estimates that the costs to sell will be ₹ 70,000. This cost consists of professional fee to be paid to external lawyers and accountants.

As at 31st March 20X2, there has been no change to the plan to sell the disposal group and entity A still expects to sell it within one year of initial classification. Mr. X, an accountant of

Entity A remeasured the following assets / liabilities in accordance with respective standards as on 31st March 20X2:

Available for sale:	(In ₹ '000)
Financial assets	410
Deferred tax assets	230
Current assets- Inventory, receivables and cash balances	400
Current liabilities	900
Non- current liabilities- provisions	250

The disposal group has not been trading well and its fair value less costs to sell has fallen to ₹ 16,50,000.

Compute the value of all assets/ liabilities within the disposal group as on the following dates in accordance with Ind AS 105:

(a) 15 September, 20X1 and

(b) 31st March, 20X2

5. CK Ltd. prepares the financial statement under Ind AS for the quarter and the year ended 30th June, 20X1. During the 3 months ended 30th June, 20X1, the following events occurred:

On 1st April, 20X1, the Company has decided to sell one of its divisions as a going concern following a recent change in its geographical focus. The proposed sale would involve the buyer acquiring the non-monetary assets (including goodwill) of the division, with the Company collecting any outstanding trade receivables relating to the division and settling any current liabilities.

On 1st April, 20X1, the carrying amount of the assets of the division were as follows:

- Purchased Goodwill – ₹ 60,000
- Property, Plant & Equipment (average remaining estimated useful life two years) - ₹ 20,00,000
- Inventories - ₹ 10,00,000

From 1st April, 20X1, the Company has started to actively market the division and has received number of serious enquiries. On 1st April, 20X1 the directors estimated that they would receive ₹ 32,00,000 from the sale of the division. Since 1st April, 20X1, market condition has improved and as on 1st August, 20X1 the Company received and accepted a firm offer to purchase the division for ₹ 33,00,000.

The sale is expected to be completed on 30th September, 20X1 and ₹ 33,00,000 can be assumed to be a reasonable estimate of the value of the division as on 30th June, 20X1. During the period from 1st April to 30th June inventories of the division costing ₹ 8,00,000 were sold for ₹ 12,00,000. At 30th June, 20X1, the total cost of the inventories of the division was ₹ 9,00,000. All of these inventories have an estimated net realisable value that is in excess of their cost.

Suggest how the proposed sale of the division will be reported in the interim financial statements for the quarter ended 30th June, 20X1 giving relevant explanations.

6. Identify which of the following is a disposal group at 31st March 20X1:
- (1) On 21st March 20X1, XYZ announced the Board's intention to sell its shares in a subsidiary company, Alpha, contingent upon the approval of Alpha's shareholders. It seems unlikely that approval will be granted in the near future and no specific potential buyer has been identified.
 - (2) PQR has entered into a contract to sell the entire delivery fleet of vehicles operated from its warehouse to a competitor, ABC, on 14th March 20X1. The assets will be transferred on 28th April 20X1 from which date the Group will outsource its delivery activities to another company, LMN.
 - (3) On 16th January 20X1, DEF's management and shareholders approved a plan to sell its retail business in Mumbai and a consultant is hired to manage the sale. As at 31st March 20X1 agreement had been signed although due diligence and the negotiation of final terms are still in process. The transaction is expected to be completed in April 20X1.

Answers

1. The property cannot be classified as held for sale at the balance sheet date as it is not available for sale immediately in its present condition. Although the renovations are expected to be completed within a short span 2 months, this fact is not relevant for classification. The delay in the timing of the transfer of the property imposed by the Entity X demonstrates that the property is not available for immediate sale.

However, if the PPE meets the criteria for held for sale by 30th April, 20X1 (i.e., 2 months from 28th February, 20X1) and the accounts are not authorised by that date, then necessary disclosures need to be given in the financial statements.

2. The factory ceases to meet the definition of held for sale post the balance sheet date but before the financial statements are authorised for issue, as it is not actively marketed at a

reasonable price. But, since the market conditions deteriorated post the balance sheet date, the asset will be classified as held for sale as at 31st March, 20X1.

3. Assessing whether the manufacturing unit can be classified as held for sale

The manufacturing unit can be classified as held for sale due to the following reasons:

- (a) The disposal group is available for immediate sale and in its present condition. The regulatory approval is customary and it is expected to be received in one year. The date at which the disposal group must be classified as held for sale is 31st July, 20X1, i.e., the date at which management becomes committed to the plan.
- (b) The sale is highly probable as the appropriate level of management i.e., board of directors in this case have approved the plan.
- (c) A firm purchase agreement has been entered with the buyer.
- (d) The sale is expected to be complete by 31st March, 20X2, i.e., within one year from the date of classification.

Measurement of the manufacturing unit as on the date of classification as held for sale

Following steps need to be followed:

Step 1: Immediately before the initial classification of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) shall be measured in accordance with applicable Ind AS.

This has been done and the carrying value of the disposal group as on 31st July, 20X1 is determined at ₹ 2,600. The difference between the carrying value as on 31st December, 20X0 and 31st July, 20X1 is accounted for as per the relevant Ind AS.

Step 2: An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

The fair value less cost to sell of the disposal group as on 31st July, 20X1 is ₹ 1,750 (i.e. 1,850 - 100). This is lower than the carrying value of ₹ 2,600. Thus, an impairment loss needs to be recognised and allocated first towards goodwill and thereafter pro-rata between non-current assets of the disposal group which are within the scope of Ind AS 105 based on their carrying value.

Thus, the assets will be measured as under:

Particulars	Carrying value – 31 st July, 20X1	Impairment	Carrying value as per Ind AS 105 – 31 st July, 20X1
Goodwill	500	(500)	-
Plant and Machinery	900	(115)	785
Building	1,850	(235)	1,615
Debtors	1,050	-	1,050
Inventory	400	-	400
Creditors	(250)	-	(250)
Loans	<u>(1,850)</u>	<u>-</u>	<u>(1,850)</u>
	<u>2,600</u>	<u>(850)</u>	<u>1,750</u>

Measurement of the manufacturing unit as on the date of classification as at the year end

The measurement as at the year-end shall be on similar lines as done above.

The assets and liabilities in the disposal group not within the scope of this Standard are measured as per the respective Standards.

The fair value less cost to sell of the disposal group as a whole is calculated. This fair value less cost to sell as at the year-end shall be compared with the carrying value as at the date of classification as held for sale. It is provided that the fair value as on the year end is less than the carrying amount as on that date – thus the impairment loss shall be allocated in the same way between the assets of the disposal group falling within the scope of this standard as shown above.

4. (a) As at 15th September, 20X1

The disposal group should be measured at ₹ 18,30,000 (19,00,000-70,000). The impairment write down of ₹ 3,30,000 (₹ 21,60,000 – ₹ 18,30,000) should be recorded within profit from continuing operations.

The impairment of ₹ 3,30,000 should be allocated to the carrying values of the appropriate non-current assets.

Asset/ (liability)	Carrying value as at 15 th September, 20X1	Impairment	Revised carrying value as per Ind AS 105
Attributed goodwill	200	(200)	-
Intangible assets	930	(62)	868
Financial asset measured at fair value through other comprehensive income	360	-	360
Property, plant & equipment	1,020	(68)	952
Deferred tax asset	250	-	250
Current assets – inventory, receivables and cash balances	520	-	520
Current liabilities	(870)	-	(870)
Non-current liabilities – provisions	<u>(250)</u>	<u>-</u>	<u>(250)</u>
Total	<u>2,160</u>	<u>(330)</u>	<u>1,830</u>

The impairment loss is allocated first to goodwill and then prorata to the other assets of the disposal group within Ind AS 105 measurement scope. Following assets are not in the measurement scope of the standard- financial asset measured at other comprehensive income, the deferred tax asset or the current assets. In addition, the impairment allocation can only be made against assets and is not allocated to liabilities.

(b) As on 31 March, 20X2:

All of the assets and liabilities, outside the scope of measurement under Ind AS 105, are remeasured in accordance with the relevant standards. The assets that are remeasured in this case under the relevant standards are the financial asset measured at fair value through other comprehensive income (Ind AS 109), the deferred tax asset (Ind AS 12), the current assets and liabilities (various standards) and the non-current liabilities (Ind AS 37).

Asset/ (liability)	Carrying amount as on 15 th September, 20X1	Change in value to 31 st March 20X2	Impairment	Revised carrying value as per Ind AS 105
Attributed goodwill	-	-	-	-
Intangible assets	868	-	(29)	839
Financial asset measured at fair value through other comprehensive income	360	50	-	410
Property, plant & equipment	952	-	(31)	921
Deferred tax asset	250	(20)	-	230
Current assets – inventory, receivables and cash balances	520	(120)	-	400
Current liabilities	(870)	(30)	-	(900)
Non-current liabilities – provisions	<u>(250)</u>	<u>-</u>	<u>-</u>	<u>(250)</u>
Total	<u>1,830</u>	<u>(120)</u>	<u>(60)</u>	<u>1,650</u>

5. The decision to offer the division for sale on 1st April, 20X1 means that from that date the division has been classified as held for sale. The division available for immediate sale, is being actively marketed at a reasonable price and the sale is expected to be completed within one year.

The consequence of this classification is that the assets of the division will be measured at the lower of their existing carrying amounts and their fair value less cost to sell. Here the division shall be measured at their existing carrying amount ie ₹ 30,60,000 since it is less than the fair value less cost to sell ₹ 32,00,000.

The increase in expected selling price will not be accounted for since earlier there was no impairment to division held for sale.

The assets of the division need to be presented separately from other assets in the balance sheet. Their major classes should be separately disclosed either on the face of the balance sheet or in the notes.

The Property, Plant and Equipment shall not be depreciated after 1st April, 20X1 so its carrying value at 30th June, 20X1 will be ₹ 20,00,000 only. The inventories of the division will be shown at ₹ 9,00,000.

The division will be regarded as discontinued operation for the quarter ended 30th June, 20X1. It represents a separate line of business and is held for sale at the year end.

The Statement of Profit and Loss should disclose, as a single amount, the post-tax profit or loss of the division on classification as held for sale.

Further, as per Ind AS 33, EPS will also be disclosed separately for the discontinued operation.

6. Presented as held for sale

- (2) PQR's fleet is classified as held for sale because it constitutes a group of assets to be sold in their present condition and the sale is highly probable at the reporting date (as a contract has been entered into).
- (3) DEF's sale of its retail business will not be completed until the final terms (e.g. of purchase price) are agreed. However, the business is ready for immediate sale and the sale is highly probable unless other evidence after the reporting date but before the financial statements are approved for issue, comes to light to indicate the contrary.

Not presented as held for sale

- (1) XYZ's shares in Alpha are not available for an immediate sale as shareholders' approval is required. Also no specific potential buyer has been identified. In taking these facts into consideration for the assessment of whether the sale is highly probable, it is clearly not highly probable.

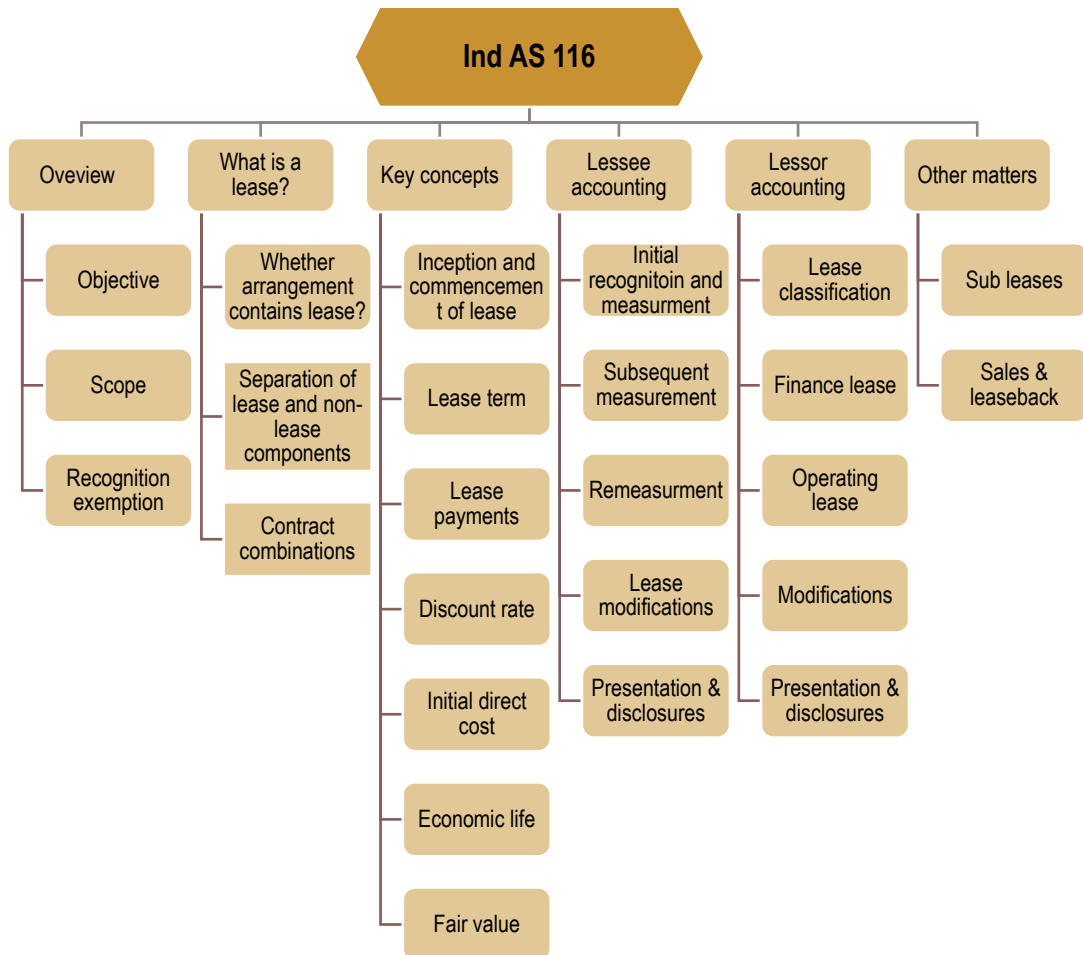
UNIT 8: INDIAN ACCOUNTING STANDARD 116 : LEASES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ☐ List the scope and explain the definitions given in the standard
- ☐ Comprehend the criteria for recognition of lease
- ☐ Analyse whether an arrangement contains a lease
- ☐ Identify and separate the lease and non-lease components of a contract
- ☐ Demonstrate the concept of inception and commencement of lease
- ☐ Determine lease term
- ☐ Identify other key concepts like lease payments, discount rate and economic life
- ☐ Provide the accounting in the books of lessee with respect to recognition, measurement, presentation and disclosure aspects
- ☐ Learn the accounting in the books of lessor with respect to recognition, measurement, presentation and disclosure aspects
- ☐ Produce accounting for subleases and sale and lease back transactions
- ☐ Apply the transitional provisions on applying Ind AS 116 for the first time.

UNIT OVERVIEW





8.1 OVERVIEW

The Ministry of Corporate Affairs (MCA) has notified new standard on leases i.e Ind AS 116 vide its notification dated 30th March, 2019. Lease accounting has undergone significant changes on introduction of Ind AS 116 which is fully converged with IFRS 16. This new standard replaced the erstwhile Ind AS 17 and is effective from financial periods beginning on or after 1st April, 2019.

Ind AS 17 was based on dual classification model of operating and finance leases with different classification and measurement guidance for each of them. The dual classification model did not account for the assets and liabilities associated with the rights and obligations that arise out of the most “operating” leases.

Under Ind AS 116, leases are accounted for based on a ‘right-of-use model’. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the time when it makes the underlying asset available for use by the lessee. Ind AS 116, Leases, requires most leases to be recognized on the balance sheet and requires enhanced disclosures. It is believed that this will result in a more faithful representation of lessees’ assets and liabilities and greater transparency about the lessee’s obligations and leasing activities. However, Ind AS 116 does not make fundamental changes to existing lessor accounting model.

8.1.1 Objective

The objective of this standard is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity. This standard requires an entity to consider the terms and conditions of contracts and all relevant facts and circumstances, and to apply the standard consistently to contracts with similar characteristics and in similar circumstances.

For many reporting entities, leasing is an important way to obtain access to property. A leasing arrangement conveys the use of an asset from one party to another without transferring ownership. The leasing arrangement may take various forms. Some arrangements are clearly within the scope of lease accounting, for example, property lease that provides an explicit contractual right to use a building for a specified period of time in exchange for consideration. However, the right to use an asset can also be conveyed through arrangements that are not leases in form. Therefore, it is very critical to assess as to which arrangement contains a lease for assessing correct impact on financial position.

Ind AS 116, Leases, identifies arrangements that are to be accounted for as leases. This unit discusses how to identify which arrangements, or components within an arrangement, should be

accounted for under Ind AS 116 and sets out the principles for the recognition, measurement, presentation and disclosure of leases.

8.1.2 Scope

Ind AS 116 shall be applied to ALL LEASES, including leases of Right-of-Use (ROU) assets in a sub-lease, **EXCEPT** for:

S.N.	Particulars	Reason
1	Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources	Within the scope of Ind AS 106 ' <i>Exploration for and Evaluation of Mineral Resources</i> '
2	Leases of biological assets held by a lessee	Within the scope of Ind AS 41 ' <i>Agriculture</i> '
3	Service concession arrangements	Within the scope of Appendix D of Ind AS 115 ' <i>Revenue from Contracts with Customers</i> '
4	Licences of intellectual property granted by a lessor	Within the scope of Ind AS 115 ' <i>Revenue from Contracts with Customers</i> '
5 [#]	Rights held by a lessee under licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights	Within the scope of Ind AS 38 ' <i>Intangible Assets</i> '

[#]A lessee may, but is not required to, apply Ind AS 116 to leases of intangible assets other than those described herein.

8.1.3 Recognition Exemptions

In addition to above scope exclusions, a lessee can elect not to apply Ind AS 116's recognition requirements to:

1. Short-term leases; and
2. Leases for which the underlying asset is of low value

If a lessee **elects to apply** the above recognition exemption, the lessee shall recognise **the lease payments** associated with those leases as an expense on **either a straight-line basis over the lease term or another systematic basis**, if that basis is more representative of the pattern of the lessee's benefit.

Short term leases:

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset. As the determination is made at the commencement date, a lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months.

The short-term lease exemption can be made by **class of underlying asset** to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations.

For example, consider an entity which has leased several items of office equipment - some of them for less than 12 months and some for more than 12 months, with none containing purchase options. Assuming that the items of office equipment are all considered to be of the same class if the entity wishes to use the short-term lease exemption it must apply for that exemption for all the leases with terms of 12 months or less. The leases with terms longer than 12 months will be accounted for in accordance with the general recognition and measurement requirements for lessees.

A lessee that makes this election must make certain quantitative and qualitative disclosures about short-term leases. Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy.

Illustration 1 - Short-term lease**Scenario A:**

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates.

Analyze whether the lessee can take a short-term exemption in accordance with Ind AS 116.

Scenario B:

Assume the same facts as Scenario A except, at the lease commencement date, the lessee is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain.

Advise will your answer be different in this case.

Solution:**Scenario A:**

As the lessee is reasonably certain to exercise the extension option (Refer section 8.2 lease term), the lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee will not account for the lease as a short-term lease.

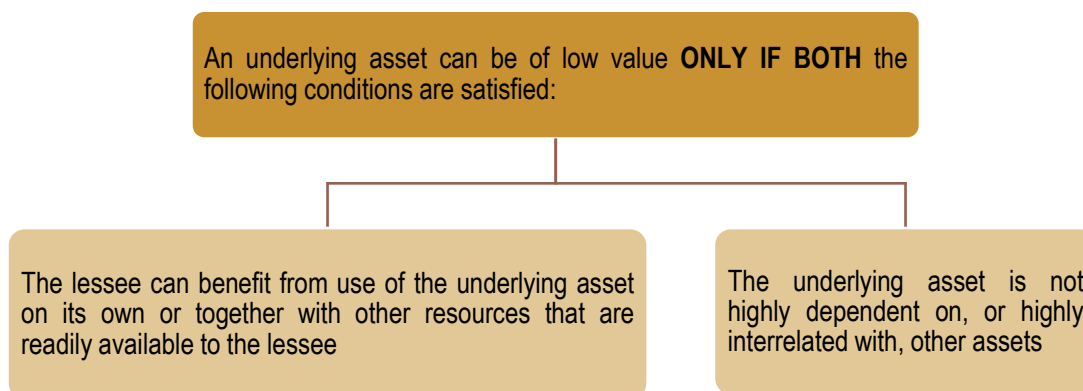
Scenario B:

In this case, the lease term is less than 12 months, i.e., nine months. Thus, the lessee may account for the said lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis.

Leases of low-value assets:

Lessees can also make an election for leases for which the underlying asset is of low value (i.e., low-value assets).

Though Ind AS 116 does not explicitly define the leases of low-value assets, it provides the conditions based on which an asset can be treated as of low-value and the said exemption can be availed accordingly for such low-value asset(s). Following are the conditions:



This can be understood with the help of the following **example**:

An entity may lease a car for use in its business and the lease includes the use of the tyres attached to the car. To use the tyres for their intended purpose, they can only be used with the car and as such, they are dependent on, or highly interrelated with the car. Therefore, the tyres would not qualify for the low-value asset exemption.

The election for leases for which the underlying asset is of low value can be made on a **lease-by-lease basis**. For example, an entity enters into a rental contract for a large number of laptops. Each laptop within the contract constitutes an identified asset. Entity has considered that the value of individual laptop would be low, even though the contract for all the laptops is not. The conditions of Para B5 of Ind AS 116 are satisfied i.e., the entity can benefit from use of an individual laptop together with other resources that are already available and each laptop does not need other assets to make it functional. Consequently, each laptop qualifies as a low value asset and the entity can elect to apply the low-value exemption to all the laptops under the contract.

The exemption for leases of low — value items intend to capture leases that are high in volume but low in value — e.g. leases of small IT equipment (laptops, mobile phones, simple printers), leases of office furniture etc. Ind AS 116 is silent on any threshold to determine the value for classifying any asset as low value assets.

The following boxes depicts the important points regarding the leases of low-value assets:

Value of an underlying asset to be assessed based on the value of the asset when it is new, regardless of the age of the asset being leased*

Leases of low-value assets are exempted regardless of whether those leases are material to the lessee

Examples of low-value underlying assets can include:

- tablet
- personal computers,
- small items of office furniture
- telephones

The assessment performed on an absolute basis. It is not affected by the size, nature or circumstances of the lessee.

*A lease of an underlying asset does not qualify as a lease of low value asset if the nature of the asset is such that, when new, the asset is typically not of low value. **For e.g.**, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

Head leases do not qualify as low value assets:

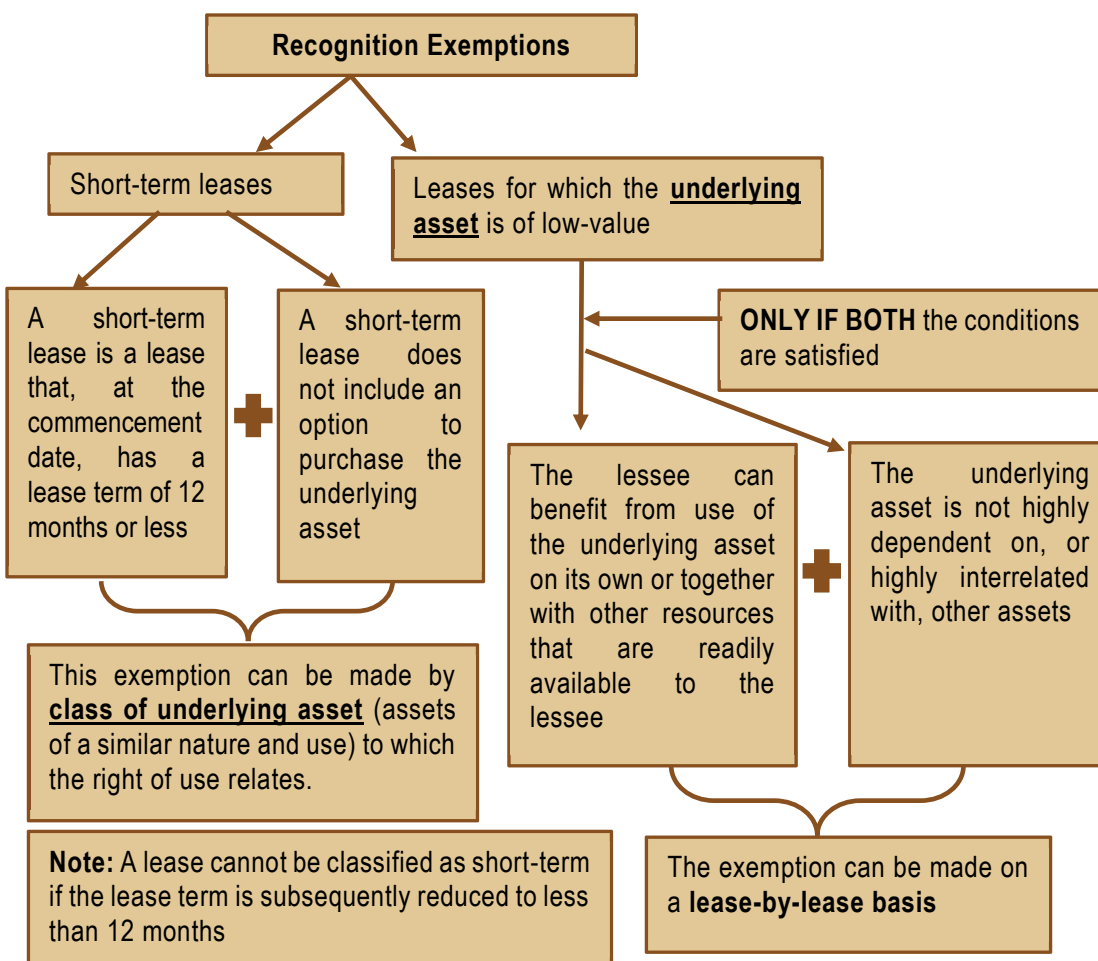
It is very important to note that if a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset. (Refer section 8.6.1 sublease)

Then, what should be the approach for such leases when the said exemptions are taken?

The lease payments shall be recognised as an expense on either a Straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.

If a lessee accounts for “short-term leases” as per the approach mentioned above, it shall consider the lease to be a “new lease” for the purposes of Ind AS 116 if:

- (a) there is a lease modification; **OR**
- (b) there is any change in the lease term

**Note:**

1. The exemption for leases of low—value items intend to capture leases that are high in volume but low in value.
2. If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset.



8.2 WHAT IS A LEASE?

At the inception of a contract, an entity shall assess whether the contract is or contains a lease. For the purpose, a lease is defined as a contract, or part of a contract that conveys the **right to control** the use of an **identified asset** for a **period of time** in **exchange for consideration**.

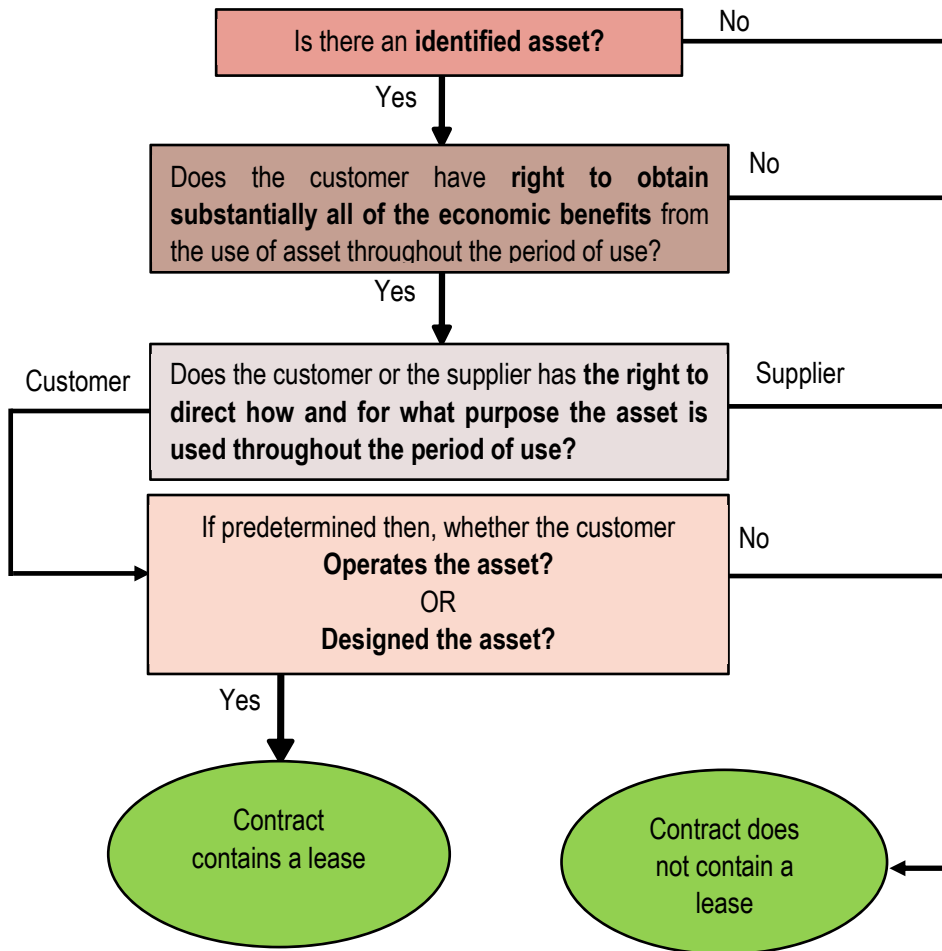
Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the inception of the contract.

The inception date is defined as the **earlier** of the following dates:

- ◆ date of a lease agreement
- ◆ date of commitment by the parties to the principal terms and conditions of the lease

'A period of time' may be described in terms of the amount of use of an identified asset (***for e.g.***, the number of production units that an item of equipment will be used to produce). It includes any non-consecutive periods of time.

8.2.1 Whether an Arrangement Contains Lease?



Comparison with AS 19:

AS 19 neither does provide additional guidance regarding “right to direct”, nor does it provide any guidance regarding cases of pre-determined activities. AS 19, in general, considers right to use an identified asset.

8.2.1.1 Identified Asset

An arrangement only contains a lease if there is an **identified asset**. Under Ind AS 116, an identified asset can be explicitly specified in a contract or implicitly specified at the time that the asset is made available for use by the customer.

Illustration 2 - Asset implicitly specified in a contract

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of rolling stock specifically designed for Customer XYZ.

The rolling stock is designed to transport materials used in Customer XYZ's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract but Supplier ABC owns only one rolling stock that is suitable for Customer XYZ's use. If the rolling stock does not operate properly, the contract requires Supplier ABC to repair or replace the rolling stock.

Comment whether there is an identified asset.

Solution:

Yes, the said rolling stock is an identified asset.

Though the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier ABC must use it to fulfil the contract.

Illustration 3 (Asset implicitly specified in a contract):

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of a car. The specification of the car is specified in the contract (i.e., brand, type, colour, options, etc.). At inception of the contract, the car is not yet built.

State whether there is an identified asset.

Solution:

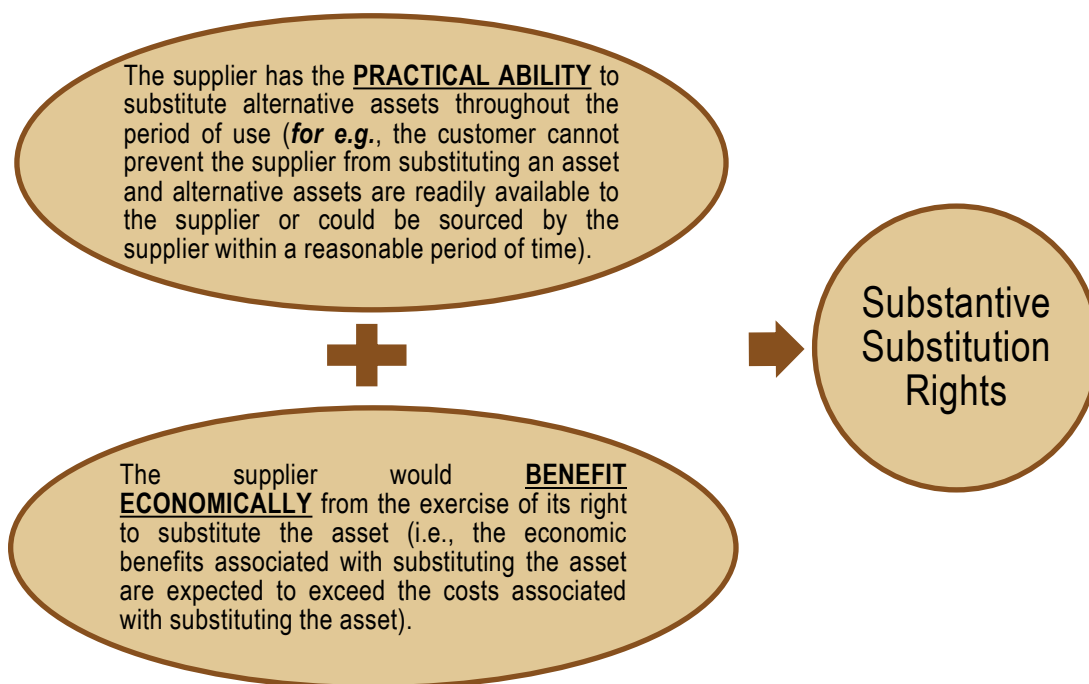
Yes, the said car is an identified asset.

Though the car cannot be identified at inception of the contract, it is **implicitly specified** at the time the same will be made available to Customer XYZ.

Substantive Substitution Rights:

This is a very important concept since without evaluating this condition, the conclusion as to whether there is an identified asset cannot be attained. So, even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use.

A supplier's right to substitute an asset is **SUBSTANTIVE** when **BOTH** of the following conditions are met:



The conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract.

In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective. Examples of factors to consider include (1) transportation costs of relocating one asset to a location where it can be used to satisfy the arrangement or to move the output from the production location to the customer, (2) foregone production resulting from down time necessary to switch assets and other disruptions to the suppliers' business, (3) excess operational costs to convert an asset that may not have produced identical output, etc.

Further, if the supplier has a right or an obligation to substitute the asset only on or after either a **particular date**, or the occurrence of a specified event, the supplier's substitution right is **not substantive** because the supplier does **not have the practical ability** to substitute alternative assets **throughout the period of use**.

An entity's evaluation of whether a supplier's substitution right is substantive is based on **facts and circumstances at inception** of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur. Ind AS 116 provides the following examples of circumstances that, at inception of the contract, are not likely to occur and, thus, are **excluded** from the evaluation of whether a supplier's substitution right is substantive throughout the period of use:

(1)

An agreement by a future customer to pay an above market rate for use of the asset

(2)

The introduction of new technology that is not substantially developed at inception of the contract

(3)

A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract

(4)

A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract

The requirement that a substitution right must **benefit the supplier economically** in order to be substantive is a new concept. In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. ***For e.g.***, if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because a supplier concludes that the cost of substitution is not significant does not automatically mean that it would economically benefit from the right of substitution.

Ind AS 116 further clarifies that a customer should **presume** that a supplier's substitution right is **not substantive** when the customer **cannot readily determine** whether the supplier has a substantive substitution right. This requirement is intended to clarify that a **customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive**. However, suppliers should have sufficient information to make a determination of whether a substitution right is substantive.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (***for e.g.***, a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

Illustration 4 - Substantive Substitution Rights

Scenario A:

An electronic data storage provider (supplier) provides services through a centralised data centre that involve the use of a specified server (Server No. 10). The supplier maintains many identical

servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute for another server without the customer's consent throughout the period of use.

Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimize the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Analyze whether the substitution rights are substantive and whether there is an identified asset.

Scenario B:

Assume the same facts as in Scenario A except that Server No. 10 is customized, and the supplier does not have the practical ability to substitute the customized asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Analyze whether the substitution rights are substantive and whether there is an identified asset.

Solution

Scenario A:

The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute for the server and would benefit economically from such a substitution. Thus, there is no identified asset.

However, if the customer could not readily determine whether the supplier had a substantive substitution right (**for e.g.**, there is insufficient transparency into the supplier's operations), the customer would **presume** the substitution right is not substantive and conclude that there is an identified asset.

Scenario B:

The substitution right is not substantive, and Server No. 10 would be an identified asset because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset. In this case, neither of the conditions of a substitution right is met (whereas both the conditions must be met for the supplier to have a substantive substitution right). Therefore, Server No 10 will be considered as an identified asset.

Comparison with AS 19:

AS 19 does not include any requirement for substantive substitution right. Hence, even if a lessor has substantial substitution right, the contract may be accounted for as a lease under AS 19.

Identified Asset – Physically Distinct:

An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building may also be considered physically distinct if it can be used independent of the other floors. Similarly, a capacity or other portion of an asset that is not physically distinct (*for e.g.*, a capacity portion of a fibre optic cable) is not an identified asset unless it represents **substantially all** of the capacity of the asset and thereby provides the customer with the **right to obtain substantially all of the economic benefits** from use of the asset.

The term “substantially all” is not defined in Ind AS 116.

This can be better understood with the help of the following illustrations:

Illustration 5 (Identified Asset – Physically Distinct):

Customer XYZ enters into a 15-year contract with Supplier ABC for the right to use five fibres within a fibre optic cable between Mumbai and Pune. The contract identifies five of the cable's 25 fibres for use by Customer XYZ. The five fibres are dedicated solely to Customer XYZ's data for the duration of the contract term. Assume that Supplier ABC does not have a substantive substitution right.

Examine whether there is an identified asset.

Solution:

Yes, the said five fibres are identified assets because they are physically distinct and explicitly specified in the contract.

Illustration 6 (Identified Asset – Not Physically Distinct):**Scenario A:**

Customer XYZ enters into a ten-year contract with Supplier ABC for the right to transport oil from India to Bangladesh through Supplier ABC's pipeline. The contract provides that Customer XYZ will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Examine whether there is an identified asset.

Scenario B:

Assume the same facts as in Scenario A, except that Customer XYZ has the right to use 65% of the pipeline's capacity throughout the term of the arrangement.

Assess whether there is an identified asset.

Solution:**Scenario A:**

Yes, the capacity portion of the pipeline is an identified asset.

While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents **substantially all of the capacity** of the entire pipeline and thereby provides Customer XYZ with the **right to obtain substantially all of the economic benefits** from use of the pipeline.

Scenario B:

No, the capacity portion of the pipeline is **NOT** an identified asset.

Since 65% of the pipeline's capacity is **less than substantially all** of the capacity of the pipeline, Customer XYZ does **not have the right to obtain substantially all of the economic benefits** from use of the pipeline.

8.2.1.2 Right to Control

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

- (a) The right to obtain **substantially all of the economic benefits** from use of the identified asset; **and**
- (b) The **right to direct the use** of the identified asset

The right to control the use of an asset may not necessarily be documented, in form, as a lease agreement. Often, the right to use an identified asset is embedded in an arrangement that may appear to be a supply arrangement or service contract. Therefore, a reporting entity should consider all of the terms of an arrangement to determine whether it contains a lease.

Further, if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

Illustration 7 (Right to use for a portion of the term of contract):

ABC Ltd enters into a contract with XYZ Ltd, which grants ABC Ltd exclusive rights to use a specific grain storage facility over a five-year period in the months of May and June. During these months, ABC Ltd has the right to decide which crops are placed in storage and when to remove them. XYZ Ltd provides the loading and unloading services for the warehouse activities. During the other ten months each year, XYZ Ltd has the right to determine how the warehouse will be used.

Recommend which party has the right to control the use of the identified asset during the period of use.

Solution:

In the above case, ABC Ltd has the right to control the use of the identified asset during the period of use because they have the power to determine how the warehouse will be used during the contractually defined usage periods. The analysis should focus on the rights and economics of the use of the warehouse for the specified usage periods (May and June). During the period of use, ABC Ltd has the rights to determine how much of a crop to place in storage, and the timing of placing and removing it from storage. These rights are more significant to the economics of the use of the asset than the loading and unloading services performed by XYZ Ltd during the same period. ABC Ltd receives all of the economic benefit from use of the asset during those specified time periods. Therefore, contract contains a lease for the specified period of term.

Right to Obtain Substantially All of the Economic Benefits:

The first criterion in the control assessment is to determine whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use, i.e., to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (**for e.g.**, by having exclusive use of the asset throughout that period).

A customer can obtain economic benefits either **directly** or **indirectly** (**for e.g.**, by using, holding or subleasing the asset). Economic benefits from use of an asset include:

- ◆ the asset's primary outputs (i.e., goods or services)
- ◆ any by-products (**for e.g.**, renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items.
- ◆ benefits from using the asset that could be realised from a commercial transaction with a third party (**for e.g.**, subleasing the asset)

When assessing whether the customer has the right to obtain substantially all of the economic benefits from the use of an asset, an entity must consider the economic benefits that result from use of the asset within the **defined scope** of the customer's right to use the asset.

For example:

- (a) if a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity considers only the economic benefits from use of the motor vehicle within that territory, and not beyond; or
- (b) if a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity considers only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond.

A right that **solely protects** the supplier's interest in the underlying asset (***for e.g.***, limits on the number of miles a customer can drive a supplier's vehicle as explained in the above example) does not, in and of itself, prevent the customer from obtaining substantially all of the economic benefits from use of the asset and, therefore, are **not considered** when assessing whether a customer has the right to obtain substantially all of the economic benefits.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from the use of an asset as consideration (***for e.g.***, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use), that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

Illustration 8 (Right to obtain substantially all of the economic benefits):

Company MNO enters into a 15-year contract with Power Company PQR to purchase all of the electricity produced by a new solar farm. PQR owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and MNO will receive renewable energy credits that accrue from use of the solar farm.

Examine who has the right to substantial benefits from the solar farm.

Solution:

Company MNO has the right to obtain substantially all of the economic benefits from use of the solar farm over the 15-year period because it obtains:

- ◆ the electricity produced by the farm over the lease term — i.e. the primary product from use of the asset; and
- ◆ the renewable energy credits — i.e. the by-product from use of the asset.

Although PQR receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the ownership of the solar farm. The tax credits do not relate to use of the solar farm and therefore are not considered in this assessment.

Right to Direct the Use of the Identified Asset

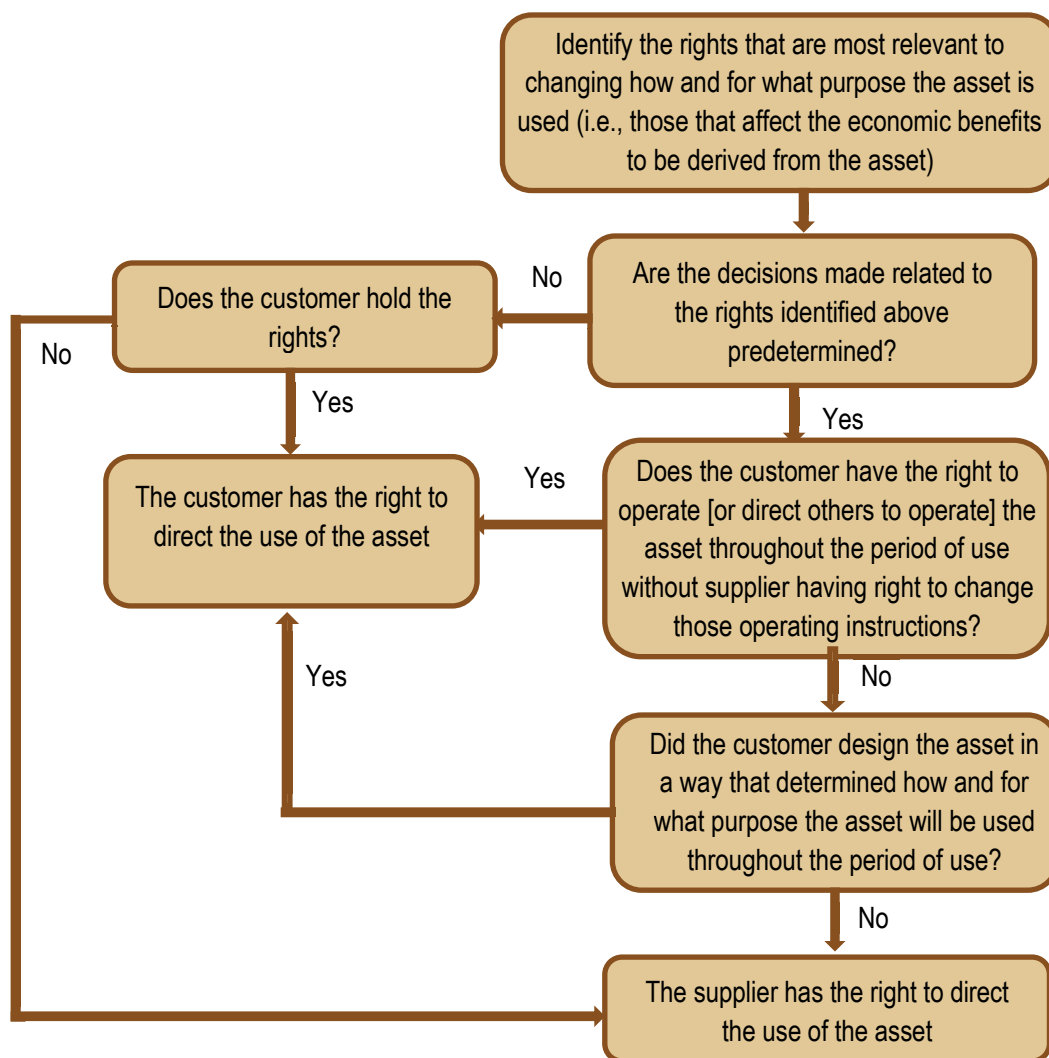
The second criterion in the control assessment is to determine whether the customer has the right to direct the use of the identified asset throughout the period of use.

Decisions about **how and for what purpose an asset will be used are the most relevant factors** to consider when assessing which party directs the use of the identified asset. Because such rights determine the economic benefits that can be derived from using the asset during the period of use.

Decisions regarding **where and when the asset is to be used are likely to be more important** than how those decisions are implemented. For example, if a customer outsources operation of an asset to an outside service provider, the outsourcing does not typically influence the economic benefits that can be derived from the asset.

In some arrangements, the decisions related to how and for what purpose an asset is used, are already specified in the contract before the lease term commences. These decisions will need to be considered in conjunction with decisions made during the period of use to properly identify the party that directs the assets' use. Simply specifying the output prior to the term does not, on its own, constitute the ability to direct the use.

The following figure illustrates the analysis that should be used to determine **which party has the right to direct the use of an identified asset.**



A customer has the right to direct the use of an identified asset whenever it has the right to direct **how and for what purpose** the asset is used throughout the period of use (i.e., it can **change** how and for what purpose the asset is used throughout the period of use). How and for what purpose an asset is used is a **SINGLE CONCEPT** (i.e., 'how' an asset is used is **not assessed separately** from 'for what purpose' an asset is used).

When evaluating whether a customer has the right to change how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the **decision-making rights that will most affect the economic benefits** that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

Ind AS 116 provides the following examples of decision-making rights that grant the right to change how and for what purpose an asset is used:

Particulars	Examples
The right to change the type of output that is produced by the asset	(i) Deciding whether to use a shipping container to transport goods or for storage (ii) Deciding on the mix of products sold from a retail unit
The right to change when the output is produced	Deciding when an item of machinery or a power plant will be used
The right to change where the output is produced	(i) Deciding on the destination of a truck or a ship (ii) Deciding where a piece of equipment is used or deployed
The right to change whether the output is produced and the quantity of that output	Deciding whether to produce energy from a power plant and how much energy to produce from that power plant

Although **the decisions about maintaining and operating the asset** are often essential to the efficient use of that asset, the right to make those decisions, **in and by itself, does not result** in the right to change how and for what purpose the asset is used throughout the period of use.

The customer does **not need the right to operate** the underlying asset to have the right to direct its use, i.e., the customer may direct the use of an asset that is operated by the supplier's personnel. However, the right to operate an asset will often provide the customer with the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

The relevant decisions about how and for what purpose an asset is used are predetermined:

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when

- ◆ the most relevant decisions about how and for what purpose an asset is used are **predetermined by contractual restrictions** on the use of the asset (***for e.g.***, the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed) **OR**
- ◆ the most relevant decisions about how and for what purpose an asset is used are, in effect, **predetermined by the design of the asset**

In cases where the decisions about how and for what purpose an asset is used are predetermined, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- ◆ Has the **right to operate** the asset, **OR direct others to operate** the asset in a manner it determines, throughout the period of use without the supplier having the right to change those operating instructions **OR**
- ◆ **Designed** the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Significant judgement may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Specifying the output of an asset before the period of use

If a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, the customer does **not have the right to direct the use of that asset unless** it designed the asset, **OR** specific aspects of the asset.

If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that does not give it any other relevant decision-making rights relating to the use of the asset (**for e.g.**, the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in an arrangement (i.e., a contract that does not contain a lease).

Protective rights

A supplier's protective rights, **in isolation, do not prevent the customer from having the right to direct the use** of an identified asset.

Protective rights typically define the scope of the customer's right to use the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests. For example, a contract may

- (i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset,
- (ii) require a customer to follow particular operating practices, or
- (iii) require a customer to inform the supplier of changes in how an asset will be used.

Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

Illustration 9 - Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a five-year period. The vehicle is identified in the contract. Supplier Y cannot substitute for another vehicle unless the specified vehicle is not operational (for e.g., if it breaks down). Under the contract:

- *Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (for e.g., hires a driver).*
- *Customer X decides how to use the vehicle (within contractual limitations). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.*
- *Supplier Y prohibits certain uses of the vehicle (for e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.*

State whether Customer X has the right to direct the use of the vehicle throughout the period of lease.

Solution:

Yes, Customer X has the right to direct the use of the identified vehicle throughout the period of use because it has the **right to change** how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered **protective rights** that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

Illustration 10 - Right to direct the use of an asset

Entity A contracts with Supplier H to manufacture parts in a facility. Entity A designed the facility and provided its specifications. Supplier H owns the facility and the land. Entity A specifies how many parts it needs and when it needs the parts to be available. Supplier H operates the machinery and makes all operating decisions including how and when the parts are to be produced, as long as it meets the contractual requirements to deliver the specified number on the specified date. Assuming supplier H cannot substitute the facility and hence is an identified asset.

Examine which party has the right to control the use of the identified asset (i.e., equipment) during the period of use.

Solution:

Entity A does not direct the use of the asset that most significantly drives the economic benefits because Supplier H determines how and when the equipment is operated once the contract is signed. Therefore, Supplier H has the right to control the use of the identified asset during the period of use. Although Entity A stipulates the product to be provided and has input into the initial decisions regarding the use of the asset through its involvement in the design of the asset, it does not have decision making rights over how and for what purpose the asset will be used over the asset during the period of use. This arrangement is a supply agreement, not a lease.

Illustration 11 - Right to direct the use of an asset

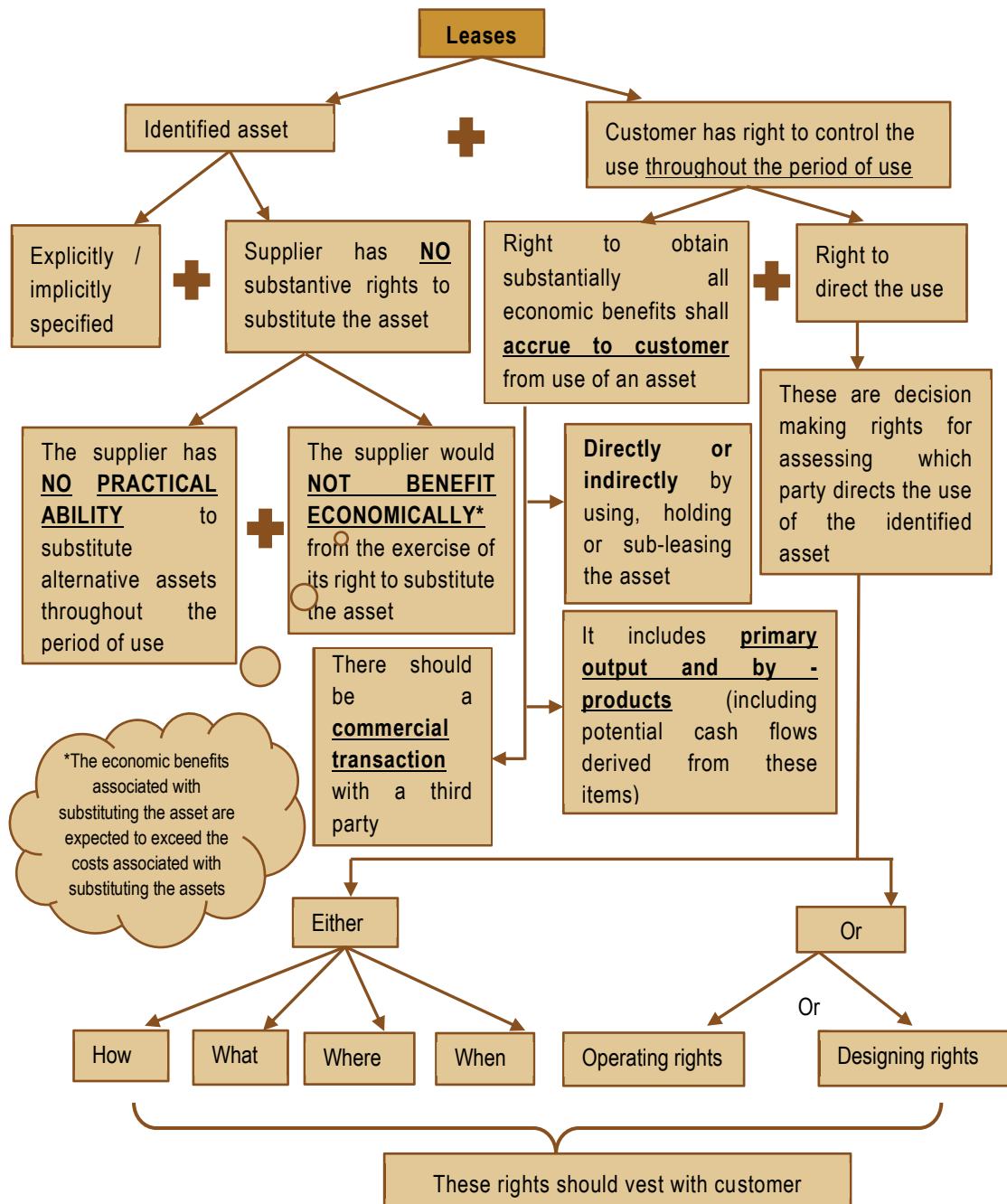
Entity L enters into a five - year contract with Company A, a ship owner, for the use of an identified ship. Entity L decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent Entity L from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. Company A operates and maintains the ship and is responsible for safe passage.

State who has the right to direct the use of the ship during the period of use.

Solution:

Entity L has the right to direct the use of the ship. The contractual restrictions are protective rights. In the scope of its right of use, Entity L determines how and for what purpose the ship is used throughout the five — year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. Entity L has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.

The concept explained in para 8.2.1 has been summarised as follows:



*The economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset

Note:

1. In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective.
2. If the supplier has a right or an obligation to substitute the asset only on or after either a **particular date**, or the occurrence of a specified event, the supplier's substitution right is **not substantive** because the supplier does **not have the practical ability** to substitute alternative assets **throughout the period of use**.
3. An entity's evaluation of whether a supplier's substitution right is substantive is based on **facts and circumstances at inception** of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur.
4. Contract terms that allow or require a supplier to substitute alternative assets only when the underlying **asset is not operating properly (for e.g., a normal warranty provision)** or when a **technical upgrade** becomes available **do not create a substantive substitution right**.
5. Circumstances that, at inception of the contract, are not likely to occur and, thus, are **excluded** from the evaluation of whether a supplier's substitution right is substantive throughout the period of use.
6. The right to control the use of an asset may not necessarily be documented, in the form as a lease agreement.
7. Ind AS 116 further clarifies that a customer should **presume** that a supplier's substitution right is **not substantive** when the customer **cannot readily determine** whether the supplier has a substantive substitution right. This requirement is intended to clarify that a **customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive**.
8. An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. Similarly, a capacity or other portion of an asset that is not physically distinct is not an identified asset unless it represents **substantially all** of the capacity of the asset and thereby provides the customer with the **right to obtain substantially all of the economic benefits** from use of the asset.

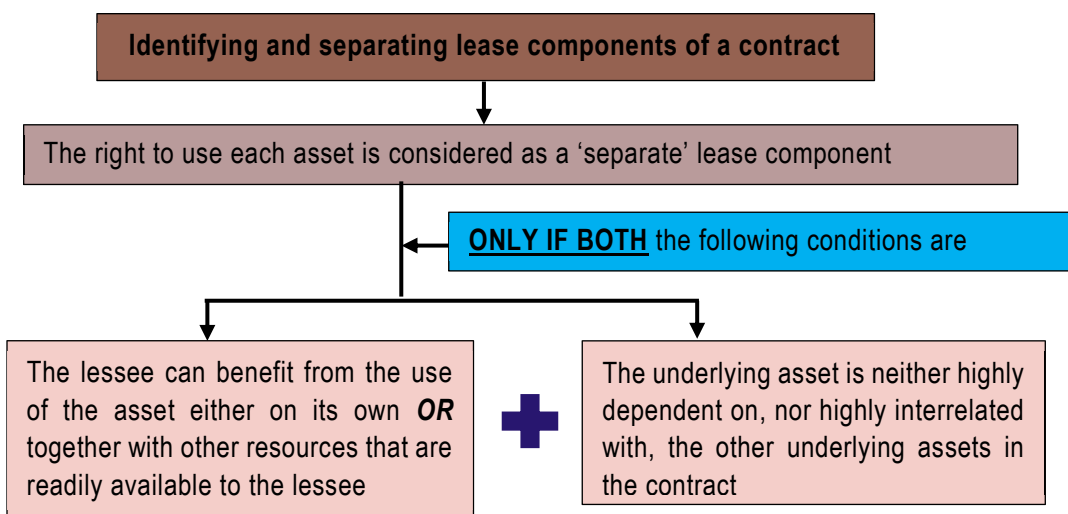
8.2.2 Separation of Lease and Non-Lease Components

8.2.2.1 Identifying and separating lease components of a contract

Sometimes, there are contracts that contain rights to use multiple assets (**for e.g.**, a building and an equipment, multiple pieces of equipment, etc.). The right to use each such asset is considered as a 'separate' lease component **ONLY IF BOTH** the following conditions are satisfied:

- ◆ The lessee can benefit from the use of the asset either on its own **OR** together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events) **AND**
- ◆ The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

If one or both of these criteria are not met then, the right to use multiple assets is considered a 'single' lease component, i.e., not a 'separate' lease component.



Note: If one or both criteria are not met then, the right to use multiple assets is considered as a 'single' lease component, i.e., not a 'separate' lease component

Let us have a look at the following illustration to have a better understanding:

Illustration 12 - Identifying and separating lease components

Scenario A:

A lessee enters a lease of an excavator and the related accessories (for e.g., excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine.

State how many lease and non-lease components are there.

Scenario B:

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (**for e.g.**, to transport iron ores at another mine).

Solution:**Scenario A:**

The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories. Thus, from the perspective of the lessee, the contract contains one lease component.

Scenario B:

The lessee can benefit from the loading truck on its own or together with other readily available resources because the loading truck could be deployed for other uses independent of the excavator. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

Thus, from the perspective of the lessee, the contract contains two lease components, viz., a lease of the excavator (together with the accessories) and a lease of the loading truck.

8.2.2.2. Separating lease components from non-lease components:

There may be many contracts containing a lease coupled with an agreement to purchase or sell other goods or services (i.e., the non-lease components under Ind AS 116). For example, a supplier may lease a truck and also operate the leased asset on behalf of a customer (i.e., provide a driver). This service is not related to securing the use of the truck. The only items that contribute to securing the output of the asset are lease components. In this example, only the use of the truck is considered a lease component. Similarly, costs incurred by a supplier to provide maintenance on an underlying asset, as well as the materials and supplies consumed as a result of the use of the asset, are not lease components.

The non-lease components are identified and accounted for separately from the lease component in accordance with other standards. **For e.g.**, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to Ind AS 115 by lessors (suppliers).

Costs related to property taxes and insurance do not involve the transfer of a good or service. Consequently, if these costs are fixed in the contract, they should be included in the overall contract consideration to be allocated to the lease and non-lease components.

Lessee reimbursements – whether a separate component of a contract?

As already discussed above that under Ind AS 116, payments for maintenance activities, including common area maintenance (**for e.g.**, cleaning the common areas of a building, removing snow

from a car park for employees and customers) and other goods or services transferred to the lessee (**for e.g.**, providing utilities or rubbish removal) are considered as **non-lease components** because they provide the lessee with a service.

But, in some leases, a lessee also may **reimburse (or make certain payments on behalf of)** the lessor that relate to the leased asset for activities and costs that do not transfer a good or service to the lessee (**for e.g.**, payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is).

Under Ind AS 116, such costs are **not separate components of the contract** because they do not represent payments for goods or services and are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components, if any).

Illustration 13 - Identifying different components in the contract

Entity L rents an office building from Landlord M for a term of 10 years. The rental contract stipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also requires Landlord M to perform all common area maintenance (CAM) during the term of the arrangement. Entity L makes a single monthly rental payment and does not pay for the maintenance separately. The office building has a useful life of 40 years and the HVAC system and office furniture each has a life of 15 years.

State what are the units of account in the lease.

Solution:

There are three components in the arrangement – the building assets (office building and HVAC), the office furniture, and the maintenance agreement.

The office building and HVAC system are one lease component because they cannot function independently of each other. The HVAC system was designed and tailored specifically to be integrated into the office building and cannot be removed and used in another building without incurring substantial costs. These building assets are a lease component because they are identified assets for which Entity L directs the use.

The office furniture functions independently and can be used on its own. It is also a lease component because it is a group of distinct assets for which Entity L directs the use.

The maintenance agreement is a non-lease component because it is a contract for service and not for the use of a specified asset.

Optional exemption of using Practical Expedient to not to separate non-lease component

Ind AS 116 provides a practical expedient that permits lessees to make an **accounting policy election**, by **CLASS OF UNDERLYING ASSET**, to account for each separate lease component

of a contract and any associated non-lease components as a **SINGLE LEASE COMPONENT**. It is important to note that such practical expedient is not permissible for lessor.

Making this election relieves the lessee of the obligation to perform a pricing allocation, although it will increase the total lease liability to be recorded on its balance sheet. This expedient is not available for lessors. Lessees that make the **policy election** to account for each separate lease component of a contract and any associated non-lease components as a **SINGLE LEASE COMPONENT**, **allocate ALL of the contract consideration to the lease component**.

It is very important to note that the practical expedient does not allow lessees to account for multiple lease components of a contract as a single lease component, if it meets the conditions provided in Section 8.2.2.1.

Comparison with AS 19:

AS 19 does not contain any guidance on separation of lease and non-lease components. It seems that AS 19 requires accounting for the entire contract including the non-lease components. The Scope of AS 19 mentions that “AS 19 applies to contracts that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Examples include the supply of property, vehicles, and computers.” Hence, one would be required to account for the entire contract as a lease under AS 19, without separating the non-lease components.

8.2.2.3 Determining and allocating the consideration in the contract – Lessee

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient, as discussed above, to account for each separate lease component of a contract and any associated non-lease components as a single lease component, are required to **allocate** the consideration in the contract to the lease and non-lease components on a **RELATIVE STAND-ALONE PRICE BASIS**.

Lessees are required to use **observable** stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees **estimate** stand-alone prices, maximizing the use of observable information.

Illustration 14 - Activities which are not components of a lease contract

Scenario A:

A lessee enters into a five-year lease of equipment, with fixed annual payments of ₹10,000. The contract contains fixed annual payments as follows: ₹8,000 for rent, ₹1,500 for maintenance and ₹500 for administrative tasks.

Explain how the consideration would be allocated.

Scenario B:

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition.

Explain how the consideration would be allocated.

Solution:**Scenario A:**

The contract contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee.

Assuming that the lessee does not elect to use the practical expedient as per para 15 of Ind AS 116, both the lessee and the lessor account for the lease of equipment and maintenance components separately and the administration charge is included in the total consideration to be allocated between those components. Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B:

The contract still contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term.

Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Illustration 15 - Allocating contract consideration to lease and non-lease components – Lessees

A lessee enters into a lease of equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

<i>Lease</i>	<i>₹ 80,000</i>
<i>Maintenance</i>	<i>₹ 10,000</i>
Total	₹ 90,000

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximizing the use of observable information, of the lease and non-lease components, as

<i>follows:</i>	
<i>Lease</i>	₹ 85,000
<i>Maintenance</i>	₹ 15,000
Total	₹ 1,00,000

In the given scenario, assuming lessee has not opted the practical expedient, explain how will the lessee allocate the consideration to lease and non-lease component?

Solution:

The stand-alone price for the lease component represents 85% (i.e., ₹ 85,000 / ₹ 1,00,000) of total estimated stand-alone prices. The lessee allocates the consideration in the contract (i.e., ₹ 90,000), as follows:	
Lease	* ₹ 76,500
Maintenance	** ₹ 13,500
Total	₹ 90,000

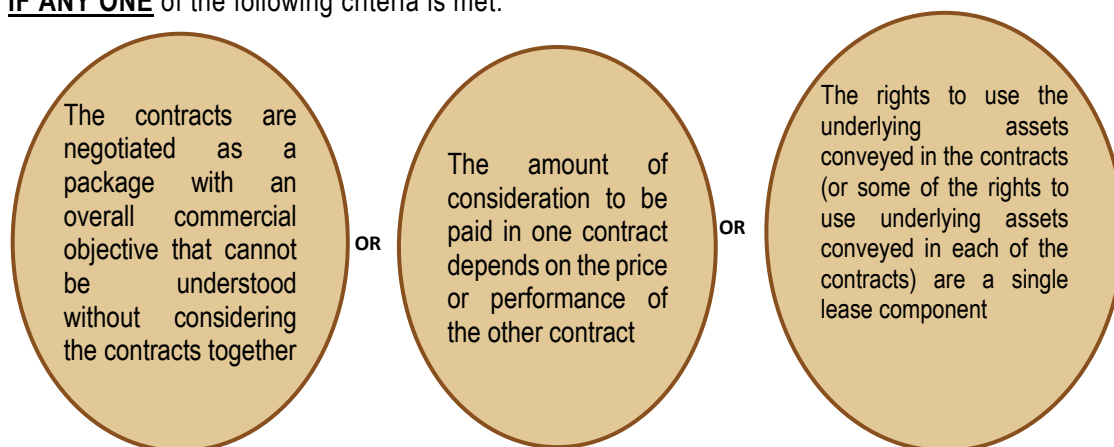
* ₹ 90,000 x 85% ** ₹ 90,000 x 15%.

8.2.2.4 Determining and allocating the consideration in the contract – Lessors:

Lessors are required to **allocate** the consideration in the contract to the lease and any associated non-lease components by applying paragraphs **73 – 90 of** Ind AS 115 *Revenue from Contracts with Customers*.

8.2.3 Contract Combinations

Ind AS 116 requires that two or more contracts entered into at or near the **same time** with the **same counterparty (or related parties of the counterparty)** be considered a **'single' contract IF ANY ONE** of the following criteria is met:



8.2.4 Portfolio Application

Ind AS 116 applies to individual leases. However, entities that have a large number of leases of similar assets (**for e.g.**, leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis.

Thus, Ind AS 116 includes a practical expedient that allows entities to use a portfolio approach for leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio. If accounting for a portfolio, an entity uses estimates and assumptions that reflect the size and composition of the portfolio.

This approach is consistent with that under Ind AS 115. A decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

Comparison with AS 19:

AS 19 does not provide any guidance on combining contracts or portfolio application of principles.



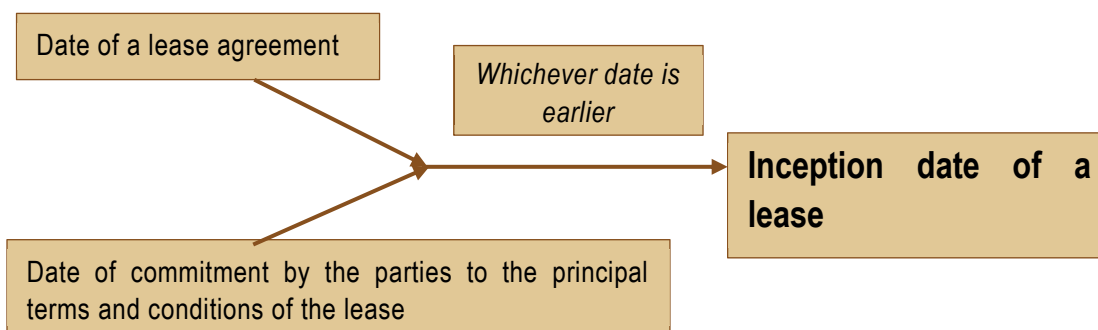
8.3 KEY CONCEPTS

8.3.1 Inception and Commencement of Lease

Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the **inception** of the contract.

The **inception date** is defined as the *earlier* of the following dates:

- ◆ date of a lease agreement
- ◆ date of commitment by the parties to the principal terms and conditions of the lease



The **commencement date** is defined as the date on which a lessor makes an underlying **asset available for use** by a lessee. Where, the 'underlying asset' is an asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

In certain cases, the commencement date of the lease may be before the date stipulated in the lease agreement (***for e.g.***, the date on which rents become due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (***for e.g.***, during the period a lessee uses the leased space to construct its own leasehold improvements).

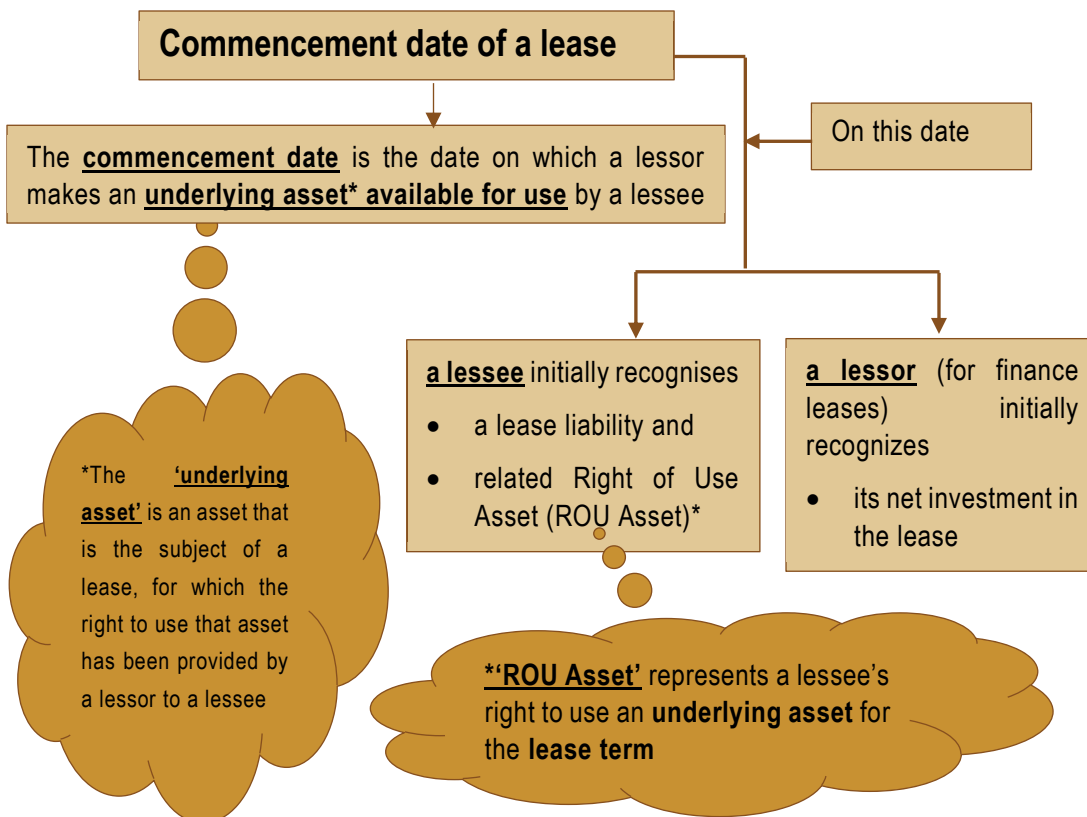
If a lessee takes possession of, or is given control over, the use of the underlying asset **before** it begins operations or making lease payments under the terms of the lease, **the lease term has commenced even if** the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date.

The timing of when lease payments begin under the contract **does not affect** the commencement date of the lease.

As discussed earlier, **inception date** is the date when an entity shall **assess** if the contract is or contains lease. While the **commencement date** is relevant because on that date:

- (i) a lessee (except where the exemption of short-term lease or low-value asset is taken) **initially recognises a lease liability** and related Right of Use Asset (hereinafter referred to as "ROU Asset") on the commencement date
- (ii) a lessor (for finance leases) initially recognises its net investment in the lease on the commencement date.

Where, **'ROU Asset'** is defined as an asset that represents a lessee's right to use an **underlying asset** for the **lease term**.

**Note:**

- In certain cases, the commencement date of the lease may be before the date stipulated in the lease agreement.
- The timing of when lease payments begin under the contract **does not affect** the commencement date of the lease.

8.3.2 Lease Term

Determination of the lease term is a very crucial step before the calculation of the Lease Liability and the corresponding ROU Asset.

In simple terms, lease term is the **summation** of the following:

	Particulars	Years
1	Rent free period	XXX
2	Non-cancellable period	XXX

3	Optional renewable periods (where lessee is reasonably certain to extend the lease)	XXX
4	Periods covered by option to terminate the lease (where lessee is reasonably certain not to terminate early)	<u>XXX</u>
	Total Lease terms	<u>XXXX</u>

The lease term begins at the lease **commencement date**. The lease term starts when the lessor makes the underlying asset available for use by the lessee and includes any rent-free periods provided.

The assessment of whether it is reasonably certain that a lessee will exercise an extension or termination option **should be done on lease commencement date**. An entity should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option. The assessment should not be based solely on the lessee's intentions, past practices, or estimates. It should focus on the factors that create an economic incentive for the lessee, including contract, asset, entity, or market-based factors. Example of relevant factors to consider are:

Contractual terms vis-a vis market rates	Asset related factors
1. Lease rentals in optional period, ex. Termination penalties and residual value guarantees	1. Specialised asset
2. Variable or contingent payment	2. Location of underlying asset
3. Terms and condition after initial optional period, ex. Purchase option	3. Availability of suitable alternatives
4. Cost relating to the termination of the lease and signing of new replacement lease	4. Existence of significant leasehold improvement

In certain cases, it can be more difficult to determine whether the exercise of the option is reasonably certain where the period from the commencement of the lease to the exercise date of an option is longer. The said difficulty arises from several factors. **For e.g.**, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets such as those involving technology is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

An artificially short lease term (**for e.g.**, a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four-year lease term), may effectively create a

significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may affect a lessee's decisions about whether it is reasonably certain to exercise a purchase or renewal option. **For e.g.**, a company that leases a specialized facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the company while it searched for a replacement asset.

An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

A lessee may enter into a lease contract for non-consecutive periods. This is seen in the retail industry when retailers enter into contracts with shopping centers to lease the same retail space for certain non-consecutive months of the year (e.g., during an annual holiday period). Similar arrangements also exist when sports teams lease a sports stadium for particular non-consecutive days of the year. These arrangements will usually meet the definition of a lease because during the agreed period of use, the customer controls the right to use the underlying asset. In these arrangements, the lease term is the aggregate of the non-consecutive periods.

Illustration 16 - Determining the lease term**Scenario A:**

Entity ABC enters into a lease for equipment that includes a non-cancellable term of six years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity ABC is reasonably certain to exercise the renewal option.

Explain the lease term.

Scenario B:

Entity XYZ enters into a lease for a building that includes a non-cancellable term of eight years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity XYZ pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of eight years, and that value can only be realised through continued occupancy of the leased property.

Describe the lease term.

Scenario C:

Entity PQR enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity PQR for only the months of October, November and December during a non-cancellable term of seven years. The lessor agrees to provide the same retail space for each of the seven years.

Explain the lease term.

Solution:**Scenario A:**

At the lease commencement date, the lease term is six years (being the non-cancellable period). The renewal period of two years is not taken into consideration since Entity ABC is not reasonably certain to exercise the option because there are no penalties or other factors which indicate that the entity will opt for renewal of lease.

Scenario B:

At the lease commencement, Entity XYZ determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period of eight years. Thus, at the lease commencement, Entity XYZ concludes that the lease term is ten years (being eight years of non-cancellable period plus the renewal period of two years where the lessee is reasonably certain to exercise the option).

Scenario C:

At the lease commencement date, the lease term is 21 months (three months per year over the seven annual periods as specified in the contract), i.e., the period over which Entity PQR controls the right to use the underlying asset.

Cancellable leases:

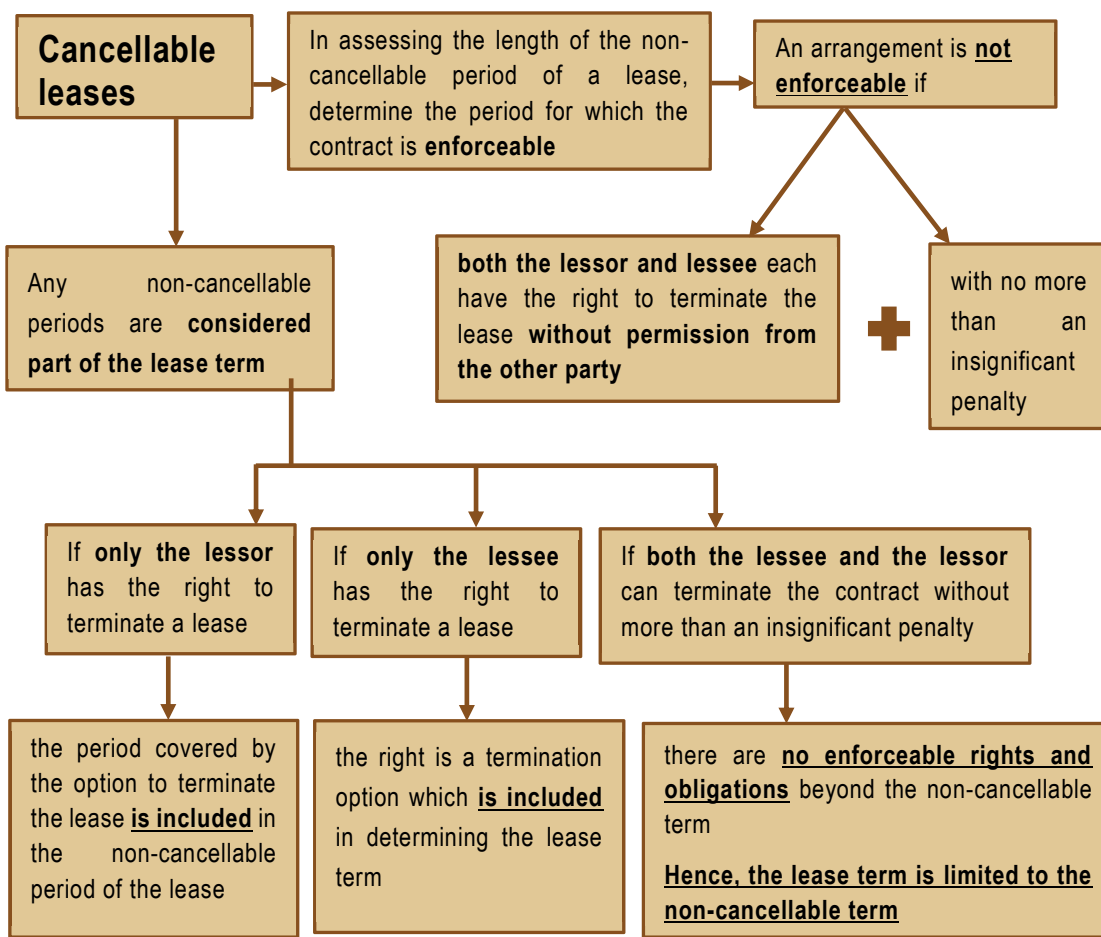
In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A 'contract' is defined as an agreement between two or more parties that creates enforceable rights and obligations.

An arrangement is **not enforceable** if:

- (i) both the lessor and lessee each have the right to terminate the lease without permission from the other party; **AND**
- (ii) with no more than an insignificant penalty

Any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only the lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the non-cancellable period of the lease. If only the lessee has the right to terminate a lease, that right is a termination option that is considered when determining the lease term.

Ind AS 116 defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations. Thus, Ind AS 116 applies to contracts that are referred to as 'cancellable', 'month-to-month', 'at will', 'evergreen', 'perpetual' or 'rolling' if they create enforceable rights and obligations. These types of lease generally allow for the contract to continue beyond a non-cancellable period until one party gives notice to terminate the contract (**for e.g.**, the contract will roll monthly until the lessee or the lessor elect to terminate the contract). If both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then there are no enforceable rights and obligations beyond the non-cancellable term (i.e., the lease term is limited to the non-cancellable term). However, if only the lessee holds a renewal option, there may be other factors to consider determining whether the lessee is reasonably certain to extend the lease, including economic disincentives (as discussed above).



This can be understood better with the help of the following illustrative situation:

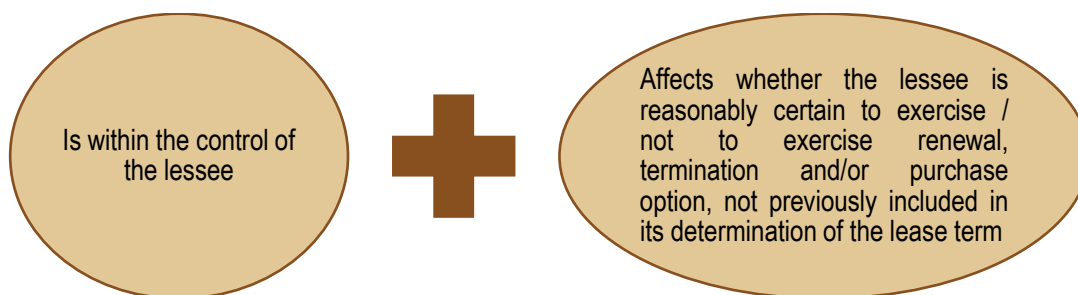
Suppose the term of a contract is 10 years and the non-cancellable / lock-in period is 6 years. The lease term shall be as follows:

If the termination option is with 'Lessor'	If the termination option is with 'Lessee'	If the termination option is with 'Both' (i.e., any party can terminate)
The lease term shall be <u>10 years</u>. <i>Because even after 6th year, the lessee would be contractually bound until 10th year i.e. lessee cannot refuse</i>	The lease term shall be <u>10 years</u> assuming reasonable certainty. <i>Because after the expiry of 6th year, though the lessee is not contractually bound till 10th year, i.e., the lessee can</i>	The lease term shall be <u>6 years</u>. <i>Because after 6th year, either party can terminate the contract without the consent of the other party and hence,</i>

to make the payment till the expiry of the contract and also, has the right to use the asset until 10 th year, unless lessor terminates the contract.	refuse to make payment anytime without lessor's permission but, it is assumed that the lessee is reasonably certain that it will not exercise this option to terminate. Hence, though there is no enforceable obligation from lessee's point of view beyond 6 th year but, basis the said assumption, the lease term shall be 10 years.	the contract is not enforceable after 6 th year <u>ONLY</u> in case there is insignificant penalty for termination.

Reassessment of lease term and purchase options (for lessees):

After the lease commencement, Ind AS 116 requires lessees to monitor leases for **significant changes** that could trigger a change in the lease term. Lessees are required to **reassess** the lease term upon the occurrence of either a **significant event** **OR** a **significant change** in the circumstances that:



Following are some of the examples of significant events or significant changes in circumstances within the lessee's control:

1) Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable

2) Making significant modifications or customisations to the underlying asset

3) Making a business decision that is directly relevant to the lessee's ability to exercise, or not to exercise, an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset)

4) Subleasing the underlying asset for a period beyond the exercise date of the option

Changes in market-based factors (**for e.g.**, a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and therefore, they **do not trigger a reassessment by themselves**.

Ind AS 116 also requires lessees to revise the lease term if there is change in the non-cancellable period of lease. Following are the example which leads to change in non-cancellable period of a lease:

If the lessee **exercises an option** not previously included in the entity's determination of the lease term

If the lessee **does not exercise an option** previously included in the entity's determination of the lease term;

Change in non-cancellable lease period

An event occurs that **contractually obliges the lessee** to exercise an option not previously included in the entity's determination of the lease term

An event occurs that **contractually prohibits** the lessee from exercising an option previously included in the entity's determination of the lease term.

As the lessee is required to reassess the lease term upon the occurrence of either a significant event or a significant change in the circumstances that is within the control of the lessee, the revision of the lease term often happens before the actual exercise of the option in these circumstances.

Illustration 17 - Re-assessment of exercise of lease extension option

Retailer M enters into a five-year lease for a building floor, followed by two successive five-year renewal options. On the commencement date, Retailer M is not reasonably certain to exercise the extension option. At the end of third year, Retailer M extended to include another floor from year 4 due to a business acquisition. For this purpose, the lessee concludes a separate seven-year lease for an additional floor in the building already leased.

Analyze whether Retailer M required to reassess the lease term in this case.

Solution:

Ind AS 116 requires a lessee to reassess the lease term if there is change in business decision of the company which is directly relevant to exercising or not exercising an option to renew / extend the lease. In the given case, Retailer M at the end of third year has extended to include another floor in the same building on account of acquiring another company. As Retailer M has entered into fresh lease of another floor for a seven-year term, it is reasonably certain to exercise the renewal option of original lease for a further five-year term. Hence Retailer M will have to reassess the lease term at the end of third year.

Illustration 18 - Re-assessment of non-cancellable period of lease

Company N has taken 10 vehicles on lease for an initial period of 5 years with an extension option at the option of the lessee for a further period of 5 years at the same rental amount. The remaining useful life of the vehicles as on the commencement date of the lease is 15 years. Company N determined at the commencement date that it is reasonably certain to exercise the extension option and hence it has taken a period of 10 years for the lease. At the end of 4th year, there is an announcement by the government that all the cars of this particular model have to be discontinued from the road within 1 year due to the change in the pollution norms in the country.

Examine will the lease term be reassessed in this case.

Solution:

In the given case, as per Ind AS 116, the announcement by the government to discontinue the use of the underlying asset will prohibit the lessee from exercising the extension option that was already included in the non-cancellable period by Company N and hence, Company N will reassess the non-cancellable period to exclude the extension option of 5 years.

Reassessment of lease term and purchase options (for lessors):

Ind AS 116 requires the lessor to revise the lease term to account for the lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset, when exercise of such options was not already included in the lease term.

Comparison with AS 19:

AS 19 does not contain any guidance on re-assessment or changes to lease term.

8.3.3 LEASE PAYMENTS

Lease payments are defined as payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

- (a) fixed payments (including in-substance fixed payments), **less** any lease incentives
- (b) variable lease payments that depend on an index or a rate
- (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- (d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees.

For the lessors, lease payment instead includes residual value guarantees provided by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Exclusion of payments for calculating lease liability:

- a. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.
- b. Variable lease payments that do not depend on index or rate.

8.3.3.1 Fixed lease payments

'Fixed payments' are defined as payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.

Fixed payments can either be a fixed amount paid at various intervals in a lease (e.g., a five-year equipment lease with annual lease payments of ₹ 20,000) or they can be payments that change

over time (e.g., lease payments of ₹ 20,000 per month at lease commencement that increase annually by ₹ 2,500 per month).

Illustration 19 - Determining the fixed payments

Entity M and Lessor A enter into a 10-year lease of an office building for fixed annual lease payments of ₹ 200,000. Per the terms of the lease agreement, annual fixed lease payments comprise ₹ 170,000 for rent and ₹ 30,000 for real estate taxes.

State the fixed lease payments for the purpose of classifying the lease.

Solution:

The fixed lease payments are ₹ 2,00,000. Although real estate taxes are explicitly stated in the lease contract, they do not represent a separate non-lease component as they do not provide a separate good or service. The right to use the office building is the only component. The annual lease payments of ₹ 2,00,000 represent payments related to that single lease component.

In-substance fixed lease payments:

As mentioned above, lease payments also include any in-substance fixed lease payments which are the payments that may, **in form**, contain variability but that, **in substance**, are unavoidable. Examples may include:

- (a) if payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance.

Examples of those types of payments include:

- ◆ payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; **OR**
 - ◆ payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved.
- (b) if there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In such a case, an entity shall consider the realistic set of payments to be lease payments.
 - (c) if there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In such a case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments.

Illustration 20 - In substance fixed lease payments

Entity Q enters into a seven-year lease for a piece of machinery. The contract sets out the lease payments as follows.

- If Q uses the machinery within a given month, then an amount of 2,000 accrues for that month.*
- If Q does not use the machinery within a given month, then an amount of 1,000 accrues for that month.*

Explain what is considered as lease payment in this case.

Solution:

Q considers the contract and notes that although the lease payments contain variability based on usage, and there is a realistic possibility that Q may not use the machinery in some months, a monthly payment of 1,000 is unavoidable. Accordingly, this is an in-substance fixed payment, and is included in the measurement of the lease liability.

Illustration 21 - In-substance fixed lease payment

Entity P enters into a five-year lease for office space with Entity Q. The initial base rent is ₹ 1 lakh per month. Rents increase by the greater of 1% of Entity P's generated sales or 2% of the previous rental rate on each anniversary of the lease commencement date.

Describe the lease payments for the purpose of measuring lease liability.

Solution:

In the given case, the lease payments for purposes of classifying the lease are the fixed monthly payments of ₹ 1 lakh plus the minimum annual increase of 2% of the previous rental rate. Entity P is required to pay no less than a 2% increase regardless of the level of sales activity; therefore, this minimum level of increase is in substance fixed lease payment.

Illustration 22 - In substance fixed lease payments

Company N leases a production line. The lease payments depend on the number of operating hours of the production line – i.e., N has to pay ₹ 1,000 per hour of use. The annual minimum payment is ₹ 10,00,000. The expected usage per year is 1,500 hours.

Determine the lease payment.

Solution:

The lease contains in substance fixed payments of ₹ 10,00,000 per year, which are included in the initial measurement of the lease liability. The additional ₹ 5,00,000 that Company N expects to pay per year are variable payments that do not depend on an index or a rate but usage.

Lease incentives

'Lease incentives' is defined as payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an upfront cash payment to the lessee, payment of costs for the lessee (such as moving / transportation expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party.

For lessee, lease incentives that are paid or payable to lessee by the lessor are deductible from lease payments and reduce the initial measurement of lessee' ROU asset.

For lessors, lease incentives are also deducted from lease payments and affect the lease classification test. For finance leases, lease incentives that are payable to the lessee reduce the expected lease receivables at the commencement date and thereby the initial measurement of the lessor's net investment in the lease. Consequently, the selling profit or loss is not affected. For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term.

Lessor reimbursement for some (or all) of the costs a lessee incurs to complete leasehold improvements is a common example of a lease incentive. To determine whether a payment from the lessor to the lessee represents a lease incentive, a reporting entity should evaluate the nature of the improvement and determine whether it represents an asset for lessee or a lessor. If an improvement represents an asset for lessee, the lessor payment is a lease incentive that should be recorded as a reduction to fixed lease payments. On the other hand, reimbursement for an improvement that is an asset for lessor is not a lease incentive; it should be recorded as a reimbursement to the lessee for the cost of the asset of lessor.

8.3.3.2 Variable lease payments that depend on an index or a rate:

'**Variable lease payments**' are defined as the portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

These may include, **for e.g.**, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates. Such payments are **included** in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement).

Despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (for lessor) and a liability (for lessee) because they are **unavoidable** and **do not depend on any future activity** of the lessee. Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments.

Illustration 23 - Variable lease payments that depend on an index or rate

An entity enters into a 10-year lease of property. The lease payment for the first year is ₹ 1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108.

Determine the lease payments?

Solution:

At the lease commencement date, the lease payments are ₹ 1,000 per year for 10 years. The entity does not take into consideration the potential future changes in the index. At the end of year one, the payments have not changed and hence, the liability is not updated.

At the end of year two, when the lease payments change, the entity updates the remaining eight lease payments to ₹ 1,080 per year (i.e., ₹ 1,000 / 100 x 108).

Variable lease payments that do not depend on an index or a rate:

Variable lease payments that do not depend on an index or rate and are **not, in substance, fixed** (as discussed above – In-substance fixed lease payments). Examples may include payments such as those based on performance (**for e.g.**, a percentage of sales) or usage of the underlying asset (**for e.g.**, the number of hours flown, the number of units produced), are **not included** as lease payments. Instead, they are recognised in profit or loss in the period in which the event that triggers the payment occurs (unless they are included in the carrying amount of another asset in accordance with other Ind AS).

In some cases, the variability may be resolved during the lease term, so that payments become fixed for the remainder of the lease term. The new fixed payments are then used to remeasure the lease liability (with an offset to the ROU Asset).

When variable payments not included in consideration in the contract are recognized, lessees also allocate these amounts between lease and non-lease components on the same basis as the allocation of consideration in the contract. These payments include variable payments not based on an index or rate or the changes in variable payments based on an index or rate after the commencement date of the lease.

Illustration 24 - Variable lease payments that do not depend on an index or rate

Entity XYZ is a medical equipment manufacturer and a supplier of the related consumables. Customer ABC operates a medical centre. Under the agreement entered into by both parties, Entity XYZ grants Customer ABC the right to use a medical laboratory machine at no cost and Customer ABC purchases consumables for use in the equipment from Entity XYZ at ₹ 100 each.

The consumables can only be used for that equipment and Customer ABC cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer ABC estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer ABC has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract.

Analyze whether these payments affect the calculation of lease liability and ROU Asset. Further discuss how Entity XYZ and Customer ABC would allocate these lease payments.

Solution:

There are two components in the arrangement, viz., a lease of equipment and the purchase of consumables.

Even though Customer ABC may believe that it is highly unlikely to purchase lesser than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (for Entity XYZ and Customer ABC) and lease classification (for Entity XYZ).

Entity XYZ and Customer ABC would allocate the payments associated with the future payments to the lease and consumables component of the contract (assuming Customer ABC does not elect to combine lease and non-lease components for this class of asset).

If Customer ABC elects the practical expedient not to separate the associated non-lease component from the lease component and instead accounts for the lease component and the non-lease component as a single lease component, the future payments for the consumables will still constitute genuine variability. Hence there will also be no lease payments for purposes of initial measurement.

Illustration 25 - Variable lease payments

Entity A enters into a five-year lease of an office building. The lease payments are ₹ 5,00,000 per year and the contract includes an additional water charge calculated as ₹ 0.50 per litre consumed. Payments are due at the end of year. Entity A elects to apply the practical expedient to combine lease and non-lease components

Solution:

As stated above, payments are due at the end of the year. Entity A elects to apply the practical expedient not to separate lease and non-lease components.

At the commencement date, Entity A measures the lease liability as the present value of the fixed lease payments (i.e. five annual payments of ₹ 5,00,000). Although Entity A has elected to apply the practical expedient to combine non-lease components (i.e. water charges) with the lease component, Entity A excludes the non-lease component from its lease liability because they are variable payments that depend on usage. That is, the nature of the costs does not become fixed just because Entity A has elected not to separate them from the fixed lease payments. Entity A recognises the payments for water – as a variable lease payment – in profit or loss when they are incurred.

In contrast, if B does not elect to apply the practical expedient to combine lease and non-lease components, then it recognises the payments for water – as an operating expense – in profit or loss when they are incurred.

8.3.3.3 Exercise price of a purchase option

If the lessee is **reasonably certain** to exercise a purchase option, the exercise price is **included** as a lease payment, i.e., entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (as discussed earlier).

8.3.3.4. Penalties for terminating a lease

If it is **reasonably certain** that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is **excluded** from the lease payments. **Otherwise**, the lease termination penalty is **included** as a lease payment. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options (as discussed earlier).

8.3.3.5. Residual value guarantees (lessees):

'Residual value guarantee' is defined as a guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.

For a lessee, lease payments include amounts expected to be **payable by the lessee** under residual value guarantees. A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least of a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. A lessee is required to remeasure the lease liability if there is a change in the amounts expected to be payable under a residual value guarantee.

Illustration 26 - Residual value guarantee included in lease payments

An entity (a lessee) enters into a lease and guarantees that the lessor will realise ₹ 20,000 from selling the asset to another party at the end of the lease. At lease commencement, based on the lessee's estimate of the residual value of the underlying asset, the lessee determines that it expects that it will owe ₹ 8,000 at the end of the lease. Whether the lessee should include the said payment of ₹ 8,000 as a lease payment?

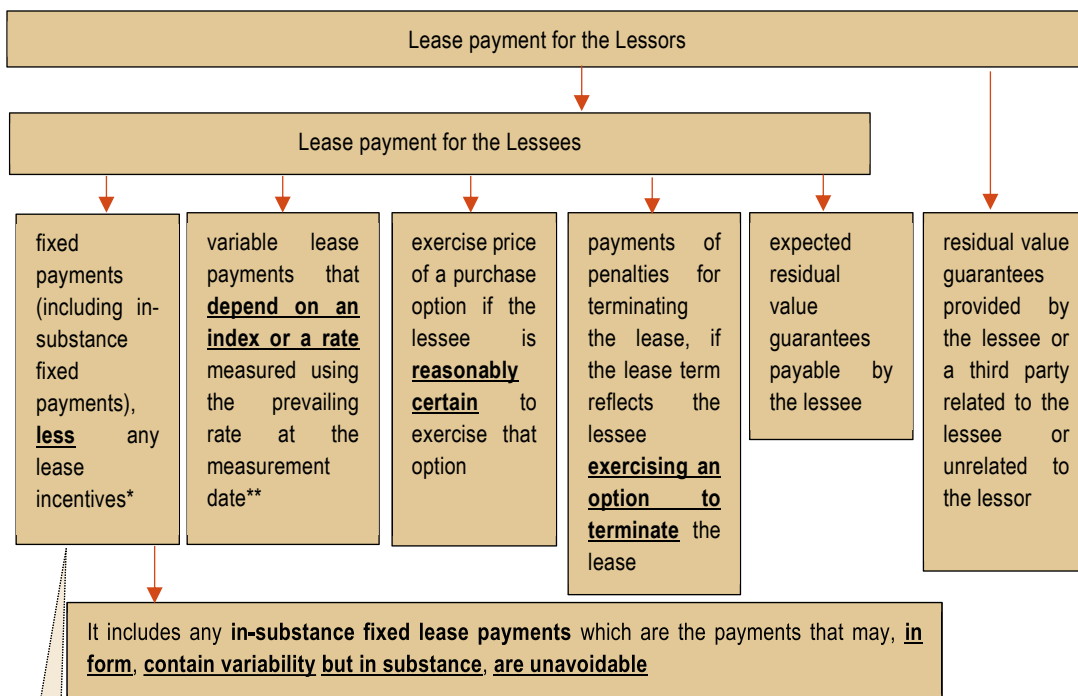
Solution:

The lessee should include the amount of ₹ 8,000 as a lease payment because it is expected that it will owe the same to the lessor under the residual value guarantee.

Residual value guarantees (lessors):

Ind AS 116 requires lessors to **include** in the lease payments, any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. This amount included in the lease payments is **different** from that for a lessee which only includes the amount expected to be payable by lessee only (as discussed above).

The concept explained in para 8.3.3 above can be summarized as follows:



***Lease incentives**

- **For lessee** - lease incentives that are paid or payable to lessee by the lessor are deductible from lease payments and reduce the initial measurement of lessee's ROU asset.
- **For lessors** - lease incentives are also deducted from lease payments and affect the lease classification test.



For finance leases

- lease incentives reduce the expected lease receivables at the commencement date and thereby the initial measurement of the lessor's net investment in the lease.
- Selling profit or loss is not affected.



For operating leases

- defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term.

****Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments.**

Exclusion of payments for calculating lease liability:

- Lease payments allocated to non-lease components of a contract**, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.
- Variable lease payments that **do not** depend on index or rate. They are recognised in profit or loss in the period in which the event that triggers the payment occurs.

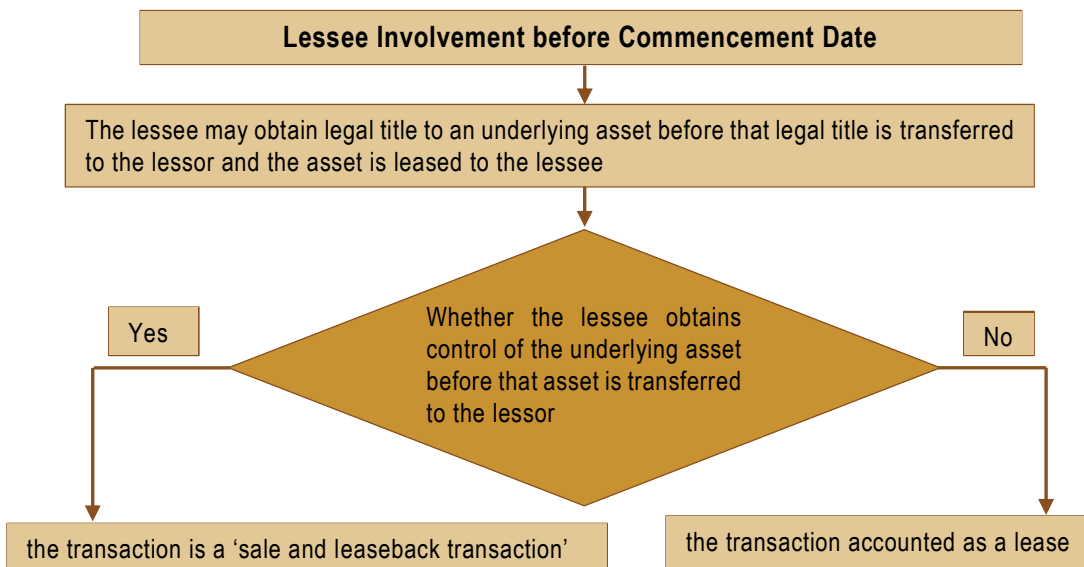
8.3.4 Lessee Involvement before Commencement Date

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Thus, based on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset since, payments for the right to use an underlying asset are the payments for a lease, regardless of the timing of those payments. Thus, if the lessee incurs such costs, they are accounted by applying other Ind AS (such as Ind AS 16, Property, Plant and Equipment).

The lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction. If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a 'sale and leaseback transaction' (Please refer Section 8.6.2 'Sale and Leaseback Transactions' for further discussion)

However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a 'sale and leaseback transaction'. **For e.g.**, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset, but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but it is rather accounted as a lease.



8.3.5 Initial Direct Costs

'Initial direct costs' are defined as **the incremental costs of obtaining a lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

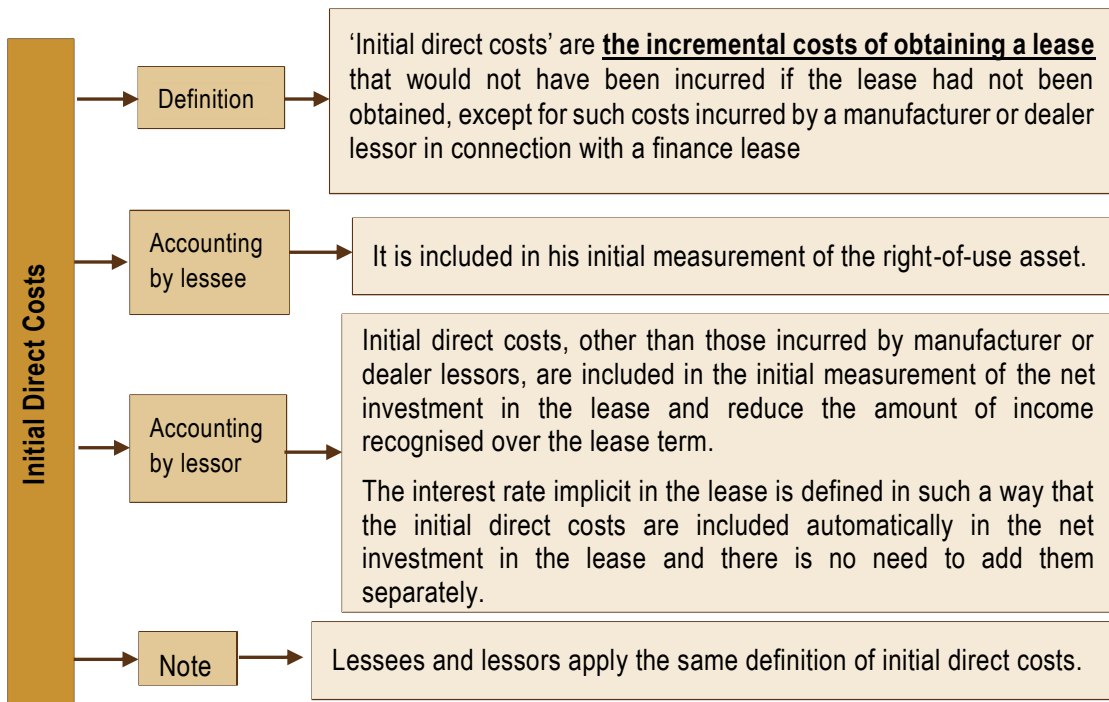
Ind AS 116 requires lessees to include their initial direct costs in their initial measurement of the right-of-use asset.

Examples of costs included and excluded from initial direct costs is provided below.

Included	Excluded
Commission (including payments to employees acting as selling agents)	Employee salaries
Legal fees resulting from the execution of the lease	Legal fees for services rendered before the execution of the lease
Lease document preparation costs incurred after the execution of the lease	Negotiating lease term and conditions
Certain payments to existing tenants to move out	Advertising
Consideration paid for a guarantee of a residual asset by an unrelated third party	Depreciation and amortization

Lessees and lessors apply the same definition of initial direct costs. The requirements under Ind AS 116 for initial direct costs are consistent with the concept of incremental costs in Ind AS 115, Revenue from Contracts with Customers.

For lessors, initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and there is no need to add them separately.

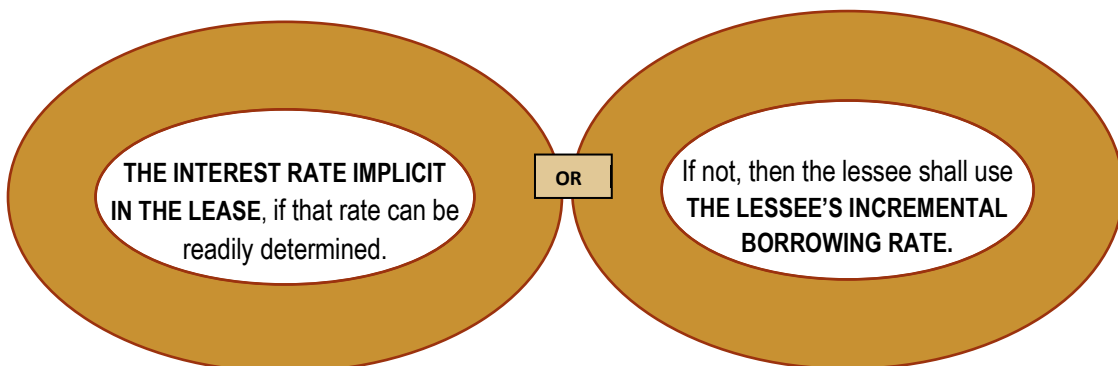


8.3.6 Discount Rates

Discount rates are used to determine the present value of the lease payments, which are used to determine Right of Use asset and Lease liability in case of a lessee and to measure a lessor's net investment in the lease.

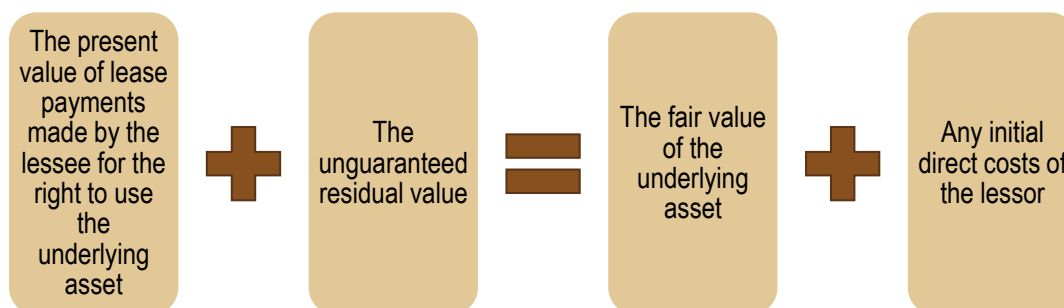
For a Lessee

As per Ind AS 116, the Discount Rate to be used should be:



Where,

'Interest rate implicit in the lease' is defined as the rate of interest that causes the following:



Lease payments are discounted using the interest rate implicit in the lease (as above and to be calculated from the perspective of lessor) if that rate can be readily determined. But, if that rate cannot be readily determined then, the lessee uses the incremental borrowing rate.

As discussed above, the lessee's **incremental borrowing rate** is the rate of interest that

- the lessee would have to pay to borrow over a **similar term**,
- and with a **similar security**,
- the funds necessary to obtain an asset of a **similar value** to the Right of use Asset
- in a **similar economic environment**.

In determining the incremental borrowing rate, the lessee considers borrowings with a similar term and security to the ROU Asset (**NOT the underlying asset**). ***For e.g.***, in the case of a five-year property lease, the lessee considers the borrowings with a similar term to the five-year ROU Asset (and NOT the property itself), which may have a significantly longer life. Observable rates (such as a property yield) can be used as a **starting point** to determine the incremental borrowing rate but adjustments need to be considered for an asset with a value similar to the ROU Asset. Other potential sources of adjustment may include the credit profile of the lessee, the borrowing currency, or the length of the lease term. It is likely that, in some cases, **significant judgement** will be needed to determine the incremental borrowing rate.

As discussed above, the lessee's incremental borrowing rate reflects the rate of interest that a lessee would have to pay, among others, in a similar economic environment. If the contract requires lease payments to be made in a currency other than the functional currency of the lessee (i.e., payments are to be made in a foreign currency) then, the incremental borrowing rate of the lessee should be determined based on a borrowing of a similar amount in that foreign currency.

For a Lessor:

Lessor to use the interest rate implicit in the lease as discussed above.

8.3.7 Economic Life

'Economic Life' is defined as either

- ◆ the period over which an asset is expected to be economically usable by one or more users or
- ◆ the number of production or similar units expected to be obtained from an asset by one or more users.

8.3.8 Fair Value

The fair value for the purposes of applying the lessor accounting requirements in Ind AS 116 is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The fair value definition for lessors has been carried forward from Ind AS 17.

Please note that for the purposes of determination of fair value under Ind AS 116, the above stated definition is to be considered, hence Ind AS 113 "Fair Value Measurement" is not applicable for determination of fair value.



8.4 LESSEE ACCOUNTING

8.4.1 Initial Recognition and Measurement

A '**lessee**' is defined as an entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.

At the commencement date, a lessee shall recognise a ROU Asset and a Lease Liability. Ind AS 116 requires lessees to recognise a liability to make lease payments and an asset representing the right to use the underlying asset (i.e., the ROU Asset) during the lease term for **ALL** leases (**except** for short-term leases and leases of low-value assets, if they choose to apply such exemptions).

Measuring the lease liability:

At the commencement date, a lessee initially measures the Lease Liability at the **present value of the remaining lease payments to be made over the lease term, discounted using the rate implicit in the lease (or if that rate cannot be readily determined, the lessee's incremental borrowing rate)**. Lease payments used in measuring the lease liability are amounts due to the lessor excluding any payments that a lessee makes before lease commencement. (Refer Section 8.3.3 Lease payments).

At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- ◆ fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- ◆ variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
- ◆ amounts expected to be payable by the lessee under residual value guarantees;
- ◆ the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- ◆ payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Illustration 27: Initial measurement of lease liability

Entity L enters into a lease for 10 years, with a single lease payment payable at the beginning of each year. The initial lease payment is ₹ 100,000. Lease payments will increase by the rate of LIBOR each year. At the date of commencement of the lease, LIBOR is 2 per cent.

Assume that the interest rate implicit in the lease is 5 per cent. How is lease liability initially measured?

Solution:

In the given case, the lease payments depend on a rate (i.e., LIBOR) and hence is included in measuring lease liability. As per Ind AS 116, the lease payments should initially be measured using the rate (i.e. LIBOR) as at the commencement date. LIBOR at that date is 2 per cent; therefore, in measuring the lease liability, it is assumed that each year the payments will increase by 2 per cent, as follows:

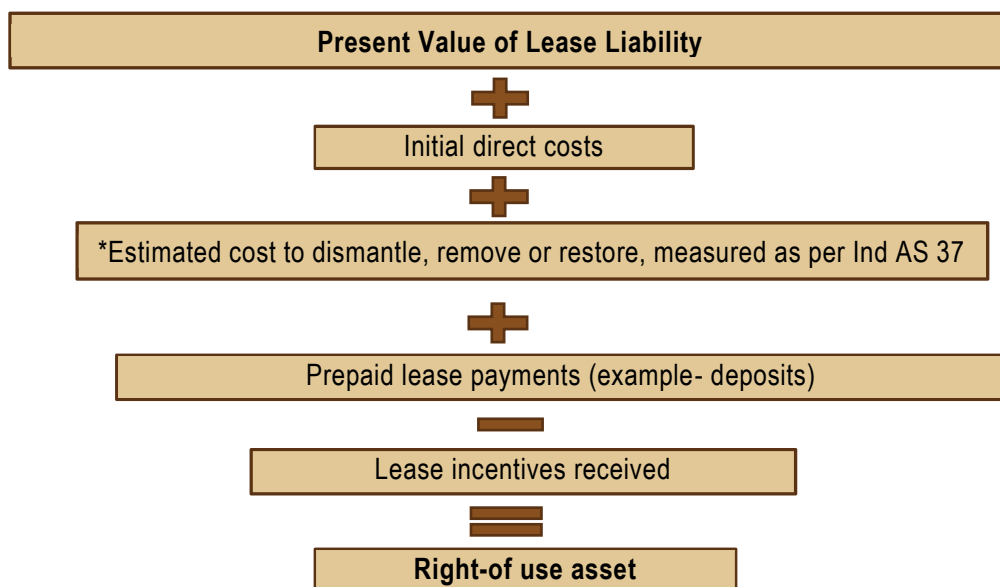
Year	Lease Payment	Discount factor @ 5%	PV of lease payments
1	1,00,000	1	100,000
2	1,02,000	0.952	97,102
3	1,04,040	0.907	94,364
4	1,06,121	0.864	91,689
5	1,08,243	0.823	89,084
6	1,10,408	0.784	86,560
7	1,12,616	0.746	84,012

8	1,14,869	0.711	81,672
9	1,17,166	0.677	79,321
10	1,19,509	0.645	<u>77,083</u>
			<u>8,80,887</u>

Therefore, the lease liability is initially measured at ₹ 8,80,887

Measuring the right-of-use asset:

A lessee initially measures the ROU Asset at **COST**, which consists of ***ALL*** of the following:



Journal entry in the books of lessee

ROU Asset	Dr.	Sum total of all below items
To Lease liability	Cr.	PV of outstanding lease payments by lessee using interest rate implicit in lease
To Lessor / Supplier	Cr.	Any lease payment made on or before the commencement date <u>less</u> lease incentives received
To Bank / Creditor	Cr.	Initial direct costs incurred by lessee
To Provision for dismantling / removing the underlying asset	Cr.	Estimate of costs to be recognised only when lessee incurs an obligation for these costs (Ind AS 37)

*On initial measurement, a lessee is required to recognise dismantling, removal and restoration costs as part of the ROU Asset. Costs may be incurred at lease commencement or during a particular period as a consequence of having used an underlying asset. Costs that are incurred during a particular period as a consequence of having used the ROU Asset to produce inventories are accounted for under Ind AS 2 *Inventories*. The liability associated with dismantling, removal and restoration costs is recognised and measured in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Illustration 28: Measuring right-of-use asset

Entity Y and Entity Z execute a 12-year lease of a railcar with the following terms on 1 January, 20X1:

- ◆ The lease commencement date is 1 February 20X1.
- ◆ Entity Y must pay Entity Z the first monthly rental payment of ₹10,000 upon execution of the lease.
- ◆ Entity Z will pay Entity Y ₹50,000 cash incentive to enter into the lease payable upon lease execution.

Entity Y incurred ₹1,000 of initial direct costs, which are payable on 1 February 20X1. Entity Y calculated the initial lease liability as the present value of the lease payments discounted using its incremental borrowing rate because the rate implicit in the lease could not be readily determined; the initial lease liability is ₹8,50,000.

How would Lessee Company measure and record this lease?

Solution:

Entity Y would calculate the right-of-use asset as follows:

₹

Initial measurement of lease liability	8,50,000
Lease payments made to Entity Z at or before the commencement date	10,000
Lease incentives received from Entity Z	(50,000)
Initial direct cost	<u>1,000</u>
Initial measurement of right-of-use asset	<u>8,11,000</u>

Illustration 29 - Dismantling costs to be included in initial measurement of ROU Asset

Company H leases an aircraft for a period of 5 years. The aircraft must undergo a planned check after every 100,000 flight hours. At the end of the lease, company H must have a check performed

(or refund the costs to the lessor), irrespective of the actual number of flight hours. What are the lease payments for purposes of calculating ROU asset?

Solution:

In the given case, the legal requirement to perform a check after every 1,00,000 flight hours does not directly lead to an obligation as it depends on future circumstances. However, as the check must be carried out at the end of the lease irrespective of the actual number of flight hours gives rise to an obligation.

As a result, company H has to recognize a provision for the costs of the final check ("present value of the expected cost") at the beginning of the lease term. At the same time, these costs must be included in the cost of the right-of-use (ROU) asset pursuant to para 24 (d) of Ind AS 116.

Comparison with AS 19:

AS 19 is based on dual classification model of operating and finance leases with different classification and measurement guidance for each of them.

- In case of finance lease, asset and liability is recognized at an amount equal to the fair value of the leased asset at the inception of the lease, unless the present value of minimum lease payments is less than the fair value.
- In case of operating lease, rentals payable is charged as an expense in the statement of profit and loss on a straight-line basis over the lease term, even if the payments are not made on that basis, unless another systematic basis is more representative of the time pattern of the user's benefit.

Hence, the accounting for leases in the books of lessee under AS 19 is completely different from that under Ind AS 116. ROU asset is not required to be accounted for under AS 19. Hence, the subsequent measurement, presentation and disclosure of ROU asset is also not relevant from AS 19 perspectives.

8.4.2 Subsequent Measurement

8.4.2.1 Right-of-use assets (ROU Asset)

After the commencement date, the right-of-use asset should be measured using a cost model, unless it applies the revaluation model as specified under Ind AS 16.

Cost model for right-of-use assets:

To follow the cost model, an entity measures a right-of-use asset at cost:

- (a) Less **accumulated depreciation** and accumulated impairment losses (recognised in accordance with Ind AS 36, Impairment of Assets); and
- (b) Adjusted for **re-measurements of the lease liability** specified in section 8.4.3

Depreciation for right-of-use assets

ROU Assets measured under the cost model should be depreciated in accordance with the depreciation requirements given in Ind AS 16, subject to the following:

- If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the ROU Asset reflects that the lessee will exercise a purchase option, the ROU Asset should be depreciated from the commencement date to the end of the useful life of the underlying asset;
- otherwise, the right-of-use asset should be depreciated from the commencement date to the earlier of the end of the useful life of the ROU Asset and the end of the lease term.

Where, **'useful life'** is defined as 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 an asset by an entity.

Therefore, if the ownership of the underlying asset transfers to the lessee at the end of the lease term, or it is reasonably certain that the lessee will exercise a purchase option, depreciation is based on the useful life of the underlying asset. Otherwise, depreciation is determined by reference to the useful life of the right-of-use asset (provided that is not longer than the lease term).

Revaluation model for right-of-use assets:

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in Ind AS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

However, if right-of-use assets that meet the definition of investment property under Ind AS 40 "Investment Property", then, revaluation model cannot be applied because at present Ind AS 40 "Investment property" does not permit revaluation model and only cost model is allowed for all investment properties.

8.4.2.2 Lease liability:

A Lease Liability should be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). Consequently, the lease liability is accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment requiring a change in the discount rate has not been triggered). Lease payments reduce the lease liability when paid.

Thus, after the commencement date, a lessee shall measure the lease liability by:

- increasing the carrying amount to reflect interest on the lease liability;
- reducing the carrying amount to reflect the lease payments made; and
- remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments.

8.4.2.3 Expense recognition

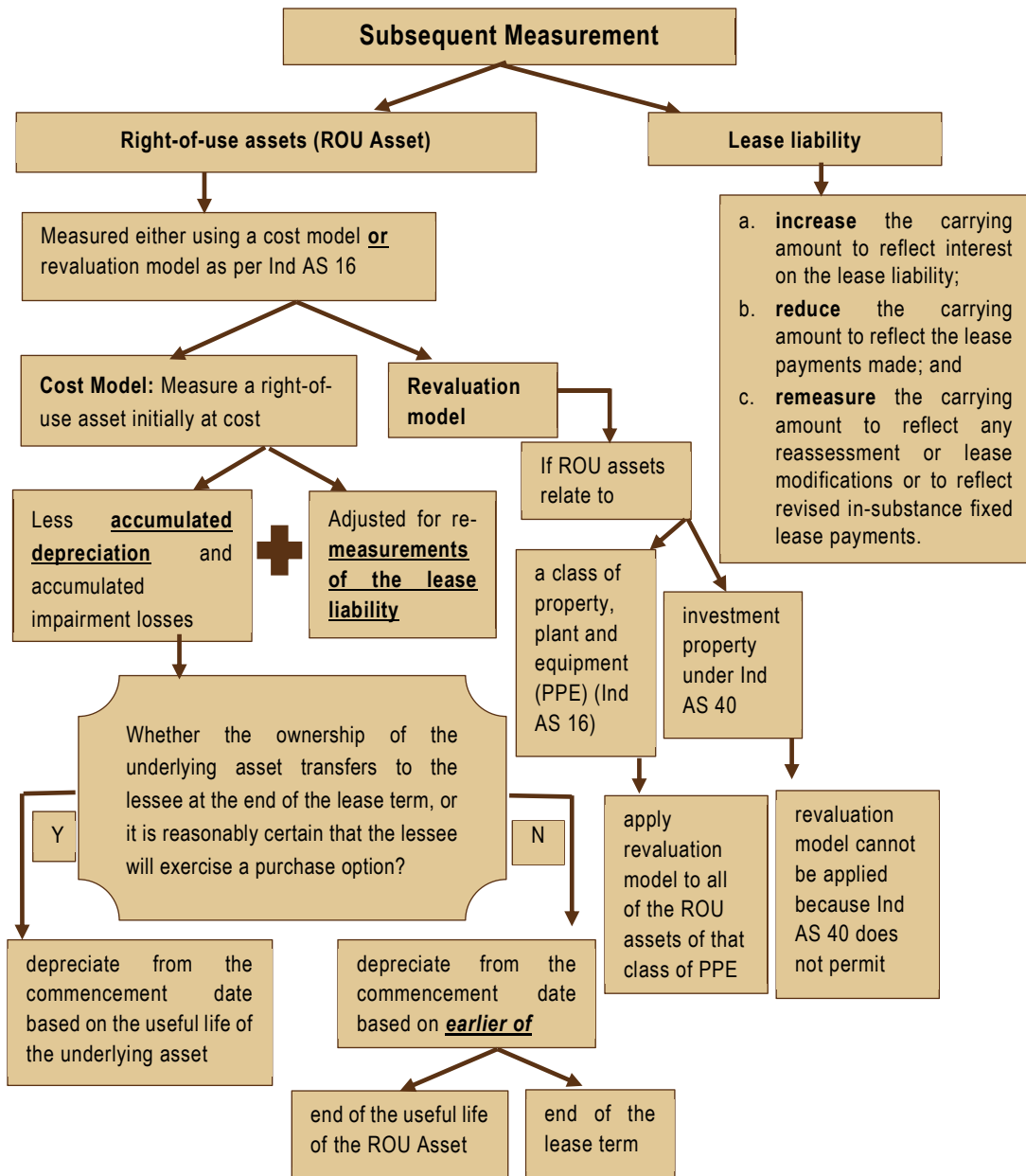
Lessees recognise the following items in expense for leases:

- ◆ Depreciation of the ROU Asset
- ◆ Interest expense on the Lease Liability
- ◆ Variable lease payments that are not included in the lease liability (**for e.g.**, variable lease payments that do not depend on an index or rate)
- ◆ Impairment of the ROU Asset

These expenses are further explained below:

<i>Depreciation of the ROU Asset and Interest on the Lease Liability</i>	<i>Variable lease payments</i>	<i>Impairment of the ROU Asset</i>
After the commencement date, a lessee recognises depreciation of the ROU Asset and separately recognises interest on the lease liability. When a lessee depreciates the ROU Asset on a straight-	After the commencement date, lessees recognise in profit or loss, any variable lease payments <u>not included</u> in the measurement of the lease liability in the period in which the event or condition that triggers those payments	Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36, <i>Impairment of Assets</i> . If a lessee determines that a ROU Asset is impaired, it recognises an <u>impairment</u>

line basis, the total periodic expense (i.e., the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Interest expense decreases as cash payments are made during the lease term and the lease liability decreases because a constant interest rate is applied to the lease liability. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the ROU Asset, results in a <u>front-loaded expense recognition pattern</u>.	occur.	<u>loss</u> and measures the ROU Asset at its carrying amount immediately after the impairment. A lessee subsequently depreciates, generally on a straight-line basis, the ROU Asset from the date of the impairment to the earlier of the end of the useful life of the ROU Asset or the end of the lease term. However, the depreciation period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.



Let us have a look at illustration on 'Lessee Accounting':

Illustration 30 - Lessee Accounting

Entity ABC (lessee) enters into a three-year lease of equipment. Entity ABC agrees to make the following annual payments at the end of each year:

- ₹ 20,000 in year one

- ₹ 30,000 in year two
- ₹ 50,000 in year three.

For simplicity purposes, there are no other elements to the lease payments (like purchase options, lease incentives from the lessor or initial direct costs). Assumed a discount rate of 12% (which is Entity ABC's incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined). Entity ABC depreciates the ROU Asset on a straight-line basis over the lease term.

How would Entity ABC account for the said lease under Ind AS 116?

Solution:

At the commencement date, Entity ABC would initially recognise ROU Asset and the corresponding Lease Liability of ₹ 77,364 which is calculated as follows:

Year	Payments (Cash flows)	Discounting Factor @12%	Discounted Cash flows / Present Value
1	20,000	0.8929	17,858
2	30,000	0.7972	23,916
3	<u>50,000</u>	0.7118	<u>35,590</u>
	<u>1,00,000</u>		<u>77,364</u>

Then, the next step would be to prepare a schedule for Lease Liability and ROU Asset as follows:

Lease Liability

Year	Opening balance	Interest Expense	Payments	Closing balance
1	77,364	9,284	(20,000)	66,648
2	66,648	7,998	(30,000)	44,646
3	44,646	5,354*	(50,000)	-

* Difference of ₹ 4 is due to approximation.

ROU Asset (assuming no lease incentives, no initial direct costs, etc.):

Year	Opening balance	Depreciation	Closing balance
1	77,364	(25,788)	51,576
2	51,576	(25,788)	25,788
3	25,788	(25,788)	-

At lease commencement, Entity ABC would recognise the Lease Liability and the corresponding ROU Asset as follows:

ROU Asset	Dr.	77,364	
To Lease Liability			77,364
<i>To initially recognise the Lease Liability and the corresponding ROU Asset</i>			

The following journal entries would be recorded in the first year:

Interest Expense	Dr.	9,284	
To Lease Liability			9,284
<i>To record interest expense and accrete the lease liability using the effective interest method (₹ 77,364 x 12%)</i>			
Depreciation Expense	Dr.	25,788	
To ROU Asset			25,788
<i>To record interest expense and accrete the lease liability using the straight-line method (₹ 77,364 / 3 years)</i>			
Lease Liability	Dr.	20,000	
To Cash / Bank			20,000
<i>To record lease payment</i>			

Following is the summary of the said lease contract's accounting (assuming no changes due to reassessment):

Particulars	Initially	Year 1	Year 2	Year 3
Cash lease payments		20,000	30,000	50,000
<u>Lease Expense Recognised:</u>				
Interest Expense		9,284	7,998	5,354
Depreciation Expense		<u>25,788</u>	<u>25,788</u>	<u>25,788</u>
Total Periodic Expense		<u>35,072</u>	<u>33,786</u>	<u>31,142</u>
<u>Balance Sheet:</u>				
ROU Asset	77,364	51,576	25,788	-
Lease Liability	(77,364)	(66,648)	(44,646)	-

Illustration 31 - Subsequent measurement using cost model

Company EFG enters into a property lease with Entity H. The initial term of the lease is 10 years with a 5-year renewal option. The economic life of the property is 40 years and the fair value of the leased property is ₹ 50 Lacs. Company EFG has an option to purchase the property at the end of the lease term for ₹ 30 lacs. The first advance annual payment is ₹ 5 lacs with an increase of 3% every year thereafter. The implicit rate of interest is 9.04%. Entity H gives Company EFG an incentive of ₹ 2 lacs (payable at the beginning of year 2), which is to be used for normal tenant improvement.

Company EFG is reasonably certain to exercise that purchase option. How would EFG measure the right-of-use asset and lease liability over the lease term?

Solution:

As per Ind AS 116, Company EFG would first calculate the lease liability as the present value of the annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using the rate implicit in the lease of approximately 9.04%.

PV of lease payments, less lease incentive (W.N. 1)	₹ 37,39,648
PV of purchase option at end of lease term (W.N. 2)	<u>₹ 12,60,000</u>
Total lease liability	₹ 49,99,648 or ₹ 50,00,000 (approx.)

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Company EFG, lease payments made at or before the lease commencement date, or lease incentives received prior to the lease commencement date.

Entity EFG would record the following journal entry on the lease commencement date.

Right-of-use Asset	Dr.	₹ 50,00,000	
To Lease Liability			₹ 50,00,000
<i>To record ROU asset and lease liability at the commencement date.</i>			

Since the purchase option is reasonably certain to be exercised, EFG would amortize the right-of-use asset over the economic life of the underlying asset (40 years). Annual amortization expense would be ₹ 1,25,000 (₹ 50,00,000 / 40 years)

Interest expense on the lease liability would be calculated as shown in the following table. This table includes all expected cash flows during the lease term, including the lease incentive paid by Entity H and Company EFG's purchase option.

Year	Payment	Principal paid at the beginning of the year	Interest paid	Interest expense	Lease Liability (end of the year)
	a	b= a-c	c = (d of pvs. Year)	d = [(e of pvs. year- a) x 9.04%]	e = (e of pvs. Year + d - a)
Commencement					50,00,000
Year 1	5,00,000	5,00,000	-	4,06,800	49,06,800
Year 2	3,15,000*	(91,800)	4,06,800	4,15,099	50,06,899
Year 3	5,30,450	1,15,351	4,15,099	4,04,671	48,81,120
Year 4	5,46,364	1,41,693	4,04,671	3,91,862	47,26,618
Year 5	5,62,754	1,70,892	3,91,862	3,76,413	45,40,277
Year 6	5,79,637	2,03,224	3,76,413	3,58,042	43,18,682
Year 7	5,97,026	2,38,984	3,58,042	3,36,438	40,58,094
Year 8	6,14,937	2,78,499	3,36,438	3,11,261	37,54,418
Year 9	6,33,385	3,22,124	3,11,261	2,82,141	34,03,174
Year 10	6,52,387	3,70,246	2,82,141	2,49,213*	30,00,000
Year 10	<u>30,00,000</u>	<u>27,50,787</u>	<u>2,49,213*</u>	<u>-</u>	<u>-</u>
Total	<u>85,31,940</u>	<u>50,00,000</u>	<u>35,31,940</u>	<u>35,31,940</u>	

*(5,00,000 + increased by 3% - lease incentive paid amounting to 2,00,000)

Although the lease was for 10 years, the asset had an economic life of 40 years. When Company EFG exercises its purchase option at the end of the 10-year lease, it would have fully extinguished its lease liability but continue depreciating the asset over the remaining useful life.

Working Notes

1. Calculating PV of lease payments, less lease incentive:

Year	Lease Payment (A)	Present value factor @ 9.04% (B)	Present value of lease payments (A x B = C)
Year 1	5,00,000	1	5,00,000
Year 2	3,15,000	0.92	2,89,800
Year 3	5,30,450	0.84	4,45,578
Year 4	5,46,364	0.77	4,20,700
Year 5	5,62,754	0.71	3,99,555
Year 6	5,79,637	0.65	3,76,764

Year 7	5,97,026	0.59	3,52,245
Year 8	6,14,937	0.55	3,38,215
Year 9	6,33,385	0.50	3,16,693
Year 10	6,52,387	0.46	<u>3,00,098</u>
Total			<u>37,39,648</u>

2. Calculating PV of purchase option at end of lease term:

Year	Payment on purchase option (A)	Present value factor @ 9.04% (B)	Present value of purchase option (A x B = C)
Year 10	30,00,000	0.42	<u>12,60,000</u>
Total			<u>12,60,000</u>

The discount rate for year 10 is different in the above calculations because in the earlier one its beginning of year 10 and in the later one its end of the year 10.

8.4.2.4 Impairment of ROU Assets

Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36 *Impairment of Assets*. Ind AS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit (CGU) of which the asset is a part). The entity has to recognise an impairment loss if the recoverable amount of the CGU is less than the carrying amount of the CGU. After an impairment loss is recognised, the adjusted carrying amount of the ROU Asset would be its new basis for depreciation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined after depreciation, had there been no impairment.

8.4.2.5 Leases denominated in a foreign currency

Lessees apply Ind AS 21 *The Effects of Changes in Foreign Exchange Rates*, to leases denominated in a foreign currency. Lessees remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date, like they do for other monetary liabilities. Any changes to the lease liability due to exchange rate changes are recognised in profit or loss. Because the ROU Asset is a non-monetary asset measured at historical cost, it is not affected by changes in the exchange rate.

This approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses, but it will be clear to the users of financial statements that the gains or losses result solely from changes in exchange rates.

8.4.3 Remeasurement

Ind AS 116 requires lessees to **REMEASURE LEASE LIABILITIES** upon a change in lease payments on account of **ANY** of the following:

The reassessment of lease term on account of reasonable certainty to exercise/not exercise of extension and/or termination option

The reassessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset

In-substance fixed lease payments

The amounts expected to be payable under residual value guarantees

Future lease payments resulting from a change in an index or rate

When to use the 'original' and a 'revised' discount rate?

<i>Revised Discount Rate</i>	<i>Original Discount Rate</i>
Lessees use a revised discount rate when lease payments are updated for - reassessment of the lease term OR - a reassessment of a purchase option. The revised discount rate is based on the interest rate implicit in the lease for the REMAINDER of the lease term. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate.	Lessees use the original discount rate when lease payments are updated for - a change in expected amounts for residual value guarantees AND - payments dependent on an index or rate, unless the rate is a floating interest rate. - the variability of payments is resolved so that they become in-substance fixed payments.

When a lease includes a **market rate adjustment** (a market rent review), the negotiations between the lessee and the lessor may take some time to complete (i.e., the negotiation period). **For e.g.**, consider a 10-year lease that has a market rate adjustment that applies from the end of year 5. The market rent review negotiations begin during year 5 but are not completed until later in year 6. During year 6, while the negotiation is ongoing, the lessee is required to pay the original contractual lease payments. At the conclusion of the negotiation period (i.e., upon a final determination of the lease payments for year 6 until year 10), the new lease payments apply retrospectively from the beginning of year 6. In this example, the lessee does not adjust the lease

payments at the beginning of year 6 for the expected increase in rent. Rather, any adjustment is recognised as an adjustment to lease payments when the market rent review is finalised and the change in contractual cash flows takes effect.

A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the ROU Asset. However, if the carrying amount of the ROU Asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee recognises any remaining amount of the remeasurement in profit or loss.

Illustration 32- Remeasurement of a lease with variable lease payments

Entity W entered into a contract for lease of retail store with Entity J in January 1/1/20X1. The initial term of the lease is 5 years with a renewal option of a further 3 years. The annual payments for initial term and renewal term are ₹ 100,000 and ₹ 110,000 respectively. The annual lease payment will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 1/1/20X2 will be based on the CPI available at 31/12/20X1.

Entity W's incremental borrowing rate at the lease inception date and as at 1/1/20X4 is 5% and 6% respectively and the CPI at lease commencement date and as at 1/1/20X4 is 120 and 125 respectively.

At the lease commencement date, Entity W did not have a significant economic incentive to exercise the renewal option. In the first quarter of 20X4, Entity W installed unique lease improvements into the retail store with an estimated five-year economic life. Entity W determined that it will only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

Is Entity W required to remeasure the lease in the first quarter of 20X4?

Solution:

Since Entity W is now reasonably certain that it will exercise its renewal option, it is required to remeasure the lease in the first quarter of 20X4.

The following table summarizes information pertinent to the lease remeasurement.

Remeasured lease term	5 years; 2 years remaining in the initial term plus 3 years in the renewal period
Entity W's incremental borrowing rate On the remeasurement date	6%
CPI available on the remeasurement date	125
Right-of-use asset immediately before the remeasurement	₹ 1,81,840 (Refer note 1)
Lease liability immediately before the remeasurement	₹ 1,95,244 (Refer note 1)

To remeasure the lease liability, Entity W would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 6%). The following table shows the present value of the future lease payments based on an updated CPI of 125. Since the initial lease payments were based on a CPI of 120, the CPI has increased by 4.167% approx. As a result, Entity W would increase the future lease payments by 4.167%. As shown in the table, the revised lease liability is ₹ 4,91,376.

Year	4	5	6	7	8	Total
Lease payment	1,04,167	1,04,167	1,14,583	1,14,583	1,14,583	5,52,083
Discount @ 6%	1	0.943	0.890	0.840	0.792	
Present value	1,04,167	98,230	1,01,979	96,250	90,750	4,91,376

To calculate the adjustment to the lease liability, Entity W would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	4,91,376
Original lease liability	<u>(1,95,244)</u>
	<u>2,96,132</u>

Entity W would record the following journal entry to adjust the lease liability.

ROU Asset	Dr.	2,96,132	
To Lease liability			2,96,132
<i>Being lease liability and ROU asset adjusted on account of remeasurement.</i>			

Working Notes:

1. Calculation of ROU asset before the date of remeasurement

Year beginning	Lease Payment (A)	Present value factor @ 5% (B)	Present value of lease payments (A x B=C)
1	1,00,000	1.000	1,00,000
2	1,00,000	0.952	95,200
3	1,00,000	0.907	90,700
4	1,00,000	0.864	86,400
5	1,00,000	0.823	<u>82,300</u>
Lease liability as at commencement date			<u>4,54,600</u>

2. Calculation of Lease Liability and ROU asset at each year end

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 5%	Closing balance	Initial Value	Depreciation for 5 years	Closing balance
1	4,54,600	1,00,000	17,730	3,72,330	4,54,600	90,920	3,63,680
2	3,72,330	1,00,000	13,617	2,85,947	3,63,680	90,920	2,72,760
3	2,85,947	1,00,000	9,297	1,95,244	2,72,760	90,920	1,81,840
4	1,95,244				1,81,840		

8.4.4 Lease Modifications

A 'lease modification' is a **change** in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (**for e.g.**, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

The following are examples of lease modifications that may be negotiated after the lease commencement date:

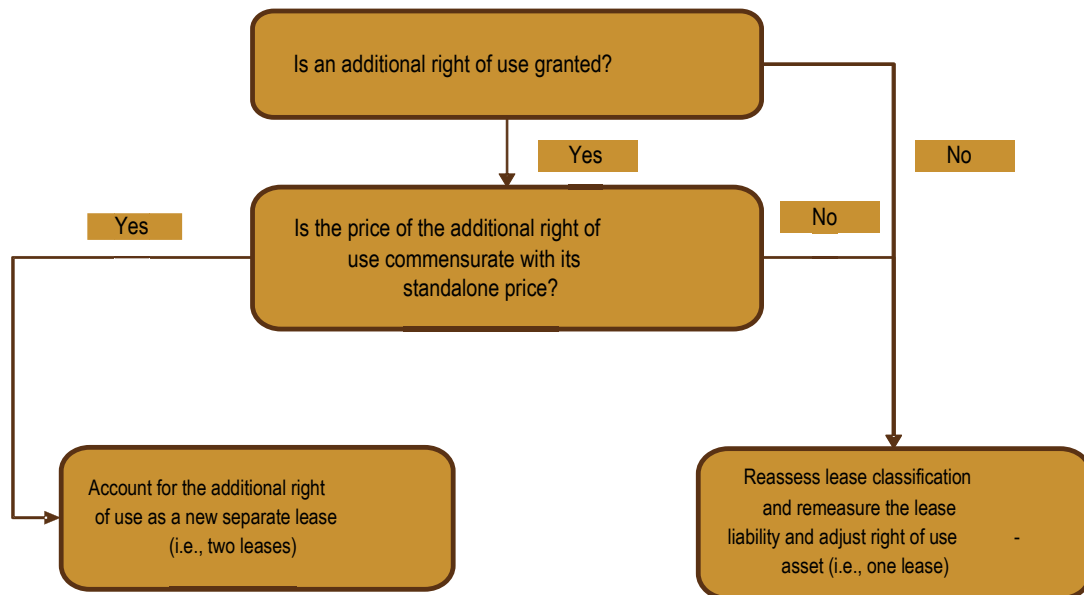
- ◆ A lease extension
- ◆ Early termination of the lease
- ◆ A change in the timing of lease payments
- ◆ Leasing additional space in the same building
- ◆ Surrendering a part of the underlying asset.

If a lease is modified (as stated above), the modified contract is evaluated to determine whether it is or contains a lease. If a lease continues to exist, lease modification can result in:

- ◆ A separate lease OR
- ◆ A change in the accounting for the existing lease (i.e., not a separate lease).

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised are **not lease modifications but can result in the remeasurement** of Lease Liabilities and ROU Assets (Remeasurement – as discussed above).

The following diagram demonstrates Lessee's analysis of a change in a lease:



Let us understand in detail when and how the lease modification will be accounted as a separate lease contract and not as a separate lease contract:

Modification – Separate lease

A lease modification is accounted for as a separate lease if both:

- The modification increases the scope of the lease by adding the right to use one or more underlying assets; **and**
- The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessee would follow the previous guidance on the initial recognition and measurement of lease liabilities and right-of-use assets.

Illustration 33 - Modification that is a separate lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

How should the said modification be accounted for?

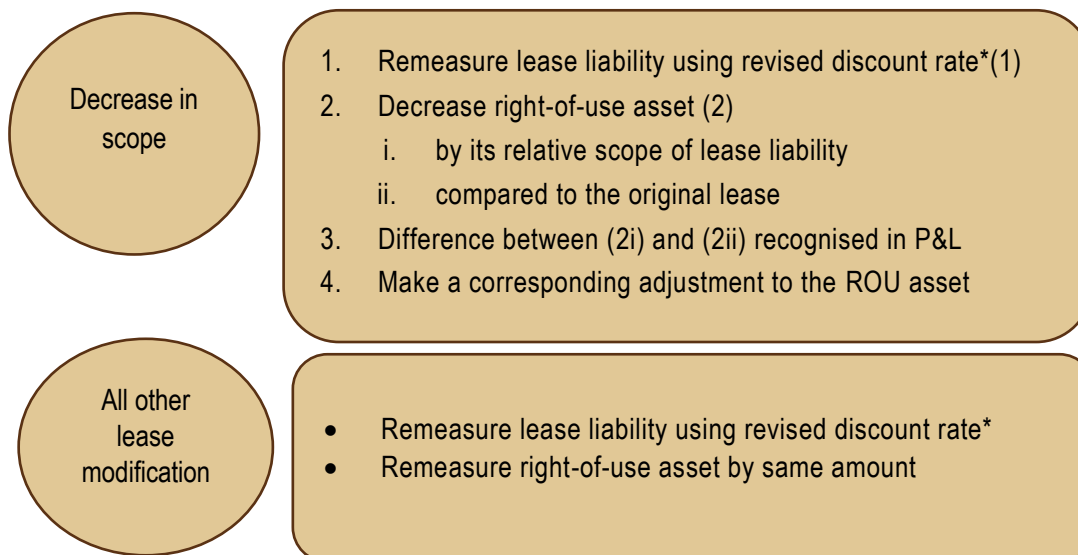
Solution:

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this question, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a ROU Asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

Modification- Not Separate Lease:

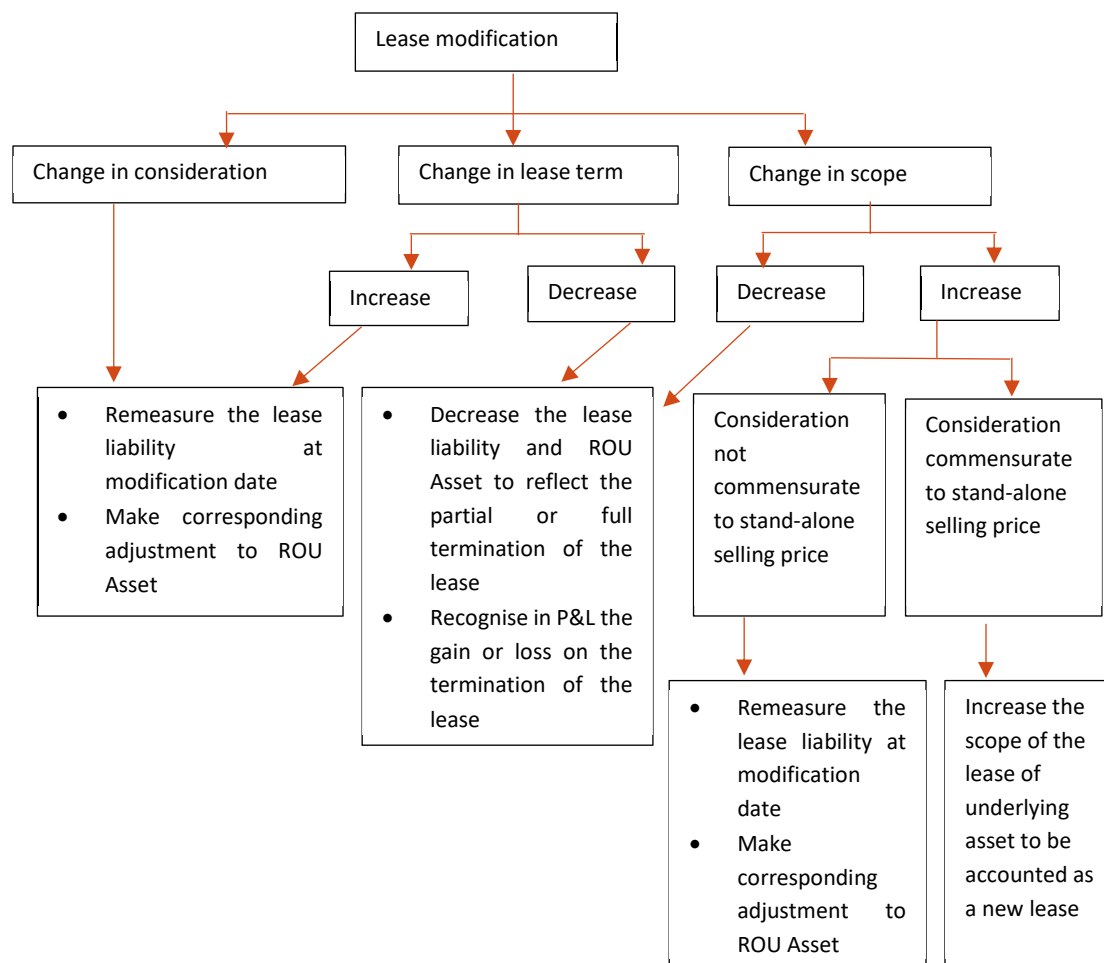
If a lease modification fails the test above (e.g. additional right of use granted, but not at a standalone price) or the modification is of any other type (e.g. a decrease in scope from the original contract), the lessee must modify the initially recognised components of the lease contract.

The accounting treatment required for lease modifications that are not accounted for as separate leases is summarised below:



*The implicit rate in the lease is to be used. If it cannot be readily determined, the incremental rate of borrowing is to be used.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.



In some cases, the lessee and lessor may agree to a modification to the lease contract that starts at a later date (i.e., the terms of the modification take effect at a date later than the date when both parties agreed to the modification). This can be understood with the help of a following example:

A lessee enters into a lease arrangement with a lessor to lease an asset for 10 years. At the beginning of year 8, the lessee and lessor agree to a modification to the contract that will take effect from the beginning of year 9.

Scenario 1 (Increase in scope – Not a Separate Lease)	Scenario 2 (Increase in scope – Separate Lease)	Scenario 3 (Decrease in scope)
If the modification is an increase in the scope that	If the modification results in a separate lease component,	If the modification is a decrease in the scope, the

does not result in a separate lease, the lessee will re-allocate the consideration in the modified contract to each of the existing lease and non-lease components and remeasure the lease liability at the date both parties agreed to the modification (the beginning of year 8).	the lessee will allocate the consideration in the modified contract to each of the existing and new lease and non-lease components at the date both parties agreed to the modification (the beginning of year 8). The lessee will remeasure the lease liability for the existing lease components at that date as well. However, recognition of the lease liability and ROU Asset for any new lease component occurs at the commencement date of the new lease component (the beginning of year 9).	lessee will re-allocate the consideration in the modified contract to each existing lease and non-lease component and remeasure the lease liability and ROU Asset at the effective date of the modification (the beginning of year 8).

This can be summarised with the help of the following flow chart:

Following are some more examples for 'lease modification':

Illustration 34 - Modification that increases the scope of the lease by extending the contractual lease term

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by four years. The annual lease payments are unchanged (i.e., ₹ 1,00,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7% p.a.

How should the said modification be accounted for?

Solution:

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on:

- (a) An eight-year remaining lease term
- (b) Annual payments of ₹ 1,00,000 and

(c) Lessee's incremental borrowing rate of 7% p.a.

The modified lease liability equals ₹ 5,97,100 (W.N.1). The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is ₹ 3,46,355 (W.N.3). Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (i.e., ₹ 2,50,745) (W.N. 4) as an adjustment to the ROU Asset.

Working Notes:

1. Calculation of modified lease liability:

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A*B=C)
7	100,000	0.935	93,500
8	100,000	0.873	87,300
9	100,000	0.816	81,600
10	100,000	0.763	76,300
11	100,000	0.713	71,300
12	100,000	0.666	66,600
13	100,000	0.623	62,300
14	100,000	0.582	<u>58,200</u>
Modified lease liability			<u>5,97,100</u>

2. Calculation of Lease liability as at commencement date:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700

9	100,000	0.592	59,200
10	100,000	0.558	<u>55,800</u>
Lease liability as at commencement date			<u>7,35,900</u>

3. Calculation of Lease liability immediately before modification date:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090	25,265	100,000	<u>3,46,355</u>
Lease liability as at modification date				<u>3,46,355</u>

4. Adjustment to ROU asset:

Modified Lease liability	5,97,100
Original Lease liability as at modification date	<u>(3,46,355)</u>
Adjustment to ROU asset	<u>2,50,745</u>

The ROU asset will be increased by ₹ 2,50,745 on the date of modification.

Illustration 35 - Modification that decreases the scope of the lease

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments to be made at the end of the year (from Year 6 to Year 10) are ₹ 30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% p.a.

How should the said modification be accounted for in the books of lessee?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 6%	Closing balance	Initial Value	Depreciation	Closing balance
	a	b	c = a x 6%	d = a-b + c	e	f	g
1	3,67,950*	50,000	22,077	3,40,027	3,67,950	36,795	3,31,155
2	3,40,027	50,000	20,402	3,10,429	3,31,155	36,795	2,94,360
3	3,10,429	50,000	18,626	2,79,055	2,94,360	36,795	2,57,565
4	2,79,055	50,000	16,743	2,45,798	2,57,565	36,795	2,20,770
5	2,45,798	50,000	14,748	2,10,546	2,20,770	36,795	1,83,975
6	2,10,546				1,83,975		

*(refer note 1)

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

- (a) a five-year remaining lease term,
- (b) annual payments of ₹ 30,000 and
- (c) Lessee's incremental borrowing rate of 5% p.a.

Year	Lease Payment(A)	Present value factor @ 5% (B)	Present value of lease payments (A x B = C)
6	30,000	0.952	28,560
7	30,000	0.907	27,210
8	30,000	0.864	25,920
9	30,000	0.823	24,690
10	30,000	0.784	<u>23,520</u>
Total			<u>1,29,900</u>

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 2,500 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (₹ 1,83,975) is ₹ 91,987.50.

50% of the pre-modification lease liability (₹ 2,10,546) is ₹ 1,05,273.

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 91,987.50 and the carrying amount of the lease liability by ₹ 1,05,273. Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,05,273 – ₹ 91,987.50 = ₹ 13,285.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Journal Entry

Lease liability	Dr.	₹ 1,05,273	
To ROU Asset			₹ 91,987.50
To Profit and Loss			₹ 13,285.50

Lessee recognises the difference between the remaining lease liability of ₹ 1,05,273 and the modified lease liability of ₹ 1,29,900 (which equals ₹ 24,627) as an adjustment to the ROU Asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Journal Entry

ROU Asset	Dr.	₹ 24,627	
To Lease liability			₹ 24,627

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment(A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	50,000	0.943	47,150
2	50,000	0.890	44,500
3	50,000	0.840	42,000
4	50,000	0.792	39,600
5	50,000	0.747	37,350
6	50,000	0.705	35,250
7	50,000	0.665	33,250
8	50,000	0.627	31,350
9	50,000	0.592	29,600
10	50,000	0.558	<u>27,900</u>
			<u>3,67,950</u>

Illustration 36 - Modification that is a change in consideration only

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from ₹ 1,00,000 per year to ₹ 95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a. The annual lease payments are payable at the end of each year.

How should the said modification be accounted for?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090			

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

- (a) a five-year remaining lease term,
- (b) annual payments of ₹ 95,000, and
- (c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	95,000	0.935	88,825
2	95,000	0.873	82,935
3	95,000	0.816	77,520
4	95,000	0.763	72,485
5	95,000	0.713	<u>67,735</u>
			<u>3,89,500</u>

Lessee recognises the difference between the carrying amount of the modified liability (₹ 3,89,500) and the lease liability immediately before the modification (₹ 4,21,090) of ₹ 31,590 as an adjustment to the ROU Asset.

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
4	1,00,000	0.792	79,200
5	1,00,000	0.747	74,700
6	1,00,000	0.705	70,500
7	1,00,000	0.665	66,500
8	1,00,000	0.627	62,700
9	1,00,000	0.592	59,200
10	1,00,000	0.558	<u>55,800</u>
Lease liability as at commencement date			<u>7,35,900</u>

Illustration 37 - Modification that both increases and decreases the scope of the lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a.

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to:

- include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and
- reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is ₹ 1,50,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract.

Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

How should the said modification be accounted for?

Solution:

The pre-modification ROU Asset and the pre-modification lease liability in relation to the lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 6%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
1	7,35,900*	44,154	(1,00,000)	6,80,054	7,35,900	(73,590)	6,62,310
2	6,80,054	40,803	(1,00,000)	6,20,857	6,62,310	(73,590)	5,88,720
3	6,20,857	37,251	(1,00,000)	5,58,108	5,88,720	(73,590)	5,15,130
4	5,58,108	33,486	(1,00,000)	4,91,594	5,15,130	(73,590)	4,41,540
5	4,91,594	29,496	(1,00,000)	4,21,090	4,41,540	(73,590)	3,67,950
6	4,21,090				3,67,950		

*Refer Note 4.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of:

- (a) A three-year remaining lease term (ie. till 8th year),
- (b) Annual payments of ₹ 150,000 and
- (c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	1,50,000	0.935	1,40,250
2	1,50,000	0.873	1,30,950
3	1,50,000	0.816	<u>1,22,400</u>
Modified lease liability			<u>3,93,600</u>

The modified liability equals ₹ 3,93,600, of which (a) ₹ 1,31,200 relates to the increase of ₹ 50,000 in the annual lease payments from Year 6 to Year 8 and (refer note 1) (b) ₹ 2,62,400 relates to

the remaining three annual lease payments of ₹ 1,00,000 from Year 6 to Year 8 with reduction of lease term (Refer Note 3).

Decrease in the lease term:

At the effective date of the modification (at the beginning of Year 6), the pre-modification ROU Asset is ₹ 3,67,950. Lessee determines the proportionate decrease in the carrying amount of the ROU Asset based on the remaining ROU Asset for the original 2,000 square metres of office space (i.e., a remaining three-year lease term rather than the original five-year lease term). The remaining ROU Asset for the original 2,000 square metres of office space is ₹ 2,20,770 [i.e., ₹ (3,67,950 / 5) x 3 years].

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is ₹ 4,21,090. The remaining lease liability for the original 2,000 square metres of office space is ₹ 2,67,300 (i.e., present value of three annual lease payments of ₹ 1,00,000, discounted at the original discount rate of 6% p.a.) (refer note 2).

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,47,180 (₹ 3,67,950 – ₹ 2,20,770), and the carrying amount of the lease liability by ₹ 1,53,790 (₹ 4,21,090 – ₹ 2,67,300). Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,53,790 – ₹ 1,47,180 = ₹ 6,610) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease Liability	Dr.	1,53,790	
To ROU Asset			1,47,180
To Gain			6,610

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7% p.a., which is ₹ 4,900 (₹ 2,67,300 – ₹ 2,62,400*), as an adjustment to the ROU Asset.

*(Refer note 3)

Lease Liability	Dr.	4,900	
To ROU Asset			4,900

Increase in the leased space:

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in leased space of ₹ 1,31,200 (i.e., present value of three annual lease payments of ₹ 50,000, discounted at the revised interest rate of 7% p.a.) as an adjustment to the ROU Asset.

ROU Asset	Dr.	1,31,200	
To Lease Liability			1,31,200

The modified ROU Asset and the modified lease liability in relation to the modified lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 7%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
6	3,93,600	27,552	(1,50,000)	2,71,152	3,47,070**	(1,15,690)	2,31,380
7	2,71,152	18,981	(1,50,000)	1,40,133	2,31,380	(1,15,690)	1,15,690
8	1,40,133	9,867*	(1,50,000)	-	1,15,690	(1,15,690)	-

*Difference is due to approximation; **Refer Note 5

Working Notes:

1. Calculation of lease liability on increased consideration:

Year	Lease Payments (A)	Present value @7% (B)	Present value of lease payments (A x B = C)
1	50,000	0.935	46,750
2	50,000	0.873	43,650
3	50,000	0.816	<u>40,800</u>
Modified lease liability			<u>1,31,200</u>

2. Calculation of remaining lease liability for the original contract of 2000 square meters at original discount rate:

Year	Lease Payments (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	<u>84,000</u>
Remaining lease liability			<u>2,67,300</u>

3. Calculation of remaining lease liability for the original contract of 2000 square meters at revised discount rate:

Year	Lease Payments (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.935	93,500
2	1,00,000	0.873	87,300
3	1,00,000	0.816	<u>81,600</u>
Remaining lease liability			<u>2,62,400</u>

4. Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	<u>55,800</u>
Lease liability as at commencement date			<u>7,35,900</u>

5. Calculation of opening balance of Modified ROU Asset at the beginning of 6th year:

The remaining ROU Asset for the original 2,000 square metres of office space after decrease in term	2,20,770
Less: Adjustment for increase in interest rate from 6% to 7%	(4,900)
Add: Adjustment for increase in leased space	<u>1,31,200</u>
	<u>3,47,070</u>

8.4.5 Presentation

ROU Assets and lease liabilities are subject to the same considerations as other assets and liabilities in classifying them as current and non-current in the balance sheet. The following table depicts how lease-related amounts and activities are presented in lessees' financial statements:

<i>Balance Sheet</i>	<i>Statement of profit and loss</i>	<i>Statement of cash flows</i>
<u>ROU Assets:</u> They are presented either: - Separately from other assets (e.g., owned assets) OR - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are presented as investment property <u>Lease Liabilities:</u> They are presented either: - Separately from other liabilities OR - Together with other liabilities with disclosure of the balance sheet line items that includes lease liabilities and their amounts	<u>Depreciation and Interest:</u> Depreciation on Right of use asset and interest expense accreted on lease liabilities are presented <u>separately</u> (i.e., they <u>CANNOT</u> be combined). This is because interest expense on the lease liability is a component of <u>finance costs</u>	<u>Principal portion of the lease liability:</u> - These cash payments are presented within <u>financing activities</u> <u>Interest portion of the lease liability:</u> - These cash payments are presented within <u>financing activities</u> <u>Short-term leases and leases of low-value assets:</u> - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within <u>operating activities</u> <u>Variable lease payments not included in the lease liability:</u> - These are also presented within <u>operating activities</u> <u>Non-cash activity:</u> Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)

8.4.6 Disclosure

Disclosure objective:

The objective of the disclosures is for lessees to disclose information in the notes that, together with the information provided in the balance sheet, statement of profit and loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance, and cash flows of the lessee.

Ind AS 116 requires lessees to present all disclosures in:

- a single note **OR**
- separate section in the financial statements.

Quantitative Disclosure Requirement		
Balance sheet	Statement of Profit and Loss	Statement of Cash Flows
– Additions to right-of-use assets. – Carrying value of right-of-use assets at the end of the reporting period by class. – Maturity analysis of lease liabilities separately from other liabilities based on Ind AS 107 requirements.	– Depreciation of assets by class. – Interest expense on lease liabilities. – Short-term leases expensed* – Low-value leases expensed* – Variable lease payments expensed. – Income from subleasing. – Gains or losses arising from sale and leaseback transactions.	– Total cash outflow for leases.

* These disclosures need not include leases with lease terms of one month or less.

All of the above disclosures are required to be presented in tabular format, unless another format is more appropriate. The amounts disclosed include costs that a lessee has included in the carrying amount of another asset during the reporting period.

Other disclosure requirements also include:

- ◆ Commitments for short-term leases if the current period expense is dissimilar to future commitments.

- ◆ For right-of-use assets that meet the definition of investment property, the disclosure requirements of Ind AS 40, *Investment property*, with a few exclusions.
- ◆ For right-of-use assets where the revaluation model has been applied, the disclosure requirements of Ind AS 16, *Property, plant and equipment*.
- ◆ Entities applying the short-term and/or low-value lease exemptions are required to disclose that fact.

Qualitative Disclosure Requirements
– A summary of the nature of the entity's leasing activities; – Potential cash outflows the entity is exposed to that are not included in the measured lease liability, including: – Variable lease payments; – Extension options and termination options; – Residual value guarantees; and – Leases not yet commenced to which the lessee is committed. – Restrictions or covenants imposed by leases; and – Sale and leaseback transaction information.

In providing additional information, lessees are required to consider:

- (a) Whether that information is relevant to the users of the financial statements. The additional information (as specified above) is included **ONLY IF** that information is **expected to be relevant** to users of financial statements. For e.g., this is likely to be relevant if it helps those users to understand:

<i>The flexibility provided by leases</i>	<i>for e.g., a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions</i>
<i>Restrictions imposed by leases</i>	<i>for e.g., by requiring the lessee to maintain particular financial ratios</i>
<i>Sensitivity of reported information to key variables</i>	<i>for e.g., future variable lease payments</i>
<i>Deviations from industry practice</i>	<i>for e.g., unusual or unique lease terms and conditions that affect a lessee's lease portfolio</i>

<i>Exposure to other risks arising from leases</i>	

- (b) Whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements.

8.4.7 Income tax accounting

For lessees, Ind AS 116 requires recognition of lease related assets and liabilities that are not on the balance sheet under today's accounting (i.e. amounts related to leases that are operating leases under Ind AS 17) and could change the measurement of other lease-related assets and liabilities. These changes affect certain aspects of accounting for income taxes such as the following:

- (a) recognition and measurement of deferred tax assets and liabilities; and
- (b) assessment of the recoverability of deferred tax assets.

8.5 LESSOR ACCOUNTING

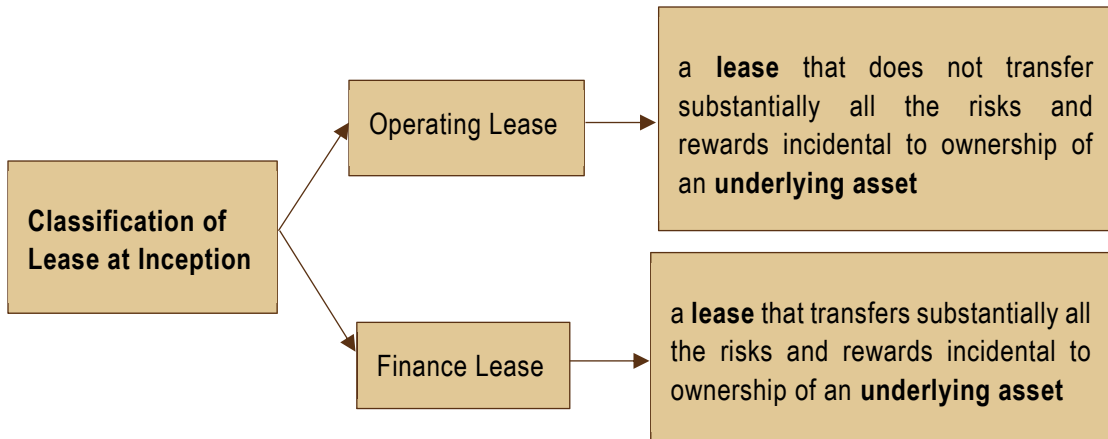
8.5.1 Lease Classification

A '**lessor**' is defined as an entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.

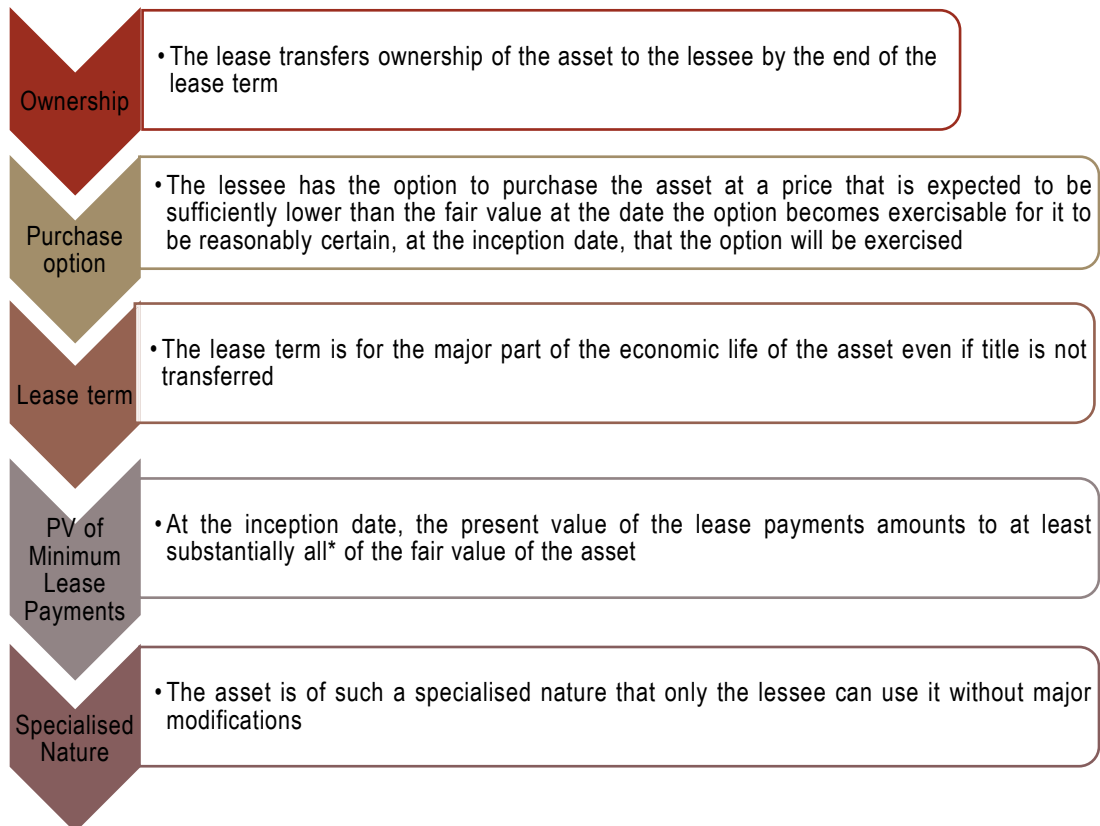
At inception, lessors classify all leases as FINANCE LEASE or OPERATING LEASE. Lease classification is very important because it determines how and when a lessor recognizes lease income and what assets are recorded. Classification is based on the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract.

Where, a '**Finance Lease**' is defined as a **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.

Where, an '**Operating Lease**' is defined as a **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.



Ind AS 116 lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a **FINANCE LEASE**:



*The term “substantially all” is not defined in Ind AS 116.

Additionally, Ind AS 116 lists the following indicators of situations that, individually or in combination, could also lead to a lease being classified as a **FINANCE LEASE**:

Loss on cancellation

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee

Risk of fair value of the residual asset

- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease)

Option to extend lease

- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

Other considerations that could be made in determining the economic substance of the lease arrangement include the following:

- ♦ Are the lease rentals based on a market rate for use of the asset (which would indicate an operating lease) or a financing rate for use of the funds, which would be indicative of a finance lease?
- ♦ Is the existence of put and call options a feature of the lease? If so, are they exercisable at a predetermined price or formula (indicating a finance lease) or are they exercisable at the market price at the time the option is exercised (indicating an operating lease)?

Lease classification test for land and buildings:

For a lease that includes both land and buildings elements, the lessor **separately assesses** the classification of each element as a finance lease or an operating lease, **having fact that land normally has an indefinite economic life**.

The lessor allocates lease payments between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case, the entire lease is classified as an operating lease.

For a lease of land and buildings in which the amount for the land element is **immaterial** to the lease, the lessor may treat the land and buildings as a **single unit** for the purpose of lease classification and classify it as a finance lease or an operating lease. In such a case, the lessor regards the economic life of the buildings as the economic life of the **entire** underlying asset.

Residual value guarantees included in the lease classification test:

In evaluating Ind AS 116's lease classification criteria, lessors are required to include in the 'substantially all' test, **any (i.e., the maximum obligation) residual value guarantees** provided by both lessees and any other third party unrelated to the lessor.

Reassessment of lease classification:

Lessors are required to **reassess** the lease classification only if there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease). Lessors reassess lease classification as at the **effective date of the modification** using the modified conditions at that date. If a lease modification results in a separate new lease, that new lease would be classified in the **same manner** as any new lease.

Key concepts applied by the lessor:

'Gross investment in the lease' is the **SUM** of:

- (a) the lease payments receivable by a lessor under a finance lease; **AND**
- (b) any unguaranteed residual value accruing to the lessor.

'Net investment in the lease' is the gross investment in the lease discounted at the interest rate implicit in the lease.

'Unguaranteed residual value' is that portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

8.5.2 Finance Leases

8.5.2.1 Recognition

At the commencement date, a lessor shall recognise assets held under a finance lease in its balance sheet and present them as receivable at an amount equal to the **net investment in the lease**.

8.5.2.2 Initial Measurement

At lease commencement, a lessor accounts for a finance lease, as follows:

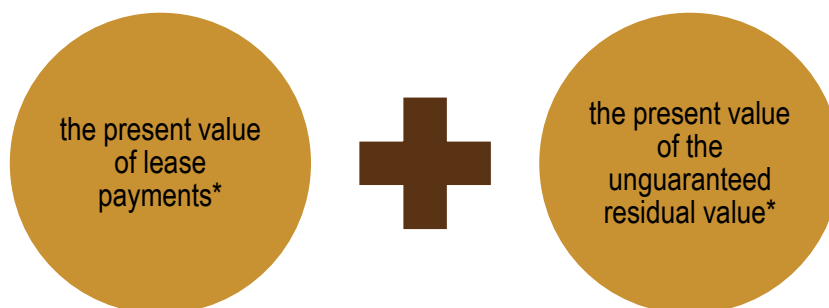
Derecognises the carrying amount of the underlying asset

Recognises the net investment in the lease

Recognises, in profit or loss, any selling profit or selling loss

For finance leases (other than those involving manufacturer and dealer lessors), initial direct costs are included in the initial measurement of the finance lease receivable. Initial direct costs are included in the lease and are not added separately to the net investment in lease.

The net investment in the lease is initially measured as the sum of:



*discounted using the interest rate implicit in the lease (i.e., the discount rate).

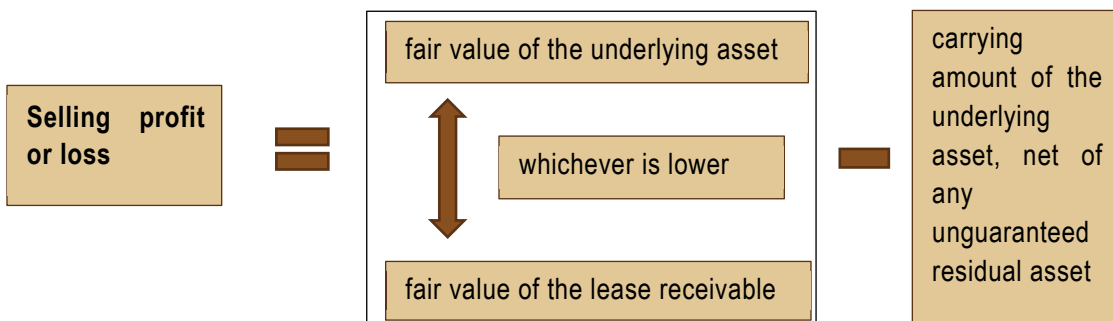
*Lease payments as described in section 8.3.3

Any selling profit or loss is measured as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset, net of any unguaranteed residual asset.

Journal entry for finance lease on initial measurement

Finance lease receivable	Dr.	Net investment
To Underlying asset		Carrying amount

(Balancing figure is profit or loss)



8.5.2.3 Initial Measurement – Manufacturer or Dealer Lessors

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss in accordance with its policy for outright sales to which Ind AS 115 applies.

Therefore, at lease commencement, a manufacturer or dealer lessor recognises the following:

The fair value of the underlying asset as revenue **OR** the present value of the lease payments discounted using a market rate of interest, whichever is **lower**.

The cost (or carrying amount) of the asset (less) the present value of the unguaranteed residual value, as cost of sale.

The selling profit or loss in accordance with the policy for outright sales.

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss on a **finance lease**, regardless of whether the lessor transfers the underlying asset as described under Ind AS 115. Costs incurred by a manufacturer or dealer lessor in connection with obtaining a finance lease are recognised as an expense at the commencement date and are **excluded** from the net investment in the lease because they are mainly related to earning the manufacturer or dealer's selling profit.

Accounting for initial direct costs shall be done in the following manner:

By Lessor

Finance Lease:

Ind AS 116 requires 'lessors' (*other than manufacturer or dealer lessors*) to include initial direct costs in the initial measurement of their net investments in finance leases and reduce the amount of income recognised over the lease term.

The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and they are not added separately. (*Initial direct costs related to finance leases incurred by manufacturer or dealer lessors are expensed at lease commencement*).

Operating Lease:

Ind AS 116 requires lessors to include initial direct costs in the carrying amount of the underlying asset in an operating lease. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income.

8.5.2.4 Subsequent Measurement

After lease commencement, a lessor accounts for a finance lease, as follows:

- ◆ Recognises **finance income** (in profit or loss) over the lease term in an amount that produces a constant periodic rate of return on the remaining balance of the net investment in the lease (i.e., using the interest rate implicit in the lease).

- Income is recognised on the components of the net investment in the lease, which is Interest on the lease receivables.
- ◆ Reduces the net investment in the lease for lease payments received (net of finance income calculated above)
- ◆ Separately recognises income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned
- ◆ Recognises any impairment of the net investment in the lease

Remeasurement of the net investment in the lease:

After lease commencement, the net investment in a lease is **NOT REMEASURED UNLESS** in either of the following situations:

- ◆ The lease is modified (i.e., a change in the scope of the lease, or the consideration for the lease, that was not part of the original terms and conditions of the lease) and the modified lease is not accounted for as a separate contract

OR

- ◆ The lease term is revised when there is a change in the non-cancellable period of the lease (Refer section 8.5.4 Modification of lease)

Summary-Accounting treatment in the books of a lessor

Particulars	Finance lease	Operating lease
<u>Initial measurement</u>		
Balance sheet	• Derecognise the carrying amount of the underlying asset • Recognise the net investment in the lease i.e. a finance lease receivable (equal to the present value of the lease payments to be received)	• Continue to present the underlying asset • Add any initial direct costs incurred in connection with obtaining the lease to the carrying amount of the underlying asset • A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not equivalent of a sale

Statement of Profit and loss	Recognises, in profit or loss, any <u>selling profit or selling loss</u>	
<u>Subsequent measurement</u>		
Balance sheet	- Reduce the net investment in the lease for lease payments received (net of finance income calculated above) <u>After</u> lease commencement, the net investment in a lease is <u>NOT REMEASURED UNLESS</u> either: - The lease is modified and the modified lease is not accounted for as a separate contract OR - The lease term is revised when there is a change in the non-cancellable period of the lease. - Recognise any impairment of the net investment in the lease, if there has been a <u>reduction in the estimated unguaranteed residual value</u>	- Calculate depreciation in accordance with Ind AS 16 and Ind AS 38. - Apply Ind AS 36 to determine whether an underlying asset is impaired and to account for any impairment loss identified.
Statement of Profit and loss	- Apportion the amount received between the finance income and reduction in receivable - Finance income will be computed to give a constant periodic rate of return - Separately recognises income from variable lease payments	- Recognise lease income over the lease term, typically on a straight line basis - Depreciation expense to be recognised related to the underlying asset - Recognise variable lease payments that do not depend on an index or rate (e.g.,

	that are not included in the net investment in the lease in the period in which that income is earned • Revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued, if there has been a reduction in the estimated unguaranteed residual value	performance- or usage- based payments) as they are earned.

Illustration 38 - Lessor accounting for a finance lease → dealer-lessor case

A Dealer-Lessor enters into a 10-year lease of equipment with Lessee. The equipment is not specialised in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- ◆ Lessor receives annual lease payments of ₹ 15,000, payable at the end of the year
- ◆ Lessor expects the residual value of the equipment to be ₹ 50,000 at the end of the 10-year lease term
- ◆ Lessee provides a residual value guarantee that protects Lessor from the first ₹ 30,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., ₹ 50,000)
- ◆ The equipment has an estimated remaining economic life of 15 years, a carrying amount of ₹ 1,00,000 and a fair value of ₹ 1,11,000
- ◆ The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option to purchase the underlying asset
- ◆ The interest rate implicit in the lease is 10.078%.

How should the Lessor account for the same in its books of accounts?

Solution:

Lessor shall classify the lease as a **FINANCE LEASE** because the sum of the present value of lease payments amounts to **substantially all** of the fair value of the underlying asset.

At lease commencement, Lessor accounts for the finance lease, as follows:

Net investment in the lease	Dr.	₹ 1,11,000 ^(a)	
Cost of goods sold	Dr.	₹ 92,340 ^(b)	
To Revenue			₹ 1,03,340 ^(c)
To Property held for lease			₹ 1,00,000 ^(d)

To record the net investment in the finance lease and derecognise the underlying asset.

(a) *The net investment in the lease consists of:*

- (1) *the present value of 10 annual payments of ₹ 15,000 plus the guaranteed residual value of ₹ 30,000, both discounted at the interest rate implicit in the lease, which equals ₹ 1,03,340 (i.e., the lease payment) (Refer note 1) **AND***
- (2) *the present value of unguaranteed residual asset of ₹ 20,000, which equals ₹ 7,660 (Refer note 2).*

Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet.

- (b) *Cost of goods sold is the carrying amount of the equipment of ₹ 1,00,000 (less) the present value of the unguaranteed residual asset of ₹ 7,660.*
- (c) *Revenue equals the lease receivable.*
- (d) *The carrying amount of the underlying asset.*

At lease commencement, Lessor recognizes selling profit of ₹ 11,000 which is calculated as = lease payment of ₹ 1,03,340 – [carrying amount of the asset (₹ 1,00,000) – net of any unguaranteed residual asset (₹ 7,660) ie which equals ₹ 92,340]

Year 1

Journal entry for a finance lease

Cash	Dr.	₹ 15,000 ^(e)	
To Net investment in the lease			₹ 3,813 ^(f)
To Interest income			₹ 11,187 ^(g)

(e) *Receipt of annual lease payments at the end of the year.*

(f) *Reduction of the net investment in the lease for lease payments received of ₹ 15,000, net of interest income of ₹ 11,187*

(g) *Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Please refer the computation below:*

The following table summarizes the interest income from this lease and the related amortization of the net investment over the lease term:

Year	Annual Rental Payment	Annual Interest Income ^(h)	Net investment at the end of the year
Initial net investment	-	-	1,11,000
1	15,000	11,187	1,07,187
2	15,000	10,802	1,02,989
3	15,000	10,379	98,368
4	15,000	9,914	93,282
5	15,000	9,401	87,683
6	15,000	8,837	81,520
7	15,000	8,216	74,736
8	15,000	7,532	67,268
9	15,000	6,779	59,047
10	15,000	5,953	50,000 ⁽ⁱ⁾

(h) Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For e.g., Year 1 annual interest income is calculated as ₹ 1,11,000 (initial net investment) x 10.078%.

(i) The estimated residual value of the equipment at the end of the lease term.

Working Notes:

1 Calculation of net investment in lease:

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
1	15,000	0.908	13,620
2	15,000	0.825	12,375
3	15,000	0.750	11,250
4	15,000	0.681	10,215
5	15,000	0.619	9,285

6	15,000	0.562	8,430
7	15,000	0.511	7,665
8	15,000	0.464	6,960
9	15,000	0.421	6,315
10	15,000	0.383	5,745
10	30,000	0.383	<u>11,480*</u>
			<u>1,03,340</u>

* Figure has been rounded off for equalization of journal entry.

2 Calculation of present value of unguaranteed residual asset

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
10	20,000	0.383	7,660

Impairment of the net investment in the lease:

A lessor shall apply the derecognition and impairment requirements in Ind AS 109 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

8.5.3 Operating Leases

8.5.3.1 Recognition and Measurement

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis **OR** another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit derived from the use of the underlying asset is diminished.

Lessors **subsequently** recognise lease payments over the lease term on either a straight-line basis or another systematic and rational basis if that basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. After lease commencement, lessors recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) **as they are earned**.

A lessor recognises costs, including depreciation, incurred in earning the lease income as an expense.

Ind AS 116 also requires lessors of operating leases to **add** initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset at lease commencement and recognise those costs as an expense over the lease term on the **same basis** as lease income.

The depreciation policy for depreciable underlying assets subject to operating leases must be consistent with the lessor's normal depreciation policy for similar assets. A lessor calculates depreciation in accordance with Ind AS 16 and Ind AS 38. A lessor applies Ind AS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not equivalent of a sale.

8.5.4 Lease Modifications

A '**lease modification**' is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (**for e.g.**, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

8.5.4.1 Finance Lease Modification

Modification- Separate lease:

A lease modification is accounted for as a separate lease if both:

- (a) The modification increases the scope of the lease by adding the right to use one or more underlying assets; **and**
- (b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessor would follow the existing lessor guidance on initial recognition and measurement.

Modification- Not Separate lease:

If a lease modification fails the test to be considered as separate lease as mentioned above, the lessor follows the following guidance:

When a modification to a finance lease is not a separate lease, the lessor first assesses whether the lease classification would have been different if the modified terms had been effective at the inception date. If the lease would have been classified as an operating lease had the modified terms been effective at the inception date, then the lessor:

- accounts for the lease modification as a termination of the original lease and the creation of a new lease from the effective date of the modification; and
- measures the carrying amount of the underlying asset as the net investment in the original lease immediately before the effective date of the lease modification.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.

8.5.4.2 Operating Lease Modification:

A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

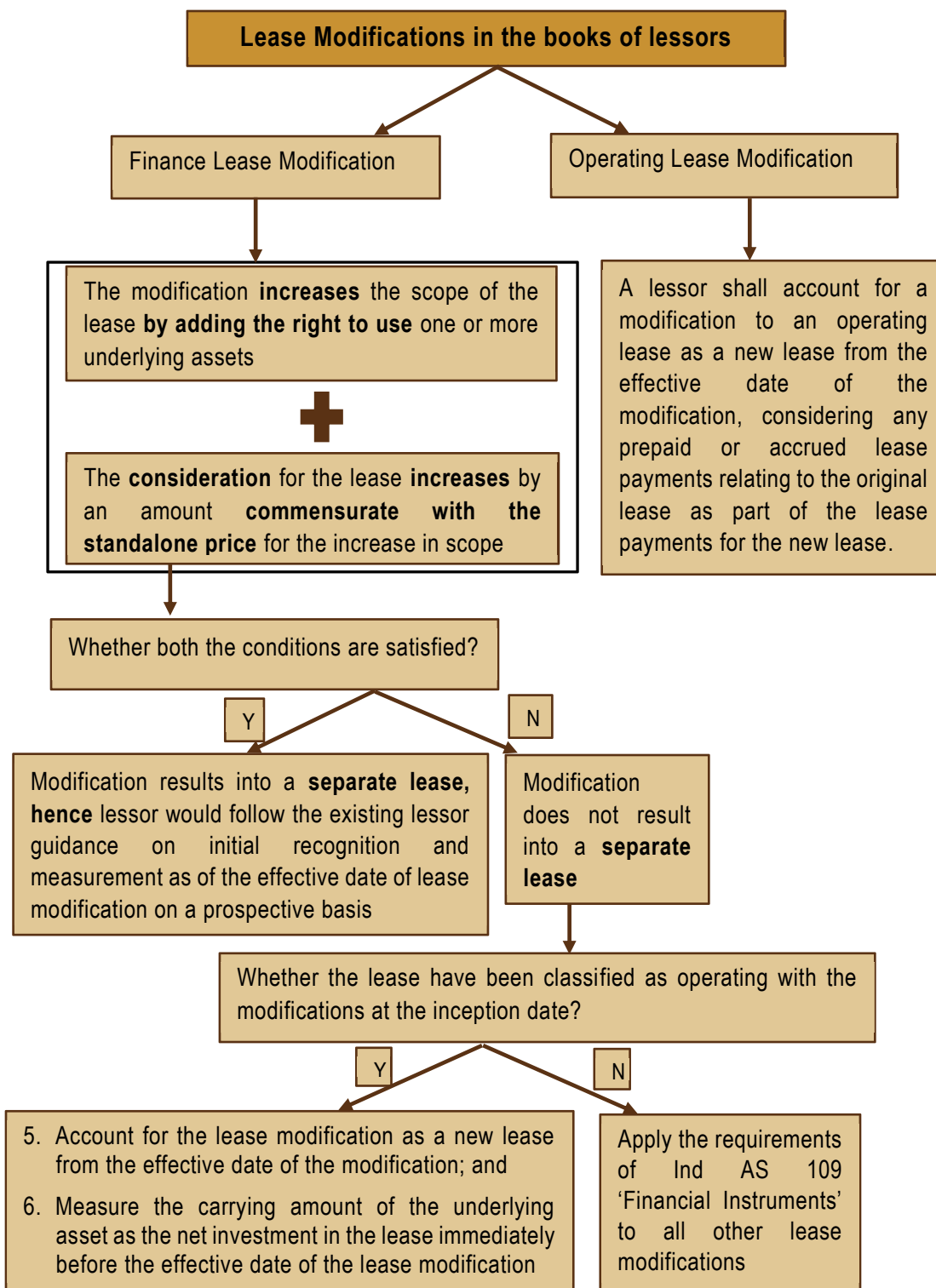


Illustration 39- Deferral of lease payments not a lease modification

Lessor L leases retail space to Lessee Z and classifies the lease as an operating lease. The lease includes fixed lease payments of ₹ 10,000 per month.

Due to the COVID-19 pandemic, L and Z agree on a rent concession that allows Z to pay no rent in the period from July, 2020 to September, 2020 but to pay rent of 20,000 per month in the period from January 2021 to March 2021. There are no other changes to the lease.

How this will be accounted for by lessor?

Solution:

L determines that the reduction in lease payments in July 2020 to September 2020 and the proportional increase in January 2021 to March 2021 does not result in an overall change in the consideration for the lease.

L does not account for the change as a lease modification. L continues to recognise operating lease income on a straight-line basis, which is representative of the pattern in which Z's benefit from use of the underlying asset is diminished.

Illustration 40 - Unamortised lease incentive: Lease modification

Lessor M enters into a 10-year lease of office space with Lessee K, which commences on 1 April 2015. The rental payments are 15,000 per month, payable in arrears. M classifies the lease as an operating lease. M reimburses K's relocation costs of ₹ 600,000, which M accounts for as a lease incentive. The lease incentive is recognised as a reduction in rental income over the lease term using the same basis as for the lease income – in this case, on a straight-line basis over 10 years.

On 1 April 2020, during the COVID-19 pandemic, M agrees to waive K's rental payments for May, June and July 2020.

This decrease in consideration is not included in the original terms and conditions of the lease and is therefore a lease modification.

How this will be accounted for by the lessor?

Solution:

M accounts for this modification as a new operating lease from its effective date – i.e. 1 April 2020. M recognises the impact of the waiver on a straight-line basis over the five-year term of the new lease. M also takes into account the carrying amount of the unamortised lease incentive on 1 April 2020 of ₹ 3,00,000. M amortises this balance on a straight-line basis over the five-year term of the new lease.

Illustration 41 - Modification that is not a separate lease and lease would have been classified as an operating lease

Lessor L enters into an eight-year lease of 40 lorries with Lessee M that commences on 1 January 2018. The lease term approximates the lorries' economic life and no other features indicate that the lease transfer or does not transfer substantially all of the risks and rewards incidental to ownership of the lorries. Assuming that substantially all of the risks and rewards incidental to ownership of the lorries are transferred, L classifies the lease as a finance lease.

During the COVID-19 pandemic, M's business has contracted. In June 2020, L and M amend the contract so that it now terminates on 31 December 2020.

Early termination was not part of the original terms and conditions of the lease and this is therefore a lease modification. The modification does not grant M an additional right to use the underlying assets and therefore cannot be accounted for as a separate lease.

How this will be accounted for by lessor?

Solution:

L determines that, had the modified terms been effective at the inception date, the lease term would not have been for major part of the lorries' economic life. Furthermore, there are no other indicators that the lease would have transferred substantially all the risks and rewards incidental to ownership of the lorries. Therefore, the lease would have been classified as an operating lease.

In June 2020, L accounts for the modified lease as a new operating lease. The lessor L:

- derecognises the finance lease receivable and recognises the underlying assets in its statement of financial position according to the nature of the underlying asset – i.e. as property, plant and equipment in this case; and
- measures the aggregate carrying amount of the underlying assets as the amount of the net investment in the lease immediately before the effective date of the lease modification.

Comparison with AS 19:

While the accounting for leases in the books of lessor is similar under AS 19 to that under Ind AS 116, AS 19 does not provide guidance on lease modifications.

8.5.5 Presentation

Lessors have the following presentation requirements under Ind AS 116, depending on the classification of the leases:

Finance Leases	Operating Leases
Lessors recognise assets held under a finance lease in the balance sheet and present them as a receivable at an amount equal to the net investment in the lease	Lessors are required to present underlying assets subject to operating leases according to the

under Ind AS 116.

In addition, the net investment in the lease is subject to the **same considerations** as other assets in classification as current or non-current assets in a balance sheet.

nature of that asset in the balance sheet under Ind AS 116.

8.5.6 Disclosure

The objective of the disclosure requirements for lessors to disclose information in the notes that together with the information provided in the balance sheet, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.

The lessor disclosure requirements in Ind AS 116 are more extensive to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities.

Following are the disclosure requirements under Ind AS 116 for lessors:

Quantitative Disclosure Requirements	
Finance leases	– Selling profit or loss; – Finance income on the net investment; – Income from variable lease payments; – Qualitative and quantitative explanation of changes in the net investment; and – Maturity analysis of lease payments receivable.
Operating leases	– Lease income, separately disclosing variable lease payments; – Disclosure requirements of Ind AS 16 for leased assets, separating leased assets from non-leased assets; – Other applicable disclosure requirements based on the nature of the underlying asset (eg. Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41); and – Maturity analysis of lease payments.

The standard prescribes that the quantitative disclosures should be presented in a tabular format, unless another format is more appropriate to be presented.

Qualitative Disclosure Requirements

Similar to the lessee disclosure requirements, Ind AS 116 requires a lessor to disclose additional qualitative and quantitative information about its leasing activities in order to provide users with a basis for assessing the leasing's impact on the financial statements.

This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including:

- Buy-back agreements;
- Residual value guarantees;
- Variable lease payments for excess use; and
- Any other risk management strategies.



8.6 OTHER MATTERS

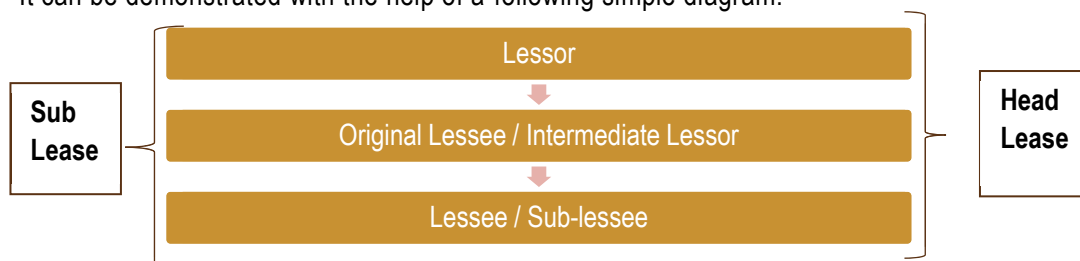
8.6.1 Sub-Leases

8.6.1.1 Recognition and Measurement

A 'Sub-lease' is defined as a transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the original lease ('head lease') between the head lessor and lessee remains in effect.

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect, where, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a 'head lease', the original lessee is often referred to as an 'intermediate lessor' or 'sub-lessor' and the ultimate lessee is often referred to as the 'sub-lessee'.

It can be demonstrated with the help of a following simple diagram:



In some cases, the sublease is a separate lease agreement while, in other cases, a third party assumes the original lease but, the original lessee remains the primary obligor under the original lease.

Intermediate Lessor Accounting:

Where an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease, i.e., the original lessee generally continues to account for the original lease (the head lease) as a lessee and accounts for the sublease as the lessor (intermediate lessor).

When the head lease is a short-term lease, the sublease is classified as an operating lease. Otherwise, the sublease is classified using the classification criteria (as discussed earlier) BUT, it should be by reference to the 'ROU Asset' in the head lease (and NOT the 'underlying asset' of the head lease). This can be understood better with the help of a following illustration:

Illustration 42 - Classification of a sublease in case of an Intermediate Lessor

Entity ABC (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 40 years. Entity ABC subleases the building for four years.

How should the said sublease be classified by Entity ABC?

Solution:

The sublease is classified with reference to the 'ROU Asset' in the head lease (and **NOT** the 'underlying building' of the head lease). Hence, when assessing the useful life criterion, the sublease term of four years is compared with five-year ROU Asset in the head lease (**NOT** compared with 40-year economic life of the building) and accordingly may result in the sublease being classified as a finance lease.

The intermediate lessor accounts for the sublease as follows:

<i>If the sublease is classified as a 'Finance Lease'</i>	<i>If the sublease is classified as an 'Operating Lease'</i>
The original lessee derecognises the ROU Asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the lessee accounting model. The original lessee (as the intermediate lessor) recognises a net investment in the sublease and evaluates it for impairment.	The original lessee continues to account for the lease liability and ROU asset on the head lease like any other lease. If the total remaining carrying amount of the ROU asset on the head lease exceeds the anticipated sublease income, this may indicate that the ROU asset associated with the head lease is impaired (which is assessed for impairment under Ind AS 36).

In a sublease, an intermediate lessor may use the discount rate for the head lease (**adjusted for initial direct costs, if any, associated with the sublease**) to measure the net investment in the sublease, if the interest rate implicit in the lease cannot be readily determined.

When contracts are entered into at or near the same time, an intermediate lessor is required to consider the criteria for **combining contracts** (*for e.g.*, when the contracts are negotiated as a package with a single commercial objective, or when the consideration to be paid in one contract depends on the price or performance of the other contract). If the contracts are required to be combined, the intermediate lessor accounts for the head lease and sublease as a **single combined transaction**.

An intermediate lessor who subleases, or expects to sublease an asset, **CANNOT** account for the head lease as a lease of a low-value asset **even when** the required criteria w.r.t. 'leases of low-value assets' (as discussed earlier) are satisfied.

Let us consider some more examples with regards to applying the requirements of Ind AS 116 to an intermediate lessor that enters into a head lease and a sublease of the same underlying asset:

Illustration 43 - Intermediate Lessor – Where the sublease is classified as a 'Finance Lease'

Head lease:

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease:

At the beginning of Year 3, the intermediate lessor subleases the 10,000 square metres of office space for the remaining lease term i.e three years of the head lease to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Solution:

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the three-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as a finance lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease).

When the intermediate lessor **enters into** a sublease, the intermediate lessor:

- (i) derecognises the ROU asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;
- (ii) recognises any difference between the ROU asset and the net investment in the sublease in profit or loss; **AND**

- (iii) retains the lease liability relating to the head lease in its balance sheet, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both

- finance income on the sublease **AND**
- interest expense on the head lease.

Illustration 44 - Intermediate Lessor – Where the sublease is classified as a 'Operating Lease'

Head lease:

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease:

At the commencement of the head lease, the intermediate lessor subleases the 10,000 square metres of office space for two years to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Solution:

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the two-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as an operating lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease and since, it is not satisfied, classified the same as an operating lease).

When the intermediate lessor **enters into** the sublease, the intermediate lessor retains:

- the lease liability **AND**
- the ROU asset

both relating to the head lease in its balance sheet.

During the term of the sublease, the intermediate lessor:

- (a) recognises a depreciation charge for the ROU asset and interest on the lease liability; **AND**
- (b) recognises lease income from the sublease.

Sub-lessee Accounting:

A sub-lessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to Ind AS 116's recognition and measurement provisions).

8.6.1.2 Presentation

According to paragraph 32 of Ind AS 1, *Presentation of Financial Statements*, an entity **cannot offset** assets and liabilities or income and expenses, **unless** required or permitted by an Ind AS.

Thus, intermediate lessors are **not permitted** to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, **unless** those liabilities and assets meet the requirements in Ind AS 1 for offsetting.

Similarly, intermediate lessors are **not permitted** to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively, **unless** the requirements for offsetting in Ind AS 1 are met.

8.6.1.3 Disclosure

Under Ind AS 116, entities (**including intermediate lessors**) are required to disclose **qualitative** and **quantitative** information which gives a **basis** for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor (refer the disclosures for 'lessors' and 'lessees' already discussed earlier).

8.6.2 Sale and Leaseback Transactions

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee.

Sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing because under Ind AS 116, lessees are required to recognise most leases on the balance sheet (i.e., all leases **except** for leases of low-value assets and short-term leases depending on the lessee's accounting policy election).

Further, both the seller-lessee and the buyer-lessor are required to apply Ind AS 115 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset.

How to determine whether the transfer of an asset is a sale:

As discussed above, when determining whether the transfer of an asset should be accounted for as a sale or purchase, both the seller-lessee and the buyer-lessor shall apply the requirements of Ind AS 115 on when an entity satisfies a performance obligation by transferring '**control**' of an asset. Thus, there are following two possibilities in this scenario:

<u>If Control is <i>passed</i></u>	<u>If Control is <i>NOT passed</i></u>
If the control of an underlying asset is <u>passed</u> to the buyer-lessor, the transaction is accounted for as a ' <u>sale or purchase</u> ' of the asset and a ' <u>lease</u> '.	If the control of an underlying asset is <u>NOT passed</u> to the buyer-lessor, both the seller-lessee and the buyer-lessor account for the transaction as a ' <u>financing transaction</u> '.

None of the indicators mentioned under Ind AS 115 individually determine whether the buyer-lessor has obtained control of the underlying asset and thus, both the seller-lessee and the buyer-lessor must consider **all relevant facts and circumstances** to determine whether control has been transferred. Further, **not all of the indicators must be present** to determine that the buyer-lessor has gained control rather, said indicators are the factors that are often present when a customer has obtained control of an asset and the said list is meant to help entities to apply the principle of control.

The existence of a leaseback, **in isolation**, does **NOT preclude a sale** because a lease is different from the sale or purchase of an underlying asset, since a lease does **not transfer 'control'** of the underlying asset. Instead, a lease **transfers the 'right to control'** the use of the underlying asset for the period of the lease.

However, if the seller-lessee has a **'substantive repurchase option'** for the underlying asset (i.e., a right to repurchase the asset), **'NO sale'** has occurred because the buyer-lessor has **NOT** obtained control of the asset.

Accounting Treatment for Sale and Lease back Transaction

Particulars	Seller-lessee	Buyer-lessor
Transfer of asset is a sale	<u>Apply accounting for sale</u> • Recognise the cash received • Derecognise the underlying asset <u>Apply ROU Accounting</u> • Apply the lessee accounting model to the leaseback asset • Measure the ROU asset at the retained portion of the previous carrying amount • Recognise a gain or loss related to the portion of the assets transferred to the buyer-lessor	• Recognise the underlying asset based on the nature of the asset • Apply the lessor accounting model to leaseback asset
Transfer of asset is not a sale	• Continue to recognise the underlying asset • Account for the transaction as financing transaction • Recognise a financial liability under Ind AS 109 for any	• Do not recognise the underlying asset • Recognise a financial asset under Ind AS 109 for any amount paid to the seller-lessee i.e. account

	amount received from the buyer-lessor Decrease the financial liability by the payments made (as and when) less the portion considered as interest expense	for the amount paid as a receivable

Note:

- When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (**with adjustments for any off-market terms**).
- A seller-lessee recognises a lease liability and ROU asset for the leaseback (**subject to the optional exemptions** for short-term leases and leases of low-value assets).

An entity shall make the following adjustments to measure the sale proceeds at fair value if:

- the fair value of the consideration for the sale of an asset does not equal the fair value of the asset **OR**
- the payments for the lease are not at market rates:
 - any **below**-market terms shall be accounted for as a prepayment of lease payments;
AND
 - any **above**-market terms shall be accounted for as an additional financing provided by the buyer-lessor to the seller-lessee.

The entity shall measure any potential adjustment ('a' or 'b' - as described above) on the basis of the following (whichever is more readily determinable):

- the difference between the **fair value** of the consideration for the sale and the **fair value** of the asset; **OR**
- the difference between the **present value** of the contractual payments for the lease and the **present value** of payments for the lease at market rates.

The sale transaction and the resulting lease are **generally interdependent and negotiated as a package**. Consequently, some transactions could be structured with a negotiated sales price that is above or below the asset's fair value and with lease payments for the resulting lease that are above or below the market rates. These off-market terms could mislead / falsify the gain or loss on the sale and the recognition of lease expense and lease income for the lease. Thus, to ensure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are **NEITHER understated NOR overstated**, Ind AS 116 requires **adjustments for any off-market terms** of sale and leaseback transactions, on the **more readily determinable basis** (as discussed above). Thus, the two possibilities of the sale price **OR** the present value of

the lease payments being 'less' or 'greater' than the fair value of the asset **OR** present value of the market lease payments, respectively, is discussed in detail:

When sale price or Present Value is <u>LESS</u>	When sale price or Present Value is <u>GREATER</u>
Using the more readily determinable basis: When the sale price is <u>LESS</u> than the underlying asset's fair value OR the present value of the lease payments is <u>LESS</u> than the present value of the market lease payments, a seller-lessee recognises the difference as an <u>increase</u> to the sales price and the initial measurement of the ROU asset as a <u>'lease prepayment'</u>.	Using the more readily determinable basis: When the sale price is <u>GREATER</u> than the underlying asset's fair value OR the present value of the lease payments is <u>GREATER</u> than the present value of the market lease payments, a seller-lessee recognises the difference as a <u>reduction</u> in the sales price and an <u>'additional financing received'</u> from the buyer-lessor.
Buyer-lessors are also required to <u>adjust the purchase price</u> of the underlying asset for any off-market terms. Such adjustments are recognised as: - <u>'lease prepayments'</u> made by the seller-lessee OR - <u>'additional financing provided'</u> to the seller-lessee.	

Let us consider an illustration to understand the accounting for a sale and leaseback transaction:

Illustration 45 - Sale and leaseback transaction

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of ₹ 30,00,000. Immediately before the transaction, the building is carried at a cost of ₹ 15,00,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 20 years, with annual payments of ₹ 2,00,000 payable at the end of each year.

The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in Ind AS 115 'Revenue from Contracts with Customers'.

The fair value of the building at the date of sale is ₹ 27,00,000. Initial direct costs, if any, are to be ignored. The interest rate implicit in the lease is 12% p.a., which is readily determinable by Seller-lessee.

Buyer-lessor classifies the lease of the building as an operating lease.

How should the said transaction be accounted by the Seller-lessee and the Buyer-lessor?

Solution:

Considering facts of the case, Seller-lessee and buyer-lessor account for the transaction as a sale and leaseback.

Firstly, since the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer - lessor make adjustments to measure the sale proceeds at fair value. Thus, the amount of the excess sale price of ₹ 3,00,000 (as calculated below) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

Sale Price:	30,00,000
Less: Fair Value (at the date of sale):	<u>(27,00,000)</u>
Additional financing provided by Buyer-lessor to Seller-lessee	<u>3,00,000</u>

Next step would be to calculate the present value of the annual payments which amounts to ₹ 14,94,000 (calculated considering 20 payments of ₹ 2,00,000 each, discounted at 12% p.a.) of which ₹ 3,00,000 relates to the additional financing (as calculated above) and balance ₹ 11,94,000 relates to the lease — corresponding to 20 annual payments of ₹ 40,164 and ₹ 1,59,836, respectively (refer calculations below).

Proportion of annual lease payments:

Present value of lease payments (as calculated above)	(A)	14,94,000
Additional financing provided (as calculated above)	(B)	3,00,000
Relating to the Additional financing provided	(C) = (E x B / A)	40,160
Relating to the Lease	(D) = (E – C)	1,59,840
Annual payments (at the end of each year)	(E)	2,00,000

Seller-Lessee:

At the commencement date, Seller-lessee measures the ROU asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, calculated as follows:

Carrying Amount	(A)	15,00,000
Fair Value (at the date of sale)	(B)	27,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
ROU Asset	[(A / B) x C]	6,63,333

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor, calculated as follows:

Fair Value (at the date of sale)	(A)	27,00,000
Carrying Amount	(B)	15,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
Gain on sale of building	(D) = (A - B)	12,00,000
Relating to the right to use the building retained by Seller-lessee (E) = [(D/A) x C]		5,30,667
Relating to the rights transferred to Buyer-lessor	(D - E)	6,69,333

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	Dr.	30,00,000	
ROU Asset	Dr.	6,63,333	
To Building			15,00,000
To Financial Liability			14,94,000
To Gain on rights transferred			6,69,333

Buyer-Lessor:

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	Dr.	27,00,000	
Financial Asset (20 payments of ₹ 40,160 discounted @ 12% p.a.) (approx.)	Dr.	3,00,000	
To Cash			30,00,000

After the commencement date, Buyer-lessor accounts for the lease by treating ₹ 1,59,840 of the annual payments of ₹ 2,00,000 as lease payments. The remaining ₹ 40,160 of annual payments received from Seller-lessee are accounted for as:

- (a) payments received to settle the financial asset of ₹ 3,00,000 **AND**
- (b) interest revenue.

Disclosures:

A seller-lessee may be required to provide additional qualitative and quantitative information about its leasing activities that is necessary to meet the disclosure objective in Ind AS 116.

A seller-lessee is also required to disclose any gains and losses arising from sale and leaseback transaction separately from gains and losses on disposals of other assets under Ind AS 116. Thus, additional information relating to sale and leaseback transactions that, depending on the

circumstances, may be needed to satisfy the disclosure objective in Ind AS 116, could include information that helps users of financial statements to assess, **for e.g.**:

(a) The lessee's reasons for sale and leaseback transactions and the prevalence of those transactions

(b) Key terms and conditions of individual sale and leaseback transactions

(c) Payments not included in the measurement of lease liabilities

(d) The cash flow effect of sale and leaseback transactions in the reporting period

8.7 TRANSITION APPROACH

An entity shall apply Ind AS 116 for annual reporting periods beginning on or after **01 April 2019**.

For the purposes of the requirements of this 'Transition' section, the **date of initial application** is the **beginning of the annual reporting period** in which an entity first applies Ind AS 116.

Thus, Ind AS 116's transition provisions are applied at the beginning of the annual reporting period in which the entity first applies Ind AS 116 (i.e., the date of initial application). **For e.g.**, an entity with a reporting date of 31 March 2020, applies the transition provisions on 01 April 2019.

8.7.1 Definition of a Lease

There is a practical expedient provided which permits lessees and lessors to make an election of not reassessing whether existing contracts contain a lease as defined under Ind AS 116.

Thus, if an entity elects this practical expedient, contracts that do not contain a lease under Ind AS 17 (including those under Appendix C to Ind AS 17, *Determining whether an Arrangement contains a Lease*) are not reassessed either. This practical expedient has been provided because if the entities are required to reassess existing contracts by applying the lease definition guidance in Ind AS 116, probably it would not justify the costs/complexity.

Further, if an entity chooses to apply the practical expedient, it must be applied to **ALL** contracts that are ongoing at the date of initial application (i.e., an entity is **NOT** permitted to apply the option on a lease-by-lease basis) and that fact shall also be disclosed.

8.7.2 Transition Options for Lessees

A lessee is required to apply Ind AS 116 to its leases in either of the following ways:

<i>Full Retrospective Approach</i>	<i>Modified Retrospective Approach</i>
Retrospectively to each prior reporting period presented, applying Ind AS 8, i.e., an entity applies Ind AS 116 as if it had been applied since the inception of all lease contracts that are presented in the financial statements. If Ind AS 116 is applied at 1 April 2019, this means that, in the 31 March 2020 financial statements, the comparative period to 31 March 2019 must be restated (assuming that this is the only comparative period presented). A restated opening balance sheet at 1 April 2018 will also need to be disclosed as required by Ind AS 1. Hence, the balance sheets for 3 period will be presented: As at 31 March 2020, 31 March 2019 & 1 April 2018.	Retrospectively with cumulative effect of initially applying Ind AS 116 recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of the initial application. Therefore, restatement of comparatives is not required and only Balance Sheets for reporting date and comparative date is required to be presented.

A lessee shall apply the elected transition approach consistently to **ALL** leases in which it is lessee.

8.7.3 Modified Retrospective Approach

8.7.3.1 Leases Previously Classified as Operating Leases

When applying the modified retrospective approach, a lessee does not restate comparative figures rather, a lessee recognises the cumulative effect of initially applying Ind AS 116 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

For leases previously classified as operating leases under Ind AS 17, a lessee recognises a lease liability measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. A lessee measures the ROU asset on a lease-by-lease basis, at either:

- Its carrying amount as if Ind AS 116 had always been applied since the commencement date, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application (Alternative 1)

OR

- An amount equal to the lease liability, adjusted for previously recognised prepaid or accrued lease payments (Alternative 2)

A lessee applies Ind AS 36 to ROU assets at the date of initial application, unless the lessee applies the practical expedient for onerous leases (as discussed below).

A lessee is not required to make adjustments on transition for 'leases of low-value assets' (which is one of the recognition exemptions under Ind AS 116 – as discussed earlier).

Additionally, a lessee is also permitted to apply the following practical expedients to leases previously classified as operating leases (when applying modified retrospective approach), on a **lease-by-lease basis**:

Discount rate	• Apply a single discount rate to a portfolio of leases with reasonably similar characteristics;
Onerous contracts	• Rely on its assessment of whether leases are onerous by applying Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets as opposed to performing an impairment review;
Short term leases	• Not recognise leases whose term ends within 12 months of the date of initial application of Ind AS 116. If this election is taken, these leases are accounted for as short-term leases;
Initial direct cost	• Exclude initial direct costs from the measurement of right-of-use assets at the date of initial application;
Hindsight	• Use hindsight, such as in determining the lease term for leases that contain options

Ind AS 116 is silent on as to how a lessee would separate and allocate lease and non-lease components of a contract upon transition when the modified retrospective approach is adopted. So, lessees could allocate the consideration in the contract (determined at lease commencement) to each lease and non-lease component on the basis of the relative stand-alone price of the lease component on that same date unless the lessee elects to use the practical expedient to account for each lease component and any associated non-lease components as a 'single lease component' (as discussed earlier).

8.7.3.2 Leases Previously Classified as Finance Leases

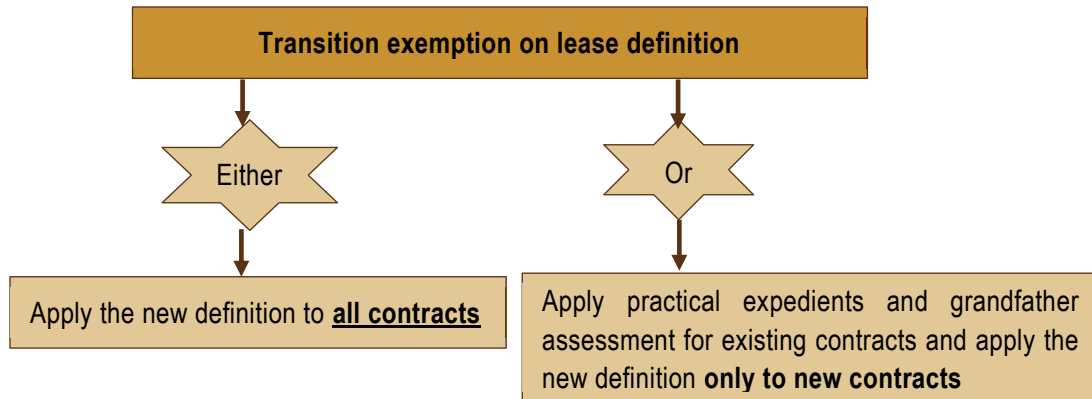
When applying modified retrospective approach, for leases that were classified as finance leases applying Ind AS 17, the carrying amount of the ROU asset and the lease liability at the date of

initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying Ind AS 17. For such leases, a lessee shall account for the ROU asset and the lease liability applying Ind AS 116 from the date of initial application. Thus, a lessee will not change its initial carrying amounts for assets and liabilities under finance leases existing at the date of initial application of Ind AS 116.

For leases previously classified as operating leases and finance leases, the below table summarises the application of Modified retrospective approach:

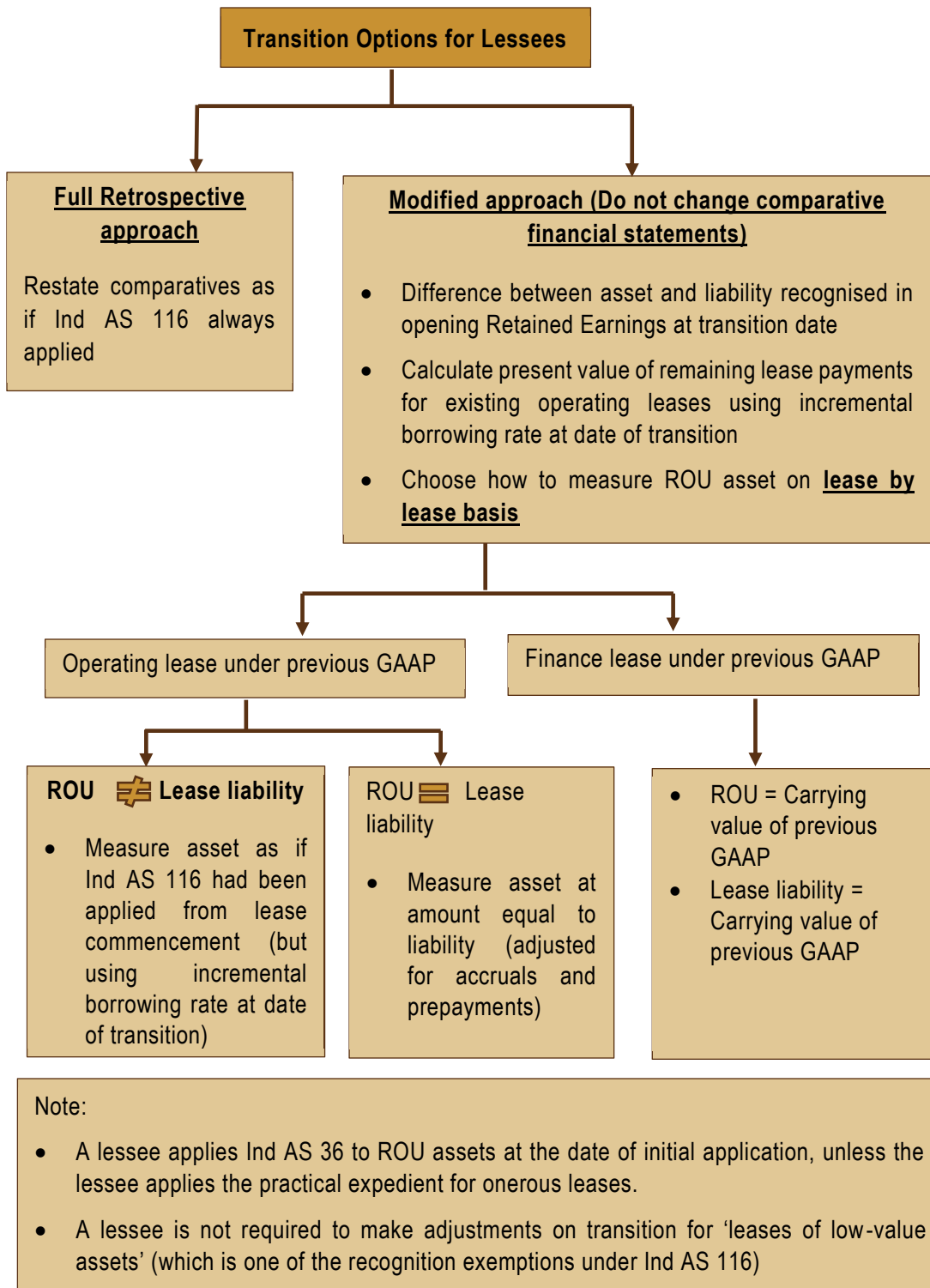
Operating Lease	Lease liability	Measure at the present value of the remaining lease payments, discounted using lessee's incremental borrowing rate at the date of initial application
	Right-of-use asset	Retrospective calculation, using a discount rate based on lessee's incremental borrowing rate at the date of initial application. or Amount of lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments relating to that lease). Lessee can choose one of the alternatives on a lease-by-lease basis.
Finance Lease	Lease liability	Carrying amount of the lease liability immediately before the date of initial application.
	Right-of-use asset	Carrying amount of the lease asset immediately before the date of initial application.
	Application of Ind AS 116	Apply the provisions of this standard to Right of Use asset and lease liability from the date of initial application.

The standard also prescribes certain practical expedients under Modified retrospective approach to leases previously classified as operating leases applying Ind AS 17.



Practical Expedient

- This exemption must be applied either for all contracts or none **i.e. cherry picking is not permitted**
- This exemption does not mean that previously identified operating leases can remain off-balance sheet for lessee (unless qualify for a recognition exemption). It merely saves the entity the costs and effort of reassessing)
- If the exemption is elected, the new definition of a lease is applied only to contracts entered into or changed on or after initial application
- Disclosure is required if a practical expedient is elected



Let us consider an illustration to understand the transition approaches in a more precise manner:

Illustration 46 - Transition Approaches

A retailer (lessee) entered into 3-year lease of retail space beginning at 1 April 2017 with three annual lease payments of ₹ 2,00,000 due on 31 March 2018, 2019 and 2020, respectively. The lease is classified as an operating lease under Ind AS 17. The retailer initially applies Ind AS 116 for the first time in the annual period beginning at 1 April 2019. The incremental borrowing rate at the date of the initial application (i.e., 1 April 2019) is 10% p.a. and at the commencement of the lease (i.e., 1 April 2017) was 12% p.a. The ROU asset is subject to straight-line depreciation over the lease term. Assume that no practical expedients are elected, the lessee did not incur initial direct costs, there were no lease incentives and there were no requirements for the lessee to dismantle and remove the underlying asset, restore the site on which it is located or restore the underlying asset to the condition under the terms and conditions of the lease.

What would be the impact for the lessee using all the following transition approaches:

Full Retrospective Approach

Modified Retrospective Approach

- Alternative 1

- Alternative 2

Solution:

Full Retrospective Approach:

Under the full retrospective approach, the lease liability and the ROU asset are measured on the commencement date (i.e., 1 April 2017 in this case) using the incremental borrowing rate **at lease commencement date** (i.e., 12% p.a. in this case). The lease liability is accounted for by the interest method subsequently and the ROU asset is subject to depreciation on the straight-line basis over the lease term of three years. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Present Value Factor @12%	Discounted Cash flows / Present Value
31 Mar 2018	2,00,000	0.8929	1,78,580
31 Mar 2019	2,00,000	0.7972	1,59,440
31 Mar 2020	<u>2,00,000</u>	0.7118	<u>1,42,360</u>
	<u>6,00,000</u>		<u>4,80,380</u>

Lease Liability Schedule:

<i>Year</i>	<i>Opening</i>	<i>Interest Expense @ 12%</i>	<i>Payments</i>	<i>Closing</i>
31 Mar 2018	4,80,380	57,646	(2,00,000)	3,38,026
31 Mar 2019	3,38,026	40,563	(2,00,000)	1,78,589
31 Mar 2020	1,78,589	21,411*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

<i>Year</i>	<i>Opening</i>	<i>Depreciation</i>	<i>Closing</i>
31 Mar 2018	4,80,380	(1,60,126)	3,20,254
31 Mar 2019	3,20,254	(1,60,127)	1,60,127
31 Mar 2020	1,60,127	(1,60,127)	-

The following table shows account balances under this method beginning at lease commencement:

<i>Date</i>	<i>ROU Asset</i>	<i>Lease Liability</i>	<i>Interest Expense</i>	<i>Depreciation Expense</i>	<i>Retained Earnings</i>
1 Apr 2017	4,80,380	4,80,380	-	-	-
31 Mar 2018	3,20,254	3,38,026	-	-	-
1 Apr 2018	3,20,254	3,38,026			(17,772)
31 Mar 2019	1,60,127	1,78,589	40,563	1,60,127	-
1 Apr 2019	1,60,127	1,78,589	-	-	-
31 Mar 2020	-	-	21,411	1,60,127	-

Ind AS 116 is applicable for the financial year beginning from 1st April 2019. Hence, 2019-2020 is the first year of adoption and using Full retrospective method the comparative for 2018-2019 needs to be restated and 1st April 2018 (i.e the opening of the comparative) is taken as transition date for adoption of this standard. At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2018 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1st April 2018 (assuming that only the 2018-2019 financial information is included as comparatives).

ROU Asset	Dr.	3,20,254	
Retained Earnings	Dr.	17,772	
To Lease Liability			3,38,026
<i>To initially recognise the lease-related asset and liability as of 1 April 2018.</i>			

The following journal entries would be recorded during 2018-2019:

Interest expense	Dr.	40,563	
To Lease Liability			40,563
<i>To record interest expense and accrete the lease liability using the interest method.</i>			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
<i>To record depreciation expense on the ROU asset.</i>			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
<i>To record lease payment.</i>			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	21,411	
To Lease Liability			21,411
<i>To record interest expense and accrete the lease liability using the interest method.</i>			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
<i>To record depreciation expense on the ROU asset.</i>			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
<i>To record lease payment.</i>			

Modified Retrospective Approach (Alternative 1):

Under the modified retrospective approach (Alternative 1), the lease liability is measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 1st April 2019 to 31st March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 01 April 2019** (i.e. 10% p.a. in this case). The ROU asset

is at its carrying amount as if Ind AS 116 had been applied since the commencement date (i.e., 1st April 2017 in this case) by using incremental borrowing rate as at transition date. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Discounting Factor @10%	Discounted Cash flows / Present Value
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		1,81,820

Lease Liability Schedule:

Year	Opening Balance	Interest Expense @ 10%	Payments	Closing Balance
31 Mar 2020	1,81,820	18,180	(2,00,000)	-

ROU Asset Schedule:

Year	Opening Balance	Depreciation	Closing Balance
31 Mar 2020	1,65,787***	(1,65,787)	-

*** (Refer note no 3)

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
1 Apr 2017	4,97,360*	4,97,360**	-	-	-
31 Mar 2018	3,31,574	3,47,096	49,736	1,65,786	-
31 Mar 2019	1,65,787	1,81,806	34,710	1,65,787	(16,019)
1 Apr 2019	1,65,787	1,81,806	-	-	-
31 Mar 2020	-	-	18,194	1,65,787	-

*(Refer note no 1)

**(Refer note no 2)

At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2019 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1st April 2019.

ROU Asset	Dr.	1,65,787	
Retained Earnings	Dr.	16,019	
To Lease Liability			1,81,806
<i>To initially recognise the lease-related asset and liability as of 1 April 2019.</i>			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	18,194	
To Lease Liability			18,194
<i>To record interest expense and accrete the lease liability using the interest method.</i>			
Depreciation expense	Dr.	1,65,787	
To ROU Asset			1,65,787
<i>To record depreciation expense on the ROU asset.</i>			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
<i>To record lease payment.</i>			

Note 1:

Calculation of Present value of lease payments as at commencement date i.e. 1st April, 2017

Year	Payments (Cash flows)	Discounting Factor @10%	Discounted Cash flows / Present Value
31 Mar 2018	2,00,000	0.9091	1,81,820
31 Mar 2019	2,00,000	0.8264	1,65,280
31 Mar 2020	<u>2,00,000</u>	0.7513	<u>1,50,260</u>
	<u>6,00,000</u>		<u>4,97,360</u>

Lease Liability Schedule:

Year	Opening	Interest Expense @ 10%	Payments	Closing
31 Mar 2018	4,97,360	49,736	(2,00,000)	3,47,096
31 Mar 2019	3,47,096	34,710	(2,00,000)	1,81,806
31 Mar 2020	1,81,806	18,194*	(2,00,000)	-

*Difference is due to approximation

Calculation of ROU asset as at transition date i.e., 1st April, 2019

<i>Year</i>	<i>Opening</i>	<i>Depreciation</i>	<i>Closing</i>
31 Mar 2018	4,97,360	(1,65,786)	3,31,574
31 Mar 2019	3,31,574	(1,65,787)	1,65,787
31 Mar 2020	1,65,787	(1,65,787)	-

Modified Retrospective Approach (Alternative 2):

Under the modified retrospective approach (Alternative 2), the lease liability is also measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 1st April 2019 to 31st March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial application being 1st April 2019 (i.e. 10% p.a. in this case). The carrying amount of the ROU asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items and hence, no impact on retained earnings as on the transition date.

Let us first calculate the Lease Liability and ROU Asset as follows:

<i>Year</i>	<i>Payments (Cash flows)</i>	<i>Discounting Factor @ 10%</i>	<i>Discounted Cash flows / Present Value</i>
31 Mar 2020	<u>2,00,000</u>	0.9091	<u>1,81,820</u>
	<u>2,00,000</u>		<u>1,81,820</u>

Lease Liability Schedule:

<i>Year</i>	<i>Opening</i>	<i>Interest Expense</i>	<i>Payments</i>	<i>Closing</i>
31 Mar 2020	1,81,820	18,182	(2,00,000)	-

ROU Asset Schedule:

<i>Year</i>	<i>Opening</i>	<i>Depreciation</i>	<i>Closing</i>
31 Mar 2020	1,81,820	(1,81,820)	-

The following table shows account balances under this method beginning at lease commencement:

<i>Date</i>	<i>ROU Asset</i>	<i>Lease Liability</i>	<i>Interest Expense</i>	<i>Depreciation Expense</i>	<i>Retained Earnings</i>
1 st Apr 2019	1,81,820	1,81,820	-	-	-
31 Mar 2020	-	-	18,182	1,81,820	-

At adoption, the lessee would record the ROU asset and lease liability at the 1st April 2019 by taking values from the above table and there will be no impact on retained earnings on the transition date being 1st April 2019 since under this alternative, ROU Asset is equal to the Lease Liability.

ROU Asset	Dr.	1,81,820	
To Lease Liability			1,81,820
<i>To initially recognise the lease-related asset and liability as of 1 April 2019.</i>			

The following journal entries would be recorded during 2019-2020:

Interest expense	Dr.	18,182	
To Lease Liability			18,182
<i>To record interest expense and accrete the lease liability using the interest method.</i>			
Depreciation expense	Dr.	1,81,820	
To ROU Asset			1,81,820
<i>To record depreciation expense on the ROU asset.</i>			
Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
<i>To record lease payment.</i>			

A summary of the lease contract's accounting (assuming there are no changes due to reassessments) is, as follows:

Particulars	Full Retrospective Approach	Modified Retrospective Approach (Alternative 1)	Modified Retrospective Approach (Alternative 2)
<u>Opening balance sheet impact as on 1 April 2019:</u>			
ROU Asset	1,60,126	1,65,787	1,81,820
Lease Liability	1,78,589	1,81,806	1,81,820
<u>Period ended 31 March 2020 activity:</u>			
Cash lease payments	2,00,000	2,00,000	2,00,000

<u>Lease payments recognised:</u>			
Interest expense	21,411	18,194	18,180
Depreciation expense	<u>1,60,127</u>	<u>1,65,787</u>	<u>1,81,820</u>
Total periodic expense	<u>1,81,538</u>	<u>1,83,981</u>	<u>2,00,002</u>

8.7.4 Disclosure

Disclosure requirements vary in accordance with the Transition Approach opted. The lessee shall disclose the following as required by Ind AS 8 (except that it is impracticable to determine the amount of the adjustment):

Full Retrospective Approach	Modified Retrospective Approach
(a) the title of the Ind AS;	(a) the title of the Ind AS;
(b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;	(b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
(c) the nature of the change in accounting policy;	(c) the nature of the change in accounting policy;
(d) when applicable, a description of the transitional provisions;	(d) when applicable, a description of the transitional provisions;
(e) when applicable, the transitional provisions that might have an effect on future periods;	(e) when applicable, the transitional provisions that might have an effect on future periods;
(f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment: (i) for each financial statement line item affected; and (ii) if Ind AS 33 <i>Earnings per Share</i> applies to the entity, for basic and diluted earnings per share;	(f) the weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the balance sheet at the date of initial application; and an explanation of any difference between: (i) operating lease commitments disclosed applying Ind AS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing

	rate at the date of initial application; and (ii) lease liabilities recognised in the balance sheet at the date of initial application.
(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and	(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
(h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.	(h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied. Further, if a lessee uses one or more of the practical expedients (already discussed above), it shall disclose that fact.

8.7.5 Lessors

A lessor is not required to make any adjustments on transition for leases in which it is a lessor and shall account for those leases applying Ind AS 116 from the date of initial application **except** in case of an '**Intermediate Lessor**' who shall:

- (a) reassess subleases that were classified as operating leases applying Ind AS 17 and are ongoing at the date of initial application, to determine whether each sublease should be classified as an operating lease or a finance lease applying Ind AS 116. The intermediate lessor shall perform this assessment at the date of initial application on the basis of the remaining contractual terms and conditions of the head lease and sublease at that date with reference to the ROU Asset associated with the head lease and not the underlying asset.
- (b) for subleases that were classified as operating leases applying Ind AS 17 but, finance leases applying Ind AS 116, account for the sublease as a new finance lease entered into at the date of initial application. Any gain or loss arising on the sublease arrangement is included in the cumulative catch-up adjustment to retained earnings at the date of initial application.

8.7.6 Sale and Leaseback Transactions before the date of Initial Application

An entity shall not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements under Ind AS 115 to be accounted for as a sale, i.e., a seller-lessee is prohibited from reassessing historical sale and leaseback transactions to determine whether a sale occurred in accordance with Ind AS 115.

Thus, a seller-lessee does not perform any retrospective adjustments to sale and leaseback transactions on transition to Ind AS 116. Instead, the leaseback is accounted for on transition in the following manner, depending on the classification:

<i>Finance Lease</i>	<i>Operating Lease</i>
If a sale and leaseback transaction was accounted for as a sale and a <u>finance lease</u> applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other finance lease that exists at the date of initial application AND (b) continue to amortise any gain on sale over the lease term.	If a sale and leaseback transaction was accounted for as a sale and <u>operating lease</u> applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other operating lease that exists at the date of initial application; AND (b) adjust the leaseback ROU asset for any deferred gains or losses that relate to off-market terms recognised in the balance sheet immediately before the date of initial application.

8.7.7 Amounts Previously recognised in respect of Business Combinations

If a lessee previously recognised an asset or a liability applying Ind AS 103 *Business Combinations*, relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination, the lessee shall derecognise that asset or liability and adjust the carrying amount of the ROU asset by a corresponding amount at the date of initial application.



8.8 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following are the extracts from the financial statements of the listed entity 'InterGlobe Aviation Limited' for the financial year 2021-2022 with respect to 'ROU Assets' and 'Lease Liabilities'.

In the Assets side of the Balance Sheet:

	Note	As at 31 March 2022
I. ASSETS		
Non-current assets		
a. Property, plant and equipment	3.a	8,225.20
b. Right of use assets	4	204,381.48

4. Right of use assets

As at 31 March 2022

Particulars	Aircraft and Engines	Equipment	Leasehold Land	Buildings	Total
Gross value - at cost					
Balance at the beginning of the year	251,021.62	5,387.87	2,944.16	2,316.50	261,670.15
Additions during the year	68,365.07	-	344.13	255.64	68,964.84
Disposals during the year	18,858.35	-	-	153.93	19,012.28
Adjustments during the year *	3,576.74	-	-	(177.70)	3,399.04
Balance at the end of the year	304,105.08	5,387.87	3,288.29	2,240.51	315,021.75
Accumulated depreciation					
Balance at the beginning of the year	80,086.41	849.55	373.28	499.20	81,808.44
Depreciation for the year**	46,647.74	636.38	268.75	291.24	47,844.11
Depreciation on disposals	18,858.35	-	-	153.93	19,012.28
Balance at the end of the year	107,875.80	1,485.93	642.03	636.51	110,640.27
Net carrying value as at 31 March 2022	196,229.28	3,901.94	2,646.26	1,604.00	204,381.48

*Includes adjustment on account of foreign currency loss, arising on re-statement of long-term foreign currency monetary loans used for acquisition of a depreciable capital asset, amounting to Rs. 398.00 (previous year foreign currency gain amounting to Rs. 417.55) and modification on leases amounting to Rs. 3,001.04 (previous year Rs. 1,669.70).

** Depreciation for the year includes Rs. 61.67 (previous year Rs. 167.26) capitalised as part of Capital work-in-progress.

In the Liabilities side of the Balance Sheet:

LIABILITIES			
Non-current liabilities			
a. Financial liabilities			
(i) Borrowings	17.a	4,161.71	3,816.28
(ia) Lease liabilities	17.b	250,586.59	202,805.34
Current liabilities			
a. Financial liabilities			
(i) Borrowings	17.a	34,805.65	21,239.95
(ia) Lease liabilities	17.b	79,224.42	70,734.97

17.b Lease liabilities

Particulars	As at 31 March 2022		As at 31 March 2021	
	Non-current	Current	Non-current	Current
Lease liabilities*	250,586.59	79,224.42	202,805.34	70,734.97
Total	250,586.59	79,224.42	202,805.34	70,734.97

The Company's leased assets primarily consist of leases for aircraft and engines, equipment, leasehold land and buildings.

Interest expense on lease liabilities for the year is amounting to Rs. 19,627.85 (previous year Rs. 16,435.04) (including interest amounting to Rs. 109.45 (previous year Rs. 238.17) capitalised under capital work-in-progress). Refer to Note 26.

Certain lease liabilities amounting to Rs. 13,155.50 (previous year Rs. 16,153.80) are secured against the respective aircraft. Remaining lease liabilities are secured to the extent of letter of credits issued / deposits given to lessors.

The Company has recognised an expense of Rs. 3,116.84 (previous year Rs. 2,804.57) on account of short term leases which represents leased aircraft and engines having a remaining lease term of less than 12 months as on transition date and other short term leases. The portfolio of other short-term leases to which the Company is committed at the end of the reporting period is not materially different from the portfolio of other short term leases for which expense has been recognised during the year.

The Company has several lease contracts that include extension and termination options. The management has included termination options in determination of lease term for contracts having such option. Extension options have not been included in determination of lease term since the management is reasonably certain not to exercise these options. Potential cash flows in relation to such extension options cannot be ascertained since the cash outflow for the extended period will depend on the negotiations with the lessors in the event of exercising the extension options.

Under certain lease arrangements of aircraft and engines, the Company incurs variable payments towards maintenance of the aircraft which are disclosed under "Supplementary rentals and aircraft repair and maintenance (net)".

The Company has entered into sale and leaseback arrangements, for certain aircraft and engines owned and controlled by the Company, to increase its liquidity. The Company has recorded proceeds of Rs. 6,006.43 (previous year Rs. 18,833.68) (net) from the sale and leaseback arrangements as disclosed in the Standalone Cash Flow Statement. The profit (net of loss) on sale and leaseback arrangements is Rs. 750.96 (previous year Rs. 12.81) disclosed in Note 23.

Future cash outflows for leases not yet commenced amounts to Rs. 64,435.43 (previous year Rs. 62,343.06).

The maturity analysis of lease liabilities are disclosed in Note 29. Further, information about the Company's exposure to market risks is disclosed in Note 29.

*Includes lease liabilities with related parties amounting to Rs. 5,093.61 (previous year Rs. 5,429.29). Refer to Note 35.

ACCOUNTING POLICY**Leases**

The Company's lease asset classes primarily consist of leases for aircraft and engines, equipment, leasehold land and buildings. The Company assesses at the inception date whether a contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

i) Lease liabilities

At the commencement date, the Company measures the lease liabilities at the present value of the lease payments that are not paid at that date. The lease liabilities include lease payments, payment of penalties for terminating the lease, if the lease term reflects the Company exercising the option to terminate, exercise price of a purchase option, if the company is reasonably certain to exercise that option, less any incentives receivable.

The lease payments are discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the Company uses incremental borrowing rate (IBR). The IBR is the rate of interest that the Company would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right of use assets in a similar economic environment.

After the commencement date, the amount of lease liabilities is increased to reflect the accretion of interest and reduced by the lease payments made. In addition, the carrying amount of lease liabilities is re-measured if there is a lease modification, including modification in the lease term, lease payments or assessment of an option to purchase the underlying asset. The lease liabilities are re-measured by discounting the revised lease payments using a revised discount rate at the effective date of the modification.

ii) Right of use assets

At the commencement date, the right of use assets are measured at cost. The cost includes an amount equal to the lease liabilities plus any lease payments made before the commencement date and any initial direct costs, less any incentives received from equipment manufacturer in terms of the same lease. An estimate of costs to be incurred in respect of redelivery obligation, in accordance with the terms of the lease, is also included in the right of use assets at commencement date.

After the commencement date, the right of use assets is measured in accordance with the accounting policy for property, plant and equipment i.e. right of use assets are measured at cost, less any accumulated depreciation and impairment losses, if any. Right of use assets are also correspondingly adjusted to reflect any re-measurement impact in the lease liabilities on account of lease modification. The right of use assets are also subject to impairment. Refer to the accounting policies in Note 2.(b) (xiv) Impairment of non-financial assets.

iii) Lease Term

At the commencement date, the Company determines the lease term which represents non-cancellable period of initial lease for which the asset is expected to be used, together with the periods covered by an option to extend or terminate the lease, if the Company is reasonably certain at the commencement date to exercise the extension or termination option.

iv) Other Leases

Lease payments associated with any other leases which falls outside the purview of Ind AS 116, short term leases and leases for which the underlying asset is of low value are charged to Standalone Statement of Profit and Loss on straight line basis over the lease term or another systematic basis which is more representative of the pattern of use of underlying asset.

v) Sale and leaseback transactions

The right of use arising from leaseback is measured at the proportion of previous carrying amount of the asset that relates to right of use retained by the Company. Where sale proceeds (net of maintenance obligation, if any) received are judged to reflect the aircraft's fair value, any gain or loss arising on disposal is recognised in the Standalone Statement of Profit and Loss, to the extent that it relates to the rights that have been transferred. Gains and losses that relate to the rights that have been retained are included in the carrying amount of the right of use assets recognised at commencement of the lease. Where sale proceeds (net of maintenance obligation, if any) received are not at the aircraft's fair value, any below market terms are recognised as a prepayment of lease payments, and above market terms are recognized as additional financing provided by the lessor.

vi) Depreciation

Depreciation on assets held as right of use assets is charged to Standalone Statement of Profit and Loss on a straight-line basis from the commencement date to the earlier of

the end of the useful life of the right of use assets or the end of the lease term, except for leased aircraft previously classified as finance leases under erstwhile Ind AS where depreciation is charged on useful life of right of use assets.

Depreciation on right of use assets has been charged based on the following period:

Asset Head	Useful life in years
<i>Aircraft and engines:</i>	
— <i>Aircraft and engines components including spare engines</i>	1-12
— <i>Leased aircraft previously classified as finance lease under erstwhile Ind AS</i>	20
— <i>Major inspection and overhaul costs (Refer to Note 2(b) (xxi))</i>	2-12
<i>Equipment</i>	8
<i>Leasehold land</i>	15-20
<i>Buildings</i>	1-10

(Source: Annual Report 2021-2022 - 'InterGlobe Aviation Limited')



8.9 KEY DIFFERENCES BETWEEN IND AS 17 AND IND AS 116

The significant differences between Ind AS 17 (Earlier Standard on Leases) and Ind AS 116 (New Standard on Leases) are given below:

Sr. No.	Particulars	Ind AS 17	Ind AS 116
1	Lease Definition	A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the <u>right to use</u> an asset for an agreed period of time. Under Appendix C to Ind AS 17 <i>Determining whether an Arrangement contains a Lease</i>,	A lease is a contract, or part of a contract, that conveys the <u>right to control</u> the use of an asset (the underlying asset) for a period of time in exchange for consideration. To determine if the right to control has been conveyed to the customer, an entity

		it is not necessary for an arrangement to convey the right to control the use of an asset to be in scope of Ind AS 17.	assesses whether, throughout the period of use, the customer has the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset.
2	Short-term lease exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases with a lease term of 12 months or less and without a purchase option. This option is available by 'class of underlying asset' to which the right of use relates.
3	Leases of low-value assets exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases of low-value assets. Examples of such assets include tablets and personal computers, small items of office furniture and telephones. This option is available on a 'lease-by lease' basis.
4	Lease Classification	Lessees apply a dual recognition and measurement approach for all leases. Lessees classify a lease as a 'finance lease' if it transfers substantially all the risks and rewards incidental to ownership. Otherwise a lease is classified as an 'operating lease'.	Lessees apply a single recognition and measurement approach for all leases, with options not to recognize ROU assets and lease liabilities for short-term leases and leases of low-value assets. There is not more classification of leases into operating and finance in case of lessees.

5	Lease Payments	At the commencement of the lease term, lessees recognize finance leases as assets and liabilities in their balance sheet at amounts equal to: a) the fair value of the leased property OR b) the present value of the minimum lease payments, whichever is lower, each determined at the inception of the lease. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee. No assets and liabilities are recognized for the initial measurement of operating leases, i.e., operating leases only impacted the statement of profit or loss.	At the commencement date, lessees measure the lease liability at the present value of the lease payments to be made over the lease term (except short-term leases and leases of low-value assets). Lease payments include: a) Fixed payments (including in-substance fixed payments), less any lease incentives receivable; b) Variable lease payments that depend on an index or a rate, initially measured using the index or rate at the commencement date; c) Amounts expected to be payable by the lessee under residual value guarantees; d) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; e) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease. In addition, the cost of the ROU asset comprises: a) The lease liability (as calculated above); b) Lease payments made at or before the commencement date, less any lease incentives received; c) Initial direct costs;

			d) Asset retirement obligations (unless those costs are incurred to produce inventories).
6	Reassessment of lease liability	Does not apply under Ind AS 17	After the commencement date, lessees are required to remeasure the lease liability when there is a lease modification (i.e., a change in the scope of a lease, OR the consideration for a lease that was not a part of the original terms and conditions of the lease) that is NOT accounted for as a separate contract. Lessees are also required to remeasure lease payments upon a change in ANY of the following: - The lease term; - The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset; - The amounts expected to be payable under residual value guarantees; - Future lease payments resulting from a change in an index or rate.
7	Lease income from operating leases	Ind AS 17 contains a <u>carve out</u> of not straight-lining the lease escalation, if they are in line with the expected general inflation compensating the lessor for expected inflationary cost.	There is <u>no such carve out</u> under Ind AS 116 and thus, a lessor shall recognize lease payments from operating leases as income on either a straight-line basis or another systematic basis.

8	Lease modifications to an operating lease	Ind AS 17 doesn't mention about this.	Lessors account for a modification to an operating lease as a <u>new lease</u> from the effective date of the modification (considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease).
9	Lease modifications which do not result in new separate leases	Ind AS 17 doesn't mention about this.	<u>Lessees:</u> a) Allocate the consideration in the modified contract; b) Determine the lease term of the modified lease; c) Remeasure the lease liability by discounting the revised lease payments using a revised discount rate with a corresponding adjustment to ROU asset. Additionally, lessees recognize in profit or loss any gain or loss relating to the partial or full termination of the lease. <u>Lessors:</u> If a lease would have been an operating lease, had the modification been in effect at the inception date, lessors in a finance lease would: (i) Account for the modification as a new lease; (ii) Measure the carrying amount of the underlying asset as the net investment in the lease immediately

			before the effective date of the modification. Otherwise, the modification is accounted for in accordance with Ind AS 109 <i>Financial Instruments</i>.
10	Presentation (Lessees) – Balance Sheet	Ind AS 17 doesn't mention about this.	<u>ROU Assets:</u> They are presented either: - Separately from other assets (e.g., owned assets) OR - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are presented as investment property <u>Lease Liabilities:</u> They are presented either: - Separately from other liabilities OR - Together with other liabilities with disclosure of the balance sheet line items that include lease liabilities and their amounts.
11	Presentation (Lessees) – Statement of profit or loss	Operating lease expense is presented as a <u>single item</u> .	<u>Depreciation and Interest:</u> Lease-related depreciation and lease-related interest expense are presented <u>separately</u> (i.e., they <u>CANNOT</u> be combined). This is because interest

			expense on the lease liability is a component of finance costs, which paragraph 82(b) of Ind AS 1 <i>Presentation of Financial Statements</i> requires to be presented separately in the statement of profit or loss.
12	Presentation (Lessees) – Cashflow statement	<u>For operating leases:</u> Cash payments are included within <u>operating activities</u>.	<u>Principal portion of the lease liability:</u> - These cash payments are presented within <u>financing activities</u> <u>Interest portion of the lease liability:</u> - These cash payments are presented within <u>financing activities</u> <u>Short-term leases and leases of low-value assets:</u> - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within <u>operating activities</u> <u>Variable lease payments not included in the lease liability:</u> - These are also presented within <u>operating activities</u> <u>Non-cash activity:</u> Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)
13	Disclosures	Quantitative and qualitative disclosures are required but,	<u>Detailed</u> disclosures (including the format of disclosure) are

		generally fewer disclosures are required than those under Ind AS 116.	required under Ind AS 116. Additionally , qualitative and quantitative information about leasing activities is required in order to meet the disclosure objective.
14	Sale and leaseback transactions – ‘Sale’	Ind AS 17 focuses on whether the leaseback is an <u>operating or finance</u> lease.	Seller-lessees and buyer-lessors apply the requirements in Ind AS 115 to determine whether a <u>sale</u> has occurred in a sale and leaseback transaction.
15	Sale and leaseback transactions – Accounting by seller-lessees	If a sale and leaseback transaction results in a <u>finance lease</u> , any excess of sales proceeds over the carrying amount are deferred and amortized over the lease term. If a sale and leaseback transaction results in an <u>operating lease</u> , and it is clear that the transaction is established at fair value, any profit or loss is recognized immediately.	The seller-lessee measures the <u>ROU asset</u> arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right-of use retained by the seller-lessee and recognizes only the amount of any gain or loss that relates to the rights transferred to the buyer lessor.
16	Sale and leaseback transactions – Transactions NOT at fair value	If a sale and leaseback transaction results in an <u>operating lease</u> and the sale price is: - Below fair value: Any profit or loss is recognized immediately except that, if the loss is compensated for by future lease payments at below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected	If the fair value of the consideration for the sale of an asset does <u>NOT</u> equal the fair value of the asset OR if the payments for the lease are not at market rates then, an entity is required to measure the sale proceeds at fair value with an adjustment (as appropriate) either as a prepayment of lease

		to be used. - <u>Above fair value:</u> The excess over fair value is deferred and amortised over the period for which the asset is expected to be used.	payments (any <u>below</u> market terms) OR additional financing (any <u>above</u> market terms).
17	Business combinations – Acquiree is a lessee	Unlike Ind AS 116, there is no exemption under Ind AS 17 for leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of low value (i.e., recognition exemptions). An intangible asset is recognized if the terms of operating lease are favourable relative to market terms and a liability is recognized if terms are unfavourable relative to market terms. An 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.	The acquirer is not required to recognize ROU assets and lease liabilities for leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of a lower value (i.e., recognition exemptions). The acquirer measures the ROU asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease, relative to market terms.



8.9 KEY DIFFERENCES BETWEEN IND AS 116 AND AS 19

The significant differences between Ind AS 116 and AS 19 are given below:

Sr. No.	Particulars	Ind AS 116	AS 19
1	Lease definition	Under Ind AS 116, the definition of lease is similar to that in AS 19. But, in Ind AS 116, there is substantial	Under Ind AS 116, the definition of lease is similar to that in AS 19. However,

		change in the guidance of how to apply this definition. The changes primarily relate to the concept of 'control' used in identifying whether a contract contains a lease or not. Ind AS 116 provides detailed guidance on whether an arrangement contains a lease or whether there are non-lease / service components within the arrangement.	guidance part given therein is different.
2	Modifications	Ind AS 116 brings in comprehensive prescription on accounting of modifications in lease contracts. It permits leases, as a practical expedient, not to assess whether the rent concessions that occur as a direct consequence of COVID 19 pandemic and meet specified conditions are lease modifications and instead, to account for those rent concessions as if they were not lease modifications.	No such comprehensive coverage is there
3	Scope	Ind AS 116 has no such scope exclusion	AS 19 excludes leases of land from its scope
4	Definition	Ind AS 116 makes a distinction between 'inception of lease' and 'commencement of lease'	No such distinction has been made in AS 19
5	Classification	Ind AS 116 eliminates the requirement of classification of leases as either operating leases or finance leases for a lessee and instead, introduces a single lessee accounting model which requires lessee to recognise assets and liabilities for all leases unless it applies the recognition exemption (for leases of low value assets or short-term leases)	AS 19 requires a lessee to classify leases as either finance leases or operating leases

6	Sale & Leaseback transactions	In Ind AS 116, the approach for computation of gain/loss for a completed sale is different. The amount of gain/loss should reflect the amount that relates to the right transferred to the buyer-lessor.	As per AS 19, if a sale and leaseback transaction results in a finance lease, excess, if any, of the sale proceeds over the carrying amount shall be deferred and amortised by the seller-lessee over the lease term in proportion to depreciation of the leased asset.
		Ind AS 116 requires a seller-lessee and a buyer-lessor to use the definition of a sale as per Ind AS 115, <i>Revenue from Contracts with Customers</i> to determine whether a sale has occurred in a sale and leaseback transaction. If the transfer of the underlying asset satisfies the requirements of Ind AS 115 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor. If not, then the seller-lessee shall recognise a finance liability and the buyer-lessor will recognise a financial asset to be accounted for as per the requirements of Ind AS 109, <i>Financial Instruments</i>.	AS 19 does not contain such specific requirement
7	Treatment of initial direct costs		
	Finance lease – lessor accounting		
	Non-manufacturer/ Non-dealer	Interest rate implicit in the lease is defined in such a way that the initial direct costs included automatically in the finance lease receivable.	Either recognised as expense immediately or allocated against the finance income over the lease term.
	Manufacturer/d	Same as per AS 19.	Recognised as expense

	dealer		immediately.
	Operating lease- Lessor accounting	Added to the carrying amount of the leased asset and recognised as expense over the lease term on the same basis as lease income.	Either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or recognized as expense in the period in which incurred
8	Initial direct costs	Ind AS 116 contains clearer definition of 'initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. Ind AS 116 define initial direct costs as 'Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.' Further, definition of the term 'interest rate implicit in the lease' has been modified in Ind AS 116.	Different guidance given
9	Presentation	As a consequence of introduction of single lease model for lessees, there are many changes in the presentation in the three components of financial statements viz. Balance sheet, Statement of Profit and Loss, Statement of Cash flows.	Different guidance given
10	Disclosure	There are a number of changes in the disclosure relating to qualitative aspects of leasing transactions. For eg. Entities are required to disclose the nature and risks arising from leasing transactions. Also, in case of lessor, there are changes in the disclosure of maturity analysis of leases payments receivable.	Different guidance given



8.10 MAJOR CHANGES UNDER IND AS 116 FROM IFRS 16

Ind AS 116, like other Ind AS, has been converged from the global standards, i.e., IFRS, which has been made applicable to the Indian entities (based on the net worth criteria) in a phased manner via Ministry of Corporate Affairs Roadmap. While converging from IFRS 16 (which is applicable globally from the reporting periods beginning on or after 1 January 2019), following are the carve outs given under Appendix 1 to Ind AS 116, keeping in mind, the requirements of other converged Ind AS and the economic environment in India:

S. No.	Particulars	IFRS 16	Ind AS 116
1	Subsequent measurement of investment property	Paragraph 34 of IFRS 16 provides that if lessee applies fair value model in IAS 40 to its investment property, it shall apply that fair value model to the ROU assets that meet the definition of investment property.	Paragraph 34 has been <u>deleted</u> under Ind AS 116 since Ind AS 40 <i>Investment Property</i> does <u>NOT</u> allow the use of fair value model. Consequently, reference of the same appearing anywhere under Ind AS 116 has also been <u>deleted</u> .
2	Interest portion of lease liability – classification in cash flow statement	Paragraph 50(b) of IFRS 16 requires classifying cash payments for interest portion of lease liability applying requirements of IAS 7 <i>Statement of Cash Flows</i> . IAS 7 provides option of treating interest paid as <u>operating or financing activity</u> .	Ind AS 7 requires interest paid to be treated as <u>financing activity only</u> . Accordingly, paragraph 50(b) has been <u>modified</u> under Ind AS 116 to specify that cash payments for interest portion of lease liability will be classified as financing activities applying Ind AS 7.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

QUESTIONS

1. A lessee enters into a ten-year contract with a lessor (freight carrier) to transport a specified quantity of goods. Lessor uses rail wagons of a particular specification and has a large pool of similar rail wagons that can be used to fulfil the requirements of the contract. The rail wagons and engines are stored at lessor's premises when they are not being used to transport goods. Costs associated with substituting the rail wagons are minimal for lessor.

Whether the lessor has substantive substitutions rights and whether the arrangement contains a lease?

2. Customer M enters into a 20-year contract with Energy Supplier S to install, operate and maintain a solar plant for M's energy supply. M designed the solar plant before it was constructed – M hired experts in solar energy to assist in determining the location of the plant and the engineering of the equipment to be used. M has the exclusive right to receive and the obligation to take any energy produced. Whether it can be established that M is having the right to control the use of identified asset?

3. A Customer enters into a ten-year contract with a Company (a ship owner) for the use of an identified ship. The customer decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent the company from sailing the ship into waters at a high risk of piracy or carrying explosive materials. The company operates and maintains the ship and is responsible for safe passage.

Does the customer have the right to direct how and for what purpose the ship is to be used throughout the period of use and whether the arrangement contains a lease?

4. A Lessee enters into a ten-year lease contract with a Lessor to use equipment. The contract includes maintenance services (as provided by the lessor). The Lessor obtains its own insurance for the equipment. Annual payments are ₹ 10,000 (₹ 1,000 related to maintenance services and ₹ 500 to insurance costs).

The Lessee is able to determine that similar maintenance services and insurance costs are offered by third parties for ₹ 2,000 and ₹ 500 a year, respectively. The Lessee is unable to find an observable stand-alone rental amount for similar equipment because none is leased without related maintenance services provided by the lessor.

How would the Lessee allocate the consideration to the lease component?

5. A Lessee enters into a non-cancellable lease contract with a Lessor to lease a building. Initially, the lease is for five years, and the lessee has the option to extend the lease by another five years at the same rental.

To determine the lease term, the lessee considers the following factors:

- ◆ Market rentals for a comparable building in the same area are expected to increase by 10% over the ten-year period covered by the lease. At inception of the lease, lease rentals are in accordance with current market rents.
- ◆ The lessee intends to stay in business in the same area for at least 20 years.
- ◆ The location of the building is ideal for relationships with suppliers and customers.

What should be the lease term for lease accounting under Ind AS 116?

6. A Lessee enters into a lease of a five-year-old machine. The non-cancellable lease term is 15 years. The lessee has the option to extend the lease after the initial 15-year period for optional periods of 12 months each at market rents.

To determine the lease term, the lessee considers the following factors:

- ◆ The machine is to be used in manufacturing parts for a type of plane that the lessee expects will remain popular with customers until development and testing of an improved model are completed in approximately 15 years.
- ◆ The cost to install the machine in lessee's manufacturing facility is significant.
- ◆ The non-cancellable term of lessee's manufacturing facility lease ends in 15 years, and the lessee has an option to renew that lease for another twelve years.
- ◆ Lessee does not expect to be able to use the machine in its manufacturing process for other types of planes without significant modifications.
- ◆ The total remaining life of the machine is 30 years.

What should be the lease term for lease accounting under Ind AS 116?

7. A Company leases a manufacturing facility. The lease payments depend on the number of operating hours of the manufacturing facility, i.e., the lessee has to pay ₹ 2,000 per hour of use. The annual minimum payment is ₹ 2,00,00,000. The expected usage per year is 20,000 hours.

Whether the said payments be included in the calculation of lease liability under Ind AS 116?

8. Entity X (lessee) entered into a lease agreement ('lease agreement') with Entity Y (lessor) to lease an entire floor of a shopping mall for a period of 9 years. The annual lease rent of ₹ 70,000 is payable at year end. To carry out its operations smoothly, Entity X simultaneously entered into another agreement ('facilities agreement') with Entity Y for using certain other facilities owned by Entity Y such as passenger lifts, DG sets, power supply infrastructure, parking space etc., which are specifically mentioned in the agreement, for annual service charges amounting to ₹ 1,00,000. As per the agreement, the ownership of the facilities shall remain with Entity Y. Lessee's incremental borrowing rate is 10%.

The facilities agreement clearly specifies that it shall be co-existent and coterminous with 'lease agreement'. The facility agreement shall stand terminated automatically on termination or expiry of 'lease agreement'.

Entity X has assessed that the stand-alone price of 'lease agreement' is ₹ 1,20,000 per year and stand-alone price of the 'facilities agreement' is ₹ 80,000 per year. Entity X has not elected to apply the practical expedient in paragraph 15 of Ind AS 116 of not to separate non-lease component(s) from lease component(s) and accordingly it separates non-lease components from lease components.

How will Entity X account for lease liability as at the commencement date?

9. Entity X is an Indian entity whose functional currency is Indian Rupee. It has taken a plant on lease from Entity Y for 5 years to use in its manufacturing process for which it has to pay annual rentals in arrears of USD 10,000 every year. On the commencement date, exchange rate was USD = ₹ 68. The average rate for Year 1 was ₹ 69 and at the end of year 1, the exchange rate was ₹ 70. The incremental borrowing rate of Entity X on commencement of the lease for a USD borrowing was 5% p.a.

How will entity X measure the right of use (ROU) asset and lease liability initially and at the end of Year 1?

ANSWERS

1. In this case, the rail wagons are stored at lessor's premises, and it has a large pool of similar rail wagons and substitution costs to be incurred are minimal. Thus, the lessor has the practical ability to substitute the asset. If at any point, the same becomes economically

beneficial for the lessor to substitute the wagons, he can do so and hence, the lessor's substitution rights are substantive, and the arrangement does not contain a lease.

2. In this case, the nature of the solar plant is such that all the decisions about how and for what purpose the asset is used are predetermined because:
- the type of output (i.e. energy) and the production location are predetermined in the agreement; and
 - when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because M designed the solar plant and thereby predetermined any decisions about how and for what purpose it is used, M is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give the supplier the right to direct how, and for what purpose the solar plant is used. Hence, M has a right to control the use of asset.

3. The customer has the right to direct the use of the ship because the contractual restrictions are merely protective rights that protect the company's investment in the ship and its personnel. In the scope of its right of use, the customer determines how and for what purpose the ship is used throughout the ten-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport.

The customer has the right to change these decisions throughout the period of use and hence, the contract contains a lease.

4. The observable stand-alone price for maintenance services is ₹ 2,000. There is no observable stand-alone price for the lease. Further, the insurance cost does not transfer a good or service to the lessee and therefore, it is not a separate lease component.

Thus, the Lessee allocates ₹ 8,000 (₹ 10,000 – ₹ 2,000) to the lease component.

5. After considering all the stated factors, the lessee concludes that it has a significant economic incentive to extend the lease.

Thus, for the purpose of lease accounting under Ind AS 116, the lessee uses a lease term of ten years.

6. The lessee notes that the terms for the optional renewal provide no economic incentive and the cost to install is significant. The lessee has no incentive to make significant modifications to the machine after the initial 15-year period. Therefore, the lessee does not expect to have a business purpose for using the machine after the non-cancellable lease term of 15 years.

Thus, the lessee concludes that the lease term consists of 15-year non-cancellable period only.

7. The said lease contains in-substance fixed payments of ₹ 2,00,00,000 per year, which are included in the initial measurement of the lease liability under Ind AS 116.

However, the additional ₹ 2,00,00,000 that the company expects to pay per year are variable payments that do not depend on an index or rate and, thus, are not included in the initial measurement of the lease liability but, are expensed when the over-use occurs.

8. Entity X identifies that the contract contains lease of premises and non-lease component of facilities availed. As Entity X has not elected to apply the practical expedient as provided in paragraph 15, it will separate the lease and non-lease components and allocate the total consideration of ₹ 1,70,000 to the lease and non-lease components in the ratio of their relative stand-alone selling prices as follows:

Particulars	Stand-alone Prices	% of total Stand-alone Price	Allocation of consideration
	₹		₹
Building rent	1,20,000	60%	1,02,000
Service charge	<u>80,000</u>	<u>40%</u>	<u>68,000</u>
Total	<u>2,00,000</u>	<u>100%</u>	<u>1,70,000</u>

As Entity X's incremental borrowing rate is 10%, it discounts lease payments using this rate and the lease liability at the commencement date is calculated as follows:

Year	Lease Payment (A)	Present value factor @ 10% (B)	Present value of lease payments (A x B = C)
Year 1	1,02,000	0.909	92,718
Year 2	1,02,000	0.826	84,252
Year 3	1,02,000	0.751	76,602
Year 4	1,02,000	0.683	69,666
Year 5	1,02,000	0.621	63,342
Year 6	1,02,000	0.564	57,528
Year 7	1,02,000	0.513	52,326
Year 8	1,02,000	0.467	47,634
Year 9	1,02,000	0.424	43,248
Lease Liability at commencement date			5,87,316

Further, ₹ 68,000 allocated to the non-lease component of facility used will be recognised in profit or loss as and when incurred.

9. On initial measurement, Entity X will measure the lease liability and ROU asset as under:

Year	Lease Payments (USD)	Present Value factor @ 5%	Present Value of Lease Payment	Conversion rate (spot rate)	INR value
1	10,000	0.952	9,520	68	6,47,360
2	10,000	0.907	9,070	68	6,16,760
3	10,000	0.864	8,640	68	5,87,520
4	10,000	0.823	8,230	68	5,59,640
5	10,000	0.784	<u>7,840</u>	68	<u>5,33,120</u>
Total			<u>43,300</u>		<u>29,44,400</u>

As per Ind AS 21 *The Effects of Changes in Foreign Exchange Rates*, monetary assets and liabilities are restated at each reporting date at the closing rate and the difference due to foreign exchange movement is recognised in profit and loss whereas non-monetary assets and liabilities carried measured in terms of historical cost in foreign currency are not restated.

Accordingly, the ROU asset in the given case being a non-monetary asset measured in terms of historical cost in foreign currency will not be restated but the lease liability being a monetary liability will be restated at each reporting date with the resultant difference being taken to profit and loss.

At the end of Year 1, the lease liability will be measured in terms of USD as under:

Lease Liability:

Year	Initial Value (USD) (a)	Lease Payment (b)	Interest @ 5% (c) = (a x 5%)	Closing Value (USD) (d = a + c - b)
1	43,300	10,000	2,165	35,465

Interest at the rate of 5% will be accounted for in profit and loss at average rate of ₹ 69 (i.e., USD 2,165 x 69) = ₹ 1,49,385.

Particulars	Dr. (₹)	Cr. (₹)
Interest Expense	Dr. 1,49,385	
To Lease liability		1,49,385

Lease payment would be accounted for at the reporting date exchange rate, i.e. ₹ 70 at the end of year 1

Particulars	Dr. (₹)	Cr. (₹)
Lease liability Dr.	7,00,000	
To Cash		7,00,000

As per the guidance above under Ind AS 21, the lease liability will be restated using the reporting date exchange rate i.e., ₹ 70 at the end of Year 1. Accordingly, the lease liability will be measured at ₹ 24,82,550 ($35,465 \times ₹ 70$) with the corresponding impact due to exchange rate movement of ₹ 88,765 ($24,82,550 - (29,44,400 + 1,49,385 - 700,000)$) taken to profit and loss.

At the end of year 1, the ROU asset will be measured as under:

Year	Opening Balance (₹)	Depreciation (₹)	Closing Balance (₹)
1	29,44,400	5,88,880	23,55,520

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OTHER INDIAN ACCOUNTING STANDARDS



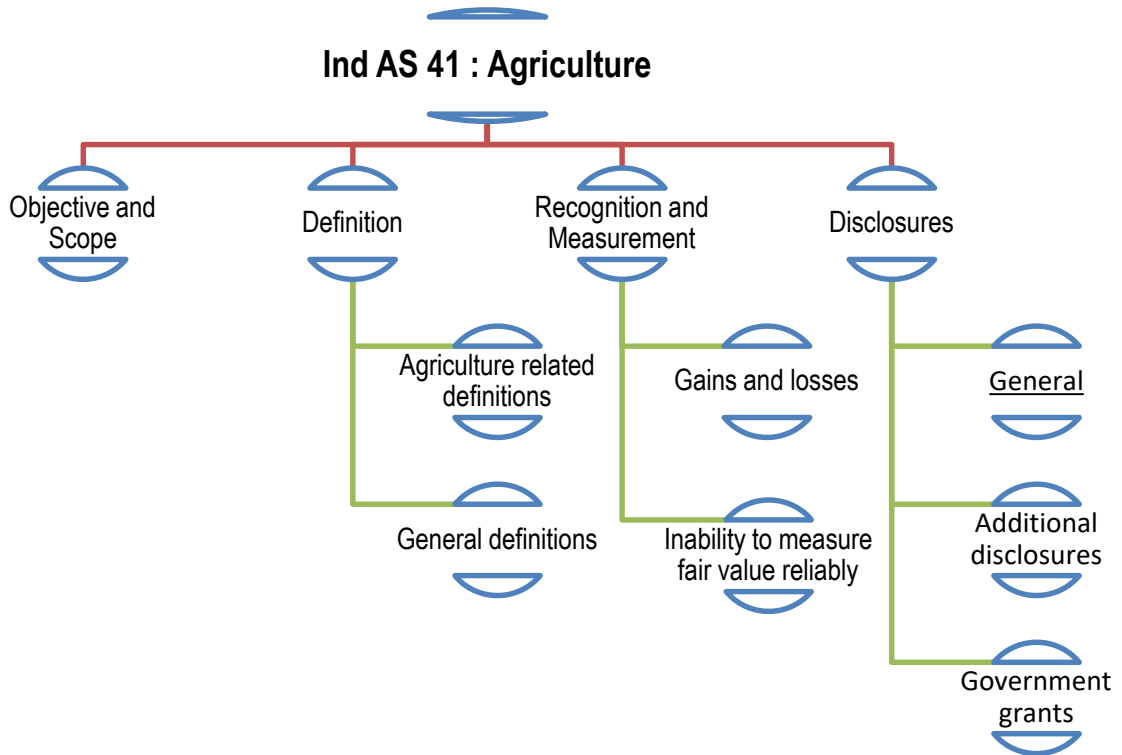
UNIT 1: INDIAN ACCOUNTING STANDARD 41: AGRICULTURE

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ☐ State the objective and scope of the standard
- ☐ Define the terms agricultural activity, agricultural produce, bearer plant, biological asset and biological transformation
- ☐ Explain the principles of recognition and measurement
- ☐ Compute the gain and loss on initial and subsequent measurement
- ☐ Account for the grant relating to a biological asset
- ☐ List the various disclosures prescribed in this standard

UNIT OVERVIEW





1.1 INTRODUCTION AND OBJECTIVE

Ind AS 41, Agriculture is the first standard that specifically covers the accounting and reporting requirements for the primary sector. Prior to this standard, there were no established guidance on agriculture and allied industry. This Standard introduces a fair value model to agriculture accounting which is a major shift away from the traditional cost model widely applied in primary industry.

Ind AS 41 Agriculture sets out the accounting for agricultural activity, the management of the transformation of biological assets (living plants and animals) into agricultural produce (harvested product of the entity's biological assets). The standard generally requires biological assets to be measured at fair value less costs to sell.

Ind AS 41 addresses following key critical issues:

- (a) When should a biological asset or agricultural produce be recognised on the Balance Sheet?
- (b) At what value should a recognised biological asset or agricultural produce be measured?
- (c) How should the differences in value of a recognised biological asset or agricultural produce be accounted for between two different reporting dates?
- (d) What should be the key disclosures?



1.2 SCOPE

1. This Standard shall be applied to account for the following when they **relate to agricultural activity**:
 - (a) biological assets;
 - (b) agricultural produce at the point of harvest; and
 - (c) government grants
2. **Ind AS 41 does not apply to:**
 - (a) land related to agricultural activity : for example, the land on which the biological assets grow, regenerate and/or degenerate (Ind AS 16 *Property, Plant and Equipment* and Ind AS 40 *Investment Property*);
 - (b) bearer plants related to agricultural activity. Such bearer plants are covered within the scope of Ind AS 16, Property, plant and Equipment and is accounted as per the provisions of that standard. However, this Standard applies to the produce on those bearer plants.

- (c) government grants related to bearer plants (Ind AS 20 *Accounting for Government Grants and Disclosure of Government Assistance*).
- (d) intangible assets associated with the agricultural activity, for example licenses and rights are covered under Ind AS 38 *Intangible Assets* and provisions of this standard will be applicable.
- (e) right-of-use assets arising from a lease of land related to agricultural activity (Ind AS 116, *Leases*).

This Standard is applied to agricultural produce, which is the **harvested product** of the entity's biological assets, **only at the point of harvest**. Thereafter, Ind AS 2 or another applicable Standard is applied.

Examples 1 & 2

1. Processing of grapes into wine by a vintner who has grown the grapes. While such processing may be a logical and natural extension of agricultural activity, and the events taking place may bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity in this Standard.
2. Agriculture produces after the point of harvest, for example Wool, meat, fruit, rubber, logs that are processed subsequently are not covered within purview of this standard and Ind AS 2 *Inventories* shall apply.

The table below provides examples of biological assets, agricultural produce, and products that are the result of processing after harvest:

Biological assets	Agricultural produce	Products that are the result of processing after harvest
Sheep	Wool	Yarn, carpet
Trees in a timber plantation	Felled Trees	Logs, lumber
Dairy Cattle	Milk	Cheese
Pigs	Carcass	Sausages, cured hams
Cotton plants	Harvested cotton	Thread, clothing
Sugarcane	Harvested cane	Sugar
Tobacco plants	Picked leaves	Cured tobacco
Tea bushes	Picked leaves	Tea
Grape vines	Picked grapes	Wine
Fruit trees	Picked fruit	Processed fruit
Rubber trees	Harvested latex	Rubber products

Some plants, for example, tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are within the scope of Ind AS 16, *Property, plant and Equipment*. However, the produce growing on bearer plants, for example, tea leaves, grapes, oil palm fruit and latex, are within the scope of Ind AS 41.



1.3 RELEVANT DEFINITIONS

The following are the key Agriculture-related definitions:

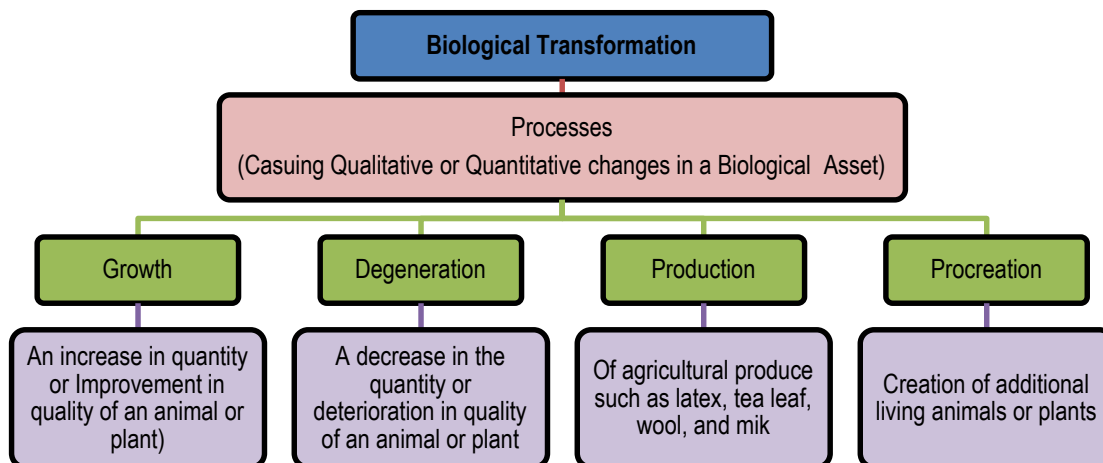
- (a) **Agricultural activity** refers to the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

The standard states that 'agricultural activity' covers a wide range of activities, e.g. 'raising livestock, forestry, annual or perennial cropping, cultivating orchards and plantations, floriculture, and aquaculture (including fish farming)'. Nevertheless, these agricultural activities have certain common features:

- I. **Capability to change** Living animals and plants are capable of biological transformation;
- II. **Management of change** Management facilitates biological transformation by enhancing, or at least stabilising, conditions necessary for the process to take place (for example, nutrient levels, moisture, temperature, fertility, and light). Such management distinguishes agricultural activity from other activities. For example, harvesting from unmanaged sources (such as ocean fishing and deforestation) is not agricultural activity; and
- III. **Measurement of change** The change in quality (for example, genetic merit, density, ripeness, fat cover, protein content, and fibre strength) or quantity (for example, progeny, weight, cubic metres, fibre length or diameter, and number of buds) brought about by biological transformation or harvest is measured and monitored as a routine management function.

Ind AS 41 does not deal with the processing of agricultural produce after harvest. The standard makes it clear that, even if the processing is considered 'a logical and natural extension of agricultural activity, and the events taking place bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity'. For example, the process of brewing beer – in which yeast (a fungus) converts sugars into alcohol – would not meet the definition of agricultural activity in the standard. Similarly, cheese production would fall outside the definition of agricultural activity.

- (b) **Biological Asset** is defined as a living animal or plant.
- (c) **Biological transformation** comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in biological asset.



- (d) **Agricultural produce** is the harvested product of the entity's biological assets.

Ind AS 41 only applies to agricultural produce (i.e. harvested produce) at the point of harvest; not prior or subsequent to harvest. Under Ind AS 41, unharvested agricultural produce is considered to be part of the biological asset from which it will be harvested. Therefore, before harvest, agricultural produce should not be accounted for separately from the biological asset from which it comes. For example, milk is accounted for as part of the dairy cow right up to the moment at which the cow is milked.

Subsequent to harvest, agricultural produce is accounted for under Ind AS 2 or another standard, if applicable. Under Ind AS 2, agricultural produce is initially recognised as inventory at its fair value less costs to sell (measured in accordance with Ind AS 41), which becomes its cost for Ind AS 2 purposes.

- (e) **Harvest** is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.
- (f) **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 definition of Fair value is as given in Ind AS 113, Fair Value Measurement)
- (g) **Costs to sell** are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. Therefore, of all the costs that are necessary for a sale to occur, costs to sell include those that would otherwise not arise. Examples of costs to sell could include brokers' and dealers' commissions, levies by regulatory agencies and commodity exchanges, transfer taxes and duties.
- (h) **Bearer plant** may be defined as a living plant that:
- is used in the production or supply of agricultural produce;
 - is expected to bear produce for more than one period; and

- iii. has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

All of the above criteria need to be met for a plant to be considered a bearer plant.

The definition captures plants that would intuitively be considered to be bearers, for instance, grape vines. Some plants that may appear to be consumable, such as the root systems of perennial plants (e.g. sugar cane, bamboo or asparagus), but due to the perennial nature of their root systems, they are expected to meet the definition of a bearer plant.

Annual crops and other plants that are held solely to be harvested as agricultural produce (e.g. many traditional arable crops such as maize, wheat and soya, as well as trees grown for lumber), are explicitly excluded from the definition of a bearer plant. In addition, plants that have a dual use (i.e. plants cultivated to bear agricultural produce, but for which there is more than remote likelihood that the plant itself will be harvested and sold as agricultural produce, beyond incidental scrap sales) are not bearer plants. This may be the case when, for example, an entity holds rubber trees to sell both the latex as agricultural produce and the trees as lumber.

For example, tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are outside the scope of Ind AS 41 and covered under Ind AS 16.

However, produce growing on bearer plant is a biological asset.

This is important to note here that animals are not covered in the definition of the bearer plants. For example, Sheep, Cows etc are not bearer plants.

Illustration 1

ABC Ltd grows vines, harvests the grapes and produces wine. Which of these activities are in the scope of Ind AS 41?

Solution

The grape vines are bearer plants that continually generate crops of grapes which are covered by Ind AS 16, *Property, Plant and Equipment*.

When the entity harvests the grapes, their biological transformation ceases and they become agricultural produce covered by Ind AS 41, *Agriculture*.

Wine involves a lengthy maturation period. This process is similar to the conversion of raw materials to a finished product rather than biological transformation hence treated as inventory in accordance with Ind AS 2, *Inventories*.



1.4 RECOGNITION OF ASSETS

Entities are required to recognise a biological asset or agricultural produce when, and only when, all of the following conditions are met:

- a) the entity controls the asset as a result of past events;

Control over biological assets or agricultural produce may be evidenced by legal ownership or rights to control, for example legal ownership of cattle and the branding or otherwise marking of the cattle on acquisition, birth, or weaning.

- b) it is probable that future economic benefits associated with the asset will flow to the entity; and

Future economic benefits are expected to flow to the enterprise from its ownership or control of the asset. The future benefits are normally assessed by measuring the significant physical attributes.

- c) the fair value or cost of the asset can be measured reliably.



1.5 MEASUREMENT

Biological Asset should be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except for the case where the fair value cannot be measured reliably.

There is a presumption that fair value can be measured reliably for a biological asset. In the following cases biological asset should be measured at its cost less any accumulated depreciation and any accumulated impairment losses in accordance with Ind AS 2, Ind AS 16 and Ind AS 36:

- quoted market prices are not available for the biological assets and;
- alternative fair value measurements are determined to be clearly unreliable.

Once the fair value of such a biological asset becomes reliably measurable, an entity shall measure it at its Fair value less costs to sell.

The presumption can be rebutted only on initial recognition. An entity that has previously measured a biological asset at its fair value less costs to sell continues to measure the biological asset at its fair value less costs to sell until disposal.

In all cases, an entity measures agricultural produce at the point of harvest at its fair value less costs to sell. This Standard reflects the view that the fair value of agricultural produce at the point of harvest can always be measured reliably.

Agricultural produce harvested from an entity's biological assets should be measured at its fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying Ind AS 2 or another applicable Standard.

The fair value measurement of a biological asset or agricultural produce may be facilitated by grouping biological assets or agricultural produce according to significant attributes; for example, by age or quality. An entity selects the attributes corresponding to the attributes used in the market as a basis for pricing.

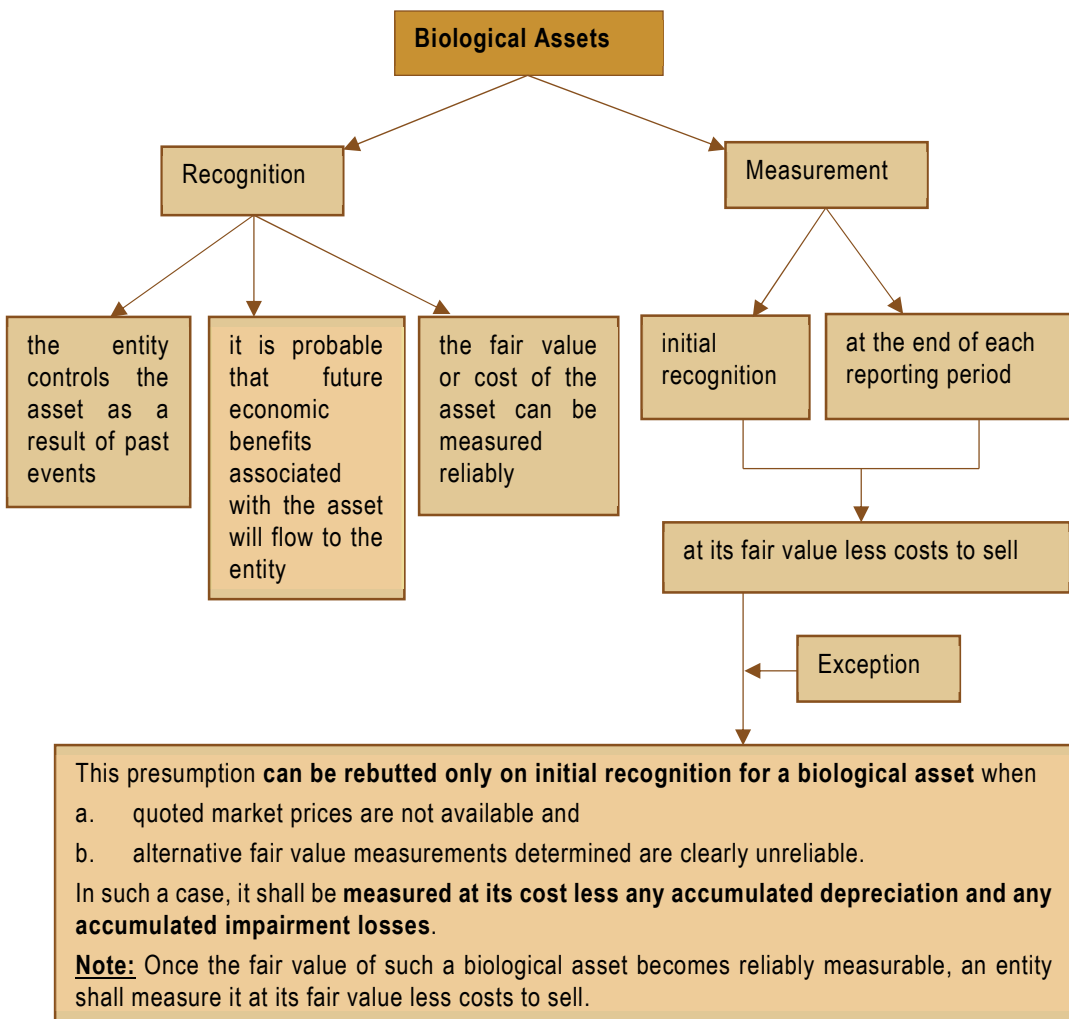
The fair value less cost to sell of a biological asset can change due to both physical changes and price changes in the market.

Entities often enter into contracts to sell their biological assets or agricultural produce at a future date. Contract prices are not necessarily relevant in measuring fair value, because fair value reflects the current market conditions in which market participant buyers and sellers would enter into a transaction. As a result, the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract.

Cost may sometimes approximate fair value, particularly when:

- a) little biological transformation has taken place since initial cost incurrence (for example, for fruit tree seedlings planted immediately prior to the end of a reporting period or newly acquired livestock); or
- b) the impact of the biological transformation on price is not expected to be material (for example, for the initial growth in a 30-year pine plantation production cycle)

Biological assets are often physically attached to land (for example, trees in a plantation forest). There may be no separate market for biological assets that are attached to the land but an active market may exist for the combined assets, that is, the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to measure the fair value of the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

**Note:**

Once a **non-current** biological asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale) as per Ind AS 105, it is presumed that fair value can be measured reliably.

Illustration 2

A farmer owned a dairy herd, of three years old cattle as at 1st April, 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 31st March, 20X2 was ₹ 60 per cattle. The fair value of four-year cattle as at 31st March, 20X2 is ₹ 75 per cattle.

Calculate the measurement of group of cattle as at 31st March, 20X2 stating price and physical change separately.

Solution

Particulars	Amount (₹)
Fair value as at 1 st April, 20X1	13,750
Increase due to Price change $[250 \times \{60 - (13,750/250)\}]$	1,250
Increase due to Physical change $[250 \times \{75-60\}]$	<u>3,750</u>
Fair value as at 31 st March, 20X2	<u>18,750</u>

At the end of reporting period 31st March 20X2

Biological Asset (Cattle A/c)	Dr.	5,000	
To Gain – Change in value (P/L A/c)			5,000

(Being change in value of Cattle recognised at the end of the reporting period)

Illustration 3

XYZ Ltd., on 1st December, 20X3, purchased 100 sheep from a market for ₹ 5,00,000. The transaction cost of 2% on the market price of the sheep was incurred which was paid by the seller. Sheep's fair value increased from ₹ 500,000 to ₹ 600,000 on 31st March, 20X4. Transaction cost of 2% would have to be incurred by the seller to get the sheep to the relevant market.

Determine the fair value on the date of purchase and the reporting date and pass necessary journal entries thereon.

Solution

The fair value less cost to sell of sheep's on the date of purchase would be ₹ 4,90,000 (5,00,000-10,000). Expense of ₹ 10,000 would be recognised in profit and loss.

On date of Purchase

Biological Asset	Dr.	4,90,000	
Loss on initial recognition	Dr.	10,000	
To Bank			5,00,000

(Being biological asset purchased)

On 31st March, 20X4 sheep 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

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)



1.6 GAINS AND LOSSES

1) Biological Asset:

A gain or loss arising on initial recognition of a Biological Asset at Fair value less costs to sell and from a change in Fair value less costs to sell of a biological asset shall be included in Profit or Loss for the period in which it arises.

A loss may arise on initial recognition of a biological asset, because cost to sell are deducted in determining fair value less cost to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

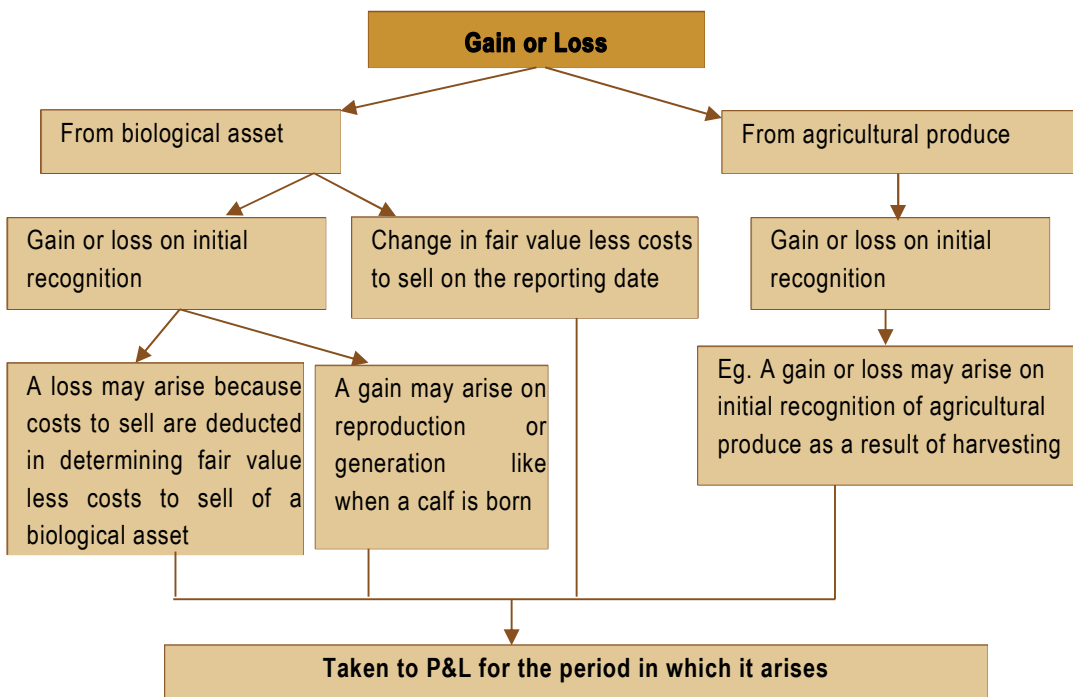
Example 3

During the reporting period 20X1-20X2, an entity is having a cow which has given birth to a calf. The fair value less estimated cost to sell for a calf is ₹ 5,000. The amount of ₹ 5,000 is, therefore, immediately recognised in the Statement of Profit and Loss.

2) Agriculture Produce:

A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in profit or loss for the period in which it arises.

A gain or loss may arise on initial recognition of agricultural produce as a result of harvesting.





1.7 GOVERNMENT GRANTS

1) Biological Asset measured at fair value less cost to sell:

a) Unconditional Grant:

An unconditional government grant related to a biological asset measured at its fair value less costs to sell shall be recognised in profit or loss when, and only when, the government grant becomes receivable.

b) Conditional Grant:

If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met.

Terms and conditions of government grants vary. For example, a grant may require an entity to farm in a particular location for five years and require the entity to return the entire grant if it farms for a period shorter than five years. In this case, the grant is not recognised in profit or loss until the five years have passed. However, if the terms of the grant allow part of it to be retained according to the time elapsed, the entity recognises that part in profit or loss as time passes.

Example 4

Sun Ltd cultivated a huge plot of land. The government offers a grant of ₹ 10 crore under the condition that the land is being cultivated for 5 years. If the land will be cultivated for a shorter period, the entity is required to return the entire grant.

Therefore, the government grant will be recognised as income only after 5 years of cultivation. The situation would be different if the returning obligation referred to the years of not cultivating the land is with respect to retention of grant for the period till which the entity has cultivated the land. In this case, the amount of ₹ 10 crore would be recognised as income, proportionately with the time period, meaning ₹ 2 crore per annum.

2) Biological Asset measured at its cost:

If a government grant relates to a Biological Asset measured at its cost less any accumulated depreciation and any accumulated impairment losses i.e. (i.e. inability to measure fair value reliably), Ind AS 20 is applied.

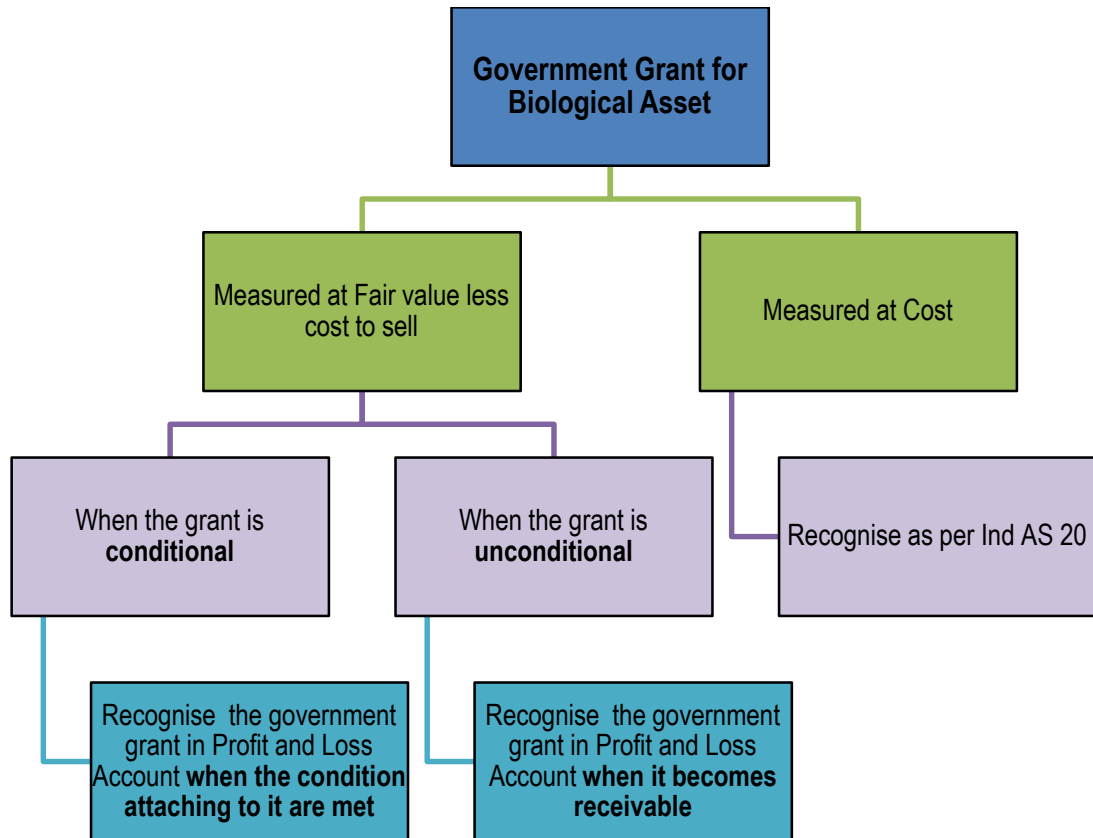


Illustration 4

Agro Foods Ltd. runs a poultry farm business. It has received a government grant from the government for setting up a new poultry unit in a backward area. Agro Foods Ltd used the amount of government grants to buy the first batch of broiler birds, incubators etc. The broiler birds are measured at fair value less costs to sell. However, the incubator machine is measured as per the cost model in Ind AS 16.

As such there are no conditions attached to the release of the government grants pertaining to purchase of poultry birds. However, as regards the investment in incubators and other related plant and machinery items, the government grant contains a condition that the plant and machinery item should be used for a minimum period of 3 years. The useful life of the incubator machine has also been determined to be 3 years in accordance with the management estimate of the time period over which the economic benefits embedded in the incubator machine shall be consumed.

Advise the accounting requirements prescribed in Ind AS 41 Agriculture and Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance in respect of both the government grants?

Solution

Ind AS 41 requires an unconditional government grant related to a biological asset measured at its fair value less costs to sell to be recognised in profit or loss when, and only when, the government grant becomes receivable. Accordingly, the amount of government grant attributable to the broiler birds which qualify as a biological bird shall be recognized in profit or loss account when the grant becomes receivable.

If a government grant is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity should recognize the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met. This provision of Ind AS 41 is not applicable as we have been informed that there are no conditions attached to the release of the government grant pertaining to broiler birds. In the given case, the grant related to broiler birds has already been received for the purpose of providing immediate financial support to the entity with no future related conditions to be fulfilled. Accordingly, the grant relating to broiler birds is to be recognized in profit and loss in the period in which it is received.

If a government grant relates to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses, the entity applies Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance. The incubator machine does not qualify as a biological asset as it is specifically covered by Ind AS 16 which states that plant and machinery items used to develop or maintain biological assets is covered by Ind AS 16. Therefore, the provisions relating to Government grants contained in Ind AS 41 will not apply to the incubator machine. Therefore, we have to apply directly the provisions contained in IAS 20. Ind AS 20 contains two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to assets are regarded as acceptable alternatives:

- One method recognises the grant as deferred income that is recognized in profit or loss on a systematic basis over the useful life of the asset.
- The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognized in profit or loss over the life of a depreciable asset as a reduced depreciation expense.

Therefore, the grant relating to incubator machine will have to be accounted as a deferred income that is recognized in Profit or loss on a systematic basis over a period of 3 years in line with the condition attached to the grant. Alternatively, the grant may be deducted in determining the carrying amount of the incubator. In such a case the grant is recognised in Profit or Loss over the 3-year useful life of the depreciable incubator machine as a reduced depreciation expense.



1.8 DISCLOSURE

1) Description of biological assets and activities.

The entity is required to provide a description of each group of biological assets. This disclosure may take the form of a narrative or quantified description. An entity is encouraged to provide a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate.

2) Gains and losses recognised during the period.

An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.

3) Reconciliation of changes in biological assets.

A detailed reconciliation is required of changes in the carrying amount of biological assets between the beginning and the end of the current period, which includes:

- a) gain or loss arising from changes in fair value less costs to sell;
- b) increases arising from purchases;
- c) decreases attributable to sales and biological assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105;
- d) decreases due to harvest;
- e) increases resulting from business combinations;
- f) net exchange differences arising on the translation of financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity; and
- g) other changes.

4) Restricted assets, commitments and risk management strategies.

The entity should disclose:

- a) the existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities;

- b) the amount of commitments for the development or acquisition of biological assets; and
- c) financial risk management strategies related to agricultural activity.

5) Additional disclosures when fair value cannot be measured reliably.

If biological assets within the scope of Ind AS 41 are measured at cost less any accumulated depreciation and any accumulated impairment losses at the end of the period, the following disclosures are required:

- a) a description of the biological assets;
- b) an explanation of why fair value cannot be measured reliably;
- c) the range of estimates within which fair value is highly likely to lie;
- d) the depreciation method used;
- e) the useful lives or the depreciation rates used; and
- f) the gross carrying amount and the accumulated depreciation and impairment losses at the beginning and end of the period.

6) Government grants

The following disclosures are required for government grants relating to agricultural activity:

- a) the nature and extent of government grants recognised;
- b) unfulfilled conditions and other contingencies attaching to government grants; and
- c) significant decreases expected in the level of government grants.

Illustration 5

Moon Ltd prepares financial statements to 31st March, each year. On 1st April 20X1 the company carried out the following transactions:

- *Purchased a land for ₹ 50 Lakhs.*
- *Purchased 200 dairy cows (average age at 1st April, 20X1 is 2 years) for ₹ 10 Lakhs.*
- *Received a grant of ₹ 1 million towards the acquisition of the cows. This grant was non-refundable.*

For the year ending 31st 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 1st October, 20X1, 100 calves were born. There were no other changes in the number of animals during the year ended 31st March, 20X2. As of 31st 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 st April, 20X1	1 st October, 20X1	31 st 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 Balance Sheet and Statement of Profit and Loss that would be reflected in the financial statements of the entity for the year ended 31st March, 20X2.

Solution

Extract from the Statement of Profit & Loss

	WN	Amount
Income		
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	<u>72,000</u>
Total Income		<u>13,02,000</u>
Expenses		
Maintenance Costs	WN 2	6,00,000
Breeding Fees	WN 2	<u>4,00,000</u>
Total Expense		<u>(10,00,000)</u>
Net Income		<u>3,02,000</u>

Extracts from Balance Sheet

Property, Plant and Equipment:		
Land	WN 1	50,00,000
Biological assets other than bearer plants:		
Dairy Cow	WN 2	11,00,000
Calves	WN 4	<u>1,30,000</u>
		62,30,000
Inventory:		
Milk	WN 5	<u>72,000</u>
		72,000

Working Notes:

1. **Land:** The purchase of the land is not covered by Ind AS 41. The relevant standard which would apply to this transaction is Ind AS 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 Ind AS 41 the mature cows would be recognised in the Balance Sheet at 31st March, 20X2 at the fair value of 200 x ₹ 5,500 = ₹ 11,00,000.
Increase in price change $200 \times (5,200 - 5,000) = 40,000$
Increase in physical change $200 \times (5,500 - 5,200) = 60,000$
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 Ind AS 20. Under Ind AS 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 $100 \times ₹ 1,300 = ₹ 1,30,000$ recognised in the Balance Sheet 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 $3,000 \times ₹ 24 = ₹ 72,000$. This is regarded as 'cost' for the future application of Ind AS 2 to the unsold milk.



1.9 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Avanti Feeds Limited' for the financial year 2021-2022 with respect to 'Biological assets', and its accounting policy.

Balance Sheet as at 31st March, 2022

(All amounts in Lakhs in Indian Rupees, unless otherwise stated)

Particulars	Note No.	As at 31 st March, 2022	As at 31 st March, 2021
ASSETS			
Non-current Assets			
Property, Plant and Equipment	3	14,622.48	15,586.59
Capital work-in-progress	3	2,312.85	12.26
Intangible assets	4	7.15	11.27
Right-of-use Assets	5(a)	177.95	132.05
Financial assets			
Investments	6(a)	20,702.54	19,703.81
Loans	7(a)	60.81	72.97
Other financial assets	8	645.08	570.88
Non-current tax assets (net)	20(b)	1,642.37	1,589.54
Other non-current assets	9 (a)	779.52	2.94
Total Non-current Assets		40,950.75	37,682.31
Current Assets			
Inventories	10 (a)	71,467.25	31,333.73
Biological Assets	10 (b)	84.14	66.25

10 b) Biological Assets

Particulars	As at 31 st March, 2022	As at 31 st March, 2021
Biological Assets (Refer note below)	84.14	66.25
Note:		
Brood stock	51.93	66.25
Post Larval	32.21	-
	84.14	66.25
Reconciliation of changes in the carrying amount of biological assets:		
Particulars	As at 31 st March, 2022	As at 31 st March, 2021
As at beginning of the year	66.25	-
Increase due to purchase/production/physical change	742.00	1,182.44
Decrease due to Physical change/sales	724.11	1,116.19
Net change in the Fair value less estimated cost to sell	84.14	66.25

ACCOUNTING POLICY**Biological Assets**

The Company recognises biological assets only when, the Company controls the assets as a result of past events, it is probable that future economic benefits associated with such assets will flow to the Company. Biological assets of the Company are in the nature of Consumable Biological Assets. It is bifurcated into Brood Stock, (the Parents) and harvested species which undergo biological transformation under different stages as nauplius, Zoea, Mysis and Post Larvae. The Company sells the biological assets harvested from brood stock at nauplius and Post Larvae Stages. The Brood Stock has a maximum useful life of 6 months for laying eggs, and thereafter these are destroyed.

The valuation of the Brood stock biological assets are determined on the following basis:

Brood stock are used for captive consumption or to support farmers, it cannot be sold before the end of its useful life and as such, there is no active market. Other references to market prices such as market prices for similar assets are also not available due to the uniqueness of the breed. Valuation based on a discounted cash flow method is considered to be unreliable given the uncertainty with respect to mortality rates and production. Consequently, brood stock and Shrimp seed (Different stages) are measured at cost, less depreciation and impairment losses.

The transmission phase from nauplius to Zoea and Mysis are not considered as significant transformation of biological asset and hence Zoea and Mysis are not valued as per Ind AS 41.

The Company recognises other biological assets at the fair value or cost of the assets that can be measured reliably. Expenditure incurred on biological assets are measured on initial recognition and at the end of each reporting period at its fair value less costs to sell. The gain or loss arising from a change in fair value less costs to sell the biological assets are included in Statement of Profit and Loss for the period in which it arises.

Management estimates the fair value less costs to sell of biological assets, taking into account the most reliable evidence available at each reporting date. The future realization of these biological assets may be affected by their survival rate, age and / or other market - driven changes that may reduce the future economic benefits associated with such assets. The fair value is arrived at based on the observable market prices of biological assets adjusted for cost to sells, as applicable.

(Source: Annual Report 2021-2022 – Avanti Feeds Limited')

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. Entity A purchased cattle at an auction on 30th June 20X1

Purchase price at 30 th June 20X1	₹ 1,00,000
Costs of transporting the cattle back to the entity's farm	₹ 1,000
Sales price of the cattle at 31 st March, 20X2	₹ 1,10,000

The company would have to incur similar transportation costs if it were to sell the cattle at auction, in addition to an auctioneer's fee of 2% of sales price. The auctioneer charges 2% of the selling price, from both, the buyer as well as the seller.

Calculate the amount at which cattle is to be recognised in books on initial recognition and at year end 31st March, 20X2. Show corresponding journal entries.

2. XY Ltd. is a farming entity where cows are milked on a daily basis. Milk is kept in cold storage immediately after milking and sold to retail distributors on a weekly basis. On 1st April 20X1, XY Ltd. had a herd of 500 cows which were all three years old.

During the year, some of the cows became sick and on 30th September 20X1, 20 cows died. On 1st October 20X1, XY Ltd. purchased 20 replacement cows from the market for ₹ 21,000 each. These 20 cows were all one-year old when they were purchased.

On 31st March 20X2, XY Ltd. had 1,000 litres of milk in cold storage which had not been sold to retail distributors. The market price of milk at 31st March 20X2 was ₹ 20 per litre. When selling the milk to distributors, XY Ltd. incurs selling costs of ₹ 1 per litre. These amounts did not change during March 20X2 and are not expected to change during April 20X2.

Information relating to fair value and costs to sell is given below:

Date	Fair value of a dairy cow (aged)				Costs to sell a cow
	1 year	1.5 years	3 years	4 years	
1 st April 20X1	20,000	22,000	27,000	25,000	1,000
1 st October 20X1	21,000	23,000	28,000	26,000	1,000
31 st March 20X2	21,500	23,500	29,000	26,500	1,100

The fair value of a 3.5 years old cow on 1st October 20X1 is ₹ 27,000.

Pass necessary journal entries of above transactions with respect to cows in the financial statements of XY Ltd. for the year ended 31st March, 20X2? Also show the amount lying in inventory if any.

- Company X purchased 100 goats at an auction for ₹ 1,00,000 on 30th September 20X1. Subsequent transportation costs were ₹ 1,000 that is similar to the cost X would have to incur to sell the goat at the auction. Additionally, there would be a 2% selling fee on the market price of the goat to be incurred by the seller.

On 31st March 20X2, the market value of the goat in the most relevant market increases to ₹ 1,10,000. Transportation costs of ₹ 1,000 would have to be incurred by the seller to get the goat to the relevant market. An auctioneer's fee of 2% on the market price of the goat would be payable by the seller.

On 1st June 20X2, X sold 18 goats for ₹ 20,000 and incurred transportation charges of ₹ 150. In addition, there was a 2% auctioneer's fee on the market price of the goat paid by the seller.

On 15th September 20X2, the fair value of the remaining goat was ₹ 82,820. 42 goats were slaughtered on that day, with a total slaughter cost of ₹ 4,200. The total market price of the carcasses on that day was ₹ 48,300, and the expected transportation cost to sell the carcasses is ₹ 420. No other costs are expected.

On 30th September 20X2, the market price of the remaining 40 goat was ₹ 44,800. The expected transportation cost is ₹ 400. Also, there would be a 2% auctioneer's fee on the market price of the goat payable by the seller.

Pass Journal entries for the initial and subsequent measurement for all above transactions. Interim reporting periods are of 30th September and 31 March and the company determines the fair values on these dates for reporting.

4. On 1st November, 20X1, C Agro Ltd. purchased 100 goats of special breed from a market for ₹ 10,00,000 with a transaction cost of 2%. Goats fair value decreased from ₹ 10,00,000 to ₹ 9,00,000 as on 31st March, 20X2.

Determine the fair value on the date of purchase and as on financial year ended 31st March, 20X2 under both the cases viz-

- (i) the transaction costs are borne by the seller and
- (ii) the transaction costs are incurred by the seller and purchaser both

Also pass journal entries under both the situations on both dates.

5. Analyse whether the following activities fall within the scope of Ind AS 41 with proper reasoning:
- Managing animal-related recreational activities like Zoo
 - Fishing in the ocean
 - Fish farming
 - Development of living organisms such as cells, bacteria and viruses
 - Growing of plants to be used in the production of drugs
 - Purchase of 25 dogs for security purpose of the company's premises.

Answers

1. Initial recognition of cattle

	₹
Fair value less costs to sell (₹ 1,00,000 – ₹ 1,000 - ₹ 2,000)	97,000
Cash outflow (₹ 1,00,000 + ₹ 1,000 + ₹ 2,000)	1,03,000
Loss on initial recognition	6,000
<i>Cattle Measurement at year end</i>	
Fair value less costs to sell (₹ 1,10,000 – 1,000 – (2% x 1,10,000))	1,06,800

At 31st March, 20X2, the cattle is measured at ₹ 1,06,800 i.e. fair value less cost to sell (transportation ₹ 1,000 and the estimated auctioneer's fee of ₹ 2,200). The estimated transportation costs of getting the cattle to the auction of ₹ 1,000 are deducted from the sales price in determining fair value.

Journal Entries on 30th June, 20X1

(All figures in ₹)

Biological Asset (Cattle A/c)	Dr.	97,000	
Loss on initial recognition	Dr.	6,000	
To Bank (Purchase and cost of transportation on purchase paid by buyer)			1,03,000
(Being biological asset purchased)			

Journal Entries on 31st March, 20X2

(All figures in ₹)

Biological Asset (Cattle A/c)	Dr.	9,800	
To Gain on remeasurement (P/L A/c)			9,800
(Subsequent measurement of cattle at fair value less costs to sell)			

2.

Journal Entries on

(All figures in ₹)

30 th September 20X1	Loss (on death of 20 cows) (W.N.)	Dr.	5,20,000	
	To Biological asset			5,20,000
	(Loss booked on death of 20 cows)			
1 st October 20X1	Biological Asset (purchase of 20 new cows) (W.N.)	Dr.	4,00,000	
	Loss on initial recognition (of 20 new cows)	Dr.	20,000	
	To Bank			4,20,000
	(Initial recognition of 20 new purchased cows at fair value less costs to sell)			
1 st October 20X1	Loss on remeasurement of old cows	Dr.	2,88,000	
	To Biological asset [(1,30,00,000 – 5,20,000) – 1,21,92,000]			2,88,000
	(Subsequent measurement of cows at fair value less costs to sell)			

Biological Asset (4,48,000 – 4,00,000)	Dr.	48,000	
To Gain on remeasurement of new cows			48,000
(Subsequent measurement of cows at fair value less costs to sell)			

Inventory (Milk) as at 31st March, 20X2 = ₹ 19,000 [1,000 x (20 – 1)].

Working Note:

Calculation of Biological asset at various dates

Date	Number	Age	Fair Value (₹)	Cost to Sell (₹)	Net (₹)	Biological asset (₹)
1 st April 20X1	500	3 years	27,000	1,000	26,000	1,30,00,000
30 th September 20X1	(20)	3.5 years	27,000	1,000	26,000	(5,20,000)
1 st October 20X1	20	1 year	21,000	1,000	20,000	<u>4,00,000</u>
						<u>1,28,80,000</u>
31 st March 20X2	480	4 years	26,500	1,100	25,400	1,21,92,000
	20	1.5 years	23,500	1,100	22,400	<u>4,48,000</u>
						<u>1,26,40,000</u>

3. Value of goat at initial recognition (30th September 20X1) (All figures are in ₹)

Biological asset (goat)	Dr.	97,000*	
Loss on initial recognition	Dr.	4,000	
To Bank (Purchase and cost of transportation on purchase paid by buyer)			1,01,000
(Initial recognition of goat at fair value less costs to sell)			

*Fair value of goat = 1,00,000 – 1,000 – 2,000 (2% of 1,00,000) = 97,000

Subsequent measurement at 31st March 20X2 (All figures are in ₹)

Biological Assets (Goat)	Dr.	9,800	
To Gain on Sale (Profit & Loss)			9,800
(Subsequent measurement of Goat at fair value less costs to sell (1,06,800** – 97,000))			

** Fair value of goat = 1,10,000 – 1,000 – 2,200 (2% of 1,10,000) = 1,06,800

Sale of goat on 1st June 20X2

(All figures are in ₹)

Biological Assets (Goats)	Dr.	226	
To Gain on Sale (Profit & Loss)			226
(Subsequent re-measurement of 18 goats at fair value less costs to sell just prior to the point at which they are sold [19,450 - {(1,06,800/100) x 18}])			
Cost to Sales (20,000 – 400 {i.e. 2% of 20,000} – 150)	Dr.	19,450	
To Biological Assets (Goats)			19,450
(Recording a cost of sales figure separately with a corresponding reduction in the value of the biological assets)			
Bank	Dr.	19,450	
Selling expenses (150 + 400)	Dr.	550	
To Revenue			20,000
(Recognition of revenue from sale of goat)			

Transfer of Goat to Inventory on 15th September 20X2

(All figures are in ₹)

Inventory (48,300 - 420)	Dr.	47,880	
Loss on remeasurement	Dr.	1,176	
To Biological Asset (Goats)			44,856 [#]
To Bank (Slaughtering cost)			4,200
(Transfer of goat to inventory)			

[#]Note: 44,856 is calculated as the proportion of goat sold using the fair value [(1,06,800 + 226 – 19,450) x 42/82]

Subsequent measurement of goat at 30th September 20X2

(All figures are in ₹)

Biological Asset (Goats)	Dr.	784	
To Gain on remeasurement			784
(Subsequent measurement of goat at fair value less costs to sell [43,504 ^{##} – {(1,06,800 + 226 – 19,450) – 44,856}])			

^{##}Fair value of goat = 44,800 – 400 – 896 (2% of 44,800) = 43,504.

- As per para 12 of Ind AS 41, a biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell. Therefore, regardless of who bears the transaction costs, the transaction costs of 2% are the costs to sell the goats on 1st November 20X1, and therefore, the goats should be measured at their fair value less costs to sell on initial recognition date, i.e., ₹ 9,80,000.

Journal Entry**As on 1st November 20X1:**

(h) Where transaction costs are borne by the seller:

Biological assets (Goats) A/c	Dr.	9,80,000	
Loss on purchase of biological assets (Goats) A/c	Dr.	20,000	
To Bank A/c			10,00,000

(ii) Where transaction costs are borne by the seller and buyer both:

Biological assets (Goats) A/c	Dr.	9,80,000	
Loss on purchase of biological asset (Goats) A/c	Dr.	40,000	
To Bank A/c			10,20,000

As on 31st March 20X2 – under both the scenarios:

Loss on fair valuation of biological assets A/c	Dr.	98,000	
To Biological assets (Goats) A/c			98,000
[9,80,000 - (9,00,000 - 18,000)]			

5.

Activity	Whether in the scope of Ind AS 41?	Remarks
Managing animal-related recreational activities like Zoo	No	Since the primary purpose is to show the animals to public for recreational purposes, there is no management of biological transformation but simply control of the number of animals. Hence it will not fall in the purview of considered in the definition of agricultural activity.
Fishing in the ocean	No	Fishing in ocean is harvesting biological assets from unmanaged sources. There is no management of biological transformation since fish grow naturally in the ocean. Hence, it will not

		fall in the scope of the definition of agricultural activity.
Fish farming	Yes	Managing the growth of fish and then harvest for sale is agricultural activity within the scope of Ind AS 41 since there is management of biological transformation of biological assets for sale or additional biological assets.
Development of living organisms such as cells, bacteria viruses	Analysis required	The development of living organisms for research purposes does not qualify as agricultural activity, as those organisms are not being developed for sale, or for conversion into agricultural produce or into additional biological assets. Hence, development of such organisms for the said purposes does not fall under the scope of Ind AS 41. However, if the organisms are being developed for sale or use in dairy products, the activity will be considered as agricultural activity under the scope of Ind AS 41.
Growing of plants to be used in the production of drugs	Yes	If an entity grows plants for using it in production of drugs, the activity will be agricultural activity. Hence it will come under the scope of Ind AS 41.
Purchase of 25 dogs for security purposes of the company's premises	No	Ind AS 41 is applied to account for the biological assets when they relate to agricultural activity. Guard dogs for security purposes do not qualify as agricultural activity, since they are not being kept for sale, or for conversion into agricultural produce or into additional biological assets. Hence, they are outside the scope of Ind AS 41.

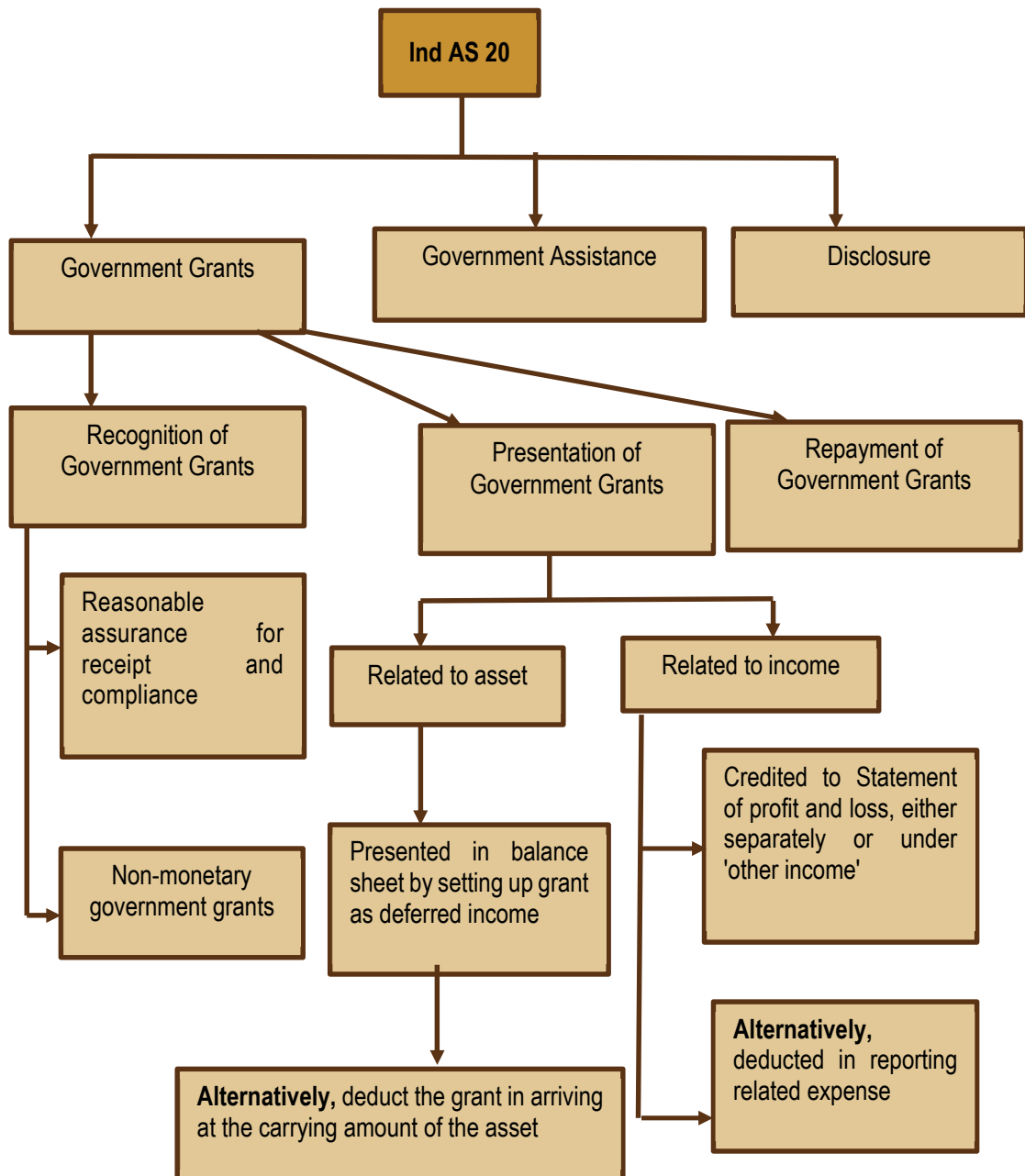
UNIT 2 : INDIAN ACCOUNTING STANDARD 20: ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ☐ Interpret the principles for recognition of government grant including non-monetary grants
- ☐ Recommend presentation requirements of grants related to assets and income
- ☐ Account for repayment of government grants

UNIT OVERVIEW





2.1 INTRODUCTION

The government gives grants to entities for various purposes including for industrial, geographic and social development, to facilitate the flow of foreign investments, to promote entrepreneurship, as subsidies to reduce the prices of goods and services offered by these entities.

The grant could be in different forms, e.g., monetary or non-monetary government grants.

Government grants may be significant for an entity and require appropriate treatment in the books of accounts and disclosures in the financial statements to facilitate comparison with other entities and with prior periods. Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, provides guidance on this.



2.2 SCOPE

2.2.1 Applicability

Ind AS 20 should be applied for:

- (a) accounting and disclosure of government grants; and
- (b) disclosure of other forms of government assistance.

2.2.2 Non-applicability

Ind AS 20 does not deal with:

- (a) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature;
- (b) government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability;

Examples of such benefits are income tax holidays, investment tax credits, accelerated depreciation.

- (c) government participation in the ownership of the entity;
- (d) government grants that will be covered by Ind AS 41, *Agriculture*.



2.3 DEFINITIONS

The following definitions are relevant for the purpose of understanding of Ind AS 20:

1. **Government** refers to government, government agencies and similar bodies whether local, national or international.

2. **Government assistance** is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government assistance for the purpose of Ind AS 20 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 assistance does not include the provision of infrastructure by improvement to the general transport and communication network and 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.

Government assistance takes many forms varying both in the nature of the assistance given and in the conditions which are usually attached to it. The purpose of the assistance may be to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided.

The receipt of government assistance by an entity may be significant for the preparation of the financial statements for two reasons:

- Firstly, if resources have been transferred, an appropriate method of accounting for the transfer must be found.
- Secondly, it is desirable to give an indication of the extent to which the entity has benefited 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.

Examples 1-4 : Government assistance

1. Free technical assistance or marketing advice and the provision of guarantees are forms of government assistance to which no value could reasonably be assigned.
2. An example of transactions with government which cannot be distinguished from the normal trading transactions of the entity is a government procurement policy that is responsible for a portion of the entity's sales. The existence of the benefit might be unquestioned but any attempt to segregate the trading activities from government assistance could well be arbitrary.
3. **Assistance in the form of priority bidding status:** The government specifies that entities below a certain size are to be given priority in bidding for a particular type of government contract by mandating a minimum number of such entities to obtain bidding status. Although the entities will benefit from the quota, the value cannot be identified, and the effects of the assistance cannot be segregated from the trading activities of the entities.

4. **Assistance in the form of credit facilities at market rates:** Three governments that amongst themselves own over 50% of the shares in an airline, participate in granting it a revolving credit facility at a market rate of interest. This is not a government grant as a loan is provided at market rate of interest which any private market participant might have accepted. However, it is government assistance as the benefit cannot be distinguished from normal trading activities of the airline.

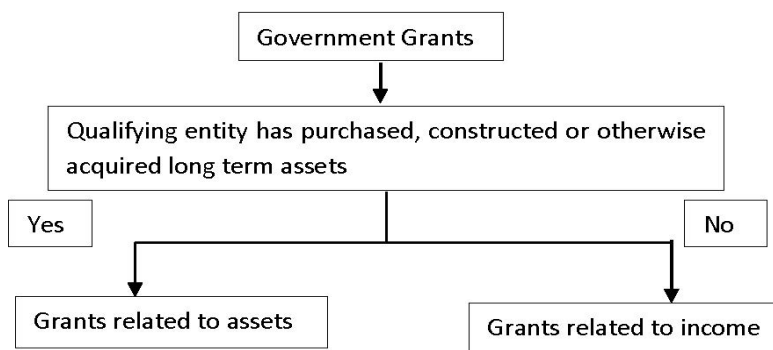
The significance of the benefit in the above examples may be such that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading.

3. **Government grants** are assistance by the 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.

They 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.

Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

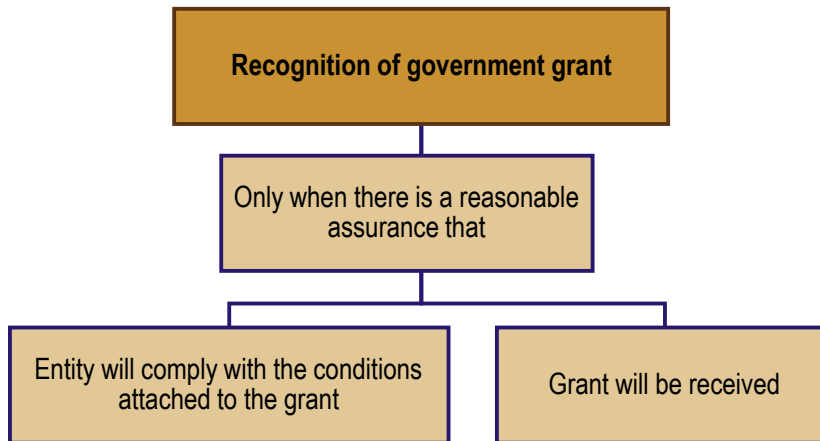
4. **Grants related to assets** are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.
5. **Grants related to income** are government grants other than those related to assets.



6. **Forgivable loans** are loans which the lender undertakes to waive repayment of under certain prescribed conditions.
7. **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 (Ind AS 113, *Fair Value Measurement*).



2.4 RECOGNITION OF GOVERNMENT GRANTS



Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

- (a) the entity will comply with the conditions attaching to them; and
- (b) the grants will be received.

A government grant is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

Illustration 1

Government gives a grant of ₹ 10,00,000 for past research of H1N1 vaccine to A Pharmaceuticals Limited. There is no condition attached to the grant.

Examine how this government grant be recognised in the books of A Pharmaceuticals Limited.

Solution

The entire grant should be recognised immediately in the statement of profit and loss.

Illustration 2

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 this government grant be recognised assuming that A Pharmaceuticals Limited has reasonable assurance that the conditions attached to the grant will be complied with.

Solution

The entire grant should be recognised immediately as deferred income and charged to profit or loss over a period of two years.

Illustration 3

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 this government grant be recognised.

Solution

A Limited will recognise ₹ 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 Ind AS 20.

Once a government grant is recognised, any related contingent liability or contingent asset is treated in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government or in the form of a non-monetary asset.

2.4.1 Forgivable loan

A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

2.4.2 Loans at less than market rate of interest

The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan should be recognised and measured in accordance with Ind AS 109, *Financial Instruments*. The benefit of the below-market rate of interest should be measured as the difference between the initial carrying value of the loan determined in accordance with

Ind AS 109 and the proceeds received. The benefit is accounted for in accordance with Ind AS 20. The entity should 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.

Illustration 4

A Limited received from the government a loan of ₹ 50,00,000 @ 5% payable after 5 years in a bullet 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 recognised.

Solution

The fair value of the loan is calculated at ₹ 37,38,328 (refer Working Note).

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 ₹ 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	
			12,61,672
			37,38,328

₹ 12,61,672 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognise as expenses the related costs for which the grant is intended to compensate. (see Illustration 5 in this regard).

Working Note:

Particulars	Amount (₹)	Discounting factor	Present value taking 12% as the discount rate (₹)
Interest @ 5% for Year 1 on loan amount of ₹ 50 lakhs	2,50,000	0.893	2,23,214
Interest @ 5% for Year 2 on loan amount of ₹ 50 lakhs	2,50,000	0.797	1,99,298
Interest @ 5% for Year 3 on loan amount of ₹ 50 lakhs	2,50,000	0.712	1,77,945
Interest @ 5% for Year 4 on loan amount of ₹ 50 lakhs	2,50,000	0.636	1,58,880
Interest @ 5% for Year 5 on loan amount of ₹ 50 lakhs	2,50,000	0.567	1,41,857
Loan	50,00,000	0.567	28,37,134
Present value of loan at the beginning of Year 1			37,38,328

The above present value above has been computed on full scale basis.



2.5 ACCOUNTING OF GOVERNMENT GRANT

There are two approaches to the accounting of government grant: 'capital approach' or 'income approach'. Under capital approach, a grant is recognised outside profit or loss, i.e., grant is credited directly to equity whereas under the income approach grant is recognised in profit or loss over one or more periods.

The Standard rejects the capital approach and prescribes only the income approach despite the following arguments in favour of capital approach:

- government grants are a financing device and should be dealt with as such in the balance sheet rather than be recognised in profit or loss to offset the items of expense that they finance. Since no repayment is expected, such grants should be recognised outside profit or loss.
- it is inappropriate to recognise government grants in profit or loss, because they are not earned but represent an incentive provided by government without related costs.

The income approach has been prescribed because of the following arguments in its favour:

- because government grants are receipts from a source other than shareholders, they should not be recognised directly in equity but should be recognised in profit or loss in appropriate periods.
- government grants are rarely gratuitous. The entity earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be recognised in

profit or loss over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

- (c) since income and other taxes are expenses, it is logical to deal also with government grants, which are an extension of fiscal policies, in profit or loss.

Principle:

Thus, government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

In most cases the periods over which an entity recognises the costs or expenses related to a government grant are readily ascertainable. Thus grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.

Illustration 5

Continuing with the facts given in the Illustration 4, 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

₹ 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 - ₹ 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, ₹ 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 - ₹ 12,61,672 will be recognised in profit or loss on the same basis as depreciation.

2.5.1 Whether receipts basis permissible

Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (Ind AS 1, *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received.

2.5.2 Grants related to non-depreciable assets

Grants related to non-depreciable assets 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.

Example 5

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.

2.5.3 Conditional Grants received as part of a package of financial or fiscal aids

In such cases, care is needed in identifying the conditions giving rise to costs and expenses which determine the periods over which the grant will be earned. It may be appropriate to allocate part of a grant on one basis and part on another.

2.5.4 Grant for expenses or losses already incurred and grant as an immediate financial support

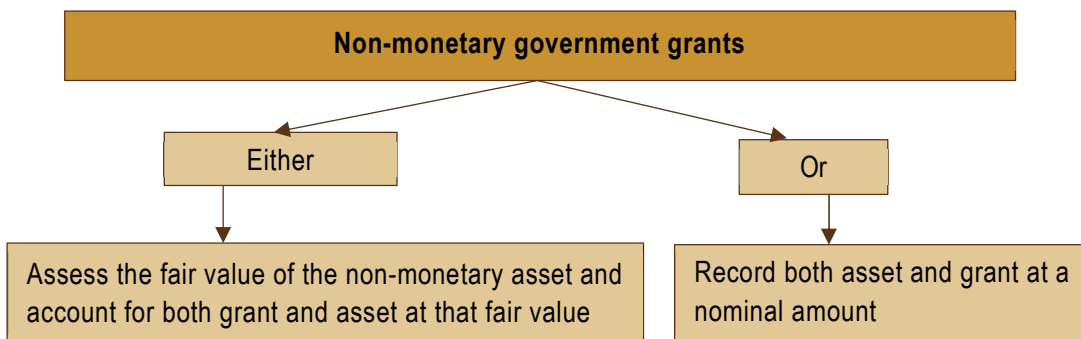
A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs should be recognised in profit or loss of the period in which it becomes receivable.

In some circumstances, a government grant may be awarded for the purpose of giving immediate financial support to an entity rather than as an incentive to undertake specific expenditures. Such grants may be confined to a particular entity and may not be available to a whole class of beneficiaries. These circumstances may warrant recognising a grant in profit or loss of the period in which the entity qualifies to receive it, with appropriate disclosures to ensure that its effect is clearly understood.

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.

2.5.5 Non-monetary government grants

A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. In these circumstances the fair value of the non-monetary asset is assessed and both grant and asset are accounted for at that fair value. Alternatively, an entity may measure both asset and grant at nominal value.

**Illustration 6**

A Limited wants to establish a manufacturing unit in a backward area and requires 5 acres of land. The government provides the land on a leasehold basis at a nominal value of ₹ 10,000 per acre. The fair value of the land is ₹ 100,000 per acre.

Calculate the amount of the government grant to be recognized by an entity.

Solution

A limited will recognise the land at fair value of ₹ 5,00,000 and ₹ 450,000 [(₹ 100,000 – ₹ 10,000) x 5] as government grant. This government grant should be presented in the balance sheet by setting up the grant as deferred income.

Alternatively, the land may be recognised by A Ltd. at nominal value of ₹ 50,000 (₹ 10,000 x 5).

2.5.6 Government Assistance – No Specific relation to Operating Activities

In some countries government assistance to entities may be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the entity.

Examples of such assistance are transfers of resources by governments to entities which:

- (a) operate in a particular industry;
- (b) continue operating in recently privatised industries; or
- (c) start or continue to run their business in underdeveloped areas.

The issue is whether such government assistance is a 'government grant' within the scope of Ind AS 20 and, therefore, should be accounted for in accordance with Ind AS 20.

In this regard, Appendix A to Ind AS 20 provides that government assistance to entities meets the definition of government grants in Ind AS 20, even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or

industry sectors. Such grants should therefore not be credited directly to shareholders' interests and should be recognised in profit or loss on a systematic basis.



2.6 PRESENTATION OF GRANTS RELATED TO ASSETS

2.6.1 Presentation in the Balance Sheet

Government grants related to assets should be presented in the balance sheet by setting up the grant as deferred income. The non-monetary grants at fair value should be presented in a similar manner.

Alternatively, it can be presented in the balance sheet by deducting the grant in arriving at the carrying amount of the asset.

The grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset.

The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognised in profit or loss over the life of a depreciable asset as a reduced depreciation expense.

Illustration 7

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.

Examine how the Government grant be realized.

Solution

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.

Alternatively, A Ltd. may deduct ₹ 50,00,000 from the cost of solar panel of ₹ 1,00,00,000.

2.6.2 Disclosure in the statement of cash flows

The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and in order to show the gross investment in assets, such movements are disclosed as separate items in the statement of cash flows. This presentation is done irrespective of the fact that the grant is deducted or not from the related asset, for the purpose of presentation in the balance sheet.

Illustration 8

Continuing with the facts given in Illustration 7 above, state how the same will be disclosed in the Statement of cash flows.

Solution

A Limited will show ₹ 1,00,00,000 being acquisition of solar panels as outflow in investing activities. The receipt of ₹ 50,00,000 from government will be shown as inflow under investing activities.

**2.7 PRESENTATION OF GRANTS RELATED TO INCOME**

Two methods are prescribed for presentation of grants related to income. The grant could be

- (a) (first method) presented as a credit in the statement of profit and loss, either separately or under a general heading such as 'Other income'; or
- (b) (second method) deducted in reporting the related expense.

The first method lays its foundation on the base:

- (a) that it is inappropriate to net income and expense items and
- (b) that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant.

It is argued for the second method:

- (a) that the expenses might well not have been incurred by the entity if the grant had not been available; and
- (b) thus, presentation of the expense without offsetting the grant may therefore be misleading.

Both methods are regarded as acceptable for the presentation of grants related to income. Disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense which is required to be separately disclosed is usually appropriate.

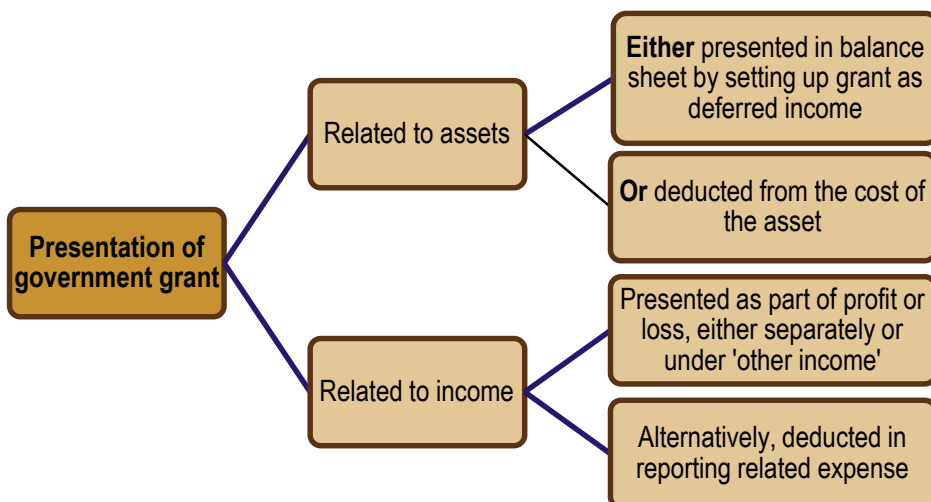


Illustration 9

A Ltd. received a government grant of ₹ 10,00,000 to defray expenses for environmental protection. Expected environmental costs to be incurred is ₹ 3,00,000 per annum for the next 5 years.

Determine the presentation of such grant related to income in the financial statements of A Ltd.?

Solution

As per paragraph 29 of Ind AS 20, grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense.

In accordance with the above, presentation of grants related to income under both the methods are as follows:

Method 1: Credit in the statement of profit and loss

The entity can recognise the grant as income on a straight line basis i.e., ₹ 2,00,000 per year in the statement of profit and loss either separately or under the head "Other Income".

The supporters of this method consider it inappropriate to present income and expense items on a net basis and that 'separation of the grant from the expense facilitates comparison with other expenses not affected by a grant'.

Method 2: As a deduction in reporting the related expense

Since the grant relates to environmental expenses incurred/to be incurred by the entity, it can present the grant by reducing the grant amount every year from the related expense i.e., environmental expense of ₹ 1,00,000 (i.e., net expense ₹ 3,00,000 – ₹ 2,00,000).

The supporters of this method are of the view that 'the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting

the grant may therefore be misleading'.

The Standard regards both the methods as acceptable for the presentation of grants related to income. However, method 2 may be more appropriate when the company can relate the grant to a specific expenditure.

The Standard also provides that disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense which is required to be separately disclosed is usually appropriate.



2.8 REPAYMENT OF GOVERNMENT GRANTS

An entity may have to repay the government grant including in cases where conditions related to the grant are not fulfilled by it.

A government grant that becomes repayable should be accounted for as a change in accounting estimate and be treated in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Repayment of a grant related to income

The following steps should be followed in repayment of a grant related to income:

- (a) The repayment should be applied first against any unamortised deferred credit recognised in respect of the grant.
- (b) To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment should be recognised immediately in profit or loss.

The repayment of a grant related to an asset should be recognised either by reducing the deferred income balance by the amount repayable or by increasing the carrying amount of the asset.

Repayment of government grant

Related to income

First applied towards any unapplied deferred credit and then charged to profit and loss account immediately

Related to asset

***Either** recognised by increasing the carrying amount of the asset
 *The cumulative additional depreciation that would have been recognised in profit or loss to date in the absence of the grant shall be recognised immediately in profit or loss.
 * Check the possible impairment of the new carrying amount of the asset.

Or by reducing the deferred income balance by the amount payable

Illustration 10

A Ltd. has received a grant of ₹ 10,00,00,000 in the year 20X1-20X2 from local government in the form of subsidy for selling goods at lower price to lower income group population in a particular area for two years. A Ltd. had accounted for the grant as income in the year 20X1-20X2. While accounting for the grant in the year 20X1-20X2, A Ltd. was reasonably assured that all the conditions attached to the grant will be complied with. However, in the year 20X5-20X6, it was found that A Ltd. has not complied with the above condition and therefore notice of refund of grant has been served to it. A Ltd. has contested but lost in court in 20X5-20X6 and now grant is fully repayable. The accounting done in previous years was not incorrect and was not an error as per Ind AS 8.

Analyse how should A Ltd. reflect repayable grant in its financial statements ending 20X5-20X6?

Solution

Paragraph 32 of Ind AS 20, states that a government grant that becomes repayable shall be accounted for as a change in accounting estimate (see Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors).

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.

The following journal entries should be passed:

S. No.	Particulars	Nature of Account		Amount (₹ in crores)
(i)	Repayment of Government Grant To Grant repayable (Being recognition of repayment of grant in statement of profit or loss)	Expense (P/L) Balance sheet (Liability)	Dr.	10 10
(ii)	Grant repayable To Bank (Being grant refunded)	Balance sheet (Liability) Balance sheet (Asset)	Dr.	10 10

Assuming that no deferred credit balance exists in the year 20X5-20X6, therefore repayment recognised in P&L.



2.9 DISCLOSURE

The following should be disclosed:

- the accounting policy adopted for government grants;
- the methods of presentation adopted for government grants in the financial statements;
- the nature and extent of government grants recognised in the financial statements;
- an indication of other forms of government assistance from which the entity has directly benefited. At times, the significance of the benefit of government assistance may be such that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading; and
- unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.



2.10 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITIES

Following is the extract from the financial statements of the listed entity 'Hindustan Unilever Limited' for the financial year 2021-2022 with respect to 'Government Grants'.

Government grants:

The Company has received approval under the Production Linked Incentive Scheme of the Government of India for specific product categories. Incentive under the scheme is subject to meeting certain committed investments and defined incremental sales threshold. Such grants are recognised as other operating revenue when there is a reasonable assurance that the Company will comply with all necessary conditions attached to that.

Income from such grants is recognised on a systematic basis over the periods to which they relate.

	Year ended 31st March, 2022	Year ended 31st March, 2021
Sale of products	50,336	45,311
Other operating revenue*		
Income from services rendered	281	225
Commission income on consignment sales	315	264
Government grants (GST budgetary support and Production linked incentives) #	140	108
Others (including scrap sales, rentals, etc)	121	88
Total	51,193	45,996

Previous period figures have been re-classified from Others for better presentation

(Source: Annual Report 2021-2022 – Hindustan Unilever Limited)



2.11 SIGNIFICANT DIFFERENCES BETWEEN IND AS 20 AND AS 12

S. No.	Particulars	Ind AS 20	AS 12
1.	Monetary grants related to non-depreciable assets	Taken to the statement of profit and loss assuming that all grants have conditions attached to it. Specifically prohibits recognition of grants directly in the shareholders' funds	Credited as capital reserve which is part of shareholder's funds. If such grant requires fulfilment of certain obligations, credit the grant amount to income over the same period over which the cost of meeting such obligations is charged to income.
2.	Non-monetary	Accounted for at fair value	Accounted for on the basis

	government grant given at a concessional rate	or at nominal value	of their acquisition cost Non-monetary assets given free of cost are recorded at a nominal value
3.	Grants in the nature of promoter's contribution	Ind AS 20 does not recognise government grants of the nature of promoters' contribution. As stated at (1) above, Ind AS 20 is based on the principle that all government grants would normally have certain obligations attached to them and it, accordingly, requires all grants to be recognised as income over the periods which bear the cost of meeting the obligation.	To be credited to capital reserve and to be treated as part of shareholders' funds
4.	Loan received from the government at below-market rate of interest	Measured in accordance with Ind AS 109 (which requires all loans to be recognised at fair value, thus requiring interest to be imputed to loans with a below-market rate of interest)	AS 12 does not deal with such cases
5.	Government assistance not falling within the definition of government grants	Requires an indication of other forms of government assistance from which the entity has directly benefited and should be disclosed in the financial statements	Does not deal with such government assistance

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

- 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 further 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].
 - Two acres of land (fair Value: ₹ 10 Lakhs) received for set up of plant.
 - ₹ 2 lakhs received for purchase of machinery of ₹ 10 lakhs. Useful life of machinery is 5 years. Depreciation on this machinery is to be charged on straight-line basis.

Recommend how should ABC Ltd. recognise the government grants in its books of accounts.

- 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 recognised. 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.

- MNC Ltd. has received grant in the nature of exemption of custom duty on capital goods with certain conditions related to export of goods under Export Promotion Capital Goods (EPCG) scheme of Government of India.

State whether the same is a government grant under Ind AS 20, Government Grants and Disclosure of Government Assistance? If yes, then how the same is to be accounted for if it is

- (a) A grant related to asset; or
- (b) A grant related to income.

4. ABC Ltd is a government company and is a first-time adopter of Ind AS. As per the previous GAAP, the contributions received by ABC Ltd. from the government (which holds 100% shareholding in ABC Ltd.) which is in the nature of promoters' contribution have been recognised in capital reserve and treated as part of shareholders' funds in accordance with the provisions of AS 12, Accounting for Government Grants.

State whether the accounting treatment of the grants in the nature of promoters' contribution as per AS 12 is also permitted under Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance.

5. Rainbow Limited carries out various projects for which it has either received government financial assistance or is in the process of receiving the same. The company has received two grants of ₹ 1,00,000 each, relating to the following ongoing research and development projects:
- (i) The first grant relates to the "Clean river project" which involves research into the effect of various chemicals waste from the industrial area in Madhya Pradesh. However, no major steps have been completed by Rainbow limited to commence this research as at 31st March, 20X2.
 - (ii) The second grant relates to the commercial development of a new equipment that can be used to manufacture eco-friendly substitutes for existing plastic products. Rainbow Limited is confident about the technical feasibility and financial viability of this new technology which will be available for sale in the market by April 20X3.

In September 20X1, due to the floods near one of its factories, the entire production was lost and Rainbow Limited had to shut down the factory for a period of 3 months. The State Government announced a compensation package for all the manufacturing entities affected due to the floods. As per the scheme, Rainbow Limited is entitled to a compensation based on the average of previous three months' sales figure prior to the floods, for which the company is required to submit an application form on or before 30th June, 20X2 with necessary figures. The financial statements of Rainbow Limited for the year ended 31st March 20X2 are to be adopted on 31st May, 20X2, by which date the claim form would not have been filed with the State Government.

Suggest the accounting treatment of, if any, for the two grants received and the flood-related compensation in the books of accounts of Rainbow Limited as at 31st March, 20X2.

6. An entity opens a new factory and receives a government grant of ₹ 15,000 in respect of capital equipment costing ₹ 1,00,000. It depreciates all plant and machinery at 20% per annum on straight-line basis.

Show the statement of profit and loss and balance sheet extracts in respect of the grant for first year under both the methods as per Ind AS 20.

7. A company receives a cash grant of ₹ 30,000 on 31st March 20X1. The grant is towards the cost of training young apprentices. Training programme is expected to last for 18 months starting from 1st April 20X1. Actual costs of the training incurred in 20X1-20X2 was ₹ 50,000 and in 20X2-20X3 ₹ 25,000.

State, how this grant should be accounted for.

8. Entity A is awarded a government grant of ₹ 60,000 receivable over three years (₹ 40,000 in year 1 and ₹ 10,000 in each of years 2 and 3), contingent on creating 10 new jobs and maintaining them for three years. The employees are recruited at a total cost of ₹ 30,000, and the wage bill for the first year is ₹ 1,00,000, rising by ₹ 10,000 in each of the subsequent years.

Calculate the grant income and deferred income to be accounted for in the books for the years 1, 2 and 3 under the following two situations:

- (a) There is reasonable assurance that the entity will comply with the conditions attaching to them and the grant will be received
- (b) There is no reasonable assurance that the grant will be received.

Answers

1. ABC Ltd. should recognise the grants in the following manner:

- ₹ 20 lakhs have been received for immediate start-up of business. This should be recognised in Statement of Profit and Loss immediately as there are no further 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.
- Land should be recognised at fair value of ₹ 10 lakhs and government grant should be presented in the balance sheet by setting up the grant as deferred income. Alternatively, deduct the amount of grant from the cost of the asset. In the given case, the land is granted at no cost. It will be presented in the books at nominal value.

- ₹ 2 lakhs should be recognised as deferred income and will be transferred to profit and loss over the useful life of the asset. In this case, ₹ 40,000 [₹ 2 lakhs/5] should be credited to profit and loss each year over a period of 5 years. Alternatively, ₹ 2,00,000 will be deducted from the cost of the asset and depreciation will be charged at reduced amount of ₹ 8,00,000 (₹ 10,00,000 – ₹ 2,00,000) every year.

2. The fair value of the loan is calculated at ₹ 74,76,656 (refer Working Note).

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.

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.

Working Note:

Particulars	Rs.	Discounting factor @ 12%	Present value taking 12% as the discount rate (Rs.)
Interest @ 5% for Year 1 on loan amount of ₹ 1 crore	5,00,000	0.893	4,46,429
Interest @ 5% for Year 2 on loan amount of ₹ 1 crore	5,00,000	0.798	3,98,597

Interest @ 5% for Year 3 on loan amount of ₹ 1 crore	5,00,000	0.712	3,55,890
Interest @ 5% for Year 4 on loan amount of ₹ 1 crore	5,00,000	0.636	3,17,759
Interest @ 5% for Year 5 on loan amount of ₹ 1 crore	5,00,000	0.567	2,83,713
Loan	1,00,00,000	0.567	56,74,269
Present value of loan at the beginning of Year 1			<u>74,76,656</u>

The above present value above has been computed on full scale basis.

- Paragraph 3 of Ind AS 20 states that 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. They 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.

In accordance with the above, in the given case exemption of custom duty under EPCG scheme is a government grant and should be accounted for as per the provisions of Ind AS 20.

Ind AS 20 defines grant related to assets and grants related to income as follows:

“Grants related to asset 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.”

Presentation

It is pertinent to note that the classification of the grant as related to asset or income will require exercise of judgement and careful examination of the facts, objective and conditions attached to the scheme of the government. Care is also required to ascertain the purpose of the grant and the costs for which the grant is intended to compensate. Based on the evaluation of facts, if it is ascertained that the grant is an asset related grant then the same shall be presented as per paragraphs 24 and 26 of Ind AS 20 which has been stated below:

Presentation of grants related to assets

As per para 24, government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet by setting up the grant as deferred income.

As per para 26, the grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset.

If it is determined that the grant is related to income then the same shall be presented as follows:

Presentation of grants related to income

As per para 29, grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense.

It may be further noted that as per paragraph 12 of Ind AS 20, government grants shall be accounted as follows:

As per para 12, government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

In the given case, if based on the terms and conditions of the scheme, the grant received is to compensate the import cost of assets subject to an export obligation as prescribed in the EPCG Scheme; recognition of grant in the statement of profit and loss should be linked to fulfilment of associated export obligations.

However, if the grant received is to compensate the import cost of the asset and based on the examination of the terms and conditions of the grant, if it can be reasonably concluded that conditions relating to export of goods are subsidiary conditions, then it is appropriate to recognise such grant in profit or loss over the life of the underlying asset.

4. Paragraph 2 of Ind AS 20, "Accounting for Government Grants and Disclosure of Government Assistance" inter alia states that the Standard does not deal with government participation in the ownership of the entity.

Since ABC Ltd. is a government company, it implies that government has 100% shareholding in the entity. Accordingly, as per Ind AS 20, the entity needs to determine whether the payment is provided as a shareholder contribution or as a government. Equity contributions will be recorded in equity while grants will be shown in the Statement of Profit and Loss.

Where it is concluded that the contributions are in the nature of government grant, the entity shall apply the principles of Ind AS 20 retrospectively as specified in Ind AS 101 'First Time Adoption of Ind AS'. Ind AS 20 requires all grants to be recognised as income on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. Unlike AS 12, Ind AS 20 requires the grant to be classified as either a capital or an income grant and does not permit recognition of government grants in the nature of promoter's contribution directly to shareholders' funds.

5. Accounting treatment for:

1. First Grant

The first grant for 'Clear River Project' involving research into effects of various chemicals waste from the industrial area in Madhya Pradesh, seems to be unconditional as no details regarding its refund has been mentioned. Even though the research has not been started nor any major steps have been completed by Rainbow Limited to commence the research, yet the grant will be recognised immediately in profit or loss for the year ended 31st March, 20X2.

Alternatively, in case, the grant is conditional as to expenditure on research, the grant will be recognised in the books of Rainbow Limited over the year the expenditure is being incurred.

2. Second Grant

The second grant related to commercial development of a new equipment is a grant related to depreciable asset. As per the information given in the question, the equipment will be available for sale in the market from April, 20X3. Hence, by that time, grant relates to the construction of an asset and should be initially recognised as deferred income.

The deferred income should be recognised as income on a systematic and rational basis over the asset's useful life.

The entity should recognise a liability in its balance sheets as at 31st March, 20X2 and 31st March, 20X3. Once the equipment starts getting used in the manufacturing process, the deferred grant income of ₹ 100,000 should be recognised over the asset's useful life to compensate for depreciation costs.

Alternatively, as per Ind AS 20, Rainbow Limited would also be permitted to offset the deferred income of ₹ 100,000 against the cost of the equipment as at 1st April, 20X3.

3. For flood related compensation

Rainbow Limited will be able to submit an application form only after 31st May, 20X2 ie in the year 20X2-20X3. Although flood happened in September, 20X1 and loss was incurred due to flood in the year 20X1-20X2, the entity should recognise the income from the government grant in the year when the application form related to it is submitted and approved by the government for compensation.

Since, in the year 20X1-20X2, the application form could not be submitted due to adoption of financials with respect to sales figure before flood occurred, Rainbow Limited should not recognise the grant income as it has not become receivable as at 31st March, 20X2.

6. (a) When grant is treated as deferred income

Statement of profit and loss – An extract

	₹
Depreciation (₹ 1,00,000 x 20%)	(20,000)
Government grant credit (W.N.1)	3,000

Balance Sheet - An extract

		₹
Non-current assets		
Property, plant and equipment	1,00,000	
Less: Accumulated depreciation	(1,00,000 x 20%) (20,000)	<u>80,000</u>
		<u>XXXX</u>
Non-current liabilities		
Government grant	[12,000 – 3,000 (current liability)]	9,000
Current liabilities		
Government grant	(15,000 x 20%)	<u>3,000</u>
		<u>XXXX</u>

Working Note:

1. Government grant deferred income account

	₹		₹
To Profit or loss (15,000 x 20%)	3,000	By Grant cash received	15,000
To Balance c/f	<u>12,000</u>		
	<u>15,000</u>		<u>15,000</u>

(b) When grant is deducted from cost of the asset

Statement of profit and loss – An extract

	₹
Depreciation [(₹ 1,00,000 – 15,000) x 20%]	(17,000)

Balance Sheet – An extract

		₹
Non-current assets		
Property, plant and equipment	(1,00,000-15,000) 85,000	
Less: Accumulated depreciation	<u>(17,000)</u>	68,000

7. As at 31st March 20X1 the grant would be recognised as a liability (deferred income) and presented in the balance sheet as a split between current and non-current amounts.

₹ 20,000 [(12 months / 18 months) x 30,000] is current which would be recognised in the statement of profit and loss for the year ended 31st March, 20X2. The balance amount of ₹ 10,000 will be shown as non-current.

At the end of year 20X1-20X2, there would be a current balance of 10,000 (being the non-current balance at the end of year 20X1-20X1 reclassified as current) in the balance sheet. This would be recognised in profit in the year 20X2-20X3.

Extracts from the financial statements are as follows:

Balance Sheet (extracts)

	31 March 20X1	31 March 20X2	31 March 20X3
Current liabilities			
Deferred income	20,000	10,000	-
Non-current liabilities			
Deferred income	10,000	-	-

Statement of profit and loss (extracts)

	31 March 20X2	31 March 20X3
Method 1		
Other Income - Government grant received	20,000	10,000
Training costs	(50,000)	(25,000)
Method 2		
Training costs (50,000 – 20,000)	30,000	
Training costs (25,000 – 10,000)		15,000

8. (a) **When there is reasonable assurance**

The grant of ₹ 60,000 should be recognised at the beginning of the first year as receivable and will be compensated for the related costs over three years.

The initial journal entry would be:

Grant Receivable Ac	Dr. ₹ 60,000
To Deferred Income A/c	₹ 60,000

Calculation of grant income and deferred income:

Year	Labour Cost	Grant Income	Computation of Grant Income	Deferred Income at the end of the year	Computation of deferred income at the end of the year
	₹	₹		₹	
1	1,30,000	21,667	$60,000 \times (130/360)$	38,333	$(60,000 - 21,667)$
2	1,10,000	18,333	$60,000 \times (110/360)$	20,000	$(38,333 - 18,333)$
3	<u>1,20,000</u>	<u>20,000</u>	$60,000 \times (120/360)$	-	$(20,000 - 20,000)$
	<u>3,60,000</u>	<u>60,000</u>			

Therefore, grant income to be recognised in the Statement of Profit and Loss for the years 1, 2 and 3 would be ₹ 21,667, ₹ 18,333 and ₹ 20,000 respectively.

The amount of grant that has not yet been credited to the statement of profit and loss i.e. deferred income is to be shown in the balance sheet. Hence deferred income balance as at end of year 1, 2 and 3 are ₹ 38,333, ₹ 20,000 and Nil respectively.

(b) When reasonable assurance is not there

The grant of ₹ 60,000 should be recognised over three years to compensate for the related costs.

The journal entry on receipt of grant at year 1 would be:

Grant Receivable Ac	Dr. ₹ 40,000
To Deferred Income A/c	₹ 40,000

Calculation of Grant Income and Deferred Income:

Year	Labour Cost	Grant Income	Computation of Grant Income	Deferred Income at the end of the year	Computation of deferred income at the end of the year
	₹	₹		₹	
1	1,30,000	21,667	$60,000 \times (130/360)$	18,333	$(40,000 - 21,667)$
2	1,10,000	18,333	$60,000 \times (110/360)$	10,000	$(50,000 - 21,667 - 18,333)$
3	<u>1,20,000</u>	<u>20,000</u>	$60,000 \times (120/360)$	-	$(60,000 - 21,667 - 18,333 - 20,000)$
	<u>3,60,000</u>	<u>60,000</u>			

Therefore, Grant income to be recognised in the statement of Profit and Loss for the years 1, 2 and 3 would be ₹ 21,667, ₹ 18,333 and ₹ 20,000 respectively.

Amount of grant that has not yet been credited to the statement of profit and loss i.e; deferred income is to be shown in the balance sheet. Hence, deferred income balance as at the end of year 1, 2 and 3 are ₹ 18,333, ₹ 10,000 and Nil respectively.

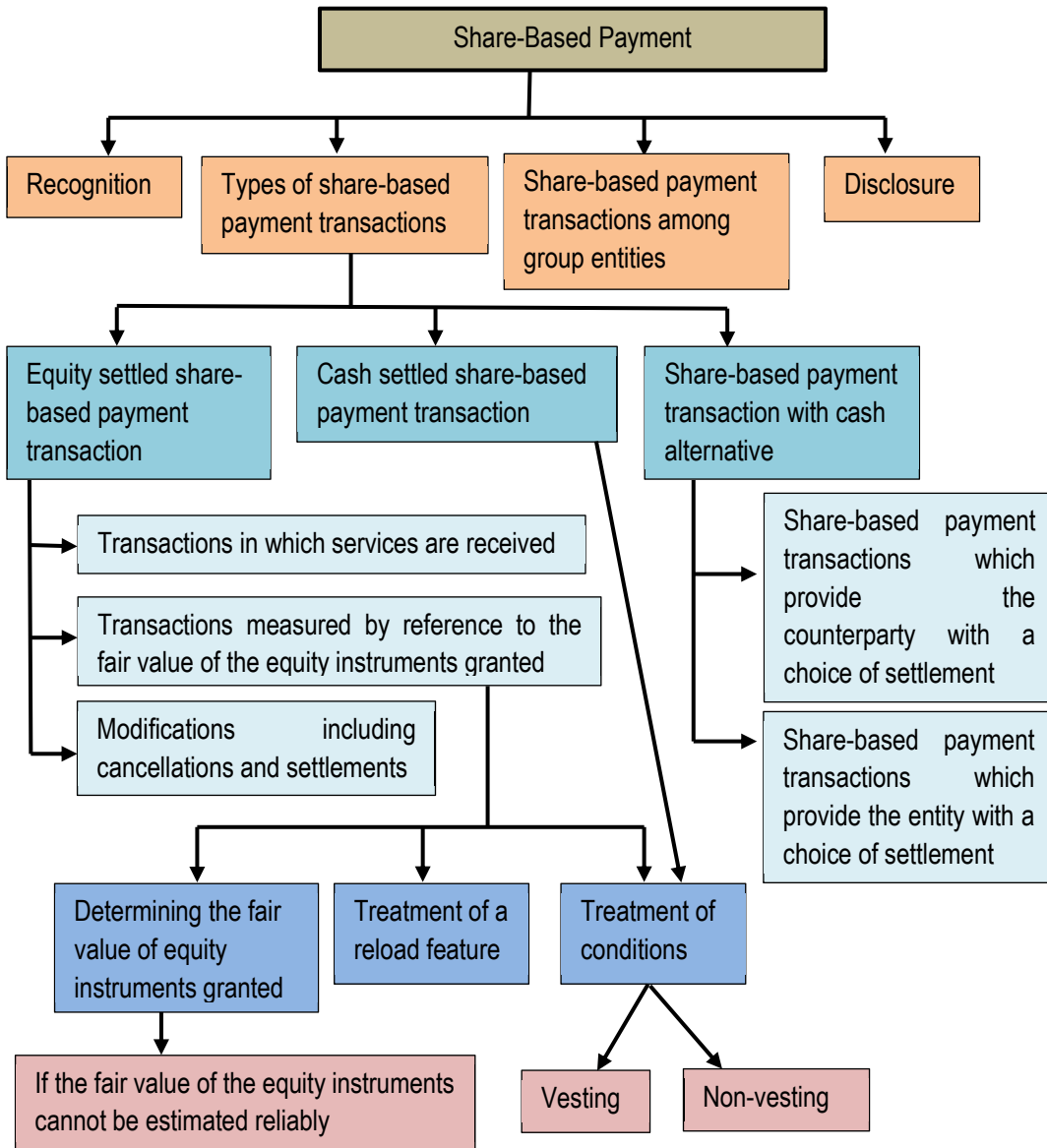
UNIT 3 : INDIAN ACCOUNTING STANDARD 102 : SHARE-BASED PAYMENT

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ☐ Examine the transactions as share-based payment transactions
- ☐ Study the various types of share-based payments
- ☐ Recognize and measure the share-based payment transactions in the books
- ☐ Deal with the accounting issues in case of various vesting conditions attached with the share-based payment transactions
- ☐ Determine the fair value of share-based payment transactions
- ☐ Identify the accounting treatment for modification, cancellation and settlements of such transactions
- ☐ Make necessary and significant disclosures with respect to share-based payment transactions in the financial statements.

UNIT OVERVIEW





3.1 INTRODUCTION



As the name suggests, 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.

In India, accounting of share-based payment transactions is done in accordance with SEBI guidelines and Guidance Note on Accounting for Employee Share-Based Payments or on the basis of Ind AS 102 “Share-Based Payment”. The corporate entities following Ind AS would not account for share-based payment based on Guidance Note. The Companies Act, 2013 also discusses about it under section 62.

Under Section 62 (1) (b) of the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees’ stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.



3.2 DEFINITION

Some of the terms used in Ind AS 102 are as follows:

- a. **Cash-settled share-based payment transaction:** A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services 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.
- b. **Employees and others providing similar services:** Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, i.e. those people having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.

- c. **Equity instrument:** A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
- d. **Equity instrument granted:** The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.
- e. **Equity-settled share-based payment transaction:** A share-based payment transaction in which the entity
 - (a) receives goods or services as consideration for its own equity instruments (including shares or share options), or
 - (b) receives goods or services but has no obligation to settle the transaction with the supplier.
- f. **Fair value:** The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.
- g. **Grant date :** The date at which the entity and another party (including an employee) agree 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 the 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.
- h. **Intrinsic value:** The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a share option with an exercise price of ₹ 15, on a share with a fair value of ₹ 20, has an intrinsic value of ₹ 5.
- i. **Market condition:** A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities.
- j. **Measurement date:** The date at which the fair value of the equity instruments granted is measured for the purposes of this Ind AS. For transactions with employees and others

providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

k. **Performance condition:** A vesting condition that requires:

- (a) the counterparty to complete a specified period of service (ie a service condition); the service requirement can be explicit or implicit; and
- (b) specified performance target(s) to be met while the counterparty is rendering the service required in (a).

The period of achieving the performance target(s):

- (a) shall not extend beyond the end of the service period; and
- (b) may start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

A performance target is defined by reference to:

- (a) the entity's own operations (or activities) or the operations or activities of another entity in the same group (i.e. a non-market condition); or
- (b) the price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group (including shares and share options) (ie a market condition).

A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

- l. **Reload feature:** A feature that provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price.
- m. **Reload option:** A new share option granted when a share is used to satisfy the exercise price of a previous share option.
- n. **Service condition:** A vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. A service condition does not require a performance target to be met.

- o. **Share option:** A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.
- p. **Vest:** To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.
- q. **Vesting condition:** A condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.
- r. **Vesting period:** The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

3.2.1 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.

3.2.2 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.

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.

Example 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 yet to be finalized and the plan is not yet communicated to the employee. Since, there is no formal communication stating the terms or conditions of the agreement, it will not attract Ind AS 102 provisions. The standard will be attracted when there will be a binding arrangement.

2. Share-based payments should be made for goods/ services and should be with an external person e.g. supplier including employee.

Examples 2 & 3

2. Goods/services have 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. Hence, Ind AS 102 will still be applicable for such unidentified goods/ services.
 3. An entity issuing its own shares to a charity without any consideration will be covered under Ind AS 102. This is a share-based payment arrangement, covered under Ind AS 102 (not a share-based payment transaction).
3. Goods/services that are being received by an entity should be from a supplier which will include an employee of the entity. The goods/services received from a counterparty who act in the capacity of shareholder will not be covered under Ind AS 102.

Example 4

Service Maintenance Agreement has been entered by an entity with one of the supplier, outside the entity which requires to pay for these services by issuing equity shares of the entity. Such an agreement will be covered under Ind AS 102.

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.

Example 5

An entity issued right shares to all its shareholders which include employees of the company. Since the employees who have received such shares are acting in the capacity of shareholders and not as employees, this transaction will **not** be covered under Ind AS 102.

5. For receiving goods / services, an entity needs to settle the transaction either by issuing its own equity shares / or group entity's shares (which is called as "equity settled") or by paying cash amount equivalent against such shares (which is called as "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) Redeemable preference shares
 - c) Written call option or warrants over such ordinary shares.
7. Share-based payment transaction may be settled by an entity through 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 and the same transaction will be covered under Ind AS 102.

Example 6

1. A parent issues share options to the employee of its subsidiary company or a subsidiary company issues share options to its employees based on the price of equity shares of its parent company or the subsidiary company respectively. Both the plans will be covered under Ind AS 102.
2. An entity issues certain benefits to its employees by taking a reference of earnings of next year. Since the benefit is not based on share price of the entity, hence this transaction will not be covered under Ind AS 102. However, it may be treated as employee benefits under Ind AS 19.

8. 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 7

A stock option has been issued by an entity to its employees those who remain in service for next 4 years. Those who leave before 4 years will not get the share-based payments. Staying with the organization for 4 years is a vesting condition in order to get the shared based payment.



3.3 SCOPE

3.3.1 What is covered within Ind AS 102?

Based on the analysis of the definitions, the scope of the standard are as follows:



- Covers settlement in equity or in cash or alternative settlement option i.e. to issue shares or by paying cash.
 - 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 Ind AS 102.
 - Un-identified goods/ services that are being received will be covered in the standard.
- 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 and receiving 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.

Examples 8 - 11

8. An entity grants 10 shares to its employees who will remain in service for next 2 years - this will be covered within the standard as equity settled share-based payment.
9. An entity grants ₹ 1,000 to each employee which is same as the current equity price. This will not be covered under Ind AS 102 as the amount of ₹ 1,000 is fixed now and it will be paid to the employees even if the market rate of its share goes up/down from the current level.
10. 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.

11. 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 Ind AS 102.

3.3.2 What is not covered in Ind AS 102?

Transactions with shareholders as a whole, i.e., when the shareholders act solely in their capacity as shareholders.

Example 12

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 Ind AS 102.

- 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 Ind AS 103 'Business Combinations', or contribution for Joint ventures as per Ind AS 111 'Joint Arrangements'.

Examples 13 and 14

13. 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 Ind AS 102.
14. 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. The instruments that are being issued as part of business purchase consideration under Ind AS 103 'Business Combination' will not be covered under Ind AS 102. However, if the equity instrument is being issued in the capacity of accepting employment in a new company, then it will be covered within Ind AS 102.
- Financial instruments issued to buy/sell non-financial items which can be settled at net will be outside Ind AS 102.

Example 15

Contracts for purchase and sale of goods/ services which are entered for settling in net amounts/ or keep it for speculation purposes will be covered under Ind AS 109- Financial Instruments and hence will not be covered under Ind AS 102.



3.4 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.



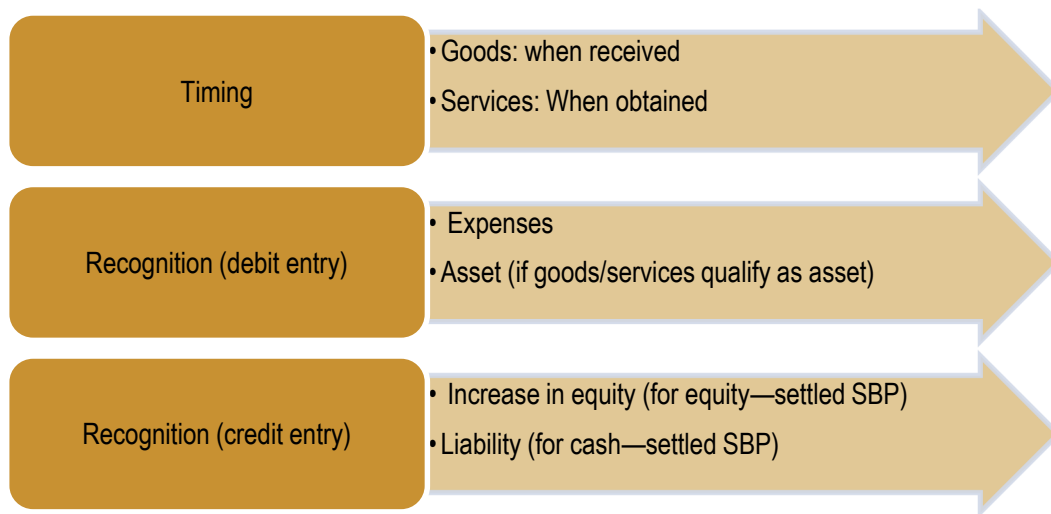
Analysis of recognition of SBP (Share-based payments)

- All such goods / services which are being received in share-based payment will be recognized when such goods are received or services are obtained.
- An entity would recognize an expense or an asset if the goods and/or services received meet the criteria for recognition as an asset.
- A corresponding increase in equity for equity settled transactions or in liabilities for cash-settled transactions would be recognized.
- 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.

Examples 16 and 17

16. An entity purchases some inventory from a supplier for which the entity will issue 100 shares as payment. The fair value of the inventory was ₹ 15,000. On purchase of inventory, the transaction will be recorded by a debit to the inventory and a credit to equity with an amount of ₹ 15,000 i.e. taking fair value of goods / services so transacted (except in case of transactions with an employee). However, if the fair value of goods / services is not reliably measurable, then fair value of shares can be considered.
17. 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 1st January, 20X1. The condition to remain in service shows that the stock option has been given for the

services to be provided in the next 4 years; hence at the end of each year, the entity will estimate the expected number of employees who will remain in service and accordingly will recognize the cost over 4 years.



3.5 TYPES OF SHARE-BASED PAYMENTS

3.5.1 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.

Analysis of the Equity Settled Share-based payments

- As per Ind AS 102, all goods or services which are received by an entity should be fair valued in order to arrive at the transaction price to recognize the share-based payment.
- In the absence of reliable information to arrive at the fair value of goods & services received, the fair value of equity instrument issued will be used.
- In the case of EMPLOYEES, it is required by the standard to use fair value of equity granted because it is practically not possible to identify the fair value of the services rendered by the employees.

- In the case of awards to non-employees, there is a rebuttable presumption that the fair value of goods/services received from any external supplier can be estimated. However, if this is not feasible, then an indirect reference can be used by taking fair value of instruments issued.
- There might be some cases where the transaction is other than with employee, where goods / services received are less than the fair value of equity share issued then some un-identified goods / services are recognized by taking a difference between fair value of equity instruments issued and fair value of goods / services received.

Examples 18 and 19

18. An entity has agreed to issue 100 shares to each of its 500 employees if they remain in service for the next 3 years. In this case 3 years is a service period, on completion of which shares will be issued by the entity. Since this is a share-based payment plan with employees of the entity, the fair value of equity instruments issued will be used for calculating transaction value of the share-based payments.
19. An entity agreed to issue 100 shares to a supplier to provide some consultancy services for next 2 years. There is a similar contract in the market which has a value of ₹ 20,000. The similar value of the contract will be used as fair value of this share-based payment transaction unless there is no reliable fair value is available.

Measurement principle for equity—settled awards:

Counterparty	Measurement basis	Measurement date	Recognition date
Employee	Fair value of equity instruments awarded	Grant date	Date goods or services received
Non-employee	Fair value of goods or services received	Date goods or services received	Date goods or services received

Illustration 1-Equity Settled Shared Based Payment- Service conditions

ABC Limited granted to its employees, share options with a fair value of ₹ 5,00,000 on 1st April, 20X0, if they remain in the organization upto 31st March, 20X3. The exercise price if the share option is NIL. 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 organization at the end of March, 20X3 and all of them exercised their options. Share options will be settled in 5,000 shares of ₹ 100 each.

Pass the Journal entries?

Solution

Period	Proportion	Fair value	To be vested	Cumulative expenses	Expenses
	a	b	c	d= b x c x a	e = d-previous period d
Period 1	1/3	5,00,000	91%	1,51,667	1,51,667
Period 2	2/3	5,00,000	89%	2,96,667	1,45,000
Period 3	3/3	5,00,000	82%	4,10,000	<u>1,13,333</u>
					<u>4,10,000</u>

Journal Entries

31 st March, 20X1			
Employee benefits expenses (transferred to P/L)	Dr.	1,51,667	
To Share-based payment reserve (equity)			1,51,667
(1/3 of expected vested equity instruments value)			
31 st March, 20X2			
Employee benefits expenses (transferred to P/L)	Dr.	1,45,000	
To Share-based payment reserve (equity)			1,45,000
(2/3 of expected vested equity instruments value)			
31 st March, 20X3			
Employee benefits expenses (transferred to P/L)	Dr.	1,13,333	
To Share-based payment reserve (equity)			1,13,333
(Final vested equity instruments value)			
Share-based payment reserve (equity)	Dr.	4,10,000	
To Share Capital/ Securities Premium			4,10,000
(re-allocated and issued shares)			

3.5.2 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.

Analysis of the Cash Settled Share-Based Payments

- It is a plan where entity issues rights to its employees/ suppliers where employees/ suppliers will be entitled for a cash payment in future based on equity share prices of the entity / or equity prices of the Group (group means parent company of the entity). In some cases, right to increase in equity prices is also provided which is known as Share Appreciation Rights (SAR).
- The goods/ services received against share-based payment plan to be settled in cash are measured at fair value of the liability and the liability continues to re-measured at every reporting date until it is actually paid off.
- There could be vesting conditions attached to the share-based payment plans e.g. to remain in service for next 3 years etc. The recognition of such share-based payment plans should be done by recognizing fair value of the liability at the time of goods/ services received and not at the date of grant. The liability so recognized will be fair valued at each reporting date and difference in fair value will be charged to profit or loss for the period.
- There could be some cases where no vesting period / condition is required to be fulfilled, in those cases, cash settled share-based payment can be recognized in full at initial recognition itself.

Examples 20 and 21

20. 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.

21. Management of an entity decides to issue bonus amount to certain key employees for their past services based on share price of the 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.



Illustration 2 - Cash Settled Shared-Based Payment - Service conditions

XYZ issued 10,000 Share Appreciation Rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹ 95. SAR can be exercised any time upto 31st March, 20X3. At the end of period on 31st 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% were exercised at the end of the 3rd year. Fair values at the end of each period have been given below:

<u>Fair value of SAR</u>		₹
31 st March, 20X1		112
31 st March, 20X2		109
31 st March, 20X3		114

Pass the Journal entries?

Solution

Period	Fair value a	To be vested b	Cumulative c= a x b x 10,000	Expense d= c-prev. period c
Start	95	100%	9,50,000	9,50,000
Period 1	112	95%	10,64,000	1,14,000
Period 2	109	92%	10,02,800	(61,200)
Period 3	114	89%	10,14,600	<u>11,800</u>
				<u>10,14,600</u>

Journal Entries

1st April, 20X0			
Employee benefits expenses (transfer to P/L)	Dr.	9,50,000	
To Share-based payment liability			9,50,000
(Fair value of the SAR recognized)			
31st March, 20X1			
Employee benefits expenses (transfer to P/L)	Dr.	1,14,000	
To Share-based payment liability			1,14,000
(Fair value of the SAR re-measured)			

31 st March, 20X2			
Share-based payment liability	Dr.	61,200	
To Employee benefits expenses (transfer to P/L)			61,200
(Fair value of the SAR re-measured & reversed)			
31 st March, 20X3			
Employee benefits expenses (transfer to P/L)	Dr.	11,800	
To Share-based payment liability			11,800
(Fair value of the SAR recognized)			
Share-based payment liability	Dr.	10,14,600	
To Cash			10,14,600
(Settlement of SAR)			

3.5.3 Share-Based Payment Transactions 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.

Analysis of Share-Based Payment Transactions with Cash Alternatives

- The choice either to settle in cash or equity may be with the entity or its counterparty which will define the way of recognizing such alternatives either equity-settled or cash-settled. The choice to select the cash or equity alternatives can be segregated in two parts –
 - 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 and equity components.
 - When such alternatives are given in case of transactions with parties other than employees where fair value of goods / services is measured directly then the difference between fair value of such goods/ services and the fair value of debt

component, at the date when the goods or services are received, will be considered to be the value of equity component.

- ◆ For other transactions, including transactions with employees, a separate fair value of compound financial instruments will be calculated and accordingly the values of goods/services received will be accounted. To apply this requirement, the entity shall first measure the fair value of the debt component, and then measure the fair value of the equity component — taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument. The fair value of the compound financial instrument is the sum of the fair values of the two components. However, share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cash settled share appreciation rights. In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. Conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component usually will be greater than zero, in which case the fair value of the compound financial instrument will be greater than the fair value of the debt component.
- ◆ The entity shall account separately for the goods or services received or acquired in respect of each component of the compound financial instrument. For the debt component, the entity shall recognise the goods or services acquired, and a liability to pay for those goods or services, as the counterparty supplies goods or renders service, in accordance with the requirements applying to cash-settled share-based payment transactions. For the equity component (if any), the entity shall recognise the goods or services received, and an increase in equity, as the counterparty supplies goods or renders service, in accordance with the requirements applying to equity-settled share-based payment transactions.
- ◆ 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 22

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 values need 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.

b) *When the entity has a choice of settlement*

If the entity can choose the settlement method then the whole award would be treated as either cash-settled or equity-settled, depending on-

- ◆ Whether entity has a present obligation to settle in cash in which case accounting of award would be as a liability. The assumption to consider present obligation to settle in cash would be in those cases when there is no commercial substance to issue equity (e.g. restriction to issue new share capital etc.) or there is past practice or stated policy to settle such type of arrangement in cash only or entity has generally settled in cash whenever counterparty asks for cash settlement.
- ◆ There is no such obligation to pay in cash then equity settled accounting treatment would be required.

In case, equity settled accounting has been done but the settlement is required to be done in cash then it would be accounted for as repurchase of an equity interest.

Upon settlement, if the entity elects the settlement alternative with the higher fair value, as at the date of settlement, the entity shall recognise an additional expense for the excess value given, i.e. the difference between the cash paid and the fair value of the equity instruments that would otherwise have been issued, or the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Examples 23 and 24

23. An entity issues stock options to its employees which provide 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.

24. 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.

Illustration 3 - Share-based payment with cash alternative

On 1st January, 20X1, ABC limited gives options to its key management personnel (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:		₹
Share alternative fair value (with restrictions)		102
Grant date fair value on 1 st January, 20X1		113
Fair value on 31 st December, 20X1		120
Fair Value on 31 st December, 20X2		132
The employees exercise their cash option at the end of 20X2.		
Pass the journal entries.		

Solution

	1 st January, 20X1 ₹	31 st December, 20X1 ₹	31 st December, 20X2 ₹
Equity alternative (1,500 x 102)	1,53,000		
Cash alternative (1,000 x 113)	1,13,000		
Equity option (1,53,000 – 1,13,000)	40,000		
Cash option (cumulative) (using period end fair value)		(1,000x120 x ½) 60,000	1,32,000
Equity option (cumulative)		(40,000 x ½) 20,000	40,000

Expense for the period			
Equity option		20,000	20,000
Cash Option		60,000	72,000
Total		80,000	92,000

Journal Entries

31 st December, 20X1		₹	
Employee benefits expenses (transfer to P/L)	Dr.	80,000	
To Share-based payment reserve (equity)*			20,000
To Share-based payment liability (Recognition of Equity option and cash settlement option)			60,000
31 st December, 20X2			
Employee benefits expenses (transfer to P/L)	Dr.	92,000	
To Share-based payment reserve (equity)*			20,000
To Share-based payment liability (Recognition of Equity option and cash settlement option)			72,000
Share-based payment liability	Dr.	1,32,000	
To Bank/ Cash (Settlement in cash)			1,32,000
Share-based payment reserve (equity)	Dr.	40,000	
To Retained Earnings			40,000

*The equity component recognized (₹ 40,000) shall remain within equity. By electing to receive cash on settlement, the employees forfeited the right to receive equity instruments.

Illustration 4-Share-based payment - Purchase of goods

Indian Inc. issued 995 shares in exchange for purchase of an office building. The title was transferred in the name of Indian Inc. on February, 20X1 and shares were issued. Fair value of the office building was ₹ 2,00,000 and face value of each share of Indian Inc was ₹ 100.

Pass the journal entries?

Solution

1 st February, 20X1		₹
Office Building	Dr.	2,00,000
To Share capital (995 x 100)		99,500
To Securities premium (balance)		1,00,500
(Recognition of equity option and cash settlement option)		

Illustration 5-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 1st April, 20X1 to 1st July, 20X1 and fair value of the service was estimated using market value of similar contracts for ₹ 1,00,000. Nominal value per share is ₹ 10.

Record the transactions in a Journal?

Solution

Fair value of services	1,00,000
Number of months	3
Monthly expense	33,333.33

30 th April, 20X1		₹
Repair & Maintenance	Dr.	33,333.33
To Share-based payment reserve (equity)		33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)		
31 st May, 20X1		
Repair & Maintenance	Dr.	33,333.33
To Share-based payment reserve (equity)		33,333.33

(Recognition of Equity settled SBP using fair value of services rendered)		
30 th June, 20X1		
Repair & Maintenance	Dr.	33,333.33
To Share-based payment reserve (equity)		33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)		
1 st July, 20X1		
Share-based payment reserve (equity)	Dr.	1,00,000
To Equity Shares (1000 x 10)		10,0000
To Securities premium (balancing figure)		90,000
(Recognition of Equity settled SBP using fair value of services rendered)		

Illustration 6 - Share-based payment - Cash & equity alternatives

Tata Industries issued share-based option to one of its key management personal which can be exercised either in cash or equity and it has following features:

<u>Option I</u>	Period	₹
No of cash settled shares		74,000
Service condition	3 years	
<u>Option II</u>		
No of equity settled shares of face value of ₹ 100 each		90,000
Conditions:		
Service	3 years	
Restriction to sell	2 years	
<u>Fair values</u>		
Equity price with a restriction of sale for 2 years		115
Fair value at grant date		135
Fair value	20X0	138
	20X1	140
	20X2	147

Pass the Journal entries?

Solution

Fair value of Equity option components:		
Fair value of a share with restrictive clause		₹ 115
Number of shares		90,000
Fair value (90,000 x 115)	A	₹ 1,03,50,000
Fair value of a share at the date of grant		₹ 135
Number of cash settled shares		74,000
Fair value (74,000 x 135)	B	₹ 99,90,000
Fair value of equity component in compound instrument (A-B)		₹ 3,60,000

Journal Entries

31/12/20X0			₹
Employee benefit expenses (Transfer to P/L) Dr.	35,24,000		
To Share-based payment reserve (equity) (3,60,000/3)			1,20,000
To Share-based payment liability (138 x 74,000) / 3			34,04,000
(Recognition of equity option and cash settlement option)			
31/12/20X1			
Employee benefits expenses (Transfer to P/L) Dr.	36,22,667		
To Share-based payment reserve (equity) (3,60,000/3)			1,20,000
To Share-based payment liability			35,02,667
(140 x 74,000) 2/3 -34,04,000			
(Recognition of equity option and cash settlement option)			
31/12/20X2			
Employee benefits expenses (Transfer to P/L) Dr.	40,91,333		
To Share-based payment reserve (equity) (3,60,000/3)			1,20,000
To Share-based payment liability			39,71,333
(147 x 74,000) 3/3 - (34,04,000 + 35,02,667)			
(Recognition of equity option and cash settlement option)			

Upon cash alternative chosen			
Share-based payment liability (147 x 74,000)	Dr.	1,08,78,000	
To Bank/ Cash			1,08,78,000
(Being settlement made in cash)			
Share-based payment reserve (equity)	Dr.	3,60,000	
To Retained Earnings			3,60,000
(Being transfer of equity from one account to another one)			
Upon equity alternative chosen			
Share-based payment liability	Dr.	1,08,78,000	
To Share Capital			90,00,000
To Securities Premium			18,78,000
(Being settlement made in equity)			
Share-based payment reserve (equity)	Dr.	3,60,000	
To Securities Premium			3,60,000
(Being transfer of equity from one account to another one)			

Example 25-Share-based payment arrangements with cash alternatives

An entity grants an employee the right to choose either 2,000 shares, ie, a right to a cash payment equal to the value of 2,000 shares, or 2,400 shares. The grant is conditional upon the completion of three years' service. If the employee chooses the share alternative, the shares must be held for three years after vesting date.

At the grant date, the entity's share price is ₹ 50 per share. At the end of years 1, 2 and 3, the share price is ₹ 52, ₹ 55 and ₹ 60 respectively. The entity does not expect to pay dividends in the next three years. After taking into account the effects of the post-vesting transfer restrictions, the entity estimates that the grant date fair value of the share alternative is ₹ 48 per share.

At the end of year 3, the employee chooses:

Scenario 1: The cash alternative

Scenario 2: The equity alternative

Application of requirements

The fair value of the equity alternative is ₹ 1,15,200 (2,400 shares x ₹ 48). The fair value of

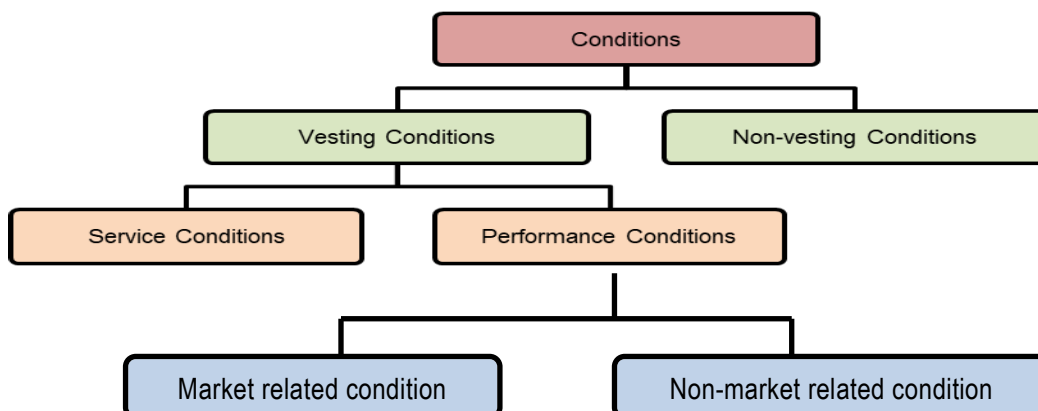
the cash alternative is ₹ 1,00,000 (2,000 shares x ₹ 50). Therefore, the fair value of the equity component of the compound instrument is ₹ 15,200 (₹ 1,15,200 - ₹ 1,00,000).

The entity recognizes the following amounts:

Year	Computation	Expense (₹)	Equity (₹)	Liability (₹)
1	Liability component: (2,000 x ₹ 52 x 1/3)	34,667		34,667
	Equity component: (₹ 15,200 x 1/3)	5,067	5,067	
2	Liability component: (2,000 x ₹ 55 x 2/3) — ₹ 34,666	38,666		38,666
	Equity component: (₹ 15,200 x 1/3)	5,067	5,067	
3	Liability component: (2,000 x ₹ 60) — ₹ 73,333	46,667		46,667
	Equity component: (₹ 15,200 x 1/3)	5,066	5,066	
End Year 3	Scenario 1: cash of ₹ 1,20,000 paid			(1,20,000)
	Scenario 1 totals	1,35,200	15,200	0
	Scenario 2: 2,400 shares issued		1,20,000	(1,20,000)
	Scenario 2 totals	1,35,200	1,35,200	



3.6 DETERMINING TYPES OF CONDITIONS



3.6.1 Vesting conditions

Share-based payment awards generally vest upon meeting specified conditions, such as service conditions (time-based) or performance conditions (eg. achieving a specified EBITDA target). These conditions affect the timing of when the expense is recognized, and in some cases, the measurement of expense. In addition, if a condition is not met, whether or not the entity may reverse previously recognized compensation expense depends on the nature of the condition that was not met. Hence classification of a condition is an important step in accounting of share-based payments.

Following are the classification of various conditions and their accounting requirements.

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.

Examples 26 & 27

26. 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. This would be considered to be a service condition; 3 years being the period over which the employee would be required to be in service as a condition.
27. If an employee remains in service for at least three years from the grant date of the award, the employee can exercise the options at any time between three and ten years from the grant date of the award. The fair value of the award at the grant date, ignoring the effect of vesting condition, is ₹ 6,00,000.

For this award, the vesting period is three years, the exercise period is seven years, and the life of the option is ten years. The requirement to remain employed is a (vesting) service condition. The entity recognizes an expense of ₹ 2,00,000 per year for three years, with a corresponding increase in equity.

If the employee leaves at the end of year two, the entity reverses the cumulative expense previously recognized. However, if the employee does not exercise options after the vesting period, expense previously recognized cannot be reversed.

Consider an alternate scenario. The employee was given an unconditional right to exercise the option at any time between the grant date and ten years from the grant date of the award. For this award, the vesting period is nil, the exercise period and the life of the option are ten years. The entity recognizes an expense of ₹ 6,00,000 immediately, with a corresponding increase in equity. Subsequently, the entity cannot

reverse this expense even if the employee does not exercise its options. This is because they are vested from day 1.

b) Performance condition

If an employee is granted share options conditional upon the achievement of a performance condition and remaining in the entity's employment until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition.

Performance condition may be

- a. Market-related; or
- b. Non-market related.

a. 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 as market-related performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted and shall not be subsequently revised.

Example 28

An entity issues stock options to its employees who will serve the organization for next 2 years and till the time the share price reaches to ₹ 100. The target price to reach ₹ 100 is one of the market-related condition.

b. Non-market related condition

When the parameter is not market driven but linked with some internal performance/ operations 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. If the performance condition is not a market condition, the entity shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Example 29

An entity 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 should rise to ₹ 10 million. Here, the EBITA target is non-market related condition.

3.6.2 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.

Examples 30 & 31

30. An entity issued some stock options to its employees wherein they are required to serve minimum period of next 2 years and from the end of 2nd year there will further be waiting time till next 1 year within which the entity should achieve revenue of ₹ 100 million. However, if an employee leaves the entity after the end of 2nd year then the employee will not lose the entitlement to get such share-based payments. Hence the condition of achieving revenue target is non-vesting condition.
31. An entity grants share options to a director on the condition that the director does not compete with the reporting entity for a period of at least three years. The fair value of the award at the date of the grant, including the effect of non - compete clause is ₹ 15 million. The 'non-compete' clause is a non-vesting condition because the entity does not receive any services. On the grant date, the entity immediately recognizes a cost of ₹ 15 million because director is not providing any future services. The entity cannot reverse the expense recognised, even if the director goes to work for a competitor and loses the share options.



3.7 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 accounting / measurement of such share-based payments and why it is crucial to segregate them.

- a. A grant of equity instruments might be conditional upon satisfying specified vesting conditions. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the entity's employment for a specified period of time. There might be performance conditions that must be satisfied, such as the entity

achieving a specified growth in profit or a specified increase in the entity's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, eg the counterparty fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements mentioned below in point c.

- b. To apply the requirements mentioned in abovementioned point (a), 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, subject to the requirements mentioned below in point c.
- c. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity shall recognize the goods or services received from a counterparty who satisfies all other vesting conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied.
- d. Similarly, an entity shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.,

Treatment of a reload feature

For options with a reload feature, the reload feature shall not be taken into account when estimating the fair value of options granted at the measurement date. Instead, a reload option shall be accounted for as a new option grant, if and when a reload option is subsequently granted.

Below mentioned table summarizes the impact of various 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 condition - Market related	Yes	No
Performance condition - Non-market related	No	Yes
Non-vesting condition	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 conditions 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.

Summary of recognising expense for an award with multiple conditions:

Scenario	Service condition met?	Market condition met?	Non-market performance condition met?	Ind AS 102 expense?
1	Yes	Yes	Yes	Yes
2	Yes	No	Yes	Yes
3	Yes	Yes	No	No
4	Yes	No	No	No
5	No	Yes	Yes	No
6	No	No	Yes	No
7	No	Yes	No	No
8	No	No	No	No

Example 32

An entity issued 100 shares each to its 1,000 employees under share-based payment upon the condition to serve the organization for at least next 2-years subject to the below scenarios:

- 1) EBIDTA of the entity shall be ₹ 10 million in next 2 years.

- 2) Share price of the entity shall be ₹ 150 in next 2 years.
- 3) Employees are required to serve additional 4 months from the end of 2 years but will have no impact on vesting rights at the end of 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 conditions 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 share-based payment.

Illustration 7 - Equity Settled – Non-market conditions

Ankita Holding Inc. grants 100 shares to each of its 500 employees on 1st January, 20X1. The employees should remain in service during the vesting period. The shares will vest at the end of the

First year if the company's earnings increase by 12%;

Second year if the company's earnings increase by 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 per share at the grant date is ₹ 122. In 20X1, earnings increased by 10%, and 29 employees left the organisation. The company 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 increased by 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 has been met.

Determine the expense for each year and pass appropriate journal entries?

Solution

Since the earnings of the entity is non-market related, hence it will not be considered in fair value calculation of the shares given. However, the same will be considered while calculating number of shares to be vested.

Workings:

	20X1	20X2	20X3
Total employees	500	500	500
Employees left (Actual)	(29)	(58)	(79)
Employees expected to leave in the next year	<u>(31)</u>	<u>(23)</u>	<u>—</u>
Year end – No of employees	<u>440</u>	<u>419</u>	<u>421</u>
Shares per employee	100	100	100
Fair value of share at grant date	122	122	122
Vesting period	1/2	2/3	3/3
Expenses-20X1 (Note 1)	26,84,000		
Expenses-20X2 (Note 2)		7,23,867	
Expenses-20X3 (Note 3)			17,28,333

Note 1:

$$\begin{aligned}
 \text{Expense for 20X1} &= \text{Number of employees} \times \text{Shares per employee} \times \text{Fair value of share} \times \\
 &\quad \text{Proportionate vesting period} \\
 &= 440 \times 100 \times 122 \times \frac{1}{2} = 26,84,000
 \end{aligned}$$

Note 2:

$$\begin{aligned}
 \text{Expense for 20X2} &= (\text{Number of employees} \times \text{Shares per employee} \times \text{Fair value of share} \times \\
 &\quad \text{Proportionate vesting period}) - \text{Expense recognized in year 20X1} \\
 &= (419 \times 100 \times 122 \times \frac{2}{3}) - 26,84,000 = 7,23,867
 \end{aligned}$$

Note 3:

$$\begin{aligned}
 \text{Expense for 20X3} &= (\text{No of employees} \times \text{Shares per employee} \times \text{Fair value of share} \times \\
 &\quad \text{Proportionate vesting period}) - \text{Expense recognized in year 20X1 and} \\
 &\quad \text{20X2} \\
 &= (421 \times 100 \times 122 \times \frac{3}{3}) - (26,84,000 + 7,23,867) = 17,28,333.
 \end{aligned}$$

Journal Entries

31 st December, 20X1			
Employee benefits expenses (transfer to P/L)	Dr.	26,84,000	
To Share-based payment reserve (equity)			26,84,000
(Equity settled shared-based payment expected vesting amount)			
31 st December, 20X2			
Employee benefits expenses (transfer to P/L)	Dr.	7,23,867	
To Share-based payment reserve (equity)			7,23,867
(Equity settled shared based payment expected vesting amount)			
31 st December, 20X3			
Employee benefits expenses (transfer to P/L)	Dr.	17,28,333	
To Share-based payment reserve (equity)			17,28,333
(Equity settled shared-based payment expected vesting amount)			
Share-based payment reserve (equity)	Dr.	51,36,200	
To Share Capital / Securities Premium			51,36,200
(Share capital Issued)			

Illustration 8 - Equity Settled – Non market conditions (Reversals)

ACC limited granted 10,000 share options to one of its managers. 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?

Solution

It is a non-market related condition. Hence the target to achieve cost reduction would be taken while estimating the number of options to be vested.

Year	Options	Fair value		FV of the options vested
Year 1	10,000	95	1/3	3,16,667
Year 2	10,000	95	0	(3,16,667)
Year 3	10,000	95	3/3	9,50,000

The condition to achieve 10% cost reduction each was not fulfilled in the year 2 and there was no expectation to vest this non-market condition in future as well and hence earlier expense amount was reversed in year 2. Since in the year 3 the non-market condition was again met, hence all such expense will be charged to Profit and Loss.

Illustration 9 - Equity Settled – Market based conditions

Apple Limited has granted 10,000 share options to one of its directors for which he must work for next 3 years and the price of the share should increase by 20% 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 ₹ 120.

How should we recognize the transaction?

Solution

The share price movement is a market-based vesting condition hence its expectations are taken into consideration while calculating the fair value of the option.

Even if the required market condition as required is not fulfilled, there is no requirement to reverse the expense previously booked.

Irrespective of the outcome of the market prices (as it is already taken care of in the fair value of the option), each period an amount of $(120 \times 10,000)/3 = ₹ 4,00,000$ will be charged to profit and loss.



3.8 GRANT DATE

Definition of 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”.

Analysis of the definition of the Grant date

- It is crucial to determine grant date correctly for 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 agreement will be considered as grant date.
- If the agreement is subject to the approval of appropriate authorities, then the grant date will be the date of approval.

Example 33

Entity initiated a share-based payment agreement in its board meeting and directed the supervisors to communicate the agreement to the employee. Consider the following scenarios to arrive at grant date:

- 1) Employees have not yet given his/her consent either implicitly or explicitly. However, entity has taken approval of the agreement in its General Meeting.
- 2) Employees have agreed to 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 to the terms but approval process is still not complete, hence the grant date should be the date when approvals are complete.
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.



3.9 SUBSEQUENT MEASUREMENT

3.9.1 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.

Equity will be credited by an additional amount (adjusted with re-estimation of expected vesting equity shares at each reporting period) and there will not be any change in the value credited to the equity.

Example 34

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 ₹ 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.

Year end	% Vest	Expense (current period)	Cumulative expenses
First	95%	$2,000 \times 100 \times 200 \times 95\% \times 1/3 = 1,26,66,667$	1,26,66,667
Second	92%	$2,000 \times 100 \times 200 \times 92\% \times 2/3 - 1,26,66,667 = 1,18,66,667$	2,45,33,333
Third	88%	$2,000 \times 100 \times 200 \times 88\% \times 3/3 - 2,45,33,333 = 1,06,66,667$	3,52,00,000

3.9.2 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 the time it is settled.

Example 35

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 ₹ 200 each. However, the fair value as at end of 1st year, 2nd year & 3rd year were ₹ 180, ₹ 190, ₹ 220 respectively.

Year end	Vest	Expense (current period)	Cumulative expenses
First	1/3	$20 \times 100 \times 180 \times 1/3 = 1,20,000$	1,20,000
Second	2/3	$20 \times 100 \times 190 \times 2/3 - 1,20,000 = 1,33,333$	2,53,333
Third	3/3	$20 \times 100 \times 220 \times 3/3 - 2,53,333 = 1,86,667$	4,40,000



3.10 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. reprice the options), which increases the fair value of those options.

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. If an entity modifies an award, it must recognize, at a minimum, cost of the original award as if the award was not modified. If modification increases fair value of the award, the entity must recognize that additional cost. The additional cost is spread over the period from the modification date until the vesting of modified options, which may differ from the vesting date of original award. Whether a modification increases or decreases the fair value of an award is determined at the modification date. If an entity modifies a vested option, it recognizes any additional fair value given on the modification date itself.
- This requirement is applicable irrespective of any modification of terms, cancellation or early settlement, if any.
- If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):
 - a. the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

- b. any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, ie as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.
- c. if new equity instruments are granted to the employee and on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 of Ind AS 102 and the guidance in Appendix B of Ind AS 102. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (b) above. If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for those new equity instruments as a new grant of equity instruments.
- If an entity or counterparty can choose whether to meet a non-vesting condition, the entity shall treat the entity's or counterparty's failure to meet that non-vesting condition during the vesting period as a cancellation.
- If an entity repurchases vested equity instruments, the payment made to the employee shall be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments repurchased, measured at the repurchase date. Any such excess shall be recognised as an expense.

Illustration 10 – Modifications – Equity-settled share-based payment

Marathon Inc. issued 150 share options to each of its 1,000 employees subject to the service condition of 3 years. Fair value of the option given was calculated at ₹ 129. Below are the details and activities related to the SBP plan-

Year 1: 35 employees left and further 60 employees are expected to leave

Share options re-priced (as MV of shares has fallen) as the FV fell to ₹ 50.

After the re-pricing they are now worth ₹ 80, hence expense is expected to increase by ₹ 30.

Year 2: 30 employees left and further 36 employees are expected to leave

Year 3: 39 employees left

How the modification/ re-pricing will be accounted?

Solution

The re-pricing was done at the end of year 1, and hence the increased expense would be spread over next 2 years equally.

Total increased value due to modification is		₹ 30	(1/2 weight each years)
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Number of employees	1,000	1,000	1,000
Employee left	(35)	(65)	104
Expected to leave	<u>(60)</u>	<u>(36)</u>	—
Net employees	905	899	896
Options per employee	150	150	150
Fair value of the option	129	129	129
Period weight	1/3	2/3	3/3
Modification		30	30
Expense (original)	58,37,250	57,59,850	57,40,500
Modification	Nil	20,22,750	20,09,250
		(899x150x30x1/2)	(896x150x30x2/2)- 20,22,750)

Illustration 11 - Cancellation- Equity Settled Share-based payment

Anara Fertilisers Limited issued 2000 share options to its 10 directors for an exercise price of ₹ 100. The directors are required to stay with the company for next 3 years.

Fair value of the option estimated ₹ 130

Expected number of directors to vest the option 8

During the year 2, there was a crisis in the company and Management decided to cancel the 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 only 9 directors were currently in employment. At the time of cancellation of such scheme, it was agreed to pay an amount of ₹ 95 per option to each of 9 directors.

Suggest how the cancellation will be recorded.

Solution

	<u>Year 1</u>	<u>Year 2</u>	
A)			
Expected directors to vest	8	9	
Fair value of option	130	130	
Number of options	<u>2,000</u>	<u>2,000</u>	
Total	<u>20,80,000</u>	<u>23,40,000</u>	
Expense weightage	1/3		Full, as it is cancelled
Expense for the year	6,93,333	16,46,667	Remaining amount since cancelled

B) Cancellation compensation	
Number of directors	9
Amount agreed to pay	95
Number of options / director	2,000
Compensation amount (9 x 95 x 2,000) Also refer working notes 1 and 2	17,10,000

Working Notes:

1. Amount to be deducted from Equity

Number of directors	9
Fair value of option (at the date of cancellation)	90
Number of options / director	2,000
Total	16,20,000

2. Amount transferred to Profit and Loss

Total cancellation compensation	17,10,000
Less: To deduct from Equity	<u>(16,20,000)</u>
Balance transferred to Profit and Loss	<u>90,000</u>

**3.11 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 the specific guidance available in the standard.

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.

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 are 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 share-based payment has service / performance conditions attached, then there is an underlying presumption that the share-based payment 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 tend to exercise options

later than lower-level employees. 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. Alternatively, expected early exercise could be modelled in a similar option pricing model that uses contractual life as an input.

2. **Expected volatility:** Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. 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 36

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, i.e. 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 (based on the option's remaining contractual life and taking into account the effects of expected early exercise). It may be necessary to use an appropriate substitute, if no such government issues exist or circumstances indicate that the implied yield on zero-coupon government issues is not representative of the risk-free interest rate (for example, in high inflation economies). Also, an appropriate substitute should be used if market participants would typically determine the risk-free interest rate by using that substitute, rather than the implied yield of zero-coupon government issues, when estimating the fair value of an option with a life equal to the expected term of the option being valued.



3.12 GROUP SHARE-BASED PAYMENT PLAN

In practice, we have come across many cases where one member of the group (typically, the parent) has obligation to settle a share-based payment transaction in which services are

provided to another member of the group (typically a subsidiary). For example, within a multinational group, shares in the listed parent entity may be granted to the employees of various subsidiary entities located around the world. In some other cases, a listed subsidiary may have obligation to settle a share-based payment transaction in which services are provided to another member of the group (including the parent). These transactions are within the scope of Ind AS 102 for the entity receiving the services. This is despite the fact that it is not a direct party to the arrangement between its group entity and its employee.

For share-based payment transactions among group entities, in its separate or individual financial statements, the entity receiving the goods or services shall measure the goods or services received as either an equity-settled or a cash-settled share-based payment transaction by assessing:

- (a) the nature of the awards granted, and
- (b) its own rights and obligations.

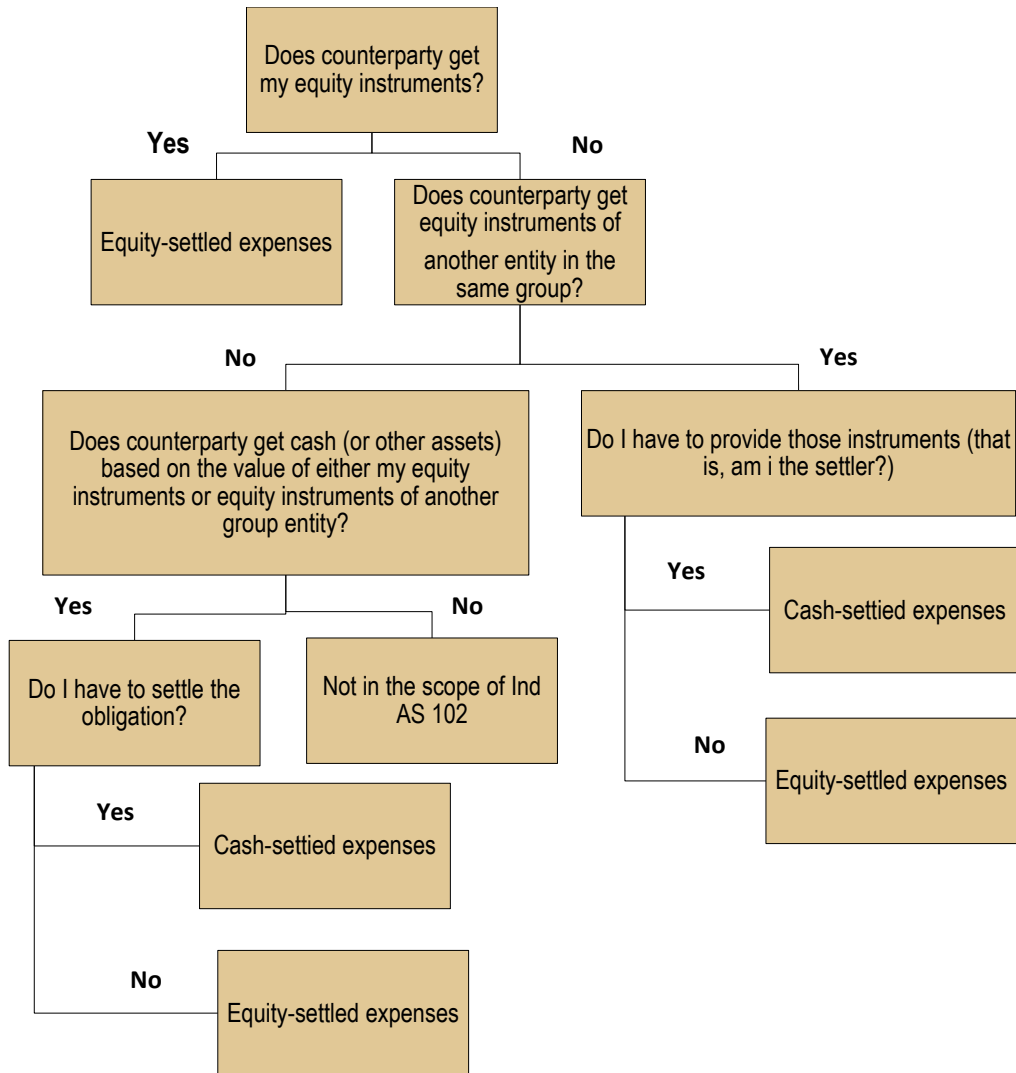
The amount recognised by the entity receiving the goods or services may differ from the amount recognised by the consolidated group or by another group entity settling the share-based payment transaction.

The entity receiving the goods or services shall measure the goods or services received as an equity-settled share-based payment transaction when:

- (a) the awards granted are its own equity instruments, or
- (b) the entity has no obligation to settle the share-based payment transaction.

The entity shall subsequently remeasure such an equity-settled share-based payment transaction only for changes in non-market vesting conditions. In all other circumstances, the entity receiving the goods or services shall measure the goods or services received as a cash-settled share-based payment transaction.

The entity settling a share-based payment transaction when another entity in the group receives the goods or services shall recognise the transaction as an equity-settled share-based payment transaction only if it is settled in the entity's own equity instruments. Otherwise, the transaction shall be recognised as a cash-settled share-based payment transaction.



Let's understand the basis of determination of the classification of share-based payment transactions in both separate financial statements and consolidated financial statements in various scenarios:

1. Parent issues its own shares for the share-based payment plan issued by its subsidiary

Since the subsidiary company do not have any obligation to settle the services/ goods which are being issued against the plan, hence it will be treated as equity-settled share-based payment (for subsidiary).

- ◆ Parent would debit these shares as "Investment in Subsidiary" and credit its equity.

- ◆ Subsidiary will treat this as equity-settled share-based payment plan and will debit its expenses (employee related cost) and credit the capital contribution from the Parent.

2. Subsidiary provides rights to its employees to get equity instruments of its parent

Subsidiary will account for this arrangement as cash-settled share-based payment plan since it has an obligation to settle the same in other than its own equity shares.

- ◆ 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).

3. Parent settles the transaction by paying cash value for share-based payment plan issued by its subsidiary

Irrespective of the cash which is settled either based on Parent's equity or Subsidiary's equity, it will be treated as equity-settled share-based payment plan in case of separate financial statements of subsidiary because the subsidiary does not have any obligation to settle the payments.

Illustration 12

A parent grants 200 share options to each of 100 employees of its subsidiary, conditional upon the completion of two years' service with the subsidiary. The fair value of the share options on grant date is ₹ 30 each. At grant date, the subsidiary estimates that 80 percent of the employees will complete the two-year service period. This estimate does not change during the vesting period. At the end of the vesting period, 81 employees complete the required two years of service. The parent does not require the subsidiary to pay for the shares needed to settle the grant of share options.

Pass the necessary journal entries for giving effect to the above arrangement.

Solution

As required by paragraph B53 of the Ind AS 102, over the two-year vesting period, the subsidiary measures the services received from the employees in accordance, the requirements applicable to equity-settled share-based payment transactions as given in paragraph 43B. 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 recognised as a contribution from the parent in the separate or individual financial statements of the subsidiary.

The journal entries recorded by the subsidiary for each of the two years are as follows:

Year 1		₹	₹
Remuneration expense (Transfer to P/L)	Dr.	2,40,000	
(200 x 100 employees x Rs. 30 x 80% x ½)			
To Equity (Contribution from the parent)			2,40,000
Year 2			
Remuneration expense (Transfer to P/L)	Dr.	2,46,000	
[(200 x 81 employees x Rs. 30) – 2,40,000]			
To Equity (Contribution from the parent)			2,46,000



3.13 DISCLOSURE

Standard requires an entity to disclose the following-

- Type and scope of agreement existing during the reporting period.
- Describing general terms & conditions of each type of share-based payment 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 share-based payment plans.
- 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 share-based payments.



3.14 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Bharti Airtel Limited' for the financial year 2021-2022 with respect to 'Share-based payment' and its accounting policy thereon.

25.1 Share-based payment plans

The following table provides an overview of all existing share option plans of the Company:

Scheme	Plan	Vesting period (years)	Contractual term (years)
Equity settled Plans			
Scheme I	2006 Plan	1 - 5	7
Scheme 2005	Long Term Incentive (LTI) Plan	1 - 3	7

The stock options vesting are subject to service and certain performance conditions mainly pertaining to certain financial parameters.

The movement in the number of stock options and the related weighted average exercise prices are as follows:

	For the year ended			
	March 31, 2022		March 31, 2021	
	Number of share options ('000)	Weighted average exercise price (₹)	Number of share options ('000)	Weighted average exercise price (₹)
2006 Plan				
Outstanding at beginning of year	113	5.00	30	5.00
Granted	-	-	93	5.00
Exercised	(113)	5.00	(10)	5.00
Outstanding at end of year	-	-	113	5.00
Exercisable at end of year	-	-	20	5.00
LTI Plan				
Outstanding at beginning of year	3,048	5.00	3,195	5.00
Granted	1,956	5.00	1,176	5.00
Exercised	(1,297)	5.00	(1,077)	5.00
Forfeited / expired	(484)	5.00	(246)	5.00
Outstanding at end of year	3,223	5.00	3,048	5.00
Exercisable at end of year	904	5.00	603	5.00

The details of weighted average remaining contractual life, weighted average fair value and weighted average share price for the options are as follows:

	March 31, 2022	March 31, 2021
Weighted average		
Remaining contractual life for the options outstanding as of (years)	0.4 to 6.4	1.4 to 6.7
Fair value for the options granted during the year ended (₹)	347.7 to 595.1	347.7 to 548.7
Share price for the options exercised during the year ended (₹)	581.7 to 716.6	483.3 to 590.2

The fair value of options is measured using Black-Scholes valuation model. The key inputs used in the measurement of the grant date fair valuation of equity settled plans is given in the table below:

	For the year ended March 31, 2022	For the year ended March 31, 2021
Risk free interest rates	5.5% to 5.8%	5.1% to 5.8%
Expected life	48 to 60 months	48 to 78 months
Volatility	32.8%	32.7%
Dividend yield	0.3%	0.4%
Exercise price (₹)	5	5
Share price on the date of grant (₹)	607.80	560.60

The expected life of the stock options is based on the Company's expectations and is not necessarily indicative of exercise patterns that may actually occur. The expected volatility reflects the assumption that the historical volatility over a period similar to the expected life of the options is indicative of future trends, which may not necessarily be the actual outcome. Further, the expected volatility is based on the weighted average volatility of the comparable benchmark companies.

ACCOUNTING POLICY

Share-based payments

The Company operates equity-settled and cash-settled employee share-based compensation plans, under which the Company receives services from employees as consideration for stock options either towards shares of the Company or cash settled units.

In case of equity-settled awards, the fair value of stock options (at grant date) is recognised as an expense in the Statement of Profit and Loss within employee benefits as employee share-based payment expenses over the vesting period, with a corresponding increase in share-based payment reserve (a component of equity).

However, in case of cash-settled awards, the credit is recognised as a liability within other non-financial liabilities over the vesting period. Subsequently, at each reporting period, until the liability is settled, and at the date of settlement, liability is re-measured at fair value through Statement of Profit and Loss.

The total amount so expensed is determined by reference to the grant date fair value of the stock options granted, which includes the impact of any market performance conditions and non-vesting conditions but excludes the impact of any service and non-market performance vesting conditions. However, the non-market performance vesting

and service conditions are considered in the assumption as to the number of options that are expected to vest. The forfeitures are estimated at the time of grant and reduce the said expense rateably over the vesting period.

The expense so determined is recognised over the requisite vesting period, which is the period over which all of the specified vesting conditions are to be satisfied. As at each reporting date, the Company revises its estimates of the number of options that are expected to vest, if required.

It recognises the impact of any revision to original estimates in the period of change. Accordingly, no expense is recognised for awards that do not ultimately vest, except for which vesting is conditional upon a market performance / non-vesting condition. These are treated as vested irrespective of whether or not the market / non-vesting condition is satisfied, provided that service conditions and all other non-market performance are satisfied.

Where the terms of an award are modified, in addition to the expense pertaining to the original award, an incremental expense is recognised for any modification that results in additional fair value or is otherwise beneficial to the employee as measured at the date of modification.

Where an equity-settled award is cancelled (including due to non-vesting conditions not being met), it is treated as if it is vested thereon, and any un-recognised expense for the award is recognised immediately. In case of cancellation of cash-settled award, change in the value of the liability, if any, is recognised in Statement of Profit and Loss.

(Source: Annual Report 2021-2022 – Bharti Airtel Limited)

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!



TEST YOUR KNOWLEDGE

Questions

1. An entity issued 100 shares each to its 1,000 employees subject to service condition of next 2 years. Grant date fair value of the share is ₹ 195 each. There is an expectation 97% of the employees will remain in service at the end of 1st year. However, at the end of 2nd year the expected employees to remain in service would be 91% of the total employees. Calculate the expense for years 1 & 2?
2. An entity issued 50 shares each to its 170 employees subject to service condition of next 2 years. The settlement is to be made in cash. Grant date fair value of the share is ₹ 85 each, however, the fair value as at end of 1st year, 2nd year were ₹ 80 & ₹ 90 respectively. Calculate the expense for years 1 and 2
3. Company P is a holding company for company B. A group share-based payment is being organized in which Parent issues its own equity-shares for the employees of company B. The details are as below –

Number of employees of company B	100
Grant date fair value of share	₹ 87
Number of shares to each employee granted	25
Vesting conditions	Immediately

Pass the journal entry in the books of company P & company B?

4. An entity P issues share-based payment plan to its employees based on the below details:

Number of employees	100
Fair value at grant date	₹ 25
Market condition	Share price to reach at ₹ 30
Service condition	To remain in service until market condition is fulfilled
Expected completion of market condition	4 years

Define expenses related to such share-based payment plan in each year subject to the below scenarios-

- a) Market condition if fulfilled in year 3, or
 - b) Market condition is fulfilled in year 5.
5. Entity X grants 10 shares each to its 1,000 employees on the conditions as mentioned below-
- To remain in service & entity's profit after tax (PAT) shall reach to ₹ 100 million.
 - It is expected that PAT should reach to ₹ 100 million by the end of 3 years.
 - Fair value at grant date is ₹ 100.
 - Employees expected for vesting right by 1st year 97%, then it revises to 95% by 2nd year and finally to 93% by 3rd year.

Calculate the expenses for next 3 years in respect of share-based payment?

6. At 1st January, 20X0, Ambani Limited grants its CEO an option to take either cash amount equivalent to 800 shares or 990 shares. The minimum service requirement is 2 years. There is a condition to keep the shares for 3 years if shares are opted.

Fair values of the shares	₹
Share alternative fair value (with restrictions)	212
Grant date fair value on 1 st January, 20X0	213
Fair value on 31 st December, 20X0	220
Fair value on 31 st December, 20X1	232

The key management personnel exercises his cash option at the end of 20X2.

Pass the journal entries.

7. MINDA issued 11,000 share appreciation rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹ 100. SAR can be exercised any time until 31st March, 20X3. It is expected that out of the total employees, 94% at the end of the period on 31st March, 20X1, 91% at the end of next year will exercise the option. Finally, when these were vested i.e. at the end of the 3rd year, only 85% of the total employees exercised the option.

Fair value of SAR	₹
31 st March, 20X1	132
31 st March, 20X2	139
31 st March, 20X3	141

Pass the Journal entries?

8. P Ltd. granted 400 stock appreciation rights (SAR) each to 75 employees on 1st April 20X1 with a fair value ₹ 200. The terms of the award require the employee to provide service for four years in order to earn the award. The fair value of each SAR at each reporting date is as follows:

31 st March 20X2	₹ 210
31 st March 20X3	₹ 220
31 st March 20X4	₹ 215
31 st March 20X5	₹ 218

What would be the difference if at the end of the second year of service (i.e. at 31st March 20X3), P Ltd. modifies the terms of the award to require only three years of service?

9. QA Ltd. had on 1st April, 20X1 granted 1,000 share options each to 2,000 employees. The options are due to vest on 31st March, 20X4 provided the employee remains in employment till 31st March, 20X4.

On 1st April, 20X1, the Directors of Company estimated that 1,800 employees would qualify for the option on 31st March, 20X4. This estimate was amended to 1,850 employees on 31st March, 20X2 and further amended to 1,840 employees on 31st March, 20X3.

On 1st April, 20X1, the fair value of an option was ₹ 1.20. The fair value increased to ₹ 1.30 as on 31st March, 20X2 but due to challenging business conditions, the fair value declined thereafter. In September, 20X2, when the fair value of an option was ₹ 0.90, the Directors repriced the option and this caused the fair value to increase to ₹ 1.05. Trading

conditions improved in the second half of the year and by 31st March, 20X3 the fair value of an option was ₹ 1.25. QA Ltd. decided that additional cost incurred due to repricing of the options on 30th September, 20X2 should be spread over the remaining vesting period from 30th September, 20X2 to 31st March, 20X4.

Suggest the suitable accounting treatment for these transaction as on 31st March, 20X3.

10. A parent, Company P, grants 30 shares to 100 employees each of its subsidiary, Company S, on condition that the employees remain employed by Company S for three years. Assume that at the outset, and at the end of Years 1 and 2, it is expected that all the employees will remain employed for all the three years. At the end of Year 3, none of the employees has left. The fair value of the shares on grant date is ₹ 5 per share. Company S agrees to reimburse Company P over the term of the arrangement for 75 percent of the final expense recognised by Company S.

What would be the accounting treatment in the books of Company P and Company S?

11. An entity which follows its financial year as per the calendar year grants 1,000 share appreciation rights (SARs) to each of its 40 management employees as on 1st January 20X5. SARs provide the employees with the right to receive (at the date when the rights are exercised) cash equal to the appreciation in the entity's share price since the grant date. All of the rights vest on 31st December 20X6; and they can be exercised during 20X7 and 20X8. Management estimates that, at grant date, the fair value of each SAR is ₹ 11; and it estimates that overall 10% of the employees will leave during the two-year period. The fair values of the SARs at each year end are shown below:

Year	Fair value at year end
31 December 20X5	12
31 December 20X6	8
31 December 20X7	13
31 December 20X8	12

10% of employees left before the end of 20X6. On 31st December 20X7 (when the intrinsic value of each SAR was ₹ 10), six employees exercised their options; and the remaining 30 employees exercised their options at the end of 20X8 (when the intrinsic value of each SAR was equal to the fair value of ₹ 12).

How much expense and liability is to be recognized at the end of each year? Pass the Journal entries.

Answers

1.

Year end	% Vest	Expense (current period)
FIRST	97%	$100 \times 1,000 \times 195 \times 97\% \times 1/2 = 94,57,500$
SECOND	91%	$100 \times 1,000 \times 195 \times 91\% \times 2/2 - 94,57,500 = 82,87,500$

2.

Year end	Vest	Expense (current period)
FIRST	1/2	$50 \times 170 \times 80 \times 1/2 = 3,40,000$
SECOND	2/2	$50 \times 170 \times 90 \times 2/2 - 3,40,000 = 4,25,000$

- ◆ Liability will be re-measured at each reporting date.
- ◆ Fair value at the end of the year will be used.

3. Books of Company P

Investment in Company B Dr. ₹ 2,17,500
 To Equity Capital / Securities Premium (Issue of Shares) ₹ 2,17,500

Books of Company B

Expense Dr. ₹ 2,17,500
 To Capital contribution from Parent P ₹ 2,17,500

4. Market conditions are required to be considered while calculating fair value at the grant date. However, service conditions will be considered as per the expected vesting right to be exercised by the employees and would be re-estimated during vesting period. However, if the market-related condition is fulfilled before it is expected then all remaining expenses would immediately be charged off. If market-related condition takes longer than the expected period, then original expected period will be followed.

a) Market condition is fulfilled in year 3:

Year 1	$2,500/4 = 625$
Year 2	$2,500/4 = 625$
Year 3	$2,500 - 625 - 625 = 1,250$
Year 4	NIL

- b) Market condition is fulfilled in year 5:

Year 1	$2,500/4 = 625$
Year 2	$2,500/4 = 625$
Year 3	$2,500/4 = 625$
Year 4	$2,500/4 = 625$
Year 5	NIL

5. Entity's PAT is one of the non-market related conditions and hence would be included while making an expectation of vesting shares and there is no requirement to make any changes in the non-market condition whether this is fulfilled or not because it has already been considered in the expectation of vesting rights at the end of each year.

Year -1	$1,000 \times 10 \times 100 \times 97\% \times 1/3 = 3,23,333$
Year-2	$1,000 \times 10 \times 100 \times 95\% \times 2/3 - 3,23,333 = 3,10,000$
Year -3	$1,000 \times 10 \times 100 \times 93\% \times 3/3 - 6,33,333 = 2,96,667$

6.

	1 st January, 20X0	31 st December, 20X0	31 st December, 20X1
Equity alternative (990 x 212)	2,09,880		
Cash alternative (800 x 213)	1,70,400		
Equity option (2,09,880 – 1,70,400)	39,480		
Cash Option (cumulative) (using period end fair value)		88,000	1,85,600
Equity Option (cumulative)		19,740	39,480
<u>Expense for the period</u>			
Equity option		19,740	19,740
Cash Option		<u>88,000</u>	<u>97,600</u>
Total		<u>1,07,740</u>	<u>1,17,340</u>

Journal Entries

31 st December, 20X0			₹
Employee benefits expenses	Dr.	1,07,740	
To Share-based payment reserve (equity)			19,740
To Share-based payment liability			88,000
(Recognition of Equity option and cash settlement option)			
31 st December, 20X1			
Employee benefits expenses	Dr.	1,17,340	
To Share-based payment reserve (equity)			19,740
To Share-based payment liability			97,600
(Recognition of Equity option and cash settlement option)			
Share-based payment liability	Dr.	1,85,600	
To Bank/ Cash			1,85,600
(Settlement in cash)			

7.

Period	Fair value	To be vested	Cumulative	Expense
Start	100	100%	11,00,000	11,00,000
Period 1	132	94%	13,64,880	2,64,880
Period 2	139	91%	13,91,390	26,510
Period 3	141	85%	13,18,350	<u>(73,040)</u>
				<u>13,18,350</u>

Journal Entries

1 st April, 20X0			
Employee benefits expenses	Dr.	11,00,000	
To Share-based payment liability			11,00,000
(Fair value of the SAR recognised)			
31 st March, 20X1			
Employee benefits expenses	Dr.	2,64,880	

To Share-based payment liability (Fair value of the SAR re-measured)		2,64,880
31st March, 20X2		
Employee benefits expenses Dr.	26,510	
To Share-based payment liability (Fair value of the SAR re-measured)		26,510
31st March, 20X3		
Share-based payment liability Dr.	73,040	
To Employee benefits expenses (Fair value of the SAR reversed)		73,040
Share-based payment liability Dr.	13,18,350	
To Cash (Settlement of SAR)		13,18,350

8. Journal entries in the books of P Ltd (without modification of service period of stock appreciation rights) (₹ in lakhs)

Date	Particulars	Debit	Credit
31.03.20X2	Profit and Loss account Dr. To Liability against SARs (Being expenses liability for stock appreciation rights recognised)	15.75	15.75
31.03.20X3	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	17.25	17.25
31.03.20X4	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	15.38	15.38
31.03.20X5	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	17.02	17.02

Journal entries in the books of P Ltd (with modification of service period of stock appreciation rights)
(₹ in lakhs)

Date	Particulars	Debit	Credit
31.03.20X2	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	15.75	15.75
31.03.20X3	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	28.25	28.25
31.03.20X4	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	20.50	20.50

Working Notes:

Calculation of expenses for issue of stock appreciation rights without modification of service period

For the year ended 31st March 20X2

$$= ₹ 210 \times 400 \text{ awards} \times 75 \text{ employees} \times 1 \text{ year} / 4 \text{ years of service}$$

$$= ₹ 15,75,000$$

For the year ended 31st March 20X3

$$= ₹ 220 \times 400 \text{ awards} \times 75 \text{ employees} \times 2 \text{ years} / 4 \text{ years of service} - ₹ 15,75,000 \text{ previously recognised}$$

$$= ₹ 33,00,000 - ₹ 15,75,000 = ₹ 17,25,000$$

For the year ended 31st March 20X4

$$= ₹ 215 \times 400 \text{ awards} \times 75 \text{ employees} \times 3 \text{ years} / 4 \text{ years of service} - ₹ 33,00,000 \text{ previously recognised}$$

$$= ₹ 48,37,500 - ₹ 33,00,000 = ₹ 15,37,500$$

For the year ended 31st March, 20X5

$$= ₹ 218 \times 400 \text{ awards} \times 75 \text{ employees} \times 4 \text{ years} / 4 \text{ years of service} - ₹ 48,37,500 \text{ previously recognised}$$

$$= ₹ 65,40,000 - ₹ 48,37,500 = ₹ 17,02,500$$

Calculation of expenses for issue of stock appreciation rights with modification of service period

For the year ended 31st March 20X2

$$= ₹ 210 \times 400 \text{ awards} \times 75 \text{ employees} \times 1 \text{ year} / 4 \text{ years of service} = ₹ 15,75,000$$

For the year ended 31st March 20X3

$$= ₹ 220 \times 400 \text{ awards} \times 75 \text{ employees} \times 2 \text{ years} / 3 \text{ years of service} - ₹ 15,75,000 \text{ previous recognised}$$

$$= ₹ 44,00,000 - ₹ 15,75,000 = ₹ 28,25,000$$

For the year ended 31st March 20X4

$$= ₹ 215 \times 400 \text{ awards} \times 75 \text{ employees} \times 3 \text{ years} / 3 \text{ years of service} - ₹ 44,00,000 \text{ previous recognised}$$

$$= ₹ 64,50,000 - ₹ 44,00,000 = ₹ 20,50,000.$$

9. Paragraph 27 of Ind AS 102 requires the entity to recognise the effects of repricing that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

If the repricing increases the fair value of the equity instruments granted paragraph B43(a) of Appendix B requires the entity to include the incremental fair value granted (ie the difference between the fair value of the repriced equity instrument and that of the original equity instrument, both estimated as at the date of the modification) in the measurement of the amount recognised for services received as consideration for the equity instruments granted.

If the repricing occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the repricing date until the date when the repriced equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.

Accordingly, the amounts recognised in years 1 and 2 are as follows:

Year	Calculation	Compensation expense for period	Cumulative compensation expense
		₹	₹
1	$[1,850 \text{ employees} \times 1,000 \text{ options} \times ₹ 1.20] \times \frac{1}{3}$	7,40,000	7,40,000
2	$(1,840 \text{ employees} \times 1,000 \text{ options} \times [(₹ 1.20 \times \frac{2}{3}) + \{(₹ 1.05 - 0.90) \times 0.5/1.5\}]) - 7,40,000$	8,24,000	15,64,000

Note: Year 3 calculations have not been provided as it was not required in the question.

10. Company S expects to recognise an expense totalling ₹ 15,000 (30 shares $\times$ 100 employees $\times$ ₹ 5 per share) and, therefore, expects the total reimbursement to be ₹ 11,250 (₹ 15,000 $\times$ 75%). Company S therefore reimburses Company P ₹ 3,750 (₹ 11,250 $\times$ 1/3) each year.

Accounting by Company S

In each of Years 1 to 3, Company S recognises an expense in profit or loss, the cash paid to Company P, and the balance of the capital contribution it has received from Company P.

Journal Entry			₹
Employee benefits expenses	Dr.	5,000	
To Cash/Bank			3,750
To Equity (Contribution from the parent)			1,250
(To recognise the share-based payment expense and partial reimbursement to parent)			

Accounting by Company P

In each of Years 1 to 3, Company P recognises an increase in equity for the instruments being granted, the cash reimbursed by Company S, and the balance as investment for the capital contribution it has made to Company S.

Journal Entry			₹
Investment in Company S	Dr.	1,250	
Cash/Bank	Dr.	3,750	
To Equity			5,000
(To recognise the grant of equity instruments to employees of subsidiary less partial reimbursement from subsidiary)			

11. The amount recognized as an expense in each year and as a liability at each year-end) is as follows:

Year	Expense ₹	Liability ₹	Calculation of Liability
31 December 20X5	2,16,000	2,16,000	= 36 x 1,000 x 12 x ½
31 December 20X6	72,000	2,88,000	= 36 x 1,000 x 8
31 December 20X7	1,62,000*	3,90,000	= 30 x 1,000 x 13
31 December 20X8	(30,000)**	0	Liability extinguished

* Expense comprises an increase in the liability of ₹ 102,000 and cash paid to those exercising their SARs of ₹ 60,000 (6 x 1,000 x 10).

** Difference of opening liability (₹ 3,90,000) and actual liability paid [₹ 3,60,000 (30 x 1,000 x 12)] is recognised to Profit and loss ie ₹ 30,000.

Journal Entries

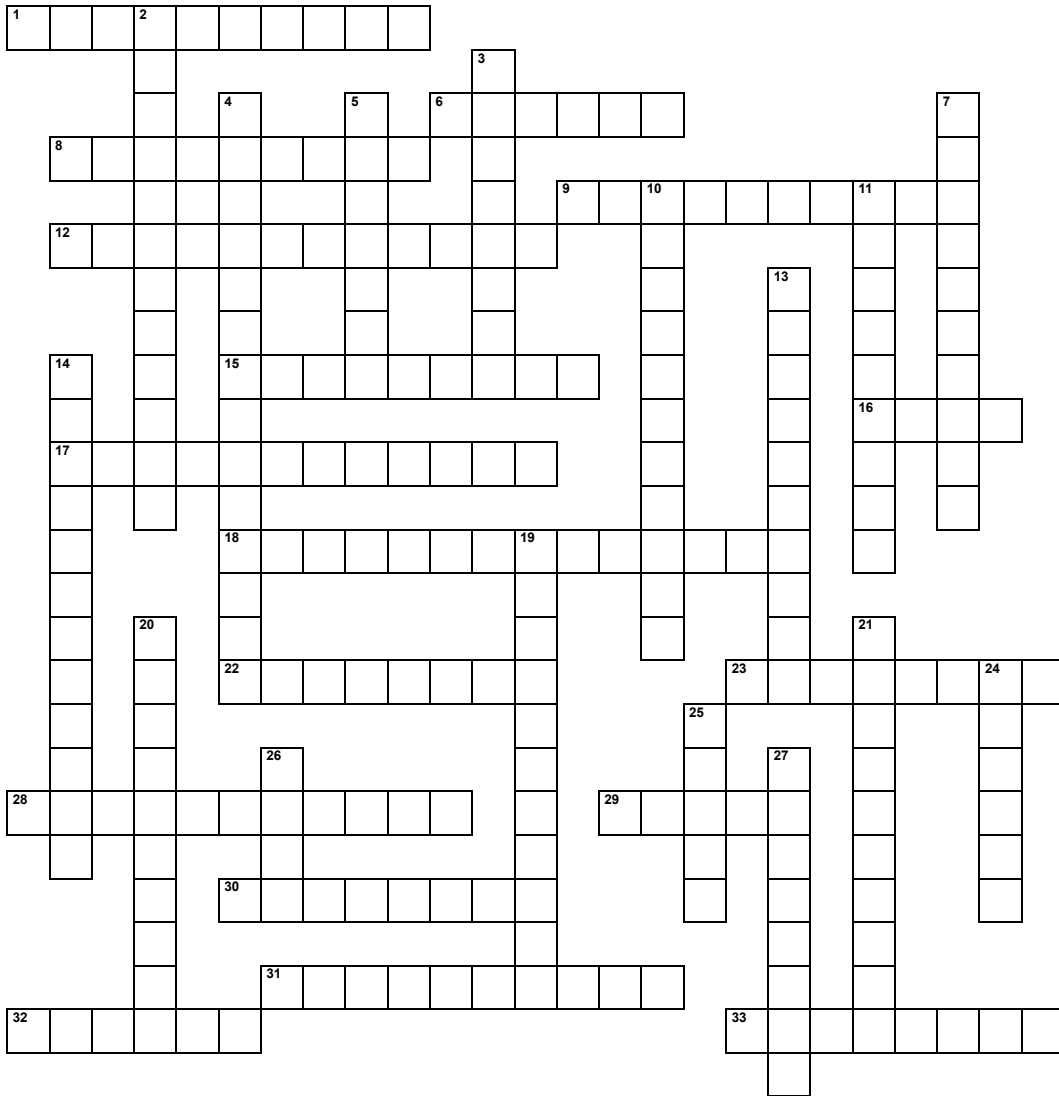
31 December 20X5			
Employee benefits expenses	Dr.	2,16,000	
To Share-based payment liability			2,16,000
(Fair value of the SAR recognized)			
31 December 20X6			
Employee benefits expenses	Dr.	72,000	
To Share-based payment liability			72,000
(Fair value of the SAR re-measured)			

31 December 20X7			
Employee benefits expenses	Dr.	1,62,000	
To Share-based payment liability			1,62,000
(Fair value of the SAR recognized)			
Share-based payment liability	Dr.	60,000	
To Cash			60,000
(Settlement of SAR)			
31 December 20X8			
Share-based payment liability	Dr.	30,000	
To Employee benefits expenses			30,000
(Fair value of the SAR recognized)			
Share-based payment liability	Dr.	3,60,000	
To Cash			3,60,000
(Settlement of SAR)			

Note: Last two entries can be combined.

[illegible]

IND AS PUZZLERS: TEST YOUR ACCOUNTING ACUMEN*



ACROSS:

1. _____ of assets refers to a decline in the recoverable amount of an asset. (10)
6. Intangible assets with _____ useful lives are subject to amortisation. (6)
8. Agricultural Produce refers to the _____ produce from biological assets. (9)

*Related to Chapters of Module 2 only

9. Ind AS 116 provides two _____ methods for its adoption viz the full retrospective approach and the modified retrospective approach. (10)
12. The cost of property, plant and equipment includes costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred _____ to add to, replace part of, or service it. (12)
15. Ind AS 102 requires use of fair value of equity granted to its employees because it is practically not possible to identify the fair value of the services rendered by the _____. (9)
16. Inventories are usually written down to net realisable value _____ wise. (4)
17. Net realisable value is the estimated _____ in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. (7,5)
18. An entity shall suspend _____ of borrowing costs during extended periods in which it suspends active development of a qualifying asset. (14)
22. A change in use, in case of transfer of a property to, or from, investment property occurs when the property meets, or ceases to meet, the definition of investment property and there is _____ of the change in use. (8)
23. The _____ of impairment loss is limited to the amount that would have been recognized had the impairment not been recognized initially. (8)
28. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be _____ separately. (11)
29. An entity shall _____ capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. (5)
30. Lessees are not required to recognize ROU assets and lease liabilities for short term leases and leases of _____ assets. (3,5)
31. Significant adverse changes in the economic or legal environment, changes in market interest rates, or obsolescence of technology are _____ that may suggest the need for impairment testing. (10)

32. Ind AS 116 introduces a _____ accounting model, where lessees recognize lease assets and lease liabilities for all leases, except for short-term leases and leases of low-value assets. (6)
33. _____ costs are expensed as incurred, while development costs meeting may be capitalized if specific conditions are met. (8)

DOWN:

2. The cost of an item of property, plant and equipment comprises directly _____ cost incurred to bring the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. (12)
3. Entities are required to _____ the amount of rental income recognized in profit or loss from investment property, including the amount of contingent rent. (8)
4. Government grants related to assets shall be presented in the balance sheet either by setting up the grant as _____ or by deducting the grant in arriving at the carrying amount of the asset. (8,6)
5. Borrowings that are not directly attributable to the acquisition, construction, or production of a qualifying asset are known as _____ Borrowings. (7)
7. Agricultural activity is the _____ by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets. (10)
10. Share-based payment reserve is the _____ amount recognized as equity in the balance sheet to reflect the fair value of equity instruments granted. (11)
11. For an entity to classify a non-current asset (or disposal group) as held for sale, the asset must be available for _____ sale in its present condition. (9)
13. _____ is the present value of the future cash flows expected to be derived from an asset or CGU. (5,2,3)
14. Ind AS 105 provides guidance on how to account for non-current assets that are held for sale, as well as the accounting treatment for _____ operations. (12)

19. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows largely _____ of other assets or groups of assets. (11)
20. If the lessee obtains control of the _____ asset before that asset is transferred to the lessor, the transaction is a 'sale and leaseback transaction'. (10)
21. Ind AS 20 provides criteria for recognizing government grants at fair value, including when there is _____ assurance that the entity will comply with the conditions and when the grant will be received. (10)
24. Intangible assets with indefinite useful lives are not amortized but are subject to an _____ impairment test. (6)
25. _____ date is the date on which the entity and the counterparty agree to the terms and conditions of the share-based payment arrangement. (5)
26. The cost of inventories shall be assigned by using _____ or weighted average cost formula. (Abbreviation 4)
27. In cash-settled share-based payment, the entity receives goods or _____ from employees or other parties, and the entity settles the obligation by paying cash or other financial instruments. (8)

To know the answer of the above Ind AS Puzzle, scan the QR Code

